The European economy: strengths and challenges

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Many thanks for inviting me here. When I last spoke at Brookings in 2013, many people expected the end of the euro. Today, judging by some headlines, there are again many who think that Europe is in a crisis. The “no” vote in the referendum in the Netherlands last week unfortunately only adds to that notion.

In the next 15 minutes, I hope to convince you that things aren’t all that bad. Of course there are challenges – and some of them are new. But Europe has learned how to deal with challenges over the years. Typically, it comes out of a crisis stronger than before.

That is no coincidence. The EU constitutes a workable model for political and economic cooperation between independent democracies – perhaps the best possible model. It may sometimes seem slow (and often it really is slow) but democracy requires time. Here in DC, you know that. And you have only one Congress – the euro zone has 19.

The EU model for political and economic cooperation is yielding results. The European economy has a number of strengths that people often aren’t aware of. Also, there is widespread support for the single currency among euro area citizens. This gives politicians the mandate to continue on the road to more cooperation, which is much needed to improve the resilience and productivity of the economy.

STRENGTHS OF THE EMU ECONOMY

First a few words on the state of the euro area economy. The euro area is now entering its fourth year of recovery. Growth is above potential. Per capita growth is moving at the same rate as in the U.S. again. This had always been the case in the previous 25 years, but the two diverged during the euro crisis. Now they are moving back in line.

At the same time, income is spread across society much more equally in the EMU than in the United States. A much larger share of the population has experienced real income gains during the last 15 years in Europe than in the U.S. The European labour market is another unexpected strong point. Our employment and participation rates are higher than in 2000, while in the U.S. they have dropped.

AN EFFECTIVE SYSTEM OF POLICY COORDINATION

Getting out of the euro crisis would have been more difficult without our system of policy coordination. Again and again, the 19 democracies of the euro zone have known how to deal with difficult times – despite the fact that there is no United States of Europe. The latest crisis, as so often in the past, has made Europe stronger. We've come up with a comprehensive reaction to the crisis and the EMU is in a better position to deal with new challenges than only a few years ago.

Let me list our main achievements. Most importantly, we were able to keep the euro together. At the height of the crisis between 2010 and 2012, several countries had lost access to financial markets and could no longer refinance themselves. This was a scenario that had been deemed unthinkable: that a country could lose access to markets once it had become a member of the monetary union.

ADVANTAGES OF THE ESM

That is why the EFSF was set up in 2010, later followed by the ESM. Without these institutions (which I manage), Greece - but probably also Portugal and Ireland – would have been forced to leave the euro.

The EFSF and ESM have a joint lending capacity of €700 billion, and have disbursed €254 billion to five countries. That is about three times as much lending as the IMF did globally during the same period. We fund ourselves in the market - at no cost to the European taxpayer - and we're one of the biggest issuers of euro-denominated bonds.

My institutions are the result of financial solidarity provided by euro area partners. By putting capital at risk, the euro area enabled other countries to get their house in order. Four of the five programme countries are now success stories. Greece remains work in progress, but it can also succeed it if sticks to the reforms it has promised.

My ESM colleagues are in Athens – along with staff from the European Commission, the ECB and the IMF – to talk with the Greek government about the reforms to be undertaken before the ESM can make its next disbursement to Athens.

There are other advantages to having the ESM. When receiving assistance, countries pledge comprehensive reform packages. As a result, they have reduced unsustainable fiscal deficits, they restored competitiveness, eliminated current account deficits and implemented structural reform. According to the OECD and the World Bank, structural reform implementation has been stronger in our programme countries than anywhere else.

Another advantage: by providing ESM financing very cheaply we help countries to return to debt sustainability. We have a high credit rating because of the guarantees from our strong member states. And so we have a low funding cost, of below 1%, which we pass on to the countries that borrow from us. Our lending is at least two thirds cheaper than that of the IMF. Needless to say, this leads to substantial budget savings for programme countries.

A final plus is that with the ESM we now have a lender of last resort for sovereigns in the monetary union. This was a role that was not foreseen when EMU was set up. That institutional gap has now been closed.

Crucial progress was also made in improving economic policy coordination. We have tightened the surveillance of fiscal policies with a stricter Stability and Growth Pact, with the Fiscal Compact and more powers for the European Commission. Importantly, there is a new procedure that aims to avoid excessive divergences and imbalances, the so-called Macroeconomic Imbalances Procedure.

BANKING UNION

Strengthening our banking system is another area where the EMU has made progress that would have been unthinkable a few years ago. Banking Union began in November 2014, with a single supervisor overseeing the 129 largest and systemically relevant banks, the so-called Single Supervisory Mechanism or SSM, which is housed at the ECB. Since the beginning of this year, we have the Single Resolution Mechanism and the Single Resolution Fund, which is building up its funds.

A BUNDESBANK PROBLEM SOLVED

The advent of the euro also solved the problem of how to create appropriate monetary conditions for the euro area as a whole. Until the beginning of the monetary union in 1999, the Bundesbank’s policies had a significant impact on other European countries, but by law could only take developments in Germany into account. From time to time, this posed problems. Many countries around the world are facing a similar problem with the Fed’s monetary policy. It affects their economies in a major way, but the Fed cannot take that into account, at least not directly. Now that we have the ECB, monetary policy – naturally – looks at the whole of the euro zone.

EUROPE: A GOOD STORY

Let me summarise. Europe has made good progress. The EMU has created essential new institutions, and its members have tied their fate together more closely. We should remind ourselves how far we’ve come, and how quickly. This will give us the confidence we need to tackle our next challenges.

Because there is no shortage of challenges: Brexit, the immigration crisis, terrorism, and rising populism. On Brexit, of course I hope that the UK will stay. A Brexit would weaken the EU politically, though it would hurt the UK even more, particularly economically. The UK would enter many years of uncertain negotiations with the EU and other countries.

A quick word on immigration and refugees. Economically, there will be a short-term boost from the hundreds of thousands of new entrants, as it adds to government spending, and therefore demand. In the longer term, it could help Europe’s ageing population – but only if migrants are integrated into the labour market successfully. Without that, the threat of social unrest is real. Lastly, a longer-lasting suspension of the Schengen accord – which allows free travel across borders within the EU – can only harm our economies, and would give the wrong political signal.

The recent wave of immigration has fed populist sentiments, and probably also added to the unfortunate outcome of the referendum in the Netherlands last week. This is worrying. But I would still warn against excessive pessimism. Surveys show persistent high support for the euro and the EU institutions among citizens.

The euro is supported by over two thirds of people in the euro area, according to the latest surveys. More than half of the people support the euro in each country, apart from Cyprus.

Those are very convincing numbers. They show that people know full well that the EU and the euro bring great benefits. This support gives politicians a strong mandate to continue with further integration steps in certain areas. A national approach cannot solve the big challenges of our time: terrorism, climate change, refugees.

WHERE EUROPE NEEDS TO IMPROVE

Let me conclude by pointing out the two main areas where the European economy is still lagging. First, Europe needs to address its low productivity gains. This is an area where we lag behind the United States. Continued structural reform of product and services markets, better education, and more investment are key.

Secondly, the euro area is still less resilient in the face of shocks than the United States. One main reason is that risk is smoothed across the 50 U.S. states through financial markets much more easily than it is across the euro area member states. This is where we need to catch up. This requires two important next steps: completing Banking Union and building a Capital Markets Union.

The completion of Banking Union requires establishing a European Deposit Insurance Scheme. This is a big step, and it may take a while. But I'm convinced that we will get there.

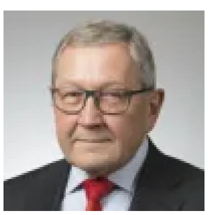
CAPITAL MARKETS UNION

Capital Markets Union is the second important step to enhance risk sharing. It’s an ambitious project that entails harmonising national corporate, tax, and bankruptcy law. The aim is to reduce hurdles in cross-border capital flows, and open new ways of funding for small and mid-sized enterprises, for instance through private equity funding. It will have the additional benefit of reducing companies’ dependence on bank financing. Again, this will make the economy more resilient and reduce the need for fiscal transfers.

On fiscal transfers, one should remember that we do already have these through the EU budget. The EU budget is small, but poorer EU countries receive 3% of their GDP in net transfers every year. More is not really needed to catch up with richer economies nor for the good functioning of EMU. But a limited fiscal capacity could be useful to address asymmetric shocks. This is one of the proposals in last year’s Five Presidents Report, which also mentions the possibility of a euro area Finance Minister. He or she could support policy coordination, external representation and visibility of EMU.

Let me conclude here. The European economy is stronger in many respects than is often recognised. It is backed by a functioning model of policy coordination between independent democracies. This system has responded comprehensively to the euro crisis. In doing so, Europe has made great strides towards closer integration. We should recognise this success more prominently – because the success in fighting the past crisis will help us tackle or indeed prevent the next.

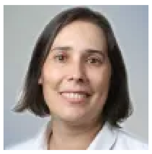
Author



Klaus Regling
Managing Director (2012 - 2022)

Contacts

Cédric Crelo
Head of Communications and Chief Spokesperson
+352 260 962 205
c.crelo@esm.europa.eu



Anabela Reis
Deputy Head of Communications and Deputy Chief Spokesperson
+352 260 962 551
a.reis@esm.europa.eu

Juliana Dahl
Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu