

**Speech at a Discussion and Luncheon jointly organized by
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“How Europe is overcoming the euro crisis”

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Introduction

- I would like to thank the American Council on Germany, the French-American Foundation and the Council for the United States and Italy for the invitation to speak to this distinguished audience and I would like to welcome everybody present.
- The three organisations provide an important platform for dialogue between Europeans and Americans. I find it particularly appropriate and enjoyable to speak at the invitation of three organisations linked to Germany, France and Italy.
- As the Managing Director of the European Stability Mechanism, the ESM, I am heading a European institution which has these three largest economies of the euro area as its most important shareholders. Together Germany, France and Italy represent about 65% of the currency union’s GDP.
- Allow me to organize my presentation to you in four parts:
- First I would like to discuss with you how the euro area got into the crisis that threatened its very existence in 2010.
- Second I would like to explain how the 17 Member States of the monetary union decided to respond to the crisis.

- Third I would like to demonstrate to you why – despite much scepticism in the US and elsewhere – we believe we have chosen the right approach. This is not only a belief. I will give you evidence that our strategy is working.
- My fourth and last point will be to look ahead and to end with a distinctly positive and optimistic note for the medium and long-term. I will draw the sketch of a monetary union that will come out of the crisis much stronger than it entered it.

How we got into the crisis

- In the US many people look at euro area as if they were looking at a country. The US like other countries has a currency - the dollar - that is backed by a central government with a federal budget, a central economic and fiscal policy and a central bank that influences the currency's external exchange rate.
- It is true that the euro area has certain elements of a sovereign state. The European Central Bank – the ECB – has very much the same possibilities as the Federal Reserve.
- But there are important differences. In the euro area Member States have irrevocably pooled their sovereignty in terms of monetary policy and melted their national currencies into a single currency – the euro. But they have retained their national sovereignty in economic and budgetary policy matters. Also there is no central budget of a size big enough to cushion economic shocks and cycles to which they may be subject.
- Instead the Member States have agreed on a rules-based approach: they committed themselves to respect certain rules – for example the commitment to maintain a balanced budget that could only go up to a deficit of 3% of GDP in an economic downturn and the commitment to maintain a debt level below 60%.

- However, many Member States did not take these rules very seriously. When Germany, France and Italy jointly decided in 2003 to break these rules, they lost much of their binding force. One of the causes of the crisis was the political failure of many euro area governments to live up to rules to which they had committed themselves. In a broader sense, euro area governments did not accept the constraints on their policy-making which membership in a monetary union requires.
- But there is another important cause. One key element in the original idea of monetary union was that the markets would discipline governments by sanctioning less solid budgetary policies with higher interest rates. It did not work out that way. It is mind-blowing today to remember that in fall 2009 Greece paid almost the same as Germany – just 30 basis points more on a 10-year government bond – despite the fact that many of its weaknesses were quite well known. Not adequately pricing in these weaknesses constitutes for me a spectacular example of market failure.
- When Greece had to unexpectedly revise up its deficit to around 15% in October 2009, the markets panicked and Greek interest rates spiked. At this moment the euro area discovered that there was a flaw in its institutional design. When monetary union was set up in the 1990s nobody could imagine a situation where a euro area country would be unable to finance itself via the market. But this is exactly what happened to Greece in 2010 and the Europeans had no response to that situation in the currency union's institutional toolbox.

How we responded to the crisis

- The response to this institutional gap is the institution I have the honour to lead. First there was the temporary euro rescue

fund – the EFSF. But the euro area governments quickly realized that a permanent fund was needed. A year ago today, on 8 October 2012, the 17 euro area finance ministers founded the ESM. Today this gap is permanently closed.

- The strategy we are following in Europe at the ESM has been used successfully over decades by the International Monetary Fund. Just like the IMF we temporarily grant loans at favourable interest rates to countries that have lost market access.
- But there are strings attached to these loans, strings that we call conditionality in our jargon. In a nutshell this means that the countries can benefit from these cheap loans only if they commit to consolidating their budgets and to reforming their economies.
- The European Commission, the ECB and the IMF form the so-called Troika which regularly visit the beneficiary countries to check whether the countries deliver what they have promised. Only if they do so will the ESM continue to disburse the next tranche of our loans. The objective is to help them bring their economy in such a sustainable shape that they regain investor confidence within a reasonable time.
- The IMF can look back at a series of success stories. In the last 30 years, countries as diverse as Mexico, South Korea, Turkey, Indonesia and Brazil have all undergone this therapy and it was very painful at the start. But the result show that it was worth the pain. All these countries have been star performers of the world economy in recent years.

The ESM's strategy is working

- EFSF and ESM are active in five euro area countries: in Ireland, Portugal, Greece and Cyprus with what we call a macroeconomic adjustment programme. And in Spain for a

financial sector assistance programme, in other words, a loan to the Spanish government which is used to recapitalize certain of the country's banks and to restructure the sector.

- The ESM has a very robust capital structure. Our 17 ESM Members – they are the same as the 17 euro area Member States - contribute a total subscribed capital of €700bn with €80bn in paid-in capital, the highest of any International Financial Institution in the world. Investors like this set-up. Today's successful inaugural bond of the ESM was an impressive demonstration of that trust.
- The ESM has a maximum lending capacity of €500bn, together with the EFSF we have a firewall of €700bn. Since early 2011, together the EFSF and ESM have disbursed €215.3 bn – twice as much as the IMF has in outstanding loans worldwide. As the ESM has committed €50bn to Spain and Cyprus, around €450bn remains unused. This corresponds to 90% of the ESM's lending capacity.
- Some people argue that the ESM would not be big enough to address a crisis in a big country such as Italy or Spain. I don't think we will have to deal with Italy or Spain. But I will nevertheless point out that the ESM's remaining lending capacity is bigger than the annual bond issuing needs of both countries.
- A crucial factor for turning around market sentiment certainly has been the action of the ECB. Particularly its announcement last year of potentially unlimited government bond purchases – in our jargon this is called OMT – has been important. It is an innovation as it links the ECB's potentially unlimited firepower to an ESM programme with strict and efficient conditionality.
- The crucial question is whether the time we buy with the EFSF and ESM loans is well used by the beneficiary countries for

reforms so that they can soon financially stand on their own feet again. If you look at the data, it looks encouraging.

- All programme countries are tackling the problems that are the root causes for their current crisis. The most pressing problem for most countries in such a crisis is the accumulated loss of competitiveness. The easy way out for a country with its own currency can be a devaluation. For euro area Member States this is not an option. The solution available for them is to decrease unit labour costs and to engineer what economists call an internal devaluation.
- Ireland, Portugal, Greece and Spain have all taken this thorny road and they have achieved considerable progress. As a result their competitiveness has improved, which in turn contributed to rising exports and a decrease of their current account deficits. These economic indicators have been pointing to an improvement for more than a year now.
- But recently there is also hard economic data which underpin our argument that the strategy is right and that conditionality is working: in most beneficiary countries exports are starting to grow again. Unemployment levels – unacceptably high in all programme countries – have stabilized and in some countries they are slowly starting to decline.
- A further result of these trends is that intra-euro area macroeconomic imbalances are decreasing. Also other countries are contributing to this trend. For example in Germany unit labour costs have been rising faster than in the past and more than any other euro area country, which is a healthy development.
- Simultaneously the beneficiary countries are successfully consolidating their budgets. Deficit levels are decreasing with

the goal to stabilize debt levels and to put them on a downward trend.

- These adjustments at national level are accompanied by better economic policy coordination at euro area level. I will spare you all technical terms and acronyms. But the basic idea is simple: the euro area's rules-based approach is reinforced so that governments do coordinate their economic and fiscal policies much more broadly and much more strictly. Also the common decision-making procedures in the currency union have been changed in such a way that non-compliance with the rules becomes much more difficult.
- We can point to tangible results among the beneficiary countries. Markets have rewarded the efforts. Ireland and Portugal were able to return to the market this spring with 10-year bonds at very acceptable rates, one important benchmark to test whether a country is regaining market access. As a result of our programme Spain was able to retain full market access.
- By the end of the year Spain's financial sector programme will end and I have no reason to believe that Spain will require further help. Also the Irish programme ends in December and we are currently discussing how to best make Ireland's return to the markets a success.
- Our achievement is to have kept monetary union intact. Without the rescue funds it is likely that countries like Ireland, Portugal or Greece would have had to leave the euro area.
- But important challenges remain. The crisis is not over although one can say that more than half of the way is behind us.
- One important challenge is to encourage the population to continue. The difficulty is that from their perspective wages and pensions are being cut and unemployment rises – they

don't see any progress. Economists know that after difficult reforms, growth and jobs always come back with a time lag. We are mindful of the difficulty this poses for governments to manage support for the programme and social cohesion.

- Another important challenge is creating a Banking Union for Europe. At the moment the financial markets are fragmented along national lines. Bank rates vary greatly across the euro area. In weaker states with doubts about the budgetary situation of the government, bank rates are high and credit is scarce. Obviously this puts a drag on growth.
- Europe has started to address this. The most important reform is the building up of a Single Supervisory Mechanism at the ECB that will supervise the 130 most important banks in Europe. Once the European supervisor is up and running, the ESM could be allowed to recapitalize banks directly. This would contribute to breaking the vicious circle between the sovereign and the banks I just described. Other important steps are currently being worked on, such as the establishment of a Single Resolution Mechanism for Europe.

Prospects for the euro area

- I argue that the euro area will come out of this crisis stronger, with sustainable economies, a better governance system, a stronger banking system and new institutional basis.
- The euro area will still not be a sovereign state as the US. However, economies in the periphery will perform better after all the reforms have been implemented; already today the budgetary situation in the euro area is better than in the US, the UK or Japan.

- The euro area's governance will function a lot better than it was before the crisis. The ESM provides a credible backstop. Also there is the possibility to act in tandem with the ECB. The euro area will have institutions that will lead to a highly integrated European banking and financial market.
- Overall, after the crisis the euro area will function better than before the crisis.
- Thank you very much for your attention!
- I am now looking forward to a discussion with you.