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Is Europe Prepared for the Next Crisis?
Prepared remarks delivered at the
Peterson Institute for International Economics
Washington, DC, October 11, 2017

(Please check against delivery)

Ladies and gentlemen,

Thank you for inviting me on stage here today. It is always a pleasure to be in the United States to talk about Europe. The Peterson Institute is an excellent platform to do so. Clearly, I am not the only person who believes that. You can also see it from the impressive line-up for the Rethinking Macroeconomic Policy conference, which is also organised by your institute, starting tomorrow.

The issue I would like to address is whether Europe is ready for the next crisis. I've seen several periods of financial turmoil in my career, and had to deal with some of them directly. For instance, the Latin American debt crisis in the '80s, the Tequila crisis in 1994-95, the Asian financial crisis in the 1990s, and, most recently, the global financial crisis and the euro debt crisis. The latter led to the establishment of the European Stability Mechanism, which I manage.

All of these events had different causes, and different effects. Only very few people saw them coming. That is just a feature of financial crises. They jump up out of seemingly nowhere, and spread rapidly. So it is not easy to answer the question whether you are ready for the next crisis. But certainly, Europe has worked very hard after the euro debt crisis to remedy the flaws that this period brought to light. And we are now in a much stronger position, both economically and institutionally. I will dedicate some time today to showing that.

Let me first say a word about politics. A year ago, Britain had just voted to leave the EU. The Dutch and the French elections were coming up, and it looked as if populist parties could soon be running these countries on a clear anti-European agenda. There were sceptics who predicted the end of the EU, just like the end of the euro has regularly been predicted over the past few years. But that sentiment has now completely reversed. Investors are seeing Europe as a safe haven for their money. They have told us so time and again on our roadshows across the world this year. Investors value the political stability in continental Europe. In the UK, uncertainty is much higher because of the Brexit. In the U.S., the Trump administration has raised question marks about where economic policy is heading, and the impact that will have on U.S. growth.

Of course, politics in Europe continues to change. Germany is heading for coalition talks that could be complex, even if I believe that Chancellor Merkel's pro-European policies will continue, whatever the outcome. There are also elections coming up in Austria and Italy. But elections are simply unavoidable when 28 independent sovereign countries decided to share part of their sovereignty, and to cooperate in the European Union. And when, on top of that, 19 sovereign countries decide to share a currency.

This puts a burden on policymakers to work hard to explain the benefits of cross-border cooperation. And here I have some good news. The popularity of the euro is at record highs. In May, 73% of the people in the monetary union said they were in favour of the single currency, the highest since 2004. In every country, a clear majority of the people support the euro. These numbers show that citizens have understood the benefits of cross-border cooperation. And that gives politicians the mandate to defend the monetary union and to continue to work make it more robust and resilient.

After that introduction, let me turn to the topic of the day: the question whether the euro area is ready for the next crisis. I will first look at Europe's strong points in three areas: the current economic situation, the fiscal position and the health of the banking industry. On each of these topics I will also identify some areas that can still be improved. Then at the end of my remarks, I will focus on ways to deepen EMU and to make it more resilient.

So let me start with the current economic situation. The euro area grew at a faster pace than the U.S. in five of the past eight quarters. Growth is also more synchronized, with each euro area country expanding. Even Greece is growing again, at a healthy 0.5% clip in both the first and the second quarter.

Drawing the comparison with the U.S. further, Europe's capacity to create wealth for its citizens is as great as in America. Per-capita growth is back in line again with that in the U.S. This was always the case in the decades before the crisis, but the relationship was disrupted during the crisis. The number shows that trend growth is equal when discounting for Europe's poor demographics.

Macroeconomic imbalances within the euro area, an important cause of the euro crisis, have decreased significantly. Most countries have regained competitiveness, as nominal unit labour costs converged to more sustainable levels. Former programme countries in particular have made good progress in this area, correcting years of excessive wage increases. The unsustainably high current account deficits from before the crisis have disappeared. To prevent such imbalances from building up again, the European Commission has now been vested with powers to monitor the situation, and take action if needed, through what is called the Macroeconomic Imbalances Procedure.

Let me say a word about Europe's social model, which has a strong safety net for those who need it. It is superior in dealing with the negative side-effects of globalisation. This is one reason why income equality is much better in Europe than in any other large economy of the world. This can for instance be measured by the GINI coefficient, which ranges from 0 to 100, with the lower bound expressing perfect equality. In the U.S., it stands at 41, and in France and Germany around 30. Income equality continued to deteriorate in the U.S – and China – during the last decade but remained broadly stable in Europe. It is true that rising inequality is a problem throughout Western societies, but Europe's starting position is far better. And this, in my view, should help to keep populism in check.

In labour markets, high unemployment remains a problem, particularly in countries such as Italy and Spain. It is a pressing issue for too many young people. What does not get enough attention to my mind however, is that the employment rate in Europe is higher today than in the year 2000, which means that a higher share of the population actually has a job than 16 years ago, despite the high unemployment rate. In America, the employment rate has dropped by more than 4 percentage points in that period.

Not everything is well, of course. Europe does need to address its low potential output growth rate. With our poor demographics, growth will mainly come from productivity gains. Structural reforms need to continue in all countries, not just in those who received an ESM assistance programme. Europe needs to further increase the participation rate of women into the labour force, and raise the mandatory and effective retirement age for everybody. Stronger investment would also help potential output growth.

In this context, countries should make every effort to integrate immigrants into the work force. Politically, this can be a thorny issue. Yet without immigration, the population of countries such as Germany and Austria would already be shrinking.

Another area where the euro area needs to do better is economic risk-sharing. Risk sharing is the sum of mechanisms through which a shock – positive or negative – to one country's economy is shared by others. This helps smooth business cycles and makes national economies more resilient, and thus the euro area as a whole. In the U.S., but also in countries such as Germany or France, economic risk-sharing is much higher than in the euro area. Risk sharing can take place both through fiscal means and through private markets and both channels need to be widened in the euro area.

One of the reasons for poor economic risk-sharing is the drop in financial integration during the crisis. During that period, the home bias of banks increased significantly. Shortly after the euro had been introduced, financial integration rose quickly, but it crashed during the crisis. While it has now recovered somewhat, it is still well below its peak. A likely explanation for that is that banks are still weighed down by non-performing loans, which are a legacy of the crisis. I will say a bit more about this in a minute.

Now let me turn to the fiscal situation of the monetary union. Public deficits jumped after the global financial crisis, as agreed by all G20 Member States in 2009. Between 2007 and 2010, the aggregate fiscal deficit of the euro area increased by 6 percentage points of GDP. During the last few years, public deficits have shrunk again, and converged to a narrow range. The euro area debt-to-GDP ratio stood at 91% last year, and is projected to drop from now. That number is much better than that of the UK, the U.S., or Japan. Importantly, this gives the region more fiscal policy space today than other large economies, should the next crisis hit.

What helps on the fiscal side, are the favourable financing conditions of the ESM loans, which reduce the high debt levels in programme countries. In the case of Greece, we have calculated that our low interest rates are causing €10 billion of budget savings each year, or 5.6% of GDP. Those are very substantial amounts.

Finally, let me look at the financial sector. European banks have strongly recovered after the crisis, just like they did elsewhere in the world. The system is much safer now. Capital has doubled, and profitability is returning, though it is still below the levels in the U.S.

Non-performing loans are coming down from a peak in 2013, and are well-provisioned. Still, they are clearly too high, particularly in some countries. This means the financial sector is not optimally efficient. Managing non-performing loans not only eats up capital that could otherwise be used for providing credit. It also means that valuable management time is needed to manage these portfolios. Time that could otherwise be spent on developing the business model and, for instance, on strategic acquisitions, also abroad. There is room for consolidation in the financial sector in many countries in Europe.

Ultimately therefore, NPLs are one of the reasons why euro area financial integration remains low. Low financial integration means less economic risk-sharing through private markets. And so, reducing non-performing loans is an urgent priority. Not just because of the banking sector. But also for the broader functioning of the economy. European ministers in July adopted an action plan to deal with non-performing loans, which I obviously welcome.

Ladies and gentlemen, I have summarized some strong points of the current economy, of the fiscal situation and of the financial sector. At the same time, I have mentioned some weaknesses that should be addressed, and in my expectation, will be addressed. In what follows, let me address this agenda of further euro area reform.

In 1951, France and Germany and four other countries first decided to give up part of their sovereignty to jointly govern their coal and steel markets. It was a daunting idea at the time, only a few years after the atrocious war those two countries fought. In 1957, Europe founded the world's largest single market, and in 1999, a number of countries adopted a single currency, the euro. From an economic point of view, these are sensible policies. Without them, the current economic situation wouldn't look as favourable as I just described. Europe is committed to multilateral cooperation, because it knows its benefits. The two have always gone hand-in-hand.

This explains why Europe fought so hard to protect the integrity of monetary union during the crisis, by setting up the ESM, for instance, and by setting up a Banking Union with a single bank supervisor and resolution authority. Those steps would have been unthinkable only a few years ago. Europe made important progress, because the crisis required it. Of course, other factors were at play as well. Countries did their homework by reining in public deficits, regaining competitiveness and modernizing their economies. And last but not least, the ECB's unorthodox policy measures played a crucial role as in calming markets, at a time that it was most needed.

Because of this comprehensive policy response, Europe is now in a much stronger position. Any remaining steps to finalize monetary union and to make the economy more resilient, are small. I am convinced that we will see these steps in the near future, because of our commitment to multilateral cooperation. The favourable pro-European results of this year's elections point in the same direction.

But that doesn't mean that we are quietly setting up a United States of Europe. There are no federal sentiments in Europe that would warrant a full political union. There is also no appetite for a full fiscal union, with larger transfers between countries. And full political and full fiscal union are not required for a good functioning of monetary union either, in my view. It is true that transfers are important to promote real convergence. But the existing EU budget already allows for significant transfers from rich to poor countries, which can amount to up to 4 percent of a receiving country's economy. The use of funds to promote real convergence could be more effective, but we do not need completely new instruments. In addition, programme countries that received EFSF or ESM loans benefit from our cheap financing. And this is equivalent to a transfer.

We also don't need a large additional budget to counter deep symmetric crises. Europe has shown that in truly exceptional cases, we can successfully fight a crisis through a simultaneous increase in fiscal deficits, such as during the global financial crisis of 2008/09. An exception clause in the Stability and Growth Pact allows breaching the 3% deficit maximum in case of a severe crisis. Finally, the euro does not need a new investment budget. It already exists for the EU, in the form of the so-called Juncker Plan and the EIB.

So much for what we don't need. Let me now mention certain further steps, which could be useful.

First, Banking Union needs to be completed. In the wake of the crisis, the euro area established the first two pillars of Banking Union: the Single Supervisory Mechanism and the Single Resolution Board. What is needed now is a financial backstop for the Single Resolution Fund, to make it more credible in the eyes of financial markets. This is a role that the ESM could take on.

And Banking Union is not complete without its third pillar, a European Deposit Insurance Scheme. Discussions on that continue, but legacy issues at banks in a number of countries need to be tackled before any form of cross-border risk sharing can take place.

Secondly, the euro area should harmonize bankruptcy, tax and corporate law, a project known as Capital Markets Union. This would ease the way for cross-border equity investments and open up new ways of funding for companies. It would also reduce heavy reliance on bank funding, one of the reasons that Europe's banking sector is so large in comparison to the size of the economy. Finishing the Banking Union and setting up the Capital Markets Union would be a big help in increasing risk-sharing in the monetary union.

There is also now a political debate about simplifying the European Union fiscal rules. Initially laid out in the Maastricht Treaty and the Stability and Growth Pact, the rules have been tightened since the crisis. But they have also become more complex by adding flexibilities. So I welcome the debate on making them more effective.

A limited euro area budget for stabilisation purposes is also under discussion. In my view, the monetary union needs a facility that deals with asymmetric economic shocks. Different ways to establish such a facility have been mentioned: rainy day funds or complementary unemployment insurance – like they exist in many U.S. states – could be an attractive option. This is because they do not lead to permanent transfers or debt mutualisation.

A number of institutional developments for the euro area is also under consideration. First, a permanent president of the Eurogroup could be useful, to better coordinate economic and financial policies and to represent the euro area in international bodies such as the G7 or the IMF. That person could become the euro area finance minister, once his or her competences have been clearly defined.

Secondly, the European Parliament could create a subgroup representing euro area countries. This would facilitate the accountability of all matters related to the euro area, which the Parliament now does not have a say in. However, national parliaments will continue to have a say over ESM lending, because the associated risk is assumed by national budgets.

Thirdly, there are thoughts about developing a European Monetary Fund. So far, the IMF has always contributed to the ESM rescue programmes in Europe, but a consensus is now growing that it will not play that same role again in a future crisis. The ESM could take over some of that role, as well as other tasks in the field of surveillance, as a backstop in Banking Union, and possibly in organising burden-sharing in a more transparent way.

Ladies and gentlemen, I have given an overview - not only of the strengths of the European economy, but also of the governance policies that underlie it. I believe these are an important factor to explain our enduring economic success: because they foster cross-border cooperation. Elections across the continent this year were a confirmation of Europe's long post-war tradition of multilateralism.

That means that the chances of success that the future reform agenda will be successful, are as good as never before. I believe you will hear more good news from Europe in the coming years.