Can the euro area weather the next crisis - speech by Klaus Regling

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"Can the euro area weather the next crisis?"

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(*Please check against delivery*)

Dear Guntram,
Dear Maria,
Ladies and gentlemen,

It is good to see that the stability of the euro area also matters here in the USA, and not only in Brussels.

“Can the euro area weather the next crisis?” Luckily, this question does not keep me awake anymore at night. Compared to ten years ago, when this question was the guiding principle of my work while establishing the Stability Facility and later the Stability Mechanism for the euro area.

To make best use of your time I could just simply answer with a “yes”. But I reckon this is not the reason why I was invited today. Let me elaborate why I believe the euro area is strong enough to withstand a possible next crisis.

In the next fifteen to twenty minutes I will argue that

- the currency union is stronger than ten years ago,
- this is thanks to a bundle of reforms which were effective in their interplay,
- the current reforms proposals will deepen the economic and monetary union (EMU) further,
- there are some ideas that could make the euro area even more resilient.

And finally, I will underline that all these reforms – which support financial stability – would also strengthen the international role of the euro.

As said, the euro area is better positioned and works better than ten years ago. This is the result of a broad package of measures, which were successful because of their combination. The most important point is that far-reaching reforms, in particular in member states with ESM-loans, have largely eliminated macroeconomic imbalances.

The unconventional monetary policy of the European Central Bank was another crucial element to get out of the crisis. At the same time, the coordination of economic policies at EU level has improved significantly. And the institutional architecture of the currency area has been substantially strengthened by setting up banking union and the two rescue funds EFSF and ESM.

Two institutions were created in the framework of **banking union**: the Single Supervisory Mechanism (SSM), which monitors the most significant banks. And the Single Resolution Mechanism (SRM), which is in charge of resolving an ailing bank.

Here a few words on the two rescue funds. In 2010, the temporary European Financial Stability Facility EFSF was established and two years later the permanent European Stability Mechanism ESM. This has closed an institutional gap in the euro area. Before the crisis, there was no "lender of last resort for countries" in the euro area. Without the creation of the rescue funds, former programme countries such as Greece, Ireland and Portugal would probably have been forced to leave the monetary union. Europe would look different today.

When granting loans, the ESM applies the basic principle used by the International Monetary Fund (IMF): loans are only disbursed if the beneficiary country implements deep reforms. Different from the IMF, the money for the loans is raised by the rescue funds on the market. And the program countries have to repay their loans in full, including interest.

With around €700 billion, the ESM has the highest capital of any international financial institution. The paid-in capital amounts to €80 billion and is a strong signal for investors. And it is the reason why the ESM has an excellent rating, and therefore pays low interest rates on the market.

These favourable financing conditions are passed on to the beneficiary countries while applying strict conditionality. The low interest rates lead to considerable budgetary savings for the respective countries: in the case of Greece the budget saves around €12 billion annually in interest payments, which is almost 7% of Greek economic output.

We have disbursed €295 billion since 2011 – to Ireland, Portugal, Greece, Spain and Cyprus. Today, the four former ESM-countries Ireland, Portugal, Spain and Cyprus are experiencing high growth and rapidly falling unemployment rates. And they can easily refinance themselves on the market again. Greece is also on the right track – provided that the country remains committed to implement the agreed reforms.

In short, much has happened during the last 10 years. And the monetary union is now more stable and better prepared for the next crisis than a decade ago. But reform efforts continue, and rightly so.

The Euro Summit in December adopted a reform package to deepen the monetary union. It involves the completion of banking union, the further development of the ESM and fiscal issues. What does this mean exactly?

First, the ESM will take on the role of a **backstop** in bank resolutions carried out by the Single Resolution Board. This is an important step forward towards trust building and the completion of banking union.

The US has also such a backstop – the US Federal Deposit Insurance Corporation – and is a good example that the European resolution fund will only rarely be used. It will be "fiscally neutral", which means that there will be no additional burden on taxpayers. By 2024 at the latest, the backstop should be fully operational. Right now, we are working on the details.

Second, the ESM will play a stronger role in **future economic adjustment programmes**. In collaboration with the European Commission, the ESM will design, negotiate and monitor future assistance programmes. Both institutions agreed on the details of their future cooperation in November 2018.

Third, the **ESM's toolbox** is reviewed to make the use of precautionary credit lines more effective. The ESM has different financial assistance instruments at its disposal. Up to now, only two have been used: long-term loans were granted in the framework of an ESM programme, to Greece, Ireland, Portugal and Cyprus and one loan was granted to Spain to recapitalise the banking sector.

And fourth, the December Euro Summit decided to strengthen the role of the ESM in **matters of debt sustainability**. It is the ESM's duty to always take a creditor's perspective. The ESM only grants loans to member states if their debt is sustainable. In the future, the European Commission and the ESM will jointly prepare a debt sustainability analysis. In addition, the ESM may mediate dialogues between member states and creditors in the course of a possible debt restructuring, if useful and if requested.

The Summit also decided to move to single-limb collective action clauses (CACs). CACs are clauses in bond contracts that allow the terms of the bond to be changed by collective vote of the holders. The idea is that if the change is approved by a certain majority of the bond holders, it becomes binding on all of them.

These debt-related discussions should not be understood as if Europe wants to have more debt restructuring. The intention is much rather to make the approach to debt restructuring more transparent and more predictable.

Looking at what has happened the last ten years, and bearing in mind the December decisions, one might wonder if this is sufficient to make the euro area more resilient. The December decisions are another important step towards a more robust monetary union. However, I think there are still a few more necessary and meaningful steps to make the euro area permanently crisis-proof.

The Summit mandated the Eurogroup to work in two areas where the discussions are still controversial: The completion of banking union with a common **European deposit insurance** and a **euro area budget**.

Most people in this room would probably agree on the importance of a European deposit insurance scheme for the banking union and the EMU. But it is important to recognise that before a European deposit insurance can be introduced, legacy problems must be tackled first. This includes a further reduction in NPLs and a reduction of the high proportion of domestic government bonds in bank balance sheets.

Alongside the European deposit insurance, a **capital markets union** would add to the euro area's resilience by diversifying funding sources and strengthening risk-sharing across the member states of the euro area. This works so well in the US and provides for quasi-automatic macroeconomic stabilisation.

Regarding the **euro area budget**, the Summit mandated "the Eurogroup to work on the design, the modalities of implementation and timing of a budgetary instrument for convergence and competitiveness".

This is a positive step as it will encourage structural reforms and strengthen competitiveness in the euro countries. It will also enhance the resilience of the monetary union as a whole. Details of this budgetary instrument are currently being worked out, the financial amount is undecided for the time being. It is clear that this instrument will be developed in the context of the EU multiannual financial framework.

Importantly, the budget could be designed to also counteract asymmetric shocks and help stabilising economies. However, currently there is no consensus among member states that macroeconomic stabilisation and fiscal risk-sharing are desirable.

All measures to deepen EMU, including the completion of banking union and capital markets union, would also support a stronger, international role of the euro.

The euro is today a strong second when it comes to the role of the reserve currency. Despite being a young currency, it has already weathered two crises. The euro is used in around 36% of international payments, just behind the dollar with almost 40%. This is above the weight of the euro area in international trade. Currently the euro area jointly contributes about 26% to global exports of goods. 60 countries across the world have linked their currencies to the euro, in one way or another.

But we operate in a new environment. We are confronted with new challenges. Strengthening the role of the euro and European financial markets matters as the geopolitical, technological, and financial landscape is changing. Europe’s economic weight in the world will continue to decline.

The goal is not 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. In my view, this would also improve the functioning of the international monetary system. The reforms that I described today, will make the euro area more robust and will also strengthen its international role.

Let me close here. I hope my speech has highlighted that we achieved a lot in the last few years. The euro area today is more robust than it was 10 years ago. But there are still some important steps to be taken, in order to make the currency area more crisis-proof.

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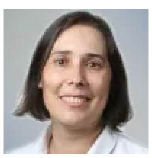

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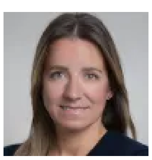

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