Journal of Financial Crises

Volume 5 | Issue 3

2023

Lessons Learned: Klaus Regling

Maryann Haggerty

Yale Program on Financial Stability Lessons Learned

Klaus Regling

By Maryann Haggerty

From 2001 to 2008, Klaus Regling was director general for economic and financial affairs of the European Commission. He is now the managing director of the European Stability Mechanism (ESM) and also ran its predecessor organization, the European Financial Stability Facility (EFSF). Regling, who is an economist, has worked for the International Monetary Fund (IMF) and with the German Ministry of Finance. This "Lessons Learned" is based on an interview with Regling in March 2021. The full transcript may be accessed [here](#).

Every crisis is unique, and the response must be tailored to the particular circumstances.

The euro crisis came soon after the Global Financial Crisis (GFC), but the causes were different, Regling pointed out. The GFC weakened European banks, he said, but the euro crisis did not stem from banking problems. He explained,

> The causes were macroeconomic imbalances in different countries, either on the fiscal side, or housing bubbles, or countries had lost competitiveness, with huge trade and current account deficits. But only some of the euro area countries, and others not. In the end, there were five that needed financial support from my institutions. So, it was a limited problem for some countries that were members of the [Economic and] Monetary Union, while the Global Financial Crisis hit everybody around the world. These are really two different types of crises. And therefore, one cannot really look back and say we learned this lesson from the Global Financial Crisis that then was helpful to respond to the euro crisis, except maybe that we all learned that the weaknesses needed to be strengthened, and banks needed more capital and better regulation.

The affected European countries lost access to financial markets. Regling's institutions had a "very simple" goal, he said: "to restore market access at reasonable interest rates." But problems varied among the five nations that received assistance, so the conditions attached to the bailouts varied, too. He said,

> No country in the Monetary Union is prepared to help another country in the Monetary Union permanently. So, the programs therefore have to look at the reasons why a country lost market access. And then the conditionality that comes with every loan, it's very much like an IMF loan. We copied the IMF simply. We did not try to reinvent the wheel; we copied IMF approaches with conditionality. For an IMF program, it's also the goal to reestablish market access, which means the problems that led to the loss of market access need to be tackled. The reasons differed, as I already mentioned briefly, housing bubbles, large fiscal deficits, large trade deficits, all countries had a loss in competitiveness, but to different degrees. And the

> conditionalities that were part of the loans were tailored in every country to address these problems.

Because they are unpredictable and unique, crises often reveal gaps in the financial stability framework that will need to be addressed.

The EFSF and ESM have issued bonds and lent the proceeds to member states facing financial difficulties. This is similar to the "lender of last resort" role the IMF plays elsewhere in the world. But the IMF alone was not equipped to provide the support European nations needed. Neither was any single European institution that existed at the time. The EFSF and ESM filled gaps in the institutional framework of the eurozone. Regling explained,

> The IMF resources are far too small when a country that is a member of the Monetary Union loses market access, because in the Monetary Union, countries are so interconnected in the real economy and also capital flows that when market access is lost, the amount of financing needed from a lender of last resort is very, very high. The IMF is just not equipped to do that.
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> The European Central Bank [ECB] could also not do it, because one of the important principles on which the Monetary Union is based is that the ECB cannot do what we call monetary financing of public budgets. So, it's prohibited by law for the ECB to step in. What the Federal Reserve can do in a crisis in the US or the Bank of England in the UK, the ECB cannot do. It can intervene in the secondary debt market, something the ECB does a lot these days, but they can never directly finance a sovereign. And that was a gap in the institutional architecture of the Monetary Union because nobody had imagined that a country after joining the Monetary Union—these are all advanced economies in a way, and joining is a difficult process. After going through that difficult process, that then the country could lose market access—that was not anticipated, was not foreseen. But it became clear that this actually did happen.

The EFSF was meant to be temporary, Regling said, "but then it became clear that several member states of the Monetary Union were facing problems, like Greece, and that's when it was decided to create a permanent institution, which is the ESM." He said,

> In Greece, we had massive debt restructuring in 2012, two years after the Greek problem became very, very, very visible. This is also something that had never been anticipated, that a member state of the euro area would have to restructure its public debt. So again, we had no experience, no good instruments. If it took very long before we got there, a lot of money could leave the country in the meanwhile, so the ESM programs had to become bigger and bigger to replace that. Now, if this were to happen again, we would use that experience and would be able to address the issues much faster.

Building defenses into the financial system to prevent problems from developing into full crises should be an important objective of financial stability.

In Europe, imbalances built up over time and ultimately caused the euro crisis. “These imbalances that were accumulating were not seen as very important,” Regling said. “It seemed like this could happen and wouldn’t have any negative consequences. But I think in the future, everybody will remember, at least for a while, what the consequences can be, when such developments happen again.” He said:

> And of course, the best lesson is to watch out and not let those kinds of macroeconomic imbalances develop at all. That, of course, is the best lesson. And I think that we have learned a lot. It may be forgotten 20 years from now, but at the moment everybody in the policy world—and that includes the European institutions like mine, but also the [European] Commission, the ECB—we all remember what happened and what went wrong, but also governments. And we will pay much closer attention to make sure that these massive imbalances are not repeated.

The COVID-19 pandemic caused yet another type of crisis that required policymaker response. It underscores the lesson that, in the wake of a crisis, defenses must be reinforced. Regling said,

> When I look at the policy world, fiscal policy, monetary policy, I think it’s important that in the crisis, fiscal and monetary policy must become very active. But then as soon as one gets out of the crisis, one should start re-creating buffers, fiscal buffers, monetary policy buffers, because there will be another crisis one day. We don’t know when, but that’s the nature of crises. So, it’s crucial to create those buffers, and I think, in Europe, but also in the US, we were not very good at doing that before COVID-19 hit.

Dated: November 2023

YPFS Lessons Learned No. 2021-04