Pierre Gramegna in interview with Jerome Bloch, Luxembourg Official

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Interview with Pierre Gramegna, ESM Managing Director
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Jérôme Bloch: Today, I have the pleasure to visit the ESM Studio to interview Pierre Gramegna. Thank you for taking the time.

Pierre Gramegna: It's nice to meet you again, Jérôme. It's a pleasure.

It's a pleasure, too. We all know the ESM. It's in Kirchberg, and the name is very familiar. It's "European Stability Mechanism", and we also read the news, and I believe stability has become a very important topic. Maybe can you present the ESM in a few words?

Besides the fact that the ESM is headquartered in Luxembourg, which many residents don't know. Kirchberg, everybody knows, obviously. But when you say "behind Auchan", then everybody knows where it is. To avoid questions like, "how is it in Brussels?”, which is a question I often get. By the way, I go to Brussels regularly, at least once a month, because there's Eurogroup and Ecofin [Economic and Financial Affairs Council] every month. So, I go to Brussels, but the headquarters are here, in Luxembourg.

This is due to the fact that, when the great financial crisis struck back in 2009, a temporary structure was set up, called EFSF [European Financial Stability Facility], which is the forerunner of the European Stability Mechanism, the ESM. That was headquartered in Luxembourg because the Luxembourg legal framework, the efficiency of the financial centre, and the AAA rating of the country appeared to be the right symbol for an institution like this one.

So, the ESM was set up after the fact that the euro had already been running for many years because the establishment of the euro happened back in 1999. The coins and the bills came in 2002. But the financial crisis happened later, and that's when the Eurogroup at the time, Ecofin, realised that we were missing an important part in the monetary union of Europe. So, the architecture was not complete.

We didn't have a lender of last resort, or you could say a rescue fund, for the euro area. The risk then was that a few countries might be in such trouble that they would have to leave the euro area. And what remains famous is the sentence of Mario Draghi when he said we're going to support the euro, “whatever it takes”. That was one arrow of the answer. The European Central Bank would do whatever it takes. And the other one was to set up the European Stability Mechanism. We have 20 member states, which are also 20 shareholders, and it is the countries that have the euro.

So, let's knock on wood. If everything goes fine, Bulgaria will join the euro area next year and then will become also a member - if it ratifies the treaty, but that's the tradition when you become a euro area member. Then, they will become the 21st member, also of the euro area. I can tell you, the newcomers, I experienced that with Croatia, they are very keen to be part of the ESM because it stabilises their own country.

Absolutely. How do you get the money in the fund?

In fact, the ESM functions in a different way than all the other lenders of last resort. The most important one is the International Monetary Fund, based in Washington, which has accumulated “capital” paid in by the countries, basically all the countries of the world. With that “capital”, they can punctually help different countries, assist them with macroeconomic programmes, and that's at the world level.

Then there are regional funds, and the one in Europe is the European Stability Mechanism. But that functions differently. The 20 countries have committed to a capital, subscribed capital, of over €700 billion. This also is a “whatever it takes”. The paid-in capital is €81 billion. With these €81 billion, which the ESM manages on an everyday basis, we reassure the markets, and the markets have guaranteed the ESM that we can lend up to €500 billion on the markets at AAA rating. So, the support we give to the countries is that they get the loans at a cheaper rate than if they would go themselves to the markets. Remember at the time of Greece, a country like Greece would have had to pay 20%, 30%-interest rates. Basically, you cannot go to the markets anymore. By setting up this system, we have a very modern institution that is unparalleled in the world.

It's like a pool, basically. You're pooling your interest to get a better rate.

I was reading today some news where we know that in Europe right now, it's popular to hope that the frozen assets of Russia, the €230 billion, might be used. Of course, for a reader like me, it's a bit scary because it already sounds like last resort. From your position, which kind monetary instability could you anticipate?

What triggered the creation of the European Stability Mechanism was the great financial crisis, which had financial repercussions on the European continent and on the European Union and the euro area.

The subprime crisis.

The subprime crisis, yes.

Now, in Covid times, which was totally unexpected - we hadn't had a pandemic for ages - we suddenly saw that one of the measures could be to do the lockdown of all economies, which had to be decided.

Obviously, that can also trigger financial instability. It's not only financial elements themselves that can trigger financial crises.

Today, as we speak, we have geopolitical fragmentation in Europe. We have a war, an aggressive war of Russia in Ukraine, at the doorstep of the European Union and on our continent. That creates lots of instability, but also financial instability risks.

We see that the stock markets yesterday were, of course, correcting a bit. We see also that there's a lot of plans for big investment. We'll talk a bit later about the Letta report, about the Draghi report.

From your position, which strategies could you implement? Is it to put more in the pool to get the potential bigger access to money later?

I think it is important to realise that the ESM, European Stability Mechanism - which is the English acronym, and by the way, in French, it's “le MES, M-E-S, Mécanisme Européen de Stabilité” - functions a bit like an insurance. I'm going to explain why.

Because the ESM is precious in times of stability and in times of financial instability. When you have an insurance against fire and your house burns down, you are pleased to have an insurance because you will have the damage reimbursed by your insurance company. But then, if you have a home and for three or four years your home doesn't burn, are you throwing away your insurance policy? No. You're happy it doesn't burn, but you're happy that you have something that protects you.

In the end, in financial peace times, having the ESM gives you tranquillity. The fact that, for example, over the last seven, eight years, we have not had any programme of assistance to euro area countries is not necessarily bad news. It is good news. It shows that we have financial stability in Europe. Now, we have tensions, as we know, of geopolitical nature and others. Then, obviously, the role of the ESM becomes more intuitive.

Now, also here, are we there to support countries in times of dire crisis, in times where the crisis is imminent and is already hitting, or do we also have a precautionary, preventive role? We have both.

We have been using the traditional instruments, programmes of financial support accompanied by large reforms, in countries in the past decade. So, that is what the public at large has seen. Support to Greece was the most important one. There were four other countries. But we have never used what we call “precautionary credit lines”, which is a preventive instrument. Now, the IMF has also such instruments. They are used less because countries tend to think that they can get over the problems they have, and they only come to the IMF when the situation becomes really critical. It is also important to realise that we have a preventive role, and we can help with lighter conditions if the crisis is milder or if you just have a pending risk.

If I follow you properly, you have a big role of advocacy among all the members to make them act before any problem comes so that they are ready whenever they need to activate one of the mechanisms.

Yes. In fact, it is countries that come individually and ask for support. That could give the impression that what needs to be monitored is just a financial situation of each and every country. But it is also important to look at the situation of the 20 euro area countries and basically all of the EU 27, because if there are major problems there, they will have an impact on each individually.

It is key for us also to say which are pending financial stability risks that are out there. The most obvious one I have already mentioned is the geopolitical risk and the possibility of conflicts that can come in the aftermath. That's the obvious one today, but there are two longer term ones that are really obvious, but we might not see them with the financial consequences they can have. Let me mention the two. One is demography and the other one is climate change.

Maybe a few words on climate change and on demography.

Now, recently, also because of the change of attitude of the American administration, climate change is seen by some as not being so important anymore. Thankfully, in Europe, we are still committed to the Paris Accord, which entails very stringent reductions of CO_2.

So, there are environmental risks there. We have seen in the latest fires, be it in Los Angeles, be it in Valencia [floods], what damage can be caused by climate change. Because the risk, obviously, of fires increases. Nature unleashes all its force. It can be tsunamis, it can be all these things. It is an environmental problem. It is also an insurance problem because only a quarter of all natural disasters can be insured or are insurable. So, we have a large insurance gap.

Third, climate change has also an impact on the valuation of assets. You might have heard about the expression of “stranded assets”. You have as an asset an oil company, and at one point in time, and that's what the Paris Accord encourages all the countries to do, we should use less and less oil. Now, your asset in oil obviously should lose value, but it might not happen immediately. It might happen step by step. This is all encompassed in the climate risks, and it has financial consequences.

Demography is even easier to understand. We have a population that gets older. In Europe today, you have three people working, financing the retirement plan of one person.

In one generation from now, around 2050, in Europe, as an average, we will only have two people working for one retired person instead of three.

That is a problem.

This is a big problem. All these three mega trends, in fact, are for us, for the time being, the most likely issues that could trigger financial instability, not in a minute, but in the medium term.

When I listen to you, one factor that comes to mind is the extreme volatility. A few years ago, weapons were clearly not an ESG acceptable asset. Now, we don't know. Things changed so fast: we see electric cars, we see sales dropping massively, not just on Tesla. It's like people are going back to oil. So yes, very complicated times.

Maybe one last risk you did not mention. We see a lot of right or extreme rights votes at the moment, and we know the narrative is, if you take Germany or France, why do we need to pay for the 26 other members? Do you see the fragmentation of Europe as an additional big risk?

I think this is a very fair question and a complicated one. Europe has navigated troubled waters or storms that were quite heavy over the last couple of decades. Up to now, Europe has always come out stronger, with more solidarity in each and every crisis.

I mentioned the great financial crisis, the subprime crisis. What happened after that? The ECB, the European Central Bank, having very friendly monetary policy with new instruments that had not existed in the past. The creation of the ESM. During Covid, we created lots of instruments. We, in fact, as ESM, proposed a pandemic crisis instrument that could have helped countries also in dire needs. We [the EU] created an instrument called Next Generation EU with a reform and a relaunch fund, the RRF [Recovery and Resilience Fund], which is an act of solidarity that is unparalleled in what Europe has done up to today.

Every time that Europe was facing major difficulties, we had a European reaction. Now, with the war at our doorstep, we see that, for the time being, Europe has answered in a united manner. But we cannot overlook that in many countries, you have extreme left and extreme right parties which are not following exactly the same reasoning and the same course of action.

That is a sign that we need to explain more. We should not take the support that Europe has decided to provide for Ukraine for granted and evident to all the people. So, we first need to explain.

Second, we can see that in this conflict, the United States is changing its vision of the situation. Also there, the support of the United States cannot be taken for granted. Things evolve very quickly.

We are lively democracies. Extreme left, extreme right parties in our countries have the right to express themselves. That's what I call liberty of expression. We have it. Despite what Vice President Vance said in Munich recently, these parties can express themselves and they can earn a lot of votes. The free flow and free happening of democracy means that if you do not agree with those, well, you need to find the right and convincing arguments.

Let's look into the future a little bit. There are two major reports which were published a few months ago. Let's start with the Draghi report: bold vision, €800 billion investment required per year. It's a huge financial challenge. Do you see this being implemented? How will Europe finance all this?

I think the Draghi report and the Letta report are two major reports that have not finished in the drawer of a desk. They are really on the table and in everybody's mind. I think what the Draghi report underlines is the lack of competitiveness of Europe over the last 10 years. But I would dare say this is something that we have noticed even for a longer period. It might have become more evident in the last 10 years. Basically, you could say in the last 10 years, the United States grew nearly 30% of its GDP and Europe 17%, nearly half. This is worrying if this trend were to continue.

The Draghi report, and many analysts, ring the alarm bell here. We have seen after the Covid crisis and after the year 2021 a huge rebound all over the planet because we had the lockdowns. But since 2022, Europe has a growth rate of around 1%, which is really low-level growth. You could call it a shallow growth. And now markets, and not only markets, the Draghi report and others start to say, are we facing here a structural issue in Europe, or is this just a transitionary phase?

I think there's a recognition that it's probably getting more and more structural, and that's what the Draghi Report is all about. The Draghi report gives a lot of ways and means to strengthen European competitiveness, and it also attributes a price tag to it. It mentioned the number of around €800 billion investments per year.

First, it is important here to underline that a large chunk of that is private investment. We need to create an atmosphere and a framework in Europe that is conducive to investments, that encourages Europeans to invest in their economy, but also foreigners, foreign enterprises to invest in Europe.

Second, you could say probably between 20% and 25%, a quarter, must come from public money. But this is also a challenge as the budgets of many European countries are strained. We have now a new Stability and Growth Pact, to be on the optimistic side here, which puts more emphasis on investment than the past one. We have a longer adjustment period in order to make sure that the countries abide by the rules of the Stability and Growth Pact. That's good news, but that's certainly not sufficient.

To stay with the Draghi report, the Commission has recently published a compass of competitiveness. A dashboard that will help us have a clear view where we stand today, but also how our competitiveness is going to improve in the future.

Two quick comments about this. Just last week, Serge Alegrezza, I think it's the Observatory of Competitiveness, published a report. We saw very clearly in this report that it's important for Europe, even more for Luxembourg, because we see that Europe was growing at a pace and the competitiveness of Luxembourg was dropping over the past 10 years. Another example I saw recently is the CEO of Michelin, who explained that he produces all over the world. The only place in the world where it doesn't work is in France, where the company is headquartered.

These are the type of challenges where, of course, decisive action is required at European level. Maybe one word about the Letta report.

If I may, to react to your comments on Luxembourg and France. The reason why competitiveness or productivity is slightly lower in Luxembourg as it used to be is because the main driver of productivity in Luxembourg is services, and in particular, financial services. Now, financial services have suffered a lot in the Covid time, and also with the ultra-low interest rates. I think that the services sector, and especially for Luxembourg, the finance sector, is in better shape now. So, we will have a kind of mechanical improvement here in Luxembourg.

That doesn't mean that nothing needs to be done. I think, though, that Luxembourg has recognised also in the last couple of years that even more must be done in digitalisation, in AI. And I think that the country is positioning itself very well. I also think of FinTech and lots of foreign players in these areas that choose Luxembourg as their hub.

If you compare Luxembourg to France, what the CEO of Michelin was saying is that the non-wage part of salaries, that means contribution to health and to pensions and other social taxes that are levied on the salaries, is extremely high in France and in Belgium.

Here again, that's not the case in Luxembourg. Basically, in France, you need to pay more than double as an entrepreneur, and the “salaryman” receives half. So, the social cost is detrimental to competitiveness. There's no easy answer to that question, especially if that's the tradition. But it underlines a problem that is pervasive in quite a few European countries, and you can only be compensated if we have a higher productivity.

You can have a very good safety net. The Scandinavians show that to us. The Danish, especially the Danish, have a very good safety net, high protection, high costs, high taxes even, and very high productivity. The two things need to go hand in hand.

I think all those countries in Europe, especially those who were having thriving economies, I have in mind, of course, Germany, France, Luxembourg, are facing many new challenges. Of course, Ukraine, of course, competition with China, and a very aggressive competition now with the US. So, of course, we need to figure out how to adapt to this new environment.

Maybe a last word about the Letta report. The idea is to have a capital markets union. What do you think about this? Do you think it would be a danger for Luxembourg with a special list of cross-border sale of funds or life insurance, or do you see this as a very positive effect for Europe?

I think the Letta report is really of a great quality. First, I like the title. The title is - well, we all call it Letta report, but Enrico Letta himself has told me, no, I've spent so much time in finding a good title for this report - and it is EU single market “Much more than a market”. I think it's all encompassed in this formula.

What does he underline? He underlines that, first of all, our EU single market is probably with the euro and Schengen, the passport-free Europe, the greatest achievement and success story of Europe. The single market was negotiated between 1985 and 1993, so that's a generation ago. For goods, it's probably quite efficient, but for services, already far less, and for the new economy, it is not adapted. What we need for the single market is a modernisation of the EU single market to look at it with the eyes of 2025, with the challenges of the economy today and the new type of hurdles that exist, that are very sophisticated and of a different nature.

Also to highlight that on a lot which is new economy, we have hurdles amongst ourselves. We have hurdles amongst ourselves in capital markets, in financial services. Despite the fact that directives on financial services, a large amount, have flourished, they have made Luxembourg strong. I'm not here to speak for the benefit of Luxembourg, but to those who think that having internal borders inside the EU is to the advantage of one country or another -- it is a big mistake.

What makes us strong is to have a market with few hurdles, or, if possible, none, because then we have a home market where companies can grow and become bigger players. If you are a US company, you have the United States home market as a base. If you had that in Europe, you would be at par. If you have it cut into pieces, you are at a big disadvantage, and size matters.

On the Letta report, it is important to realise that if you can reduce the level of barriers, it has an impact on our growth that is spectacular. The IMF has calculated that reducing by 10% the existing barriers in Europe, you gain a growth dividend of 7%. This is a huge number. Let's not forget it.

At a time where in the United States, and then as a retaliation, maybe in other countries, we're going to have higher tariffs, it will entail a slowdown of growth in Europe because we are more dependent on external markets than others.

To give you figures: for Europe, exports and imports, so foreign trade of goods and services represents 60% of our GDP. For China, 35%, and for United States, 25%. We are more prone to suffer from a departure from the free flow of goods and services. That was why we were all striving with globalisation. And we could become more weakened than others. That's why strengthening also the single market is also for that reason more important.

Last but not least on the Letta report, he also highlights that the risk coming from geopolitics and fragmentation due to the war in Ukraine and in the rest of the world could also bring into play the ESM, the European Stability Mechanism, by saying that it will be difficult for some countries to reach the 2% expenditure compared to GDP for defence purposes. As we have heard in the last couple of weeks, now, 2 is even considered a too low number. Whatever the number, or if the number is even higher, that stress on public finances will become stronger.

So, the Letta report says, well, why not use the ESM to help those countries that have little room of manoeuvre with a precautionary credit line? Again, this is more the preventive arm. Instead of waiting that countries have huge problems, which would require huge adjustment programmes and reforms, these precautionary lines could be dealt with with objective criteria of conditionality, which means if you use those loans for defence purposes, you could access the European Stability Mechanism.

That's one specific part of the Letta report. But we're just in the beginning in all the things that pertain to defence, to write down ideas, I would say, because the challenges for Europe are multiple. Not only spending enough to satisfy NATO requirements, but also additional investments that would be necessary if we want strategic autonomy of Europe in the field of defence, which I think is on everybody's mind. But it will be a long path.

A challenge to be financed. Just to conclude, I have two ideas coming to my mind. You mentioned first borders, and it's a very strong reminder, when you go to Germany today, that there are controls after the border, just after Trier, which, of course, was unimaginable just a few years ago.

The second thing which should all give us hope is that you mentioned the common market started in 1985. I think we can agree everything started with a meeting in Schengen. Let's hope that Luxembourg will again be a critical catalyst, especially between France and Germany, to take those great ideas from Enrico Letta and Mr. Draghi to find solutions in a very fast changing world. Thank you very much your time.

It was a pleasure.

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