“Safeguarding the Euro – the European Stability Mechanism” - speech by Klaus Regling

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“Safeguarding the Euro – the European Stability Mechanism”
SAFE Policy Panel
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(Please check against delivery)

Welcome everyone,

Thank you for inviting me and thank you, Benoit, for taking the time today to exchange views on the ESM and the euro area.

As stated in the invitation of this event, the ESM was not part of the initial setup of the euro area or the EU. The Maastricht Treaty does not mention the ESM. There was no lender of last resort for sovereigns.

With hindsight, one might wonder why. But the reason is simple: it was not foreseen that a euro area country could lose access to market financing. In other words, it was unthinkable that a member state of the Economic and Monetary Union (EMU) would ever find itself on the brink of default. To be fair, nobody expected a crisis like we had eight to ten years ago – the worst economic crisis in Europe in 80 years.

The incoming ECB president Christine Lagarde played a key role in helping to set up the ESM’s predecessor, the European Financial Stability Facility (EFSF). She was there – as the French Finance Minister – that fateful weekend in May 2010.

This is one of the many stories that you can find in the ESM history book “*Safeguarding the euro in times of crisis – The inside story of the ESM”* which was published in June this year. You can find it on our website.

Many factors saved the euro during this past crisis. National governments of countries in financial distress carried out tough reforms and other euro area countries stood by them in solidarity. Macroeconomic surveillance was strengthened and broadened. The ECB, of course, played a crucial role with its unconventional policies. And so did the set-up of banking union, with a single supervisor (SSM) and the Single Resolution Mechanism (SRM). And as outgoing ECB President Mario Draghi acknowledged in our book: “The EFSF, and later the ESM, were crucial tools for dealing with the sovereign debt crisis in the euro area.” You can find this quote on page 19 of the ESM book.

Why do we need a backstop?

In a monetary union, a backstop is warranted as the cost of losing market access can be very high. The crisis has shown how interconnected euro area countries are. The resources of the International Monetary Fund (IMF) were clearly insufficient to help euro area countries that lost market access. A euro area institution had to be created to supplement IMF resources.

With the ESM, the euro area now has a lender of last resort for sovereigns. As I said, this function did not exist before the crisis, and it is an important addition. The ECB is “only” the lender of last resort for euro area banks because monetary financing of euro area sovereigns is prohibited for good reasons.

The ESM has established itself as a permanent institution with sufficient firepower and it has worked well. It disburses loans only against conditionality, i.e. extensive reforms, as this helps countries to overcome the problems that led to a loss in market access and to return to long-term financial stability. This is the well-established principle of IMF lending.

During the last eight years, both rescue funds disbursed €295 billion to five countries: Ireland, Greece, Spain, Cyprus, and Portugal. Countries benefit from budgetary savings due to our loans with very long maturities and very low interest rates. The Greek budget, for example, saved €13 billion in 2018, representing 7% of Greek GDP. Greece will enjoy these savings for many years to come, and this is an essential contribution to Greece's return to debt sustainability.

We know that several factors contributed to the euro area crisis. But our crisis response would have been easier and faster if – at the beginning of the crisis – we had already had a backstop like the ESM.

Today, the euro area is more robust and better equipped to deal with a future crisis than ten years ago. But as many policymakers noted in the ESM book – more needs to be done to further strengthen the euro area's financial architecture. And more is being done.

The current reform debate

The EU Heads of State and Government endorsed a package of reforms last December. This involves the completion of banking union, the further development of the ESM, and more work on a European deposit insurance and a fiscal capacity.

In June, the Eurogroup broadly agreed on the detailed proposals to enhance the ESM's role. This decision will imply the following steps for the ESM.

First, the ESM will provide the backstop to the Single Resolution Fund (SRF). The backstop will be "fiscally neutral". This means that there will be no burden on taxpayers. If the backstop is needed, repayments will come from the banking industry. By 2024 at the latest, the backstop should be fully operational with a volume of €55-60 billion.

Second, the ESM will play a stronger role in future economic adjustment programmes. Together with the European Commission, the ESM will design, negotiate and monitor future programmes. This means the prerogatives assigned to the Commission by the EU Treaty in economic policy coordination will be respected, but the ESM will be fully involved in future programmes.

Third, the ESM’s has reviewed its financial instruments. Following the review of our toolbox, the precautionary credit lines will be easier to use.

Fourth, the ESM could, upon request, facilitate the dialogue between a euro area country and private investors if a debt restructuring is needed. A new Collective Action Clause (CAC) will be introduced to euro area sovereign bonds. It will make life more difficult for hold-outs.

These new tasks are included in a revised draft of the ESM Treaty, which will come into force after being ratified by the national parliaments of all 19 ESM Member States.

This process will start when all key legal documents related to the ESM’s new tasks are politically agreed by all governments of the ESM Member States. This is expected to happen in December 2019. Afterwards, ratification will take around 12-18 months.

How much backstop does the EMU need?

It is evident that since 2010, Europe has accomplished a great deal in strengthening EMU. However, I think there are still a few more steps needed to make the euro area crisis-proof in the future.

In my view, we are still missing **three backstops**:

First, a **backstop to ensure depositor protection** in the euro area regardless of the location of the bank. With an identical level of depositor protection across the euro area and a weaker link between banks and sovereigns, financial fragmentation would decrease, and so would the risk of bank runs in a crisis. If we had had a European deposit insurance in the last ten years, all ESM programmes could have been substantially smaller.

These are good reasons to create a European deposit insurance. But for this to happen, euro countries need to agree on a mutually acceptable balance between risk-reduction and risk-sharing. This implies that legacy problems in some countries must be tackled – meaning a further reduction in non-performing loans and a re-balancing of banks’ exposure to their own government bonds in their balance sheets.

The creation of a common deposit insurance is controversial, in particular here in Germany. A proposal by Professor Krahnen and some of his colleagues earlier this week, about a reinsurance mechanism for national deposit insurances, could be a way forward.

The second would be a **backstop for liquidity in resolution**. The completion of banking union also requires addressing the remaining risks of a liquidity gap in and after resolution. Different proposals to address the possible liquidity shortfall are currently being discussed. Some of these include public liquidity support provided by the Single Resolution Board (SRB) or the ESM. This will be difficult for the ESM given the potential financial magnitude. Other proposals suggest a stronger role for the ECB as a provider of a special liquidity facility.

As for a euro area budget, it is reasonable to allocate budgetary resources to an improvement of convergence and competitiveness. This is what the Eurogroup discusses now.

But in my view, a third **backstop – for macroeconomic stabilisation –** is needed. I know this is a controversial topic. But in my view this is perhaps the final element missing in the architecture of our monetary union. This would be useful because countries that are members of a monetary union give up two key macroeconomic policy instruments: monetary policy and exchange rate policy. Moreover, monetary policy tends to be pro-cyclical for individual countries. Such a tool could be designed without creating additional transfers. We do not need an annual budget for macroeconomic stabilisation but a revolving fund. However, currently there is no agreement among Member States that macroeconomic stabilisation and more fiscal risk-sharing are desirable.

Conclusion

You may ask, given that the euro area today is stronger and more resilient than it was ten years ago, why we need three more backstops.

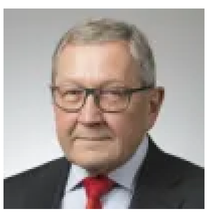
I would argue that to continue the process of deepening monetary union and to bring the reform agenda to an end, these additional backstops are indeed warranted. Not next year, but over time as the preconditions are put in place.

These backstops would make monetary union even stronger and more crisis resilient. And they would contribute to a stronger international role of the euro as international investors are waiting that these gaps are closed.

I will conclude here. I look forward to hearing Benoit’s views and to our discussion.

Thank you.

Author



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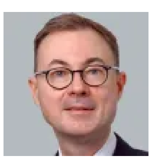

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