“Is the Euro Crisis Over?”

Bratislava, 20 October 2014 – Klaus Regling, Managing Director, ESM

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- As we all know from history, the **seeds** of the next crisis are often sown in the solution to the previous one, so it’s crucial that we not only end this crisis, we must also ensure the euro is really “fixed” and on a fundamentally more stable footing for the future.
- It’s true, we did have a very severe crisis. The crisis was so deep because Europe was hit by **two** shocks: On the one hand, this was the worst global financial crisis in over 80 years, triggered by developments in the U.S. On the other hand, the euro area had become vulnerable because some governments did not submit themselves to the economic policy coordination and the respect of agreed rules that membership in a currency union implies.
- Certainly, for many people, who have lost their jobs, or seen their standard of living reduced through austerity measures - the crisis is not over. For the financial markets, the crisis appeared to have passed. Of course, we have seen renewed volatility during the past 10 days – a point I will address in my concluding section.
- One positive outcome from the crisis was to trigger a rethink on the appropriate architecture of the single currency.
- When the euro was first created, the need to have a financial backstop for member states was simply not foreseen. The founding fathers of the euro could not imagine that a member of the euro area could lose market access. We also did not anticipate a challenge of this magnitude.
- The fact that we did not have a financial backstop became a critical matter at the height of the crisis, but now that institutional gap has been closed by the EFSF and the ESM.

- During the last three and a half years, we have disbursed loans amounting to €232 billion to five countries (three times more than the IMF globally during the same period). We have raised this money in the markets - unlike the IMF – and on very favourable terms.
- I would like to share with you four positive and important results of these EFSF/ESM activities that demonstrate our value to the euro area and its constituent member states.
- **<u>Firstly</u>**, the ESM and its temporary predecessor, the EFSF, ensured - by providing liquidity when market access was lost - that all euro area countries stayed in the euro. Remember, less than three years ago, this seemed a near impossible task. Many bankers, academics and journalists predicted with great conviction that a Greek exit from the euro area was unavoidable. Happily, they were proved wrong.
- Without the financial support from the EFSF and ESM, several countries would have left the euro area and Europe would be a very different place today.
- A **<u>second</u>** positive result is that our programme countries have become the reform champions of Europe. As you know, our lending comes with conditionality, which obliges borrowing countries to introduce agreed reform programmes. The benefit of these reforms is clear, although often very painful in the short run. In the medium and longer term, they create the foundation for much more sustainable growth.
- **<u>Conditionality works:</u>** we know that from many successful IMF programmes during the last 60 years, for example in Brazil, Indonesia and Turkey. These countries went through their respective crisis with painful adjustment and yet the implementation of IMF programmes laid the foundations for the excellent economic performance of these countries in recent years.
- The good news, is that according to the OECD and other research, our five programme countries, Ireland, Portugal, Spain, Greece and Cyprus are amongst the top reformers in the EU and in the OECD area. Therefore, they are best positioned for future growth if they continue their reforms.
- Yes, these reforms involved cutting public expenditure, raising taxes and important structural reforms like strengthening public administrations, reforming labour markets and removing

barriers to competition. The results are visible: unit labour costs and current account deficits have decreased, competitiveness is restored and deficits are cut. And this is leading to positive growth in Ireland, for example, and the start of a fall in the unemployment rates in Spain, Ireland and Greece. All this indicates the strategy is working in the programme countries.

- The **third** positive effect of our work is that EFSF and ESM lending significantly improves debt sustainability in the programme countries. The magnitude of the European solidarity offered through our institutions is not well understood, so let me point to the benefits for Greece, as the most striking example.
- Our loans, with an average maturity of 32 years, an interest rate of 1.5 % at the moment - equal to our funding cost - and a 10-year moratorium on the payment of interest produces annual budget savings of €8.6 billion per year, or the equivalent of 4.7% of Greek GDP - year after year. Consequently, there is no debt overhang in Greece, at least over the next decade, despite very high debt to GDP ratios. Because of this, debt is sustainable as long as the reforms continue.
- We have introduced a new system in Europe that goes far beyond the traditional IMF approach. Our approach not only provides emergency financing against conditionality, it also includes substantial solidarity. Budget savings in Ireland, Portugal, Cyprus and Spain are smaller than in Greece, nevertheless, they are still significant for these countries too.
- I would also like to dwell for a few moments on this newly developed concept of European **solidarity**. I know that in many of the less wealthy countries in the euro area there is sometimes a lack of understanding for being requested to support wealthier countries that have gotten into difficulties.
- I acknowledge that this must be difficult for people on low incomes to accept. In the long-run, I am very confident that solidarity becomes a “win-win” situation for everybody as a stable and sustainable currency union is in the interest of all our member states.
- Recently, one euro area Finance Minister said he considered his country’s contribution to the ESM as an “insurance policy” in case of future difficulties.

- In my view, Slovakia has shown tremendous solidarity with other euro area countries. I would like to assure you that this support, during difficult times, is much appreciated. And it is also important to understand that lending from EFSF and ESM has not led to any burden for taxpayers anywhere in the euro area.
- My **fourth** and final point is that EFSF and ESM lending takes some pressure off the ECB. In a country with its own currency, the central bank is the lender of last resort for banks and – in a crisis - also for the sovereign. In the euro area, the ECB cannot play that role as monetary financing of budgets is prohibited for good reasons. As we have demonstrated during the last three and a half years, the ESM can play this role of a lender of last resort to countries quite effectively, and that reduces pressure on the ECB to do more.
- Looking at these four positive results of EFSF/ESM activities, I believe we can be quite proud of what the youngest International Financial Institution has achieved during a relatively short period of time with a very small staff:
  - ✓ massive lending, at low interest rates, without cost for the taxpayer has kept the euro area intact
  - ✓ this has promoted reforms and debt sustainability
  - ✓ and made the life of the ECB easier
- Of course, it's not only the EFSF and ESM that contributed to bringing the euro crisis to an end. I see four other important elements:
- The first and most important element are reforms at the national level. Particularly in the five programme countries - Ireland, Portugal, Greece, Spain and Cyprus - there are impressive efforts to consolidate and structurally reform, as I already mentioned.
- The second element of the crisis strategy is the set of new rules that we have decided collectively in Europe as a result of the crisis: Six Pack, Two Pack, the European Semester, the excessive imbalance procedure new powers for the European Commission and enhanced monitoring possibilities for Eurostat – these are just some examples of what has been decided.

- It is important that all Member States respect the rules and coordination procedures they decided. And the Commission must use the new powers it was given as a result of the crisis. If Member States and the Commission make the right choices then I am convinced the euro area's weaknesses, which were among the root causes of the past crisis, will be eradicated.
- The third element is Banking Union. New supervisory agencies have been set up. The Single Supervisory Mechanism SSM will look after the systemic banks in the euro area. A Single Resolution Mechanism SRM and a Single Resolution Fund SRF are currently established. Extensive bail-in rules will significantly weaken the link between banks and sovereigns.
- If, despite the bail-in and national government intervention, European public money is needed, then the ESM may recapitalize a bank directly under certain circumstances.
- And the fourth element of the crisis response is, of course, monetary policy. Back in 2007, the ECB was the first central bank to adopt crisis measures. Since then, the ECB has initiated a series of separate measures that were absolutely critical in stabilizing the situation in the summer of 2012, when markets were about to panic and a disintegration of our monetary union was a real threat.
- In my view it is clear that all these elements taken together explain quite well why we are moving out of the crisis:
  - ✓ national reforms
  - ✓ better and broader economic policy coordination among Member States
  - ✓ Banking Union,
  - ✓ monetary policy and
  - ✓ the creation of the crisis resolution funds
- With hindsight, we developed a coherent strategy that gives the euro area a solid ground for the future.
- The crisis triggered readiness for more integration that would not have been acceptable to many Member States before. One example: Next weekend, the ECB will release the results of its stress

tests on 131 major banks in Europe and in early November will begin to directly regulate 120 of them. This is a major step forward in the creation of a common European playing field across the financial sector and a key step to preventing any renewed crisis for the euro.

- In addition, the ESM can also use its "traditional" tools in the context of the banking union: macro-economic adjustment programmes, where some of the money is used by the government to support banks, which was the case for most of our programme countries, or, as in Spain, it can finance a programme to restructure the entire banking sector.
- As I just mentioned: In future, the ESM stands ready – subject to final political ratification – to recapitalise banks directly as a last resort. This new instrument is yet another building block to mitigate any future crisis. The ESM direct bank recapitalization instrument can only be used once the extensive new bail-in rules have been applied. With these rules in place, the risk of having to use public money to bail-out banks should be significantly reduced.
- Very recently there has also been a debate about whether the ESM could be somehow used to stimulate investment and growth.
- I would like to emphasise that the ESM has contributed to growth all along. The ultimate goal of the economic policy conditionality that is always part of our lending programmes is to support economies in a crisis to become sustainable and competitive again.
- Many of our former programme countries, particularly Spain and Ireland, have impressed with growth figures above the euro area average. In Portugal and Greece, developments are also encouraging.
- On the other side larger euro area economies, especially France and Italy, are facing low growth, even stagnation. Also German growth figures have disappointed lately, creating uncertainties.
- The recovery has been both fragile and uneven. So, after four quarters of positive growth since early 2013 there was stagnation in the second quarter of 2014. And the overall growth figures from the ECB for the euro area also demonstrate the need for further measures: 0.9**%** in 2014 and 1.6% in 2015

- Currently, there is a lot of discussion about strategies to foster growth in Europe. I fully support this. But I would like to point to the fact that the European Commission and Council each year already adopt detailed and tailor-made recommendations for each Member State on ways to stimulate growth and create jobs.
- I am not exaggerating when I say that I see an implementation gap in many euro area countries with regard to these recommendations.
- Therefore, I would urge all countries, including Slovakia, to take a long hard look at these country specific recommendations that they all signed off at the summer European Council in June and implement them, they're supposed to be binding measures.
- The recommendations for Slovakia include the need for measures to reduce long-term unemployment rates, improve education and ensure the energy market works better.
- There are comparable measures for all other countries too. They are all achievable.
- The new Commission President, Jean-Claude Juncker, has announced a €300 billion investment package and I believe such a package can be important to complement reforms at the national level. He is currently working on the details but he made it clear that he did not want the level of public debt to rise as a result of his plan.
- It is clear that the European Investment Bank will have a key role in this investment plan and it is currently identifying projects that could benefit.
- You may have read in the press discussions about whether the ESM could contribute to such a package. While this could be possible in principle it would require a change of the ESM treaty. Such a change would have to be ratified by all 18 euro area Member States and there is no consensus on this. In any case, it is essential to maintain the "firepower" of the ESM for its real mandate, the stability of the euro area.
- To **conclude**, with an attempt to answer the question "Is the euro crisis over?"
- I would argue that we have made significant progress in putting the euro area on a sound and sustainable basis, more progress than I would have thought possible when the crisis started. Our

strategy of combining courageous national reforms, better economic policy coordination, Banking Union and the creation of a crisis resolution fund that provides loans against strict conditionality has created a robust framework for the euro area. I am sure we would have been able to avoid the worst of the crisis had these elements all been in place five years ago.

- I am also sure that the path we have chosen was in the best interest of all the euro area countries, not only the beneficiary countries of our programmes. I am well aware that the creation of the ESM was controversial in Slovakia. But I am convinced that the €659 million that Slovakia has contributed into the ESM's paid-in capital of €80.2 billion is well invested. It allows the ESM to be a credible firewall against all future crisis with a lending capacity of €500 billion of which €450 billion is still available.
- I would also like to stress that there is neither debt mutualisation nor fiscal transfer. We provide loans. We tap the markets to raise this money. In 2013, the EFSF and ESM were the fifth largest issuer in new issuances for euro.
- Are we fully out of the woods? Certainly not. I would say that first, we must concentrate on:
  - ✓ Reviving growth and creating jobs, which are the most urgent challenges
  - ✓ Undertaking crucial structural reforms to unlock investment and raise potential growth across the euro area
  - ✓ Ensure the new framework for economic policy coordination is credibly implemented
  - ✓ Continue to reduce financial market fragmentation
- But I am convinced that the policies chosen were in the best interest of all euro area countries, including Slovakia. Any alternative that would have included the risk of a disorderly exit of individual euro area Member States, or a disintegration of the currency union, would have proved much more costly than the path we chose.
- In the future, the euro area will function better than before the crisis.
- Thank you very much for your attention.