“What is next for the euro area?” - speech by Klaus Regling

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“What is next for the euro area?”
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Ladies and Gentlemen,

It is a great pleasure to be at Brookings again.

Since its very beginning, the euro area has been evolving, economically, institutionally and in terms of size. And it is without doubt a success story on many levels. We have drawn important lessons from the crisis and implemented important reforms during the last years. Not surprisingly, policy change is easier and can be done faster in a crisis. But I hope we can prove that progress in Europe is also possible in the absence of an existential threat such as an economic crisis, “while the sun is shining”.

Let me begin by asking “what is next for the euro area?” This question is behind the many reform proposals for Europe.

The EU is unlikely to become the United States of Europe. But I am convinced that we do not need a full political union nor a full fiscal union to make monetary union function smoothly. In that context, the subsidiarity principle is important, according to which political decisions should not be transferred to the European level if they can be taken care of better at the national or regional level.

But there are some areas where it is clearly more beneficial for us to work jointly as a union rather than as individual nations. This applies to areas such as defence and security, migration or the environment and certainly monetary issues and certain economic issues.

The EU’s joint monetary project is the euro area. Given the positive economic situation a favourable window of opportunity for reforms may exist.

In 2017, growth in the euro area was the strongest since 2007, and it was broad-based, reaching all 19 member states.

Over the past two years, GDP-per-capita growth in the euro area – which measures the average increase in standard of living – outpaced that in the US. This is expected to continue this year.

Euro area inflation is slowly picking up, while unemployment has decreased to pre-crisis levels, labour participation rates and employment reached an all-time high.

Meanwhile, confidence of consumers and investors is strong and support for the euro is at its highest since 2004.

In addition, the underlying fundamentals and the institutional framework of the euro area are more resistant to shocks today than they were ten years ago. Our continuous efforts to reduce the deep structural vulnerabilities within the euro area have paid off. Macroeconomic imbalances within the euro area have been reduced due to significant structural reforms in the programme countries and banks are much stronger now. Institutional gaps have been closed.

This is thanks to a comprehensive package of measures with which we responded to the crisis. It consisted of five parts:

- First, deep structural reforms were implemented at the national level in countries that needed ESM financing, i.e. in Cyprus, Ireland, Greece, Portugal, and Spain.
- Second, economic governance was strengthened and economic surveillance broadened at the European level.
- Third, the European Central Bank (ECB) conducted an active monetary policy with unconventional tools to combat the crisis.
- Fourth, Banking Union began with its first two pillars: the Single Supervisory Mechanism (SSM), which made the approach to banking supervision uniform for 130 systemic banks, and the Single Resolution Board (SRB), which harmonised the rules for banking resolution. This began to address the fragmentation of financial markets within the euro area and broke to some extent the negative feedback loop between banks and sovereigns.
- And finally, we established two institutions which act as lender of last resort for sovereigns in the euro area: the European Financial Stability Facility (EFSF), a temporary fund, and the European Stability Mechanism (ESM), a permanent financial institution.

These achievements are all the more impressive when one considers that it takes time to mobilise political energy in a union of 19 sovereign states where we have different political cycles. And we had a difficult starting point. First, Europe was hit by the global financial crisis. And only two years later the euro crisis resulted from deep structural problems in some member states. And managing the euro crisis was also much more difficult because the institutional architecture was insufficient.

These achievements should give us the confidence we need to tackle the remaining challenges. The strong support for the euro in all member states – the strongest since 2004 – is also encouraging. At the same time, the good economic times we experience in Europe at the moment make it more difficult to forge a consensus: there is no sense of urgency and complacency may settle in.
The good economic times will not last forever. While remaining at very high levels, business and consumer sentiment indicators have started to ease. The peak of the expansion is probably behind us, not only in the euro area but in most advanced economies.

I see several downside risks which may challenge us in the near future. These include the threat of protectionism and geopolitical risks; the maturing growth cycle in all advanced economics, including the euro area, the fact that the economy cannot grow at almost twice its potential rate for very long, particularly when the output gap is closing this year; voter disenchantment leading to a rise of populism, as well as political uncertainty around the UK leaving the EU. Finally, reform efforts will probably slow down due to elections and changes in the EU´s political leadership next year.

Against this background, it makes sense to deepen the Economic and Monetary Union (EMU) now and to make it more robust. Many proposals are on the table and they can be grouped into financial, fiscal and institutional reforms. The December Euro Summit stated that "work should concentrate on areas where the convergence of views is the greatest": Banking Union and the ESM.

First, the Banking Union is incomplete. Two steps are needed to complete the three pillars of the Banking Union: the Single Resolution Fund (SRF) needs a common backstop to make sure that it has sufficient cash available for a severe crisis. A large majority of the member states believe that the ESM should assume this role. In the longer run we need a process that paves the way for the gradual introduction of the European Deposit Insurance Scheme (EDIS), the third pillar of Banking Union. EDIS has a high signalling effect for savers because it reduces their fears and virtually eliminates the risk of nationwide bank runs. Depositors would know that not only their government but the entire European banking system protects their savings.

But before we can put a common European deposit insurance in place, we need to work on risk-reduction in order to benefit from risk-sharing. In particular, non-performing loans (NPLs) in some European countries need to be reduced further. National deposit guarantee schemes should be harmonised and fully funded, and the volume of government bonds in banks' balance sheets should be reduced. Insolvency laws relevant for financial institutions and the use of collateral should be harmonised.

Second, strengthening the ESM could also foster the resilience in the EMU. In my view, a broader mandate for the ESM could comprise the following tasks:

1. Providing a credible backstop for the Single Resolution Fund (SRF);
2. A more important role in the preparation, negotiation and review of future macroeconomic adjustment programmes. This should become a joint task of

the European Commission and the ESM. Over time, the role of the International Monetary Fund (IMF) will probably become less important than during the crisis. For eight years, the IMF’s money and expertise were very much needed in Europe. Over time, the Fund’s contributions have decreased from one-third to one-tenth to zero – so far – for the current Greek programme. Nevertheless, there is criticism inside the IMF, from its non-European members, that the Fund is too heavily engaged in European matters. As a result, we may not be able to count on the IMF to the same degree as in the past. Does that mean that the IMF should leave Europe? Not at all. All euro area countries are IMF members. More broadly, Europe wants a strong IMF at a time when multilateralism is challenged.

3. Creating a predictable framework for debt restructuring negotiations with private creditors. The ESM has experience in debt sustainability and is also very active in the market on the funding and investment side. Hence, it could take on the role of a neutral moderator in the context of such a framework. Here I would like to emphasize the word “framework” and avoid the term mechanism, because I am sceptical about the use of rigid rules, such as an automatic extension of maturities. I fear that automatic extensions of maturities could have a pro-cyclical effect and trigger adverse market reactions and capital withdrawal.

On the fiscal side, there are many of proposals on the table. However, there are certain things in the fiscal area that we do not need for a proper functioning of the monetary union. In my view, we do not need a full fiscal union nor large additional transfers between countries. Even though the EU budget is small, poor countries already get transfers from the EU budget that can be 4 percent of the size of their economy, which is very substantial. In addition, the European Investment Bank (EIB) and the so-called Juncker plan already contain significant funds to promote investment across the EU.

We also do not need a special fiscal capacity to deal with a large symmetric shock affecting the entire euro area. The EU fiscal rules already allow synchronized extra budget spending during an exceptionally severe economic shock.

However, I see a significant gap in the set of fiscal tools in the case of an asymmetric shock, in other words when a crisis does not hit the entire region, but only one or two countries. When thinking about the budgetary aspects of deepening monetary union, a new fiscal capacity for macroeconomic stabilisation should be our priority. It would be an important new fiscal channel for economic risk-sharing. Such a fiscal tool can be designed without debt mutualisation, and without creating permanent transfers. Examples here in the US such as rainy day funds or a complementary unemployment scheme show that this is possible. Such a facility should take the form of a revolving fund that would need to be repaid within a business cycle.

Shorter-term ESM loans would be another possibility for such a fiscal facility, associated with less stringent conditionality than the regular ESM programmes. The idea behind is that it might be healthier for the euro area as a whole to stabilize individual euro area countries early, with the help of a smaller shorter term emergency loan, than to wait until a major crisis breaks out and a full ESM macroeconomic adjustment programme is required.

There are currently several proposals on the possible format for such a tool, including the proposal of a rainy day fund from the IMF. Many of these proposals deliver good stabilisation properties. The problem is that most models still entail some permanent transfers, which are politically unacceptable and economically not really needed given the large annual flow of transfers in the EU.

Other ideas about fiscal reforms include an EU budget to finance public goods such as the protection of our outside borders, common defence or climate change measures. These ideas would not have a direct link to deepening monetary union, but I think it is more efficient for us to work on such issues jointly, as a union, rather than as individual nations. Which leads me to the beginning of my speech.

Ladies and Gentlemen,

Let me conclude. The coming months will be an important juncture for the euro area. We have achieved a lot over the last years. 2018 is the right time to take additional steps to make our monetary union more robust.

Thank you.

Author

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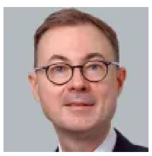

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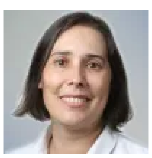

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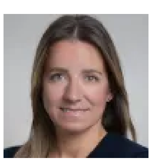

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