The future of the Economic and Monetary Union and the role of the ESM - speech by Klaus Regling

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Ladies and gentlemen,

Also from my side congratulations to the winners of the best interest rate forecast for the year 2018. As a former Director-General for Economic and Financial Affairs at the European Commission, I know the importance of accurate forecasts. And reliable forecasts are also of great value for the work of the ESM.

However, the crises of recent years were not really forecast – at least in their extent. Looking back, we know that Europe was not sufficiently prepared for the global financial crisis in 2008. A little later, we also had to overcome the internal euro crisis.

Lessons were learnt. Europe spent a lot of energy and resources after the crisis to strengthen the monetary union financially and economically. Governments, central banks, banks, banking supervisors and other market participants all did their part.

As a result, the crisis is now well behind us, and the Economic and Monetary Union (EMU) stronger than a decade ago. The overall economic situation is favourable – particularly in the countries that received ESM support, even Greece has a black zero for the third year running. We can actually look at the future with confidence.

But the question arises: have we really done enough to prepare for the next crisis? Is the monetary union working well enough to fulfil the promise of better living standards in all euro area countries?

Shouldn't Europe become more independent, now that the U.S. administration is questioning multilateralism, and is not shying away from using the dollar as a "weapon" to achieve foreign policy goals?

The ESM was set up to help Europe fight crises. I believe we have done our job rather well. It is for that reason that we are thinking of what comes next, and that we are working to strengthen the monetary union, together with the countries of the euro area.

This is what I would like to address today and what further steps are needed to deepen the monetary union. How to make the euro area more resilient against crises? And how to strengthen the role of the euro in the international monetary system.

1. What steps are needed to deepen EMU?

Europe is working on a series of political initiatives to deepen the monetary union at the moment. The topics on the agenda are completing the Banking Union, developing the ESM, and fiscal mechanisms.

The goal is to strengthen crisis mechanisms – particularly risk-sharing – without putting in place the wrong incentives, and without creating additional transfers.

Completing Banking Union consists of two steps.

Firstly, the Single Resolution Fund (SRF) needs a financial backstop, so that it has enough money in case of a very substantial crisis. The decision that the ESM will provide this backstop was taken in June. The backstop must be ready in 2024 at the latest, or earlier if risks on the balance sheets of banks have been reduced sufficiently.

Secondly, Europe should tackle the issue of a European deposit insurance. This is particularly controversial in Germany, but would certainly have a number of advantages over the long-term.

Depositors would no longer fear that they would lose their euros and get their savings back in a new national currency. This would reduce the risk of national bank runs during a crisis.

A common deposit insurance would apply regardless of where a bank is based, and this would be the best guarantee that such an insurance would almost never be needed. In short: risk-sharing reduces risks in this case.

Of course, the prerequisite for the introduction of a European deposit insurance is a considerable risk-reduction on banks’ balance sheets. First legacy issues have to be reduced.

Here, we made progress:

The capital ratio of European banks stood at around 16% in June. And the volume of non-performing loans dropped by 18% in the euro area last year. In former crisis countries, the drop was even greater.

This trend should continue. Moreover, banks should reduce their high holdings of domestic sovereign bonds.

Together with the Capital Markets Union, this would help reduce the fragmentation of capital markets in Europe, and create a true European financial market.

Financial market integration is well below the levels it reached 10 years ago. There are 19 different national markets in the monetary union today, not a single integrated one. This prohibits risk-sharing through markets, something that functions really well in the U.S., where it leads to quasi-automatic macroeconomic stabilisation.

In a more integrated financial and banking market, TARGET imbalances could also fall again. In addition, a more integrated financial market would enhance the monetary transmission mechanism in the euro area. That would possibly also allow for higher ECB interest rates.

Developing the ESM is another topic on the agenda to deepen the monetary union that is being worked on intensely at the moment. Euro area countries want to deepen and broaden the mandate of the ESM. Four new tasks are under discussion:

Firstly, as said, the ESM will provide the backstop for the SRF from 2024 at the latest. The backstop is a lifeline in a banking crisis.

Secondly, the ESM will play a stronger role in future country programmes, together with the European Commission of course. The current quartet of creditors – which came out of the troika – will then be a tandem. Obviously, the competences of the Commission as mentioned in the EU Treaty will be respected.

Thirdly, the lending toolkit of the ESM is being reviewed. In particular, we are looking at precautionary instruments.

Fourth, there are proposals to improve the burden-sharing of private creditors during a sovereign debt restructuring. The ESM can only provide loans to countries whose debt levels are sustainable. This system has developed on an “ad hoc” basis over the past few years, and it should become more transparent and more predictable. The ESM could play a role here. When a country applies for a loan, we would present a debt sustainability analysis, and moderate the discussions between that country and its creditors.

On top of this, there are several proposals for fiscal instruments, either for macroeconomic stabilisation or for convergence of living standards. But there is no consensus here between the euro area countries, and it is still a very controversial topic.

The EU budget has promoted convergence between countries for several decades. Transfers from the EU budget for convergence were not put in place because of the euro. But they also serve convergence in the euro area. That’s why I see only a limited need for additional transfers to improve convergence.

France and Germany proposed last week to create a euro area budget within the EU budget to promote competitiveness, convergence and stabilisation. This is an important signal, because it shows that the discussion about fiscal instruments in the euro area is making progress.

In my view, what is needed most is additional instruments for macroeconomic stabilisation for the following reasons:

Firstly, countries in a monetary union no longer have monetary policy and foreign exchange policy as tools of macroeconomic stabilisation. Only fiscal policy is left as a macroeconomic stabilisation tool.

Secondly, monetary policy in a large economic region tends to work pro-cyclically. Real interest rates tend to be too low in regions or countries with high growth and therefore higher inflation. While regions with low growth rates tend to have real interest rates that are too high. One sees that in Europe, just as in the U.S. or China. This may be a reason to use fiscal policy to counteract.

Thirdly, as I already said, economic risk-sharing in the euro area is much less developed than in the U.S. There are no common tax and social security systems in the euro area, which permanently stabilise economic cycles in the same way as they do in states in the U.S.

Needless to say, all countries must use national buffers to the full extent before they can use the stabilisation tool, as foreseen in the Stability and Growth Pact. Once the national buffers have been built up, they could be complemented with a euro-area instrument to create more fiscal leeway during a crisis.

Talking about building up fiscal buffers, many of you probably think of Italy, where the opposite is happening right now. The Commission was right to criticise and reject this budgetary plan. Deepening the monetary union will work only when all euro area countries stick to the rules. When dealing with Italy’s current problems, we must keep an eye on the future.

There are several proposals for a macroeconomic stabilisation tool: supporting investment, reinsure national unemployment schemes, rainy day funds and short-term ESM loans. They all work on the same principle: enhancing risk sharing between euro area countries. This could help prevent a limited problem in one country from spreading to others, and pre-empt the need for an ESM programme. But any such plan must be constructed without permanent transfers.

I strongly believe that these proposals to deepen the monetary union would make the euro area more robust and more resilient. And a better monetary union would also be a substantial contribution to strengthen the international role of the euro.

I often meet international investors during ESM roadshows, and, without exception, they complain about the fragmentation of European capital markets, and about the fact that a monetary union cannot function without a fiscal capacity.

2. Strengthening the international role of the euro

At the moment, we are experiencing how the dollar, the foremost currency in the world, might develop into a problem for the global economy. That's nothing new, but the result of the dominant role of one currency in the system.

When both the interest rates and the foreign exchange value of this currency rise – for good reasons – this could pose a problem for companies or even entire countries that have dollar-denominated debts.

We saw this in the 1980s during the Latin-American debt crisis and during the Asia crisis in the 1990s. Many emerging economies now have a similar experience. On top of that, unfortunately, the Trump administration is increasingly using the dollar as a tool for foreign policy goals.

So I think it is time to strengthen the international role of the euro. Not only to strengthen the international monetary system, but also to protect Europe's interests.

The euro may be much younger than the dollar or pound sterling, but it is clearly the second-most important currency in the world. Almost a quarter of foreign currency reserve are held in euros.

The euro's share in global payments reached almost 36% in 2017. A third of international bonds are denominated in euros, and 25% of global trade is being invoiced in euros. 60 countries across the world have pegged their currencies to the euro, including EU members such as Denmark and Bulgaria.

The goal should not be to replace the dollar. We should aim for a multipolar system, in which several currencies have a comparable role, including the dollar, euro and renminbi.

What needs to happen for the euro to become more important globally?

We need additional steps to deepen the monetary union, which I just discussed. It is of particular importance to foster the integration of financial markets. Without properly functioning and liquid financial markets, the euro will not be able to take on a role in the international monetary system that is as strong as that of the dollar.

Europe’s financial markets are much less liquid than in the U.S. The lack of depth and structure of our financial markets are holding back the international competitiveness of the euro. To improve this, fragmentation in a number of areas needs to be dealt with.

I already mentioned the completion of the Banking Union and the Capital Markets Union. Banks should rethink their business models. Some countries should reduce overbanking and overbranching. This will boost profitability, which is lagging behind the U.S. Legacy assets such as non-performing loans should be reduced further.

Europe is harmonising bankruptcy, tax and corporate law, as part of Capital Markets Union. Technically, this a complex job that will take years. But a real Capital Markets Union would open up the way for cross-border equity investment and new ways to finance business. This would make the euro more attractive for global investors.

So all of this is important not only for the proper functioning of the monetary union, but also to strengthen the international role of the euro. On top of that, the infrastructure of European financial markets should be strengthened, and developed further.

- Infrastructure

With the ECB’s TARGET2, Europe has a very efficient system for the settlement of payments, and the TARGET Instant Payment Settlement – or TIPS – is the next step to improve this process.

However, in the area of securities settlement, fragmentation is still very strong in the euro area. There is a multitude of national Central Securities Depositories (CSDs) and a few international ones. This is also the case in the sovereign debt market. This does not make things easier, particularly not for investors from outside Europe.

In the primary market, more modern technology could be used to make the issuance of bonds more efficient and more transparent for investors, banks and issuers. A single system to distribute sovereign bonds would offer investors – especially international investors – more transparency and ease access for them.

Moreover, there are many syndicated issuances from sovereigns, international institutions and national public authorities. It is worth noting that particularly in the primary market technologies in many areas are still at the level of the 1990s. In these areas, modern technology can be used to make the issuance of securities easier and more transparent for investors, banks and issuers.

A single system to issue bonds, whether syndicated or through auction, would offer more transparency for investors and ease access for them.

Together with a central connection between national and international CSDs, this would lead to stronger harmonisation of capital markets in Europe.

The ESM has started to discuss this topic with other public issuers, international financial institutions, banks and investors.

At the same time it is important that public issuers are not too dependent on the private sector or non-European providers. More independence is needed to secure long-term stability.

A strong infrastructure for public sector bond issuance would be an important step. This would enable public issuers to access global investors independently from what third-party countries decide.

- IT-Infrastructure

Europe should also work to reduce its dependence of a small number of U.S. providers in the area of IT infrastructure. There is a strong tendency towards cloud-based services here, also in the financial sector. That is no surprise, because cloud services offer many advantages when looking at cost and scalability.

But there are also risks. One of the main challenges is that a handful of U.S. providers dominate the market, something that has also been pointed out by European watchdogs.

A competitive European provider is nowhere to be seen. This harbours systemic and data protection risks. The number of single points of failure is rising, which means that an outage does not hit just one company, but the entire system, which could lead to an economic shock.

The strong EU data protection laws are ineffective as long as the data are stored outside the EU, and foreign jurisdictions reserve the right to have access to these data, something that was confirmed this spring through the U.S. CLOUD ACT.

It seems particularly problematic to be dependent on a small number of non-EU providers at a time of strengthening protectionism. Europe’s strong data protection laws, which can sometimes be burdensome, can also become a competitive advantage. Just like a financial centre that can attract new business because of its strong supervision and regulation.

When the euro one day plays a more important role on the global stage, the ECB would also have to assume a more prominent role towards third-party countries. The currency swap lines of the Federal Reserve with the ECB and central banks in countries such as Japan, Korea, Mexico, England and Switzerland were an important instrument during the crisis. Many of these contracts have expired, and it seems unlikely that the current U.S. Congress would still support them. The ECB should take on this responsibility when the euro gets a more prominent role. So far, the ECB has only set up swap lines with major central banks in the world and with non-euro area central banks in the EU.

3. Long-term vision: safe asset

Safe assets are a final point that are important when thinking about the longer-term role of the euro in the international monetary system. Safe assets would be a crucial step to integrate markets, and to render the euro more attractive for international investors.

At the moment, the German Bund is effectively the safe asset in the euro area, followed perhaps by bonds from the Netherlands, Finland, Austria and the ESM. But that is not enough, particularly not now that supply from Germany is continuously coming down. Issuance volumes in U.S. markets are much higher.

There is no magic potion to create a substantial market for a safe asset in the euro area. There are academic proposals, which are very creative, that mimic a safe asset through financial engineering. These efforts are laudable, because having a safe asset would be so important for financial market integration. A safe asset would allow Europe’s banks to reduce their holdings of national debt, and to attract international capital to Europe.

But these academic efforts to create a safe asset so far have not been successful. There is really no other way other than strengthening trust in budget policies in the countries of the euro area so that a part of national debt could be mutualised in 10 or 20 years.

This would be a crowning achievement for the monetary union. Financial market integration would then be complete, and the international role of the euro would certainly be much bigger than now.

That may sound optimistic, certainly given what is happening in Italy. But when thinking about the future, one must sometimes be able to abstract from what is happening right here and now.

Conclusion

Let me conclude here.

The monetary union is now stronger than before the crisis. But we are facing new risks and challenges. So it is important to think about further steps to deepen the monetary union, to make the euro area more resilient against crisis. With a more robust monetary union, the euro would also take on a larger role on the global stage.

Thanks for your attention.

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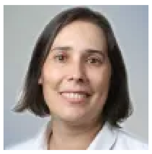

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