Policy Normalisation Risks: Entering the Old Era of Capital Flows and Exchange Rate Volatility? - speech by Klaus Regling

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Klaus Regling, ESM Managing Director
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(Please check against delivery)

Ladies and gentlemen,

This morning, we will focus on vulnerabilities in the current economic and political environment. Policy normalisation, mentioned in the title of the panel, is one such risk. But as the only non-central banker on the panel, I don’t need to say much about it.

There are also other challenges. Some are traditional, such as a normal cyclical slowdown after some years of growth above potential. This is a normal phenomenon, and dealing with it may not present unexpected difficulties. Other risks are new, however. The world is experiencing a surge of deglobalisation and neo-protectionism, primarily led by the U.S. withdrawal from multilateralism. This is a new phenomenon in the post-war period, driven by a multitude of factors, and the consequences are harder to predict.

Such events, particularly if they happen simultaneously, can damage confidence in emerging economies more than in others. Even a slight deterioration in fundamentals can lead to *sudden stops* in capital flows and to significant currency depreciation. Indonesia, like many other emerging economies, knows this only too well from its own past experience.

In Europe, capital reversals and exchange rate volatility are much less of a concern. Not only because of its overall current account surplus, but because of Europe’s single currency. We sometimes forget that Europe frequently suffered from strong currency turmoil before the introduction of the euro. The last time this happened was in 1995, when a massive appreciation of the Deutschmark in comparison to other European currencies occurred as a result of the Tequila crisis. This was not good for anybody, and hurt the single market. Such episodes of intra-European currency turmoil caused by developments outside Europe are no longer possible.

Nevertheless, this crisis response has reduced vulnerabilities in Europe, and monetary union works better now than before the crisis. Let me say a few more words about the ESM. Not only because it is my own institution, but also because its confidence-building impact as part of the Global Financial Safety Net is relevant well beyond the euro area.

Through the ESM, the euro area provides financial solidarity to countries in trouble. The ESM is the Regional Financing Arrangement for the euro area. RFAs cover every continent now, and are an indispensable layer of the Global Financial Safety Net. Other examples are FLAR in Latin America, the Arab Monetary Fund in the Middle East and the AMRO/Chiang Mai Initiative in Asia.

The ESM is the largest RFA of the world, with a combined lending capacity of €700 billion. We have successfully assisted five countries: Ireland, Greece, Spain, Portugal and Cyprus. By setting up the ESM, Europe has made a strong contribution to strengthening the global financial safety net, alongside other regions. Together, this has led to a replenishing of the overall resources in the GFSN since the crisis. International reserves rose to $11.5 trillion in 2017. The sum of the three other layers – bilateral swap arrangements, resources available from RFAs and the IMF – rose from $400 billion in 2007 to nearly $4 trillion now. Apart from the doubling of the IMF quotas, resources available in RFAs have substantially contributed to this change, and the overall lending capacity of all RFAs equals the lending power of the IMF.

Looking into the future, making the GFSN more robust, reliable and predictable would boost confidence among investors and in markets. This is also one recommendation from the G20 Eminent Persons Group. The ESM and its peers have initiated a regular dialogue among RFAs and with the IMF to see how we can better cooperate to achieve consistent actions, synergies, and global impact.

Let me return to Europe and explain what we are doing to make EMU even more robust to deal with emerging risks and challenges. These changes build on what has been achieved during the crisis. We do not need another overhaul of monetary union: we are discussing additional steps that are useful from an economic point of view, to make the monetary union more robust, and to better prepare it for the next crisis.

Two steps are needed to complete Banking Union. The Single Resolution Fund needs a financial backstop, so that it has enough money in a severe crisis. This is a role the ESM will play. There is also the need for a common deposit insurance in Europe, but this will take longer to introduce because several banks still have too many legacy problems dating back from the crisis on their books.

The role of the ESM will also be expanded. It will get a bigger role in financial assistance programmes, together with the European Commission. This would require that we are well-informed about financial and economic developments in all the 19 euro area member states, which are our shareholders. We are also reviewing the toolkit of the ESM. We are considering how to make our precautionary credit lines easier to use, without attaching a stigma for countries – a question the IMF has also been struggling with for a long time. And finally, the ESM could provide short-term loans for macroeconomic stabilisation purposes, with a lighter conditionality than regular programmes. This is part of the debate about a fiscal capacity for the euro area to facilitate fiscal risk sharing.

Other possibilities for more fiscal risk sharing are: rainy day funds, re-insurance of unemployment systems or investment protection. Economically the arguments for such fiscal mechanisms are strong, but politically it is a very controversial issue among our member states.

Let me conclude. After the global financial crisis and the euro crisis, Europe, like most of the world economy, has seen a strong recovery. A normal cyclical downturn is unavoidable, eventually. Unfortunately, other downside risks have become bigger. That is why it is a good thing that the euro area is better prepared for the next crisis, and that we are further reducing our vulnerabilities.

Author

Klaus Regling
Managing Director

Contacts

Cédric Crelo
Head of Communications and Chief Spokesperson
+352 260 962 205
c.crelo@esm.europa.eu

Anabela Reis
Deputy Head of Communications and Deputy Chief Spokesperson
+352 260 962 551
a.reis@esm.europa.eu

Juliana Dahl
Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu