"How to deepen the monetary union?" - speech by Rolf Strauch

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Ladies and gentlemen,

Thank you very much for giving me the opportunity to speak to you today at your annual meeting. It feels like a home game to me, speaking so close to my office about the deepening of Monetary Union and the role my institution, the ESM could play in this.

At the moment, deepening Monetary Union is at the heart of the debate in Europe, and rightly so. A lot of decisive steps have already been taken during recent years to make Monetary Union less vulnerable and better prepared for when the next crisis hits. But there is also still a lot to do. I think we have a unique opportunity to complete this work: the economy is doing well and there is growing consensus among euro area countries about the next steps. A number of meetings will take place in the coming months and I am hopeful that we can reach a conclusion in June.

Today, I would like to tell you more about the next steps which, in my view, are needed to deepen Monetary Union and to make it more robust. But let me first take you back to the crisis years to understand how we got to where we are now.

In Europe, we had to deal with not one but two crises. First, there was the fallout of the global financial crisis. The collapse of Lehman Brothers in 2008 also caused great upheaval among European banks. Subsequently, there was the European sovereign debt crisis: ill-devised economic policies resulted in a loss of competitiveness in some countries, deficits grew unsustainably large, and real estate bubbles emerged in some countries. That period also brought to light a number of flaws in the institutional design of Monetary Union. Nobody had thought it was possible that a country could lose market access once it had joined the single currency. But that is precisely what happened, first with Greece, then Ireland, and then others. At that moment, there was a real risk that the euro could break up.

So, Europe had to take prompt action, both at the national and at the supranational level. Countries implemented often politically difficult reforms, especially the five that received financial assistance: Ireland, Greece, Portugal, Spain, and Cyprus. As a result of these reforms, macroeconomic balances have now largely disappeared. Competitiveness has returned to these countries because of what we call, “internal devaluations”, a reduction of wages and salaries that has led to a reduction in unit labour costs. This has caused current account balances to materially converge across the euro area. Fiscal imbalances have done the same, as governments reined in spending and improved tax collection.

At the European level, economic and fiscal policy coordination was enhanced. Economic surveillance was widened beyond the fiscal side, in order to get a grip on areas like divergence in competitiveness, real estate bubbles, and debt – all factors that had contributed to the crisis. The so-called, “Macroeconomic Imbalances Procedure”, gives the European Commission the possibility to monitor and sanction such developments.

Furthermore, the ECB played a crucial role in stemming the crisis through its unconventional policy measures. This is probably best remembered by Mario Draghi’s, “Whatever it Takes”, speech of July 2012.

Europe also created important new institutions as part of its crisis response. As part of the Banking Union, we now have the Single Supervisory Mechanism, which is responsible for supervising Europe’s 130 largest systemically important banks, and the Single Resolution Board, which has the authority to wind down any of these banks if they land in trouble.

Last but not least, my own institution, the European Stability Mechanism, fulfils the role of a lender of last resort for sovereigns. This function did not exist before the crisis. The institution was set up in 2012, and was preceded by a temporary institution, the European Financial Stability Facility, or EFSF. The EFSF cannot grant new loans anymore, but it will exist for several decades to refinance its existing loans to countries such as Greece. Because the loans of the ESM and the EFSF are always conditional on tough economic reforms, we resolve the issues that brought about crises in these countries, while covering their financing needs temporarily.

Since 2011, the EFSF and the ESM have provided loans to five countries: Greece, Ireland, Portugal, Spain and Cyprus. We have disbursed a total of €279 billion in loans. By comparison, the IMF has only disbursed about €100 billion worldwide in the same period.

The ESM does not use taxpayer money to finance its programmes. Instead, we raise money on the capital markets. The rescue funds are some of the biggest bond issuers in the euro market. The 19 ESM-shareholders, that is, the euro area countries, have signed up for €700 billion of capital to us, of which €81 billion is paid-in. This capital provides security to investors and is the basis of our high credit rating. It is also why we can raise money at low interest rates.

The interest payments programme countries make to the ESM are the same as those we pay in the market. They are well below what the countries would be charged by investors. This results in substantial budget savings for the countries in question. For instance, in the case of Greece, we estimate that this saves the country almost €10 billion, or 5.6 percent of its GDP each year. These savings underscore again the magnitude of the support provided to programme countries.

Today, four out of five programme countries are success stories, with high growth rates and sinking unemployment. Greece is the sole remaining ESM programme country. Nowhere else were there so many issues and was the public administration so weak. The ESM is by far Greece’s biggest creditor, having paid out €188 billion in funds. We already have 50 percent of Greek debt on our books, and this could rise to about 60 percent by the end of the current programme.

Let me now look at the strong recovery that Europe has undergone since that period of crisis. A recovery that to my mind is no doubt due in large part to Europe’s comprehensive crisis response.

Europe shows positive broad-based growth rates in all euro area countries. It is expanding twice as fast as the potential growth rate and unemployment is falling. Of course, this will inevitably lead to a cyclical downturn at some stage in the future.

Another strong point is that the euro area debt-to-GDP ratio is projected to decline in the coming years. It is now much lower than in the U.S. or Japan. Debt reduction gives Europe more fiscal breathing space when the next downturn comes.

Per-capita growth is also back in line with the US. This was the case for decades. However, Europe fell behind during the crisis. At the moment, per-capita growth is actually higher than in the US, and this is expected to remain the case for the four consecutive years between 2016 and 2019. Europe’s headline growth is often behind the US because we have lower population growth.

So things are going well economically at the moment. And politically there is wide consensus to look for further steps to deepen Monetary Union. Therefore, last December, Europe’s leaders tasked the Eurogroup to work on a concrete agenda, which contains three elements. The first is to complete the Banking Union and the second is to develop the ESM into a more comprehensive crisis resolution mechanism. A third topic is possible further fiscal steps, though the views here are still more divergent. President Tusk asked the euro area finance ministers to work first on the areas where the consensus is the greatest, namely completing the Banking Union and developing the ESM.

This agenda makes economic sense. It provides Europe with a historic change to deepen the monetary union because of the good economic situation and the political consensus. At the same time, Europe still needs to work on tackling problems that date back to before the crisis. De-risking needs to take place before we can put measures in place to promote risk-sharing.

In that light, let me first elaborate on the banking sector. Since the beginning of the crisis, and with the implementation of the Banking Union, a lot has been done to make the euro area banking sector far more robust. It helped restore confidence in the financial sector, and banks have doubled their equity capital since the crisis, making them much safer. But not all problems have disappeared. Too many banks are still struggling under the weight of the problems they racked up during the crisis. It is true that banks are set to have their best performance since 2007, but returns still do not cover the assumed cost of equity. Non-performing loans (NPLs) continue to present a problem, especially in some countries. Although the stock of NPLs in the euro area has shrunk, the pace of reduction remains too slow. Investors and equity analysts are of the view that U.S. banks are faster at reducing costs and delivering higher returns.

So what should be done? There are two policy steps that are still needed to complete the Banking Union: a backstop for the Single Resolution Fund (SRF) and a common deposit insurance. Together, they would foster financial integration, boost economic risk-sharing and make the euro area economy more resilient.

The SRF is building up its war chest, a process which will be completed by 2023. A financial backstop would provide a clear signal to financial markets that the SRF is prepared for any eventuality. Given the broad support among euro area member states for the ESM to be a backstop to the SRF, this is one of the relatively easier steps that can be taken in June.

A common deposit insurance is a more controversial topic. There is consensus that it would make economic sense, because it would prevent country-wide bank runs in times of stress, which we saw during the last crisis. But trust between euro area countries on this topic is low. Countries will need to deal with legacy issues first, in particular the high stock of NPLs. And national deposit insurance schemes need to be funded. Once that has been achieved, the road towards a common deposit insurance is open.

Let me now turn to the development of my own institution, the ESM. I'm proud of how the ESM has substantially matured over recent years and taken on more responsibilities. We have always been in charge of financing the assistance programmes of course, but we increasingly participated in programme design and monitoring from a financial perspective. As noted by President Tusk and the President of the Eurogroup, there is broad support among euro area member states to broaden the ESM's role as Europe's crisis resolution mechanism. Of course a more powerful ESM is not a goal in itself. But – like completing the Banking Union – it can be an element to make the monetary union stronger. And it gives Europe a chance to take on more responsibility to solve its own problems.

Let me give you an overview of how the mandate of the ESM could be broadened. Firstly, as already mentioned, the ESM could be the backstop of the SRF. Secondly, the ESM could be tasked with designing, negotiating and monitoring euro area assistance programmes together with the European Commission. Europe may not be able to count on the IMF to the same degree as in the past. This not only has to do with differences in approach between the two institutions, but also with criticism from the IMF’s non-European members that the Fund is too active on this continent. So, the ESM and the European Commission could run these programmes together, of course fully respecting the competences of the two institutions as laid down in the EU Treaty. The ESM and the Commission are already jointly working on a framework which will make the division of labour clear.

Thirdly, the ESM could also run a new fiscal facility to stabilize the economy. Shorter-term ESM loans could help stabilize individual countries or investments and could reward structural reforms. Such ESM loans would have to be repaid within one business cycle and would therefore have nothing to do with permanent transfers between countries, which are not allowed in the European Union.

Finally, the ESM could also play a role if euro area countries were to define a sovereign debt restructuring framework to make settlements with private creditors more transparent. Such a framework would reduce the risk for taxpayers and instil market discipline. The framework must be set up without any automatic extension of maturities, to prevent pro-cyclical effects. Instead, it would work with a creditor committee along the lines of the London Club, which the ESM could manage. The ESM could also provide the debt sustainability analysis.

Let me now briefly discuss the third element of the agenda to deepen Monetary Union: fiscal governance and common fiscal resources. In contrast to the Banking Union and the ESM’s development, there is a higher divergence of views here and it’s not be expected that there will be conclusions on further fiscal integration in June. Nevertheless this is a debate that has been initiated and I would like to share my view on it.

First of all, we need to simplify the fiscal rules. I think everyone agrees these should be made simpler and more transparent. The fiscal rules were easy to understand in the Maastricht Treaty but have become too complex and too hard to understand, even for experts. And this, obviously, makes them less effective.

The plan to create the role of a euro area finance minister in order to coordinate policies and to provide external representation also has merit. It goes without saying that this function would need to have enough competences – either ones that already exist or new ones – in order for it to be a meaningful contribution to deepening Monetary Union.

A wide range of other ideas in the fiscal area are floating around, such as an annual EU budget to fund public goods in areas that countries cannot tackle on their own. Some examples are defence, the security of Europe's external borders and climate change. Another proposal is a euro budget aimed at equalising investment in countries over the course of their business cycles.

Some of these plans are worth considering and, even if there is no agreement, it's good that they are on the table for discussion, though we have to make sure to seize that momentum. We are willing and able to make some meaningful change, whether you look at the Banking Union, developing the ESM or strengthening the fiscal framework.

Let me come to a conclusion. As you probably noticed, I am optimistic. The economy is doing well. The political wind is blowing in the right direction, supported by an ambitious French president and a pro-European coalition in Germany. Together, we can complete the work of making the monetary union more robust and the economy less vulnerable. The issues are well-identified. In the next few months, our governments should act.

Thank you for your attention.

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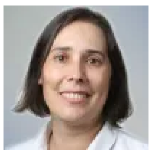

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