Rolf Strauch in interview with Luxembourg for Finance: Podcast “Shaping Finance”

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Rolf Strauch in interview with Luxembourg for Finance. Transcript of interview with ESM Chief Economist and Management Board member Rolf Strauch. Luxembourg for Finance in Luxembourg, Luxembourg. Recorded 19 March 2021, published 1 April 2021. Interviewer: Nicolas Mackel

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Transcript

Luxembourg for Finance:

Welcome to the podcast that shares the views of high-level leaders in the European and global financial services industry. Welcome to Shaping Finance, a podcast which offers a platform to high-level decision makers and shapers in international finance. My name is Nicolas Mackel, I'm the CEO of Luxembourg for Finance and the host of this podcast.

Today, I have the privilege of welcoming Rolf Strauch on our podcast. Rolf is the Chief Economist and a Management Board member at the European Stability Mechanism. He is in charge of economic and market analysis at the European Stability Mechanism and is responsible for the overall country monitoring work that the ESM as well as the European Financial Stability Facility undertake.

Prior to his current job, Rolf worked for 10 years at the European Central Bank and before that at the Bundesbank. And he was also a researcher at two prestigious German universities, the University of Mannheim and the University of Bonn. He holds a Ph.D. in economics and published numerous articles and other publications on interest rates, the sustainability of public finances and the design of fiscal rules for policymakers in the EU. Welcome, Rolf.

Rolf Strauch:

Hello, Nicolas. Nice to see you.

Europe is navigating through quite some difficult times with partial lockdowns being lifted, being reconfirmed, and preventing a true economic upturn. The European Stability Mechanism was created in the aftermath of the global financial crisis. What were the main challenges at the time that you encountered during the setting up of the ESM?

And how do they differ to the challenges brought by the current pandemic?

Well, the ESM is here to help the European people and we adapt to countries' needs in supporting financial stability. That is what we have done in the past crisis, and that is what we do in this crisis. Just a few days ago, actually, we celebrated 10 years of our bond programme being listed at the Luxembourg Stock Exchange. And when you look at the pictures, it's very hard to imagine how that programme started. These were the dark days of 2010 and 2011.

We were under tremendous pressure to ramp up the programme. Everything was stitched with a hot needle. And at the same time, there was absolutely no failure allowed; it would have been disastrous. Times were very different then, not only in terms of the set-up of the ESM, but also economically. Some countries had not adjusted to monetary union and had actually built up big imbalances and lost competitiveness. And that led to the fact that they lost market access at affordable rates.

So the ESM had to be created from scratch in order to fill an institutional gap because there was no lender of last resort. And our role was to provide financing for countries at the time when they needed to adjust in order to regain market access, and that is what we did. So over the past 10 years, we provided about €300 billion in loans to five countries, to Ireland, Portugal, Cyprus, Spain, to Greece. And those countries conducted adjustment programs in order to rebalance, in order to gain economic strength.

That was successful eventually, and actually it's that success that allowed us this time to have a different crisis response because we don't need the same adjustment. In this crisis, the pandemic crisis was actually sparked by an exogenous shock, as economists call it, so by an external force. And the main task is now to really address the consequences of the crisis. That is also why we have now adjusted our toolbox. We created the pandemic crisis support. It is a credit line that allows countries to draw in order to finance up to 2% percent of its GDP on health care expenditure. This credit line is available till the end of next year. It hasn't been used so far, but we will see whether countries will need it. And if they do, it is available and whether it's used or not, it already has helped to instil market confidence in

Europe and in the countries.

And in January this year, the members of the ESM signed an agreement amending the treaty which established the European Stability Mechanism. The agreement provides a legal basis for a set of new tasks assigned to the ESM. What are these new tasks and how can the reform support the European Monetary Union and the bloc's economic recovery?

A key component of the ESM reform is the common backstop to the Single Resolution Fund. The backstop helps to complete monetary union, to complete banking union, which in turn is a crucial element to make the European economy more resilient, and more dynamic, forward looking. We must acknowledge that the euro area economy is largely a bank-financed economy. And we need bank credit to finance the recovery, so the common backstop, when it is in place, will be a backbone for the banking sector.

This year we ratify the ESM Treaty. When it is done, then the backstop is available in order to provide a loan to the Single Resolution Fund. The Single Resolution Fund steps in when, in case of a bank resolution, additional money is needed. I think there are three features that are noteworthy here.

The first one is with the common backstop, the amount available in an emergency case or in a resolution case, is doubled. So it's really a strengthening, as I said, of the backbone.

The second element that is important is that the backstop is a measure of last resort. So the fund has to be depleted in order to call on the backstop, which we don't expect to happen often or actually only in exceptional circumstances.

And the third element that I think is important is the principle of fiscal neutrality. So when we provide a loan, it is repaid by bank contributions, it doesn't fall on the taxpayer. And that is very important.

This is not the only element in order to complete banking union. More steps are needed and particularly a common deposit insurance scheme that would help to fully establish a banking union. The euro area ministers of finance, the Eurogroup, are discussing this, and they will actually propose a work programme for the completion of banking union to the Heads of State in June. Now, this is one angle of the new ESM mandate, the backstop, but there is more to it.

I would like to mention two more elements. One is that the ministers of finance, when they devised, amended, negotiated and decided upon ESM reform, also revised our precautionary credit line and it now has a more preventive character.

The second element is that the ESM's forward-looking tasks in programmes will have a broader role. We, together with the European Commission, will derive policy conditionality - the measures needed in order for countries to stand on their feet again. So overall, I think those two elements will help us to be better prepared for any future crisis.

The European Union recently concluded the adoption of the Recovery and Resilience Facility, which is the €672.5 billion instrument that will mobilise the bulk of the recovery fund. What is, according to you, the impact of that measure on investors' confidence and financial markets?

In the crisis response, Europe has shown great resolve to act together. We are a lot in contact with investors and we can really say this has been a game-changer in the perception of Europe in the eyes of many investors. When you think back in 2020, so when the crisis hit us, national governments stepped in immediately with emergency measures for health and to cover the economic costs of the lockdown. But only a few weeks later, Europe, the Eurogroup, agreed on a first support package, European support package, of the size of €540 billion. And part of that package was the ESM, with a crisis support facility to support member states. It was the EIB to support firms and on top of that, the European

Commission in order to support workers. Next to that, the ECB greatly helped to calm financial markets and to allow banks to give credit to firms.

And then in July, the European decision-makers actually adopted the New Generation EU package of the size of overall €750 billion. And this package, as the first one, helps particularly those countries that are hit hardest by the pandemic. For example, if you look at Italy, thanks to the Next Generation EU, Italy will be a net recipient of EU funds and it will be, in absolute terms, the biggest beneficiary of it. So, this is an important element in order to create a single market.

But there are also three features that I would like to really emphasise that I think were particularly important in order to instil market confidence.

The first one is that Next Generation EU is oriented towards long-term growth. It should advance and promote investment, and at the same time, set incentives for structural reforms that help to promote growth over a longer period.

The second element is that it's based on grants and loans, and particularly the grant element is a new element of crisis support. It means transfers, direct support. That is a quantum leap in European integration.

And the third element is that the packages overall increase the amount of safe European debt. Before the crisis, the ESM, the EIB and the European Commission together had about €800 billion of safe European debt outstanding. With the packages that I mentioned, that amount can increase up to €2 trillion. And that is a very important factor for financial market integration. And I think it's the combination of these elements that indeed has led to a change in perception and actually to a lot of market confidence. Obviously, now, it's also important to follow up, make it work and actually keep the dynamic.

You mentioned before the fact that the European economy is to a large degree bank-financed. This, of course, leads me then to a question about the capital markets union

project, which offers a harmonised pan-EU capital market, where citizens are meant to be able to invest in markets of other member states like investing at home. What exactly will the CMU project bring about and how does it affect the way we finance our economies?

The recovery will require credit, but the pandemic crisis has depleted a lot of company capital and companies will need other sources of finance in order to refill this, and for new companies to be created. So that is why we need broader capital market sources. And on top of that, we will also need other funding sources for the green transition of the economies. And that is, I think, well understood in Luxembourg because the Luxembourg Stock Exchange is the world's biggest trading hub for green bonds.

The second point is then that with the low interest rates, we need to provide perspective to people in order to generate wealth and finance the days when they retire. And I feel this for myself. I feel it also when I talk to my kids who are at the start of their career. The answers that my parents gave to me don't count today anymore. And creating the possibilities for this wealth accumulation requires deeper capital markets, and it also requires to actually protect investors accordingly, so that they can invest safely and that the capital market is organised in a transparent way.

And finally, a deeper capital market, a larger capital market, will support the international role of the euro. And here we have to acknowledge that with Brexit, the position of European capital markets has changed. We have lost an access point of international finance as part of an integrated European structure and that makes us vulnerable. We are living in an international environment where it's important to be, in that regard, self-sustained and sovereign. So a bigger capital market, a strong international role of the euro, will help Europe, but it also will help the stability of the international financial system.

And in this capital markets union project, do you think that common supervision is going to be necessary and what would be its pillars?

Indeed, the success of the capital markets union will require various game-changers of institutional change. But a common supervision is a centrepiece. And here, first, you have to think of the access of international investors. Having common supervision, having harmonised standards is important for the transparency of the market and for the accessibility. You also have to think in financial innovation, we should be able to adjust to financial innovation and actually promote it.

And finally, it's important to account for the spillovers across the capital market. So it would make sense, a lot of sense, to supervise those institutions that have the large transnational footprint at the European level, but at the same time build on the expertise of national markets by national supervisors.

The United States has just adopted a new stimulus package of a whopping $1.9 trillion. How do the stimulus measures of the European Union and their respective governments compare to this?

The answer or the response of policymakers is ambitious and sizable, but the way it's designed is different. In the US, and particularly the Biden package, this largely comprises broad-based income support. And that obviously stimulates demand and eventually will even support the European economy via exports and help us grow.

In Europe, the support for households has been more targeted and channelled through social security systems, which are more important in the European context. That obviously is less visible then a political decision and a political package, but still a very sizeable support and also a very effective support. With the measures that were taken in Europe, the new financing was provided in particular to avoid the scarring of the economy. So big amounts of guarantees were made available in order for banks to lend to the firms and firms overcome the liquidity shortage that they face due to the lockdown.

On top of that, governments set up programmes in order to keep people on the job, to avoid the frictions of unemployment, so to avoid that scarring of the economy. And then on top of that, we have the European programme and we already talked about the Next

Generation EU. It is a multiannual programme. You will only see the effects kicking in next year. And as I explained before, it's meant to support growth in the long run by changing the supply, by improving the functioning of the economy.

So from that perspective, I think the measures taken on both sides of the Atlantic have been ambitious. But just going for a headline figure is not essentially very meaningful because the way the packages operate is different.

And the EU's fiscal rules are currently suspended in response to the Covid-19 pandemic. And many European economies have borrowed heavily in response to the public health crisis. How much debt can or should the EU member states sustain? And if we see a return of inflation, will the cost of debt reimbursements cause havoc in the markets?

The expansion of deficits was justified. But eventually, we also know that fiscal policies have to adjust. So, as you said rightly, the general escape clause was invoked last year and actually now the European Commission is proposing to keep it in place until next year.

And on top, the European Commission is committed to relaunch the review of the fiscal framework. And we have been supportive to a review of the fiscal rules in order to make them more effective and adjust them to the new economic reality. And here we have to acknowledge that this environment of low interest rates increases the debt-carrying capacity of member states, compared to 30 years ago when the Maastricht Treaty was signed. And then member states have actually kind of wired in, locked in, those low interest rates by extending the maturity of their debt. So in a context where monetary policy is supportive to financing, and the ECB has committed to that for some time, then actually debt servicing costs remain manageable.

Having said that, we also need to acknowledge that debt carries a very long shadow and we cannot only think over the next year, but must actually think a decade ahead or maybe even longer. And here it's also clear that risks arise. We cannot count on always having high growth. Inflation may rise and interest rates may rise, political confidence may deteriorate again.

We have to also see that the tax level in a number of European countries is already at a level that would make it difficult to increase it further in order to reduce debt. So from my perspective, actually, what I think is needed is that governments commit and derive a credible path of fiscal policy, where debt eventually will bend, the debt level will bend, and will stabilise and also eventually go down - in order to gain credibility and have the credibility in the market. And the fiscal rules at which we will be looking or that we are using, should facilitate that process and guide that process without suffocating growth in the next years to come. That, I think would be a viable framework in which we can operate.

Inflation will increase in the next years, that is almost by necessity, due to base effects. And as we have seen last year, also due to one-off effects when the German VAT reduction was revoked or ended, and then you see an increase in inflation. But at this stage, I am not very concerned that this will lead to an unbalancing of markets, but just a normal resurgence of inflation as it's actually to be expected in an economic recovery.

Before we conclude, let me ask you what now has become a traditional question, namely, if you have had in your free time the leisure to read any book that you would like to recommend to our audience?

What I'm currently reading is Bill Gates's book, “How to Avoid a Climate Disaster”. And I think it's a great book for basically two reasons. The first reason is that it tries to provide a very broad-based picture in a very structured way and generally accessible language, in order to make even non-experts understand what is otherwise a very complex topic. The second point why I like it is that it spells out the challenge. But at the same time, it shows up solutions how to address it and at least, move towards a zero emissions economy. And in that regard, it's kind of nicely actionable. And it's also optimistic. And I think as somebody working in a crisis resolution mechanism, you have to be an optimist.

Absolutely. And the interesting thing, and that is why I was smiling, is that our last guest, Michael Cole-Fontayn, already talked about this book, which I in the meantime, also have read and couldn't agree more with you. I think that the issue of climate change is definitely an issue that deserves two mentions in a row. I particularly loved the introductory paragraph of the book that spells out in just two numbers exactly what the challenges are - we have to get from 51 billion tonnes of greenhouse gas emissions that we add every year to the atmosphere to zero. And that is quite a challenge on an epic scale.

Thank you very much, Rolf, for sharing your insights with our audience. And thank you also to our listeners who have tuned in again to this podcast.

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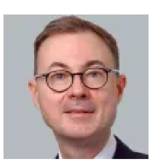

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