Strengthen stability: further development of the ESM in a deepened monetary union - speech by Klaus Regling

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“Strengthen stability: further development of the ESM in a deepened monetary union”
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(*Please check against delivery*)

Dear Mr. Schleweis,
Ladies and gentlemen,

I am very pleased to speak to you this evening about the deepening of the Economic and Monetary Union (EMU).

In particular, I would like to give you my perspective on the possible new tasks of the European Stability Mechanism (ESM) and how, overall, monetary union can be made even more robust.

Focus on what has been achieved

The tenth anniversary of the Lehman collapse provides a good opportunity to take stock: Additional steps to deepen EMU must, of course, be discussed against the background of what has been achieved so far.

In recent years, the euro area has weathered the worst recession since its inception. Today one can say that this crisis is over. Of course that does not mean there will never be problems or crises again in the euro area. But the euro crisis of 2010-2012 is over.

The growth of the euro area remains well above its long-term potential. A slowdown in growth is inevitable and a normal cyclical phenomenon.

Macroeconomic imbalances that emerged in the years before the crisis have been removed. Budget deficits have narrowed, public and private debt are falling, current account deficits have disappeared. The unemployment rate is at its lowest level since the end of 2008.

Overcoming the crisis is the result of a broad package of measures that has been successful in its interplay. Deep reforms in Member States which received EFSF and ESM loans, as well as the unconventional monetary policy of the European Central Bank (ECB) were essential crisis responses. At the same time, economic policy coordination at EU level has been strengthened and broadened. And deficits in the institutional architecture of EMU have been addressed in key areas.

Two institutional changes have strengthened the structure of the monetary union: the banking union with the creation of the Single Supervisory Mechanism and the Single Resolution Mechanism, and the creation of the two rescue funds.

The rescue funds

In 2010, the temporary European Financial Stability Facility (EFSF) was established. Two years later the permanent ESM was set up.

The crisis has made it clear that national problems in a monetary union can quickly become European problems. The ESM ensures the stability of the Eurosystem. The function of "lender of last resort for countries" did not exist before the crisis.

By lending to weaker member countries, national crises are prevented from spreading to the entire currency area. Without the creation of the EFSF and the ESM, countries such as Greece, Ireland and Portugal would probably have had to leave the Monetary Union. Europe would look very different today!

Loans are disbursed by the ESM only if the beneficiary country implements extensive reforms. This lending practice has already proven itself for decades at the International Monetary Fund (IMF).

Contrary to what is sometimes said, the ESM programmes are not funded by taxpayer money. The money for the loans is raised in the market by the two rescue funds. Program countries must repay their loans in full, including interest.

With around €80 billion, the ESM has the highest paid-in capital of all international financial institutions. The capital serves as buffer for investors. This is the reason why the ESM has an excellent rating and therefore only has to pay low interest rates in the market.

The favourable financing conditions are passed on by the ESM to its borrowers. We have the opportunity to get long-term loans at around 1% interest – but of course only under strict conditions. These low interest rates give these countries fiscal space. In the case of Greece, we estimate that the ESM loans will result in annual budget savings of almost € 12 billion. This corresponds to 6.7% of Greek economic output. This is crucial for the recovery of Greek debt sustainability.

Since 2011, the rescue funds have provided loans totalling around €295 billion to five countries. The reforms are paying off: Ireland, Portugal, Spain and Cyprus are experiencing high growth and rapidly falling unemployment. And they can easily refinance themselves on the market again. Greece is also on the right track. However, it is important to maintain the reform path in order to strengthen the growth potential and to secure investors' long-term confidence.

Italy

Do we have, after all the ESM programmes have been completed, a new problem in the euro area with Italy? The budget plan that Italy sent to the European Commission on Monday is certainly not in line with the Stability and Growth Pact. The Pact was agreed on unanimously by the member countries – including Italy. Markets have reacted accordingly. I assume that the Commission, the Ecofin and the Eurogroup will try to persuade the Italian government to make budgetary adjustments. If necessary, the Stability Pact provides further steps.

On the other hand, one should not overreact, as was observed last week at the annual IMF meeting in Bali. Some said that Italy would soon lose market access. But Italy certainly has its strengths: current account surplus, relatively high primary surplus, long maturities in the financing of the budget and high domestic savings. That is why I think it is right to remind Italy of the commitments that apply to all countries belonging to the euro area. But there is no need to panic. Ultimately, it is crucial that more than 60% of Italians support the euro. Only a quarter would like to have the lira back.

Completion of the monetary union

Let me turn to the topic of deepening the monetary union. Before the next summit of heads of state and government in December, we are working on two topics in particular: the completion of the Banking Union and the further development of the ESM.

Completing Banking Union

Two things are missing to complete banking union: the backstop for the Single Resolution Fund (SRF) and a European Deposit Guarantee Scheme.

Firstly, the ESM should provide the backstop for the SRF: this was decided at the summit in June and we are preparing internally for it. In a financial crisis, there could be a case in which the financial means at the SRF might be depleted. The FDIC – the US Federal Deposit Insurance Corporation – also has such a backstop!

The ESM could provide the Single Resolution Fund with a credit line of the same magnitude as the SFR’s own resources, i.e. around €55-60 billion. Should this credit line ever be used, the SRF would repay this money through contributions from European banks. There will be no burden for taxpayers. The timing of the introduction of the backstop is still open and depends on how quickly risks can be reduced at the banks.

The second element: I know that the DSGV is very sceptical about European deposit insurance. Let me therefore explain why I consider such a deposit insurance scheme to be useful.

I sometimes hear that with a European deposit guarantee, German savers would be liable with their savings for savers of other countries. Of course that is not correct. The banks pay an "insurance premium" from their profits for this deposit insurance. This affects the saver indirectly, should banks decide to pass these costs on to their customers. But it is not the case that savings are used directly. Furthermore, it is true that all citizens – and also banks – in the euro area benefit from a joint deposit insurance, as the risk of a financial and debt crisis falls.

Had there been a European deposit guarantee a few years ago, the lending volume of all ESM programmes would have been significantly lower. A significant part of the loans was needed to recapitalise banks in the respective program countries. Concerned savers withdrew their deposits from banks during the crisis.

With a credible European deposit insurance scheme, the savers’ fears would be erased, and the reason for national bank runs would disappear. A joint deposit insurance would help to ensure deposit protection regardless of the location of a bank. A credible deposit insurance is also the best guarantee that it is practically never used. In short, risk-sharing reduces risks in this case.

But I agree with the DSGV that the prerequisite for the introduction of a European deposit insurance scheme must be a significant risk-reduction for the banks. Progress has already been made: the Tier 1 capital ratio of euro area banks stood at around 16% in June 2018. And the share of non-performing loans fell by around 18% in the euro area last year, and even more in the problem countries. This trend must be continued. Similarly, the high proportion of domestic government bonds in bank balance sheets should be reduced.

Together with a Capital Markets Union, European deposit insurance would make it easier to overcome the fragmentation of financial markets in Europe and to create a single European financial market. This could also reduce the TARGET imbalances again. In addition, a more integrated financial market would lead to a more effective monetary policy in the euro area. That would possibly also allow for higher ECB interest rates.

Strengthening stability: deepening the ESM

Let me now turn to the second part of strengthening EMU: the further development of the ESM. You may be wondering: what does a rescue fund do when there is nothing to rescue? We have no ongoing support programme for the first time since the rescue funds were established. Let me I assure you, we are still busy.

The euro countries want to deepen and extend the mandate of the ESM. The following new tasks are being discussed:

Firstly, as already mentioned, the ESM should make the backstop available for bank resolution by 2024 at the latest.

Secondly, the ESM could play a stronger role in future crisis programmes. Of course, together with the European Commission. The current creditor quadriga would then become a tandem. Of course, the responsibilities of the Commission arising from the EU Treaty will be fully respected.

Thirdly, the toolbox of the ESM will be revised, in particular concerning the precautionary instruments.

There are also suggestions on how to improve the involvement of private creditors in debt restructuring. The ESM may only lend to Member States whose debt is sustainable. The system has become very "ad hoc" in recent years and should become more transparent.

The ESM could play an important role here: we would perform debt sustainability analysis and moderate the dialogue between the requesting country and the creditors.

Additional stabilisation

There are also numerous proposals to introduce fiscal instruments for macroeconomic stabilisation and convergence of living standards. Among the euro member states, there is still no consensus on this issue today. So the discussion is controversial.

For many decades, the EU budget has existed to promote convergence. Transfers through the EU budget to promote convergence were not created because of the euro. But they also support convergence in the euro area. Stabilisation makes sense if part of the monetary union is developing asymmetrically compared with the rest of the union.

I would like to emphasise:

Firstly, in a monetary union, there are two macroeconomic governance instruments: monetary policy and exchange rate policy. Therefore, only fiscal policy remains as a macroeconomic instrument to counteract.

Secondly, monetary policy in a large economic area tends to always be pro-cyclical. Regions or countries with high economic growth and thus higher inflation rates tend to have low real interest rates. Low growth regions and countries tend to have high real interest rates. We see this in Europe as well as in the USA or China.

Thirdly, economic risk-sharing is less pronounced in the euro area than in the United States. Financial market integration remains low. And in the euro area, there are no common tax and social security systems which permanently stabilise the economic cycle like in the US federal states.

Of course, before any fiscal macroeconomic stabilisation instrument can be used in the euro area, all euro countries should first make use of their national fiscal buffer. This is what the Stability and Growth Pact envisages. So they have to be built up first. But these national buffers could be complemented by European instruments.

There are several proposals for this: stabilising investments, reinsurance of national unemployment schemes, rainy day funds, and short-term ESM loans. All these proposals could be designed so that they do not lead to permanent transfers.

From an economic point of view, more risk-sharing in a monetary union across markets and through fiscal instruments makes sense. Smaller crises would not easily turn into major crises. The use of comprehensive ESM programmes would become less frequent.

As I said, the discussion is controversial. Definitely also here in the hall. But I was certainly also invited to give some food for thought.

Conclusion

We should now look forward to enjoying the concert. Afterwards there might still be an opportunity to discuss "my" topics.

Thank you very much.

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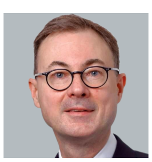

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