Klaus Regling

Managing Director, European Stability Mechanism

In conversation with Klaus Regling

Didier Cahen

Didier Cahen introduced Klaus Regling, the Managing Director of the European Stability Mechanism and thanked him for being at Eurofi.

Klaus Regling

Klaus Regling stated that he would focus on three different items, which are all linked: the short-term outlook, some longer-term concerns in terms of the European or world economy, and the remaining agenda for Economic and Monetary Union (EMU) deepening.

In the short run, Europe is coming out of the biggest economic crisis of its lifetime. Given that it is such a serious crisis with so much economic, financial and social damage, Europe has done really well. The view from the markets in general on Europe today is better than anything he has seen in the last 10 years. The markets are impressed by the speed of the decision making in Europe in the last six months, the volume of action taken, and also the good, productive coordination between different European institutions, such as the Commission, the European Central Bank, the European Investment Bank (EIB), the ESM, the Eurogroup, as well as European institutions and national authorities.

In April and May, the Eurogroup decided on the first package at the European level, of €540 billion, put together with new facilities from the Commission, the EIB and the ESM. In July the European Council decided on the recovery fund of €750 billion. These are unprecedented amounts and it all happened very quickly. Markets are impressed by that. The European action comes on top of the decisions in different member states, which are in charge of their fiscal policy, so they do even more than what happens at the European level. When everything is added up at the national level support measures have been put in place that amount to more than 30% of euro-area GDP, which is unprecedented. Some countries are able to do more than others, but on average it is 30%.

This is a combination of automatic stabilisers that are working, amounting to, on average, 5% of GDP. In addition, there is another 5% of GDP in discretionary fiscal action. Additionally, there are liquidity measures, guarantees and tax deferrals that make up another 20% of GDP. Some of that will probably end up in higher deficits over time in the future, so deficits will be affected by that. Together, this is really quite striking. Without it, the economic damage this year would be much bigger.

For the euro area, the ECB recently came out with new forecasts. The ECB forecasts a decline this year of 8%, followed by 5% GDP growth next year and 3% in 2022. That would mean that in the second half of 2022 Europe would be back at 2019 levels. In the circumstances, that is probably not bad, but it requires all the action taken at the national and European level to get there.

Not every member state is able to take the same amount of action as others. All euro-area member states realise how important it is to protect the single market and to avoid excessive divergences in the monetary union. The facilities put in place at the European level were all deliberately designed such that they helped more those countries most affected by the crisis. That is a new approach and a new degree of solidarity, as well as a very positive result from what has happened this year.

However, not everything is well. In the medium-term there are four elements that could cause worry about growth in the longer term. First, potential growth will probably be lower after the crisis than before the crisis. That is a normal phenomenon after almost every crisis: potential growth is lower because physical and human capital is destroyed. There will probably be lots of bankruptcies this year and next year that are currently prevented by these guarantees and fiscal action. Capital will be destroyed, and unemployment will increase.

Consumer behaviour is changing. Savings rates are up in all member states by six percentage points on average. Different countries traditionally have different savings rates, but it is striking that all of them are up by six percentage points this year. That means less demand, which is understandable on an individual basis. People have more precautionary savings, given the uncertainty about the pandemic and employment prospects. For the economy as a whole, however, it is bad. That is one reason why governments have to step in. Investors will also be more reluctant, given the uncertainty. The same phenomenon took place after the global financial crisis, whereby investors were shocked and saw continued uncertainty, so they invested less than they had planned to do when talked to last year or in January this year. All of that is bad for longer-term growth.

Second, world trade is collapsing this year and has not done very well over the last five years anyway. Deglobalistion has been happening and it will continue. Supply chains are being shifted back to Europe, which may be positive for some countries that benefit from it in the long run, but less world trade means less competition, and economists know that less competition means less productivity gains. It is unavoidable. With smaller productivity gains, potential growth will be lower than before the crisis.

The third element is the European banking system. Christian Sewing was absolutely right to say that banks are stronger today than they were 10 years ago. They were not the cause of this crisis and, in fact, they are helping to overcome it. Compared to US and Asian banks, profitability is low. Provisioning will have to go up because non performing loans (NPLs) will go up with the collapse in GDP; this will not happen immediately but over time, when insolvencies are coming. This means that banks may not be able to provide the financing that is really needed to finance the upswing over the longer term, which is also not very positive.

Finally, fiscal deficits are very high. Public debt will go up probably by 30 percentage points, which is not good for future growth. There is enough economic research on that. It is unavoidable. These are the longer term worries and one should be under no illusion. It is all the more important that, against that background, Europe does everything possible to follow a reform agenda, to emphasise competitiveness and to bring up potential growth.

In that sense, it is very promising that the recovery fund agreed in July will be linked to reforms. It is not a kind of troika conditionality but, in cooperation between the Commission and member states, there will be agreement on the reform and resilience agenda. This is absolutely key, given the crisis, but in terms of these longer-term concerns this is the only way to bring up potential growth. The key point here is that all the money, which is more than has been available for a long time, is really implemented in a very productive way.

The final point is that Europe should not forget about all these problems and that it needs to implement the agenda for deepening monetary union. Europe has come a long way in the last 10 years, but the remaining agenda that Richard Gnodde and Christian Sewing already talked about is there. It is being discussed. The Eurogroup will discuss tomorrow the finalisation of ESM reform, which would bring in the backstop for the Single Resolution Fund (SRF), an important part of Banking Union. The other missing element is a deposit-insurance scheme, which is still controversial but under discussion. The backstop is important in terms of the question of whether Europe will bring this backstop forward from 2024 by at least two years, which it will try to do. Completing the banking union with the backstop and deposit insurance is one important item.

The other aspect is Capital Markets Union (CMU), which is high on the agenda. It is also a really important element to strengthen potential growth. Better allocation of capital could be a key element to bring up potential growth and finally move away from the 27 national financial markets to one unified European financial market. Another element that remains controversial is the fiscal capacity for macroeconomic stabilisation. This is one of the remaining elements to complete monetary union.

One element where Europe is making good progress is the euro safe asset. Following decisions taken in the last six months, the European debt issued by the Commission, the EIB and the ESM will go up from €800 billion currently to about €2 trillion. That is an important chunk of safe assets. Together with the sovereign debt of highly rated member states of the monetary union, the EU will have safe assets equivalent to 40% of euro area GDP, which is much better than the 20% it had in the past, but still far below the 90% found in the US.

David Wright

David Wright agrees that the progress has been remarkable. His article in the Eurofi magazine very much stresses that point. He asked Klaus Regling where he sees risks building up, whether he is worried about commercial property, and whether he thinks small tourist-related types of businesses, the collapsing of travel, and changing consumer patterns could lead Europe to a concerning macro situation.

Klaus Regling

Klaus Regling stated that certain sectors will be seriously hit and will not recover to their previous strength. The expectation is for GDP to be back to its 2019 level in the second half of 2022; that may well happen, but behind that is a strong distortion in that certain sectors will not be back to their old levels. Everything to do with tourism, travel, restaurants, hotels, hospitality, the culture industry and airlines will not return to their old levels in 2022. Other sectors such as IT will do well. There will be insolvencies in sectors and Europe will need to deal with that. They are unavoidable because there is a structural break and consumer behaviour is shifting in response to that.

With all the fiscal action, however, member states have found a good way to deal with that. It does not help every individual and every company, but the longer-term problems are more concerning, which are not discussed so frequently. They are beneath the immediate problems, but the concern is right that this leads to lower potential growth.

Didier Cahen

Didier Cahen noted that Klaus Regling rightly said that markets were impressed by the speed, volume and cooperation among EU institutions, and asked him to explain Europe's inability to move forward so rapidly on Banking Union and Capital Market issues.

Klaus Regling

Klaus Regling responded that Europe will make progress on Banking Union and CMU. In the area of CMU there are technically complex issues that need to be resolved and which cannot be resolved within a few months, such as harmonising certain parts of national insolvency parts. That is much more difficult than sitting together overnight with finance ministers and saying, 'We will now spend €300 billion.' That can be done quickly, but some of the complex technical issues of CMU require a lot of technical work. Some of it is not even politically very controversial but it is very complex, so it takes time. On Banking Union, the hope is that some progress will be made tomorrow in the Eurogroup on the backstop.

Didier Cahen

Didier Cahen noted that Klaus Regling said that member states would like to avoid economic divergence between member states, but with the crisis the economic divergences between member states are increasing significantly, given that they came to the crisis with different fiscal positions. He asked Klaus Regling how Europe avoids these increasing economic divergences, as can be seen notably in the fiscal position of member states.

Klaus Regling

Klaus Regling commented that divergences would have been much worse without the actions that had been taken. The decisions were right to focus on that. From the first decision in April, the euro area always said that it needs to design these programmes in a way that member states most affected by the crisis get more help. That needs to be implemented now, which requires good implementation in individual member states.

The same is true for the recovery fund. Countries will get a lot of money; Italy will get €206 billion over three years, and the Italian Prime Minister is fully aware of that. He spoke for 10 minutes at the Ambrosetti forum a week ago about the challenge for Italy in using that money, which has never been provided to Italy in such a volume by the EU, in a way that is productive and leads Italy out of this long period of low productivity gains. That needs to happen now. Up until now decisions have been taken that can make that possible, but implementation is key.

David Wright

David Wright stated that he had spent many years listening to Klaus Regling at the Economic and Financial Committee when he was its Director General, and he always admired his ability to be precise, clear, convincing and optimistic. He thanked Klaus Regling for his time. ■