Klaus Regling
Chief Executive Officer
European Financial Stability Facility

Europe's Response to the Sovereign Debt Crisis

Governor Nowotny, distinguished guests,

Thank you for the opportunity to participate in the 40th Economics Conference organised by the Oesterreichische Nationalbank.

In my presentation today, I would like to outline the main reasons for the sovereign debt crisis. I will then elaborate on the response by the euro area Member States and the European Institutions. Finally, I will conclude by indicating potential actions for Europe to go further in tackling the current crisis and creating a stronger euro area. Let me begin with the reasons for the current problems.

The financial crisis– and later the sovereign debt crisis – have exposed weaknesses in the conduct of economic policies and gaps in the design of EMU. Loss of competitiveness and large current account imbalances aggravated the European economies' vulnerability to the financial crisis.

I can identify eight main reasons for the crisis: firstly, Member States did not fully accept the political constraints of being in EMU. The Stability and Growth Pact was met with lax implementation by Member States. The Eurogroup, the cornerstone of coordinating economic and financial policies in EMU, was functioning on the basis of peer pressure. Member States were very cautious in acting against a fellow Member State driven by the fear that "you could be the next in the firing line". Another reason for not fully accepting the full implications of being in EMU was that Germany and France opposed recommendations by the European Commission on how to reduce their budget deficits. As Germany and France did not seem to be taking the budget requirements seriously, this meant that other Member States did not see why they should comply with the fiscal discipline required either.

Secondly, economic surveillance had been too narrow. The backbone of EMU was the Stability and Growth Pact but analysis, design and conduct of economic policy remained compartmentalised. Surveillance did not adequately take into account the interaction between fiscal issues and wider macro-economic imbalances i.e. asset price bubbles, competitiveness and external current account balances.

Thirdly, methodological problems with calculating structural fiscal balances made it difficult to have a clear view on the diverging economies. Spain and Ireland were in surplus for many years but their growing real estate bubbles, sparked by a transition to permanent lower interest rates, which was a fourth key reason for the growing imbalances, went undetected by the Stability and Growth Pact.

A fifth reason was the insufficient control of data by Eurostat, which did not have the right to go into national offices and investigate the figures – it could only use numbers that were provided by the national statistics offices.

Sixth, financial market supervision remained mainly national. Due to the

existence of this national supervisory architecture, there was no true data flow between authorities and countries within EMU. This explains why, for example, supervisory authorities were unable to detect a bank's overall risk exposure early enough.

Seventh, we experienced the biggest financial crisis in 80 years. As a result, debt levels across the euro area increased by more than 20 percentage points and reached nearly 90 % of GDP last year. This was unavoidable as public finances had a key role to play to support the economy and the financial sector. But it leaves the euro area more vulnerable than before the crisis.

And finally, eight, there was no crisis resolution mechanism. The rationale had always been that the Stability and Growth Pact would deliver the necessary fiscal discipline within the Monetary Union. Cross-border financing would happen automatically. Therefore a crisis resolution mechanism would not be required.

Member States have reacted to the crisis. European governments have done a great deal to address the problems that accumulated during the first decade of Economic and Monetary Union and which became so visible during the global crisis. They have identified the main weaknesses – at the national and the European level – and they are tackling them in a way that will profoundly change governance and economic policy-making in the euro area.

Let's first look at actions taken at the national level: Member States are making progress on fiscal consolidation and structural reforms. All Member States, not just those Member States in a macro-economic adjustment programme, have budgetary consolidation paths in place with a clear objective to reach a balanced budget during the next few years, agreed by the EU finance ministers based on an assessment by the European Commission. Furthermore, all Member States have presented national reform agendas in order to improve their competitiveness and their growth potential. Next month, the European Commission will issue policy recommendations for each Member State giving guidance for national policies in 2012/13 and outlining concrete measures to boost economic growth and job creation in the medium-term. Once these recommendations have been endorsed at the European Council in June and formally adopted by the Council of Ministers in July, they will help Member States to prepare their national economic policies and budgets for parliamentary approval in the second half of this year.

Member States whose currency is the euro have in addition committed themselves to a set of far-reaching additional policy reforms under the Euro Plus Pact, aiming to foster competitiveness, promote employment and contribute to the sustainability of public finances.

Of particular concern is the development in the euro area periphery. Ireland, which is receiving financial assistance, has implemented an ambitious reform programme and has proven to be a success story. Structural reforms to enhance competitiveness are significantly advanced, the Irish current account is back in surplus and yields of Irish debt have more than halved. Portugal is also on track. The Portuguese government published consolidated general government results for the first quarter of 2012, which showed that the fiscal situation outperformed the programme guidelines set out by the Troika. Spain and Italy have both started far-reaching austerity and reform programmes to reform labour

markets, pension systems and tackle tax evasion. Clear improvements are visible. Current account deficits are dropping significantly compared to the peak four years ago. Divergences in competitiveness are also in reversal. The gap in unit labour costs has been reduced significantly not only by decreasing unit labour costs in Greece, Ireland, Spain and Portugal but also by the increase in labour costs in Germany due to the positive cyclical position. Speaking about Greece, let me note that it should be considered a unique case among the beneficiary countries, as it has been experiencing a solvency problem, as opposed to a liquidity problem. That is why the second financial assistance programme for Greece was more complex than for Portugal or Ireland, with private sector involvement that included a voluntary bond exchange and reduction of Greek debt. The euro area Member States will continue to support Greece as long as Greece continues to implement the agreed conditionality.

Second, at European level, the key is the new Treaty on Stability, Coordination and Governance in EMU, today under ratification. The Treaty, also known as the fiscal compact, provides for further enhanced coordination in fiscal and economic policy. It sets out permanently binding budgetary rules including automatic sanctions, which Member States will enshrine in their national legislation. This will help to put government finances on a sustainable footing – an important step towards creating a stability union and resolving the sovereign debt crisis.

The Treaty strengthens the reinforced Stability and Growth Pact and enhances deeper fiscal coordination. Member States are required to make significant progress towards a balanced budgetary position. Expenditure benchmarks will now be used alongside the structural budget balance to assess adjustments in budgetary consolidation. Furthermore – for the first time – a controlled reduction of the debt ratio to 60% of GDP is required. Both the reduction of the deficit and the reduction of total debt are subject to a new, graduated sanctions procedure, in which resolutions proposed by the European Commission can be adopted even against a majority of euro countries.

This has been complemented by a new procedure for detecting and avoiding excessive macroeconomic imbalances. Where excessive imbalances exist, repeated failures to follow recommendations by the European Commission will result in sanctions. Although all Member States will be analysed, the procedure is clearly focused on Member States with weak competitiveness and large current account deficits. Again, Europe closes a structural gap. In the past, imbalances could become excessive as there was no designated procedure to address them.

Another major improvement is the introduction of the so-called "European Semester". This is the first half of every year during which the Member States' budgetary and structural policies are reviewed by the Commission and partner countries. It will enable consistent

policy guidance early enough, so that Member States can take this into account when they adopt their national budgets for the following year. For the first time, spillover effects to other Member States will be taken into account before national budgets are decided by parliaments. The European Commission has pushed for this approach for many years but it needed the crisis for Member States to give up their resistance.

In addition, a new Macroeconomic Imbalance Procedure is in place, which aims to prevent and correct macroeconomic imbalances within the EU. It relies on a scoreboard of indicators, which focus, inter alia, on indebtedness and competitiveness. The Macroeconomic Imbalance Procedure has a corrective arm, known as the Excessive Imbalance Procedure. In cases of serious macroeconomic imbalances, the Member

State concerned will have to submit a corrective action plan with a clear roadmap and deadlines for implementing corrective action. The Procedure will be rigorously enforced, with financial sanctions imposed on countries following repeated non-compliance with the recommended corrective action.

It is also significant to note that Eurostat has been given extensive audit powers over Member States' national finances. It will be able to investigate whether governments are accurately reporting data on their debt and deficits.

The financial crisis revealed major deficiencies in the model of financial supervision in the EU. In order to address the pressing need to have an institution that would identify macro-prudential risks, that is risks in the EU financial system as a whole, the European Systemic Risk Board was established. The crisis also exposed shortcomings in the areas of cooperation, coordination, and consistent application of EU law between national supervisors. This has been corrected by the establishment of three new European Supervisory Authorities, dealing with the banking, securities, and insurance/pension sector. One important task of the new authorities is developing a single EU rulebook applicable to all financial institutions in the internal market.

Ladies and Gentlemen, let me stress: Member States are putting national reforms in place and strengthening economic governance at the European level. This is the key to overcoming the sovereign debt crisis. The establishment of financial crisis mechanisms – the current EFSF and the future ESM – is only of a complementary character. They can buy time for euro area Member States to do their homework – but not more. Only financing would not help much.

But, as a complement, crisis resolution mechanisms and financial backstops are very important. Europe has often been criticised for not doing enough. On this front, I disagree. Europe has created strong firewalls. Europe provided EUR 53 billion to Greece in the first Greek package, it has committed EUR 97 billion to Ireland and Portugal, it has agreed the second support pack-

age to Greece worth EUR 144 billion. The ESM, once ratified, stands ready to provide EUR 500 billion in fresh money which comes in addition to the existing EUR 192 billion in EFSF commitments for Greece, Ireland and Portugal. Furthermore, euro area Member States will provide EUR 182 billion in bilateral loans to the IMF to increase the Fund's general resources. Also the ECB has intervened on the secondary market for EUR 212 billion. Overall, Europe has mobilised approximately EUR 1,200 billion, which is more than USD 1,500 billion. Out of this amount, nearly USD 1,000 billion is still available for disbursement.

The cornerstone of the financial backstop however remains the EFSF and ESM. The EFSF was set up in 2010 as a temporary rescue mechanism until June 2013. It has a lending capacity of EUR 440 billion. The ESM is expected to take over the tasks of the temporary EFSF in October 2012. As with the EFSF, ESM assistance will only be granted under strict policy conditions. The ESM will have a subscribed capital of EUR 700 billion of which EUR 80 billion will be paid-in capital over a period of two years and EUR 620 billion in callable capital payable by the Member States. The lending capacity will be EUR 500 billion.

The ESFS (and ESM, once it becomes operational) can provide financial assistance within macro-economic adjustment programmes but they have also the flexibility to provide financial assistance in other ways. One example is that of precautionary credit lines. The objective of precautionary credit lines is to support sound policies and prevent crisis situations by encouraging countries to secure access to EFSF and ESM assistance before they face difficulties in the markets. This is in line with established IMF practice.

The EFSF/ESM can also lend for the purpose of recapitalising banks in non-programme countries when the root of the problem is the financial sector. Before EFSF/ESM engages in recapitalisation of financial institutions, in the first instance, shareholders of distressed banks are requested to provide additional capital. Secondly national government are expected to intervene. And only failing that would the EFSF/ESM participate. The restructuring or resolution of a distressed financial institution is a sine qua non condition for EFSF/ESM assistance for recapitalisation and must always be compatible with EU state aid rules.

The other new instruments, which have not been used so far, concern interventions by the EFSF and the ESM in the primary and secondary debt markets. The main objective for primary market intervention is to allow a Member State to maintain or restore its relationship with the dealer and investment community. EFSF/ESM intervention could reduce the risk of a failed auction. Through secondary market interventions, EFSF/ESM would support the functioning of debt markets and appropriate price formation in government bonds in exceptional circumstances where limited liquidity of markets threatens financial stability.

I would also like to emphasise that all new instruments are linked to appropriate conditionality. This principle of EFSF/ESM lending is independent of the used instrument, i. e. loans, precautionary credit lines, bank recapitalisation or intervention in the primary or secondary debt market.

On a positive note, it is already evident that the euro area strategy is delivering results. All Member States have clear fiscal consolidation strategies in place, which, accompanied by the measures listed above, have started to pro-

duce tangible effects. One example which can be pointed out is that the euro area's aggregate fiscal balance has been clearly improving since 2010, and is significantly better than the fiscal balance of other developed economies, such as the USA, the UK and Japan. In addition, the current account balance of the euro area's peripheral economies has been steadily improving since 2008, and the same can be said of these countries competitiveness, measured by nominal unit labour costs.

Ladies and Gentlemen, as you can see an enormous amount has been achieved but there is still work to do. There is one important area, where further progress is required. This is the area of financial markets. Let me mention one key concern which needs to be addressed urgently.

We see a clear trend towards renationalisation of banks in Europe. With the crisis and the lack of trust, banks request a lot of liquidity from the ECB and park large amounts at the ECB every night. The interbank market does not work. Financial integration in Europe, which was one of the benefits of EMU, is being reversed. This leads to unusually low interest rates in countries like Germany and Austria whilst, at the same time, to very difficult financing conditions in Southern Europe. This is a significant extra burden for the private sector in these countries as financing costs for SMEs and corporates are several percentage points higher than in the north. This will have negative consequences for the real economy and widen economic divergences in EMU again.

We should therefore begin the process of moving closer to a "banking union". This will take time. But, a European deposit insurance scheme, a bank resolution authority and a more centralised supervision for cross-border banks are three key elements to make EMU more complete. Moving towards a banking union would underpin a well-functioning financial sector which is a prerequisite to providing the economy with appropriate financing at sustainable costs.

To conclude: Europe has done a lot in response to the crisis. Budget deficits are reduced; current accounts are moving into surplus; competitiveness is restored. Economic governance is now greatly strengthened. With the fiscal compact, a reformed SGP, a new Imbalances Procedure, the European Semester – this is the new way of doing things in Europe in terms of coordination of our economic policies. A crisis resolution mechanism is in place. More needs to be done to re-integrate financial markets. This all has one single aim: creating a better functioning euro area with financial stability and growth.