“The role of the ESM in a deepening monetary union” - speech by Klaus Regling

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“The role of the ESM in a deepening monetary union”
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(*Please check against delivery*)

Ladies and gentlemen,

It is a pleasure to be with you today. I want to thank Publico for inviting me to the conference. It gives us a chance to discuss how to make the monetary union more robust, and how to further enhance the resilience of the euro area economy. I also look forward to listening to Minister Centeno’s remarks later this morning.

Our topic today is Europe. But I would like to begin with some observations about Portugal. I got to know the country very well during the crisis. So it is a pleasure to be back, now that things have improved so much. At the ESM, we are always in regular contact with former programme countries. It is part of our normal monitoring, which we call the Early Warning System. And now that we have a Portuguese president of the Eurogroup of euro area finance ministers, who is also the chairman of the ESM Board of Governors, the ties with your country are even closer.

Portugal is one of the clear examples of Europe’s successful approach to fight the euro crisis. Last year, the economy expanded by 2.7 percent, more than the euro average, and up from 1.6 percent a year earlier. Unemployment is also on the way down, and exports are contributing to growth, a sign that competitiveness has returned. Equally important, the banking sector is now more resilient.

There are also still challenges ahead. The outlook for the next years is somewhat less optimistic, as growth is expected to return to potential. So Portugal needs to keep up the reform momentum. Examples, in line with the recommendations proposed by the European Commission and issued by the Council, are the need to improve the skills of the adult working population, including digital literacy, and making revenue collection and expenditure controls more effective. The pension system needs to become more sustainable, and the performance of state-owned enterprises needs to improve. Reforms of the judiciary system are also still needed. Finally, weak profitability at banks, and the high levels of non-performing loans need particular attention. Your country’s high public debt levels make it vulnerable, and the government should use the current benign environment to reduce debt by keeping spending tight. Needless to say, once the cycle turns, it will become harder to address all these issues.

The same is true for Europe in a wider sense. Many good things have happened since the crisis, and Europe has come out stronger than before: both economically and in its institutional architecture. At the same time, some risks remain in place. Let me first talk about Europe’s comprehensive policy response to the crisis. After that, I will mention the remaining challenges, and what can be done to remedy them. This will bring me to the issue of deepening the monetary union, and the role the ESM could play in that.

Europe’s response to the euro debt crisis of 2010-2012 consisted of five main steps. First, and foremost, the economic problems at the national level that caused the crisis have largely disappeared. This is because countries implemented structural reforms, consolidated their budgets, adjusted wage policies and repaired banking systems.

Secondly, policy coordination across the euro area has been improved. Surveillance had mainly relied on fiscal rules, but that turned out to be too narrow. The European Commission now also has the mandate to monitor the build-up of other macroeconomic imbalances, and take action to prevent them, with the Macroeconomic Imbalances Procedure.

Thirdly, the ECB engaged in unorthodox policy measures. We all remember Mario Draghi's "whatever it takes" speech of July 2012.

Fourthly, Banking Union has made the financial sector much safer, with the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB). Banks have doubled equity capital since the crisis, though a number of legacy issues still need to be dealt with.

Last but not least, the ESM is a lender of last resort for countries that lose market access, or are close to losing market access. This is a function that did not exist before the crisis. Since 2011, we have disbursed €280 billion to five programme countries: Greece, Ireland, Portugal, Spain and Cyprus. Four of the five have successfully exited their programmes since then. Greece is the only country still in an active programme, which will expire in August. The ESM will remain a sizeable bond issuer for a long time to come after that moment, however, because some of our loans run over several decades, and we need to refinance them on a regular basis.

As a result, Europe's economy is now doing well. At the same time – at the European level just as in Portugal – a number of risks remain. The European economy has been growing almost at twice its potential rate for some time now, and a cyclical slowdown is inevitable at some point. The output gap is expected to close this year, and there are signs that labour markets are already tight in some countries. Also, some sentiment indicators have been easing – though they remain at fairly high levels.

The risk of protectionism is highly relevant for Europe's open economy, and is increasing under the current U.S. administration as the G7 summit last weekend showed. Risks stemming from financial markets are also growing in many advanced economies: valuations are overstretched, corporate credit conditions are deteriorating, and many large banks face liquidity mismatches. Finally, cybersecurity presents a much less well-understood threat, and is therefore harder to predict. Nevertheless, its impact could be substantial.

Europe also needs to deal with a number of longer-term problems. High unemployment is a worry, particularly among young people in some countries. Europe's low gains in productivity warrants attention, and needs to be addressed through structural reforms and investments in education and technology. Europe's poor demographics indicate the need for higher participation rates and for immigration, but this is politically difficult. Immigration can contribute to the labour supply only slowly. I already mentioned non-performing loans on the balance sheets of some banks, which are dragging down profitability, and stand in the way of greater euro area financial integration.

In short, while the recent economic performance in Europe is strong, a number of well-known weaknesses remain in place, and a handful of new risks is becoming visible. At the national level, all countries should implement reforms to strengthen growth, for example by working on the country-specific recommendations. At the European level, we should use the current favourable situation to fix remaining weaknesses in the architecture of EMU. We can still take a number of steps to make the monetary union more robust.

In the broadest of terms, what Europe lacks is economic risk sharing between countries inside the euro area. Shocks are shared to a much larger degree in the U.S. than in the euro area economy. The same is true inside large euro area countries such as France and Germany, where risk sharing is much better developed than in the euro area as a whole. Risk-sharing takes place through two channels: the market channel and the fiscal channel. The more risk is shared through banks and markets, the fewer fiscal mechanisms are needed. Improving the health of euro area banks and integrating capital markets are therefore important steps in making the economy more resilient. Both would promote private sector risk-sharing and strengthen the resilience of the euro area in case of a next crisis.

It is precisely for this reason that the current agenda to deepen the monetary union is so important. The agenda, as you know, is currently a high priority for the finance ministers of the euro area. Its different elements all work towards the same goal: reduce the vulnerability of the euro area. In the remainder of my remarks, I will say a few words about this agenda.

European Council President Donald Tusk in December mandated the finance ministers of the euro area to work on a number of concrete steps to deepen the monetary union. This followed important speeches by French President Emmanuel Macron, European Commission President Jean-Claude Juncker, and the Commission proposal, also of December. The ministers were asked to focus on those two areas where the consensus is the greatest, and the chance of success therefore the highest. First, the completion of the Banking Union. Second, the development of the European Stability Mechanism into a more comprehensive crisis resolution mechanism. There is less consensus about any fiscal tools.
The completion of the Banking Union consists of two steps. One is the implementation of a financial backstop for the Single Resolution Fund, so that it has enough cash to deal with a very big crisis. This is a role that the ESM is likely to fulfil in the future. It could take the form of a credit line that would roughly double the funds of 55 billion euros, which the SRF will have available by 2023.

A common deposit insurance is the other measure to complete Banking Union. This is still a controversial topic, because problems dating back from the crisis are more severe in some countries than in others. As long as this is the case, national banking systems cannot be expected to pool resources to guarantee depositors across borders. Also, not all national deposit guarantee schemes are equally funded. Other issues discussed under the header of “risk reduction” are the amounts of sovereign bonds on the balance sheets of some banks and differences in solvency regimes. The May agreement on safety buffers in the form of bail-inable capital was good news in this respect. Once we see sufficient progress in these areas, a common deposit insurance would have a strong role in preventing national bank runs during a crisis. Depositors simply won’t see the need to get their money out of their bank if they know that it is not just their own government backing their deposit guarantee, but all of Europe.

The second priority is the future of the ESM. Developing the mandate of the ESM is, of course, not a goal in itself. But it could be a further useful step to make the monetary union more robust. I already mentioned the first of its possible new functions, that of a backstop for the single Resolution Fund.

The ESM could also play a more important role in future assistance programmes. The IMF has become less involved in euro area rescue packages, while the role of the ESM has increased. The ESM now has its own know-how and the necessary financial power. The ESM has not only disbursed cash in its programmes, but has been involved in important parts of programme design and monitoring. This involves debt sustainability analysis, questions of financial stability and market access. In addition, the ESM monitors developments in ex-programme countries, like I already said.

Drawing up future adjustment programmes – designing, negotiating and monitoring them – could become a joint task of the Commission and the ESM. Clearly, any overlap of responsibilities between the two institutions would have to be minimised and the role of the Commission must be fully respected as laid down in the EU Treaty. The ESM will not play a role in economic policy coordination in Europe or in the implementation of the Stability and Growth Pact, which are responsibilities of the Commission. We also would not be involved with the Macroeconomic Imbalances Procedure. Instead, we would focus on our own strengths, based on our market activities analysing questions of debt sustainability, financial stability and market access.

The ESM could also manage new fiscal facilities, e.g. for macroeconomic stabilisation. Shorter-term ESM loans, to be repaid within a cycle, with a lighter conditionality than our regular programmes, could help stabilize individual euro area countries before small problems become big ones.

Ladies and gentlemen,

Let me conclude. Portugal is a clear example of what Europe can achieve when countries join forces. Portugal’s citizens and their political leaders have worked hard to fix the problems in their economy that led to the crisis. Portugal is now reaping the benefits from those efforts. The same is true for Europe, which is also experiencing a period of economic progress. In my remarks today, I have tried to make clear that Europe should use this period to push through a number of additional reforms to complete the process started during the crisis. Together, these steps will ensure that Europe is better prepared when the next crisis hits, and that the costs for all of us will be smaller.

Thank you for your attention.

Photo: Daniel Rocha

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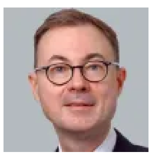

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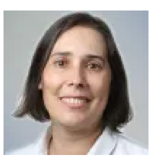

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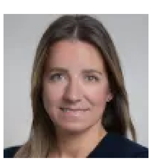

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