“What lessons have we learned from the euro crisis?”

Klaus Regling, Managing Director, ESM
Peterson Institute for International Economics (PIIE)
Washington DC, 15 April 2015
Achievements and missing pieces

Five lessons from the euro crisis

1. Reduce vulnerabilities, implement reforms
2. Strengthen governance of euro area
3. Create a stronger European banking system
4. An active monetary policy
5. Establish a crisis mechanism

Further steps to strengthen the resilience of EMU

1. Improve governance further
2. More risk sharing
3. Complete Banking Union
4. Envisage treaty changes
Achievements and missing pieces

1. Reduce vulnerabilities, implement reforms
Deficit reduction policies are paying off

Fiscal balance in programme countries (% of GDP)

Selected comparative fiscal balances (% of GDP)


* Actual figure for Ireland in 2010: -32.4%
Internal devaluations are restoring competitiveness

- Thanks to the convergence in competitiveness, unsustainable external imbalances in the periphery have corrected.

Nominal unit labour costs (2000=100)

Current account balance (% of GDP)

Source: EC European Economic Forecast – Winter 2015
Greece, Ireland, Portugal and Spain are in top 5 of 34 OECD countries with regard to implementation of structural reforms.

**Ranking in OECD report**

1. Greece
2. Ireland
3. Estonia
4. Portugal
5. Spain

“Euro area countries under financial assistance programmes are among the OECD countries whose responsiveness [to the OECD’s structural reform recommendations] was highest and also where it most increased compared with previous period.”

- *Going for Growth* (OECD Report)

Source: OECD report *Going for Growth* for 2015
Ranking takes into account responsiveness to OECD recommendations on structural reforms in key policy areas
EFSF/ESM programme countries are the reform champions (2)

- **Lisbon Council: Greece, Ireland, Spain and Portugal** ranked highest in overall measure of 4 key medium-term adjustment criteria:
  - Rise in exports
  - Reduction of fiscal deficit
  - Changes in unit labour costs
  - Progress in structural reforms

Source: “Adjustment Progress Indicator” in *2014 Euro Plus Monitor* published by the Lisbon Council
The ranking comprised 17 euro area countries + UK, Poland and Sweden
Greece has improved business regulations

- Greece has advanced from position 109 to 61 in the World Bank’s Doing Business ranking
- The ranking measures the ease of starting and operating a local business

Source: the World Bank
2. Strengthen governance of euro area
Improved economic policy coordination

- Euro governments adopted more comprehensive and binding rules for national economic policies
  - Stability and Growth Pact has stricter rules on deficit and debt
  - Less room for political interference by national governments
  - Balanced budget and debt rules now also in national legal systems
  - European Semester: yearly cycle of economic policy coordination
  - Annual country-specific recommendations
  - Stronger emphasis on avoiding macroeconomic imbalances
  - Eurostat authorised to verify national data
3. Create a stronger European banking system
A stronger banking system

- Three new European supervisory authorities: EBA, EIOPA and ESMA
- New ESRB monitors macro-prudential risks

Financial market reforms
- “Basel III” (CRDIV/CRR) is being progressively implemented
- Huge capital increase for banks – Core Tier 1 capital ratios are now 9% or more
- EU banks added €560 bn to their capital since 2008

Banking Union started in November 2014
- Single Supervisory Mechanism (SSM) operational since 4 November 2014
- Bank Recovery and Resolution Directive (BRRD) will create a uniform framework for bank recovery at national level with bail-in as a key instrument
- Single Resolution Mechanism (SRM) with Single Resolution Fund (SRF)
- ESM Direct Recapitalisation Instrument available
4. Monetary policy in crisis
Monetary policy in a crisis

- **SMP**: from 2010 to 2012, ECB purchased euro area sovereign bonds (over €200 billion) in secondary markets
- **LTRO** gave banks unlimited liquidity: in December 2011 and March 2012, around €1 trillion allotted in 3-year loans
- **OMT** announcement in September 2012 calmed the markets
- **New package** in June 2014
  - Targeted LTRO (at least €400 billion available lending capacity) designed to stimulate lending to small- and medium-sized companies
  - Negative deposit rate
- Programme for buying ABS and covered bonds announced in September 2014
- **Quantitative Easing** programme announced in January 2015
  - Asset purchases expanded to include euro area government bonds
  - Combined monthly purchases of €60 billion from March 2015 to September 2016
QE asset purchases by the ECB started in March 2015

The ECB’s balance sheet is to reach €3.4 trillion in Sept. 2016
5. Establish a crisis mechanism
EFSF and ESM: mission and scope of activity

**Mission:** to safeguard financial stability in Europe by providing financial assistance to euro area Member States

**Instruments**

- Loans
- Primary Market Purchases
- Secondary Market Purchases
- Precautionary Programme
- Bank recapitalisations through loans to governments
- Direct bank recapitalisation

All assistance is linked to appropriate conditionality

EFSF and ESM finance their activity by issuing bonds or other debt instruments
EFSF and ESM lending

- **Support for five countries (EFSF: Ireland, Portugal, Greece; ESM: Spain and Cyprus)**
  - Combined lending capacity: €700 bn
  - Committed amount to the five countries: €238.6 bn
  - Disbursed so far: €232.5 bn
  - EFSF/ESM disbursed three times as much in Europe as IMF in same period globally
  - Ireland, Spain and Portugal have exited their programmes
  - Macroeconomic adjustment programmes for Greece and Cyprus ongoing
Benefits of EFSF/ESM lending

1. All Member States have remained in the euro area
2. EFSF/ESM programmes promote fiscal adjustment and structural reforms
3. EFSF/ESM lending supports return to debt sustainability
4. The euro area has a lender-of-last-resort for sovereigns
**Loans are euro area solidarity**

**Potential savings of EFSF/ESM financing vs theoretical market cost (for 2013)**

<table>
<thead>
<tr>
<th></th>
<th>In € billion</th>
<th>As percentage of GDP</th>
<th>As percentage of total primary expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>0.24</td>
<td>1.5</td>
<td>3.4</td>
</tr>
<tr>
<td>Greece</td>
<td>8.58</td>
<td>4.7</td>
<td>8.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.68</td>
<td>0.4</td>
<td>1.1</td>
</tr>
<tr>
<td>Spain</td>
<td>2.43</td>
<td>0.2</td>
<td>0.6</td>
</tr>
<tr>
<td>Portugal</td>
<td>1.27</td>
<td>0.8</td>
<td>1.7</td>
</tr>
</tbody>
</table>

Calculated using theoretical market spread of 5- and 7-year bond of each country matching the EFSF/ESM maturity profile on the 3 months before and after each country requested support. This is compared with the equivalent EFSF/ESM funding cost.
Further steps to strengthen the resilience of EMU

1. Improve governance further
Why euro area governance needs to be strengthened?

- Rules-based approach has become too complicated
- Even specialists find it difficult to understand EU fiscal and budgetary framework
- Therefore: transition from rules to joint-decision making and common institutions
- Incomplete EMU holds back investment, growth and employment
How can governance be strengthened?

- Additional steps in euro area integration likely
- Proposals under discussion:
  - a euro area finance minister
  - a “fiscal capacity” for the euro area
  - joint decision-making for structural reforms
  - more democratic accountability and legitimacy
- Implementation legally and politically difficult and time-consuming
- But enhanced cooperation within the EU Treaty or intergovernmental agreements among 19 euro area members would allow for more integration
Further steps to strengthen the resilience of EMU

2. More risk sharing
Risk sharing options

- **Already substantial risk sharing:** EFSF, ESM, EIB, SRF, elements of monetary policy, TARGET

Additional ideas that do not require changes to the EU Treaty:

- "**Rainy day fund**" – a buffer or buffers accumulated during good times
- **Common system of minimum unemployment benefits** or system to finance when unemployment rises above "normal" levels
- **Targeted fiscal capacity** to reward structural reforms
- More risk-sharing **through financial markets**

These options can be implemented **without permanent transfers and debt mutualisation** among euro area Member States
Further steps to strengthen the resilience of EMU

3. Complete Banking Union
Complete Banking Union

- Develop capital markets union
- Single Resolution Fund (SRF) will be gradually mutualised and built up to reach target level of €55 bn by 2024
- Backstop for SRF to be developed
- Harmonisation and consolidation of Deposit Guarantee Schemes
- Promote private sector deleveraging in Europe
Private sector deleveraging

- Euro area needs to reduce private sector debt, in line with US and other advanced economies
- This applies mainly to corporate debt, as household debt is lower in euro area than in US

Total private sector debt (non-financial) as % of GDP in 2007 and 2014

Household debt/GDP (%) in major advanced economies (gross figures)

Source: BIS, IMF

Further steps to strengthen the resilience of EMU

4. Envisage treaty changes
Possibilities with EU treaty changes

- **Options for EU treaty change**
  - Incorporate intergovernmental agreements into treaty
  - Give the Commission the central political role in Europe
  - Separate out tasks such as Competition decisions
  - Separate euro area bank supervision from the ECB
GDP per capita growth comparison

GDP/capita growth since 1980 has been very similar in US and EU

Real GDP Per Capita Growth Rates

<table>
<thead>
<tr>
<th>Year</th>
<th>US</th>
<th>Euro Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>1.68</td>
<td>1.60</td>
</tr>
</tbody>
</table>

Source: Ameco and ESM calculations
Labour markets

- Since 2000, employment rate has increased in euro area but fallen by around 6 p.p. in the US

- Participation rate in euro area stabilised after rise until 2009; in US continues to decline

**Employment rate change since 2000 (%)**

**Participation rate change since 2000 (%)**

Age group: 15+ for euro area, 16+ for US
Latest observations: Q2 2014
Source: Eurostat and BLS

Age group: 15+ for euro area, 16+ for US
Latest observations: Q2 2014
Source: Eurostat, BLS and ESM
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