

Rolf Strauch in interview with Latvian news agency LETA

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Interview with Rolf Strauch, ESM Chief Economist

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Interviewer: Ing?na Uken?bele

LETA: How would you describe the situation in the European economy at the moment?

Rolf Strauch: It is now clear that the pandemic is coming to an end. At least this is the case in most of Europe, where the vaccination campaigns are well under way. This will make the situation more manageable. As a consequence, national economies are now in the process of gradually reopening, health-related restrictions are successively being lifted. Many economists think that the economy will bounce back strongly in the second half of the year and that this effect will be felt most

strongly in those countries where the restrictions were also the strictest.

The main challenge and task will be to ensure that this recovery is not just a short-lived effect of opening up, but is a lasting one that allows us to fully overcome the effects of the crisis.

Can we estimate yet what impact the Covid-19 crisis has had on the European economy?

We can see that last year's pandemic has reduced incomes. The euro area economy shrank by 6.6% last year. This year, the economy is expected to recover with a growth rate of 4.3%. During 2022, euro area economic output is expected to return to the level of 2019, i.e. before the pandemic.

If we do things right, we can not only reach 2019 levels, but also return to the previous growth trend. It is possible not only to overcome the effects of the crisis, but to exceed earlier trends. In my view, this does not mean restoring the old economy. With the pandemic, some elements of the economy have changed. For example, many people work from home and will want to continue to do so. More retail sales have turned to e-commerce and this has led to productivity gains; this effect should be maintained.

Therefore, we need to adapt the economy to post-pandemic needs and opportunities. The main challenges are certainly digitalisation, and making our economies much greener.

What are the biggest concerns that have not materialised?

The first thing to mention is that during this crisis we have benefitted greatly from the measures taken during and after the previous financial crisis. The key aspect is that the banking system was much stronger and this allowed banks to support the economy and to lend, thereby reducing the impact of the crisis. On top of this, there were support measures at European Union and national level.

The second aspect is that the downturn in the economy was not immediately reflected in a higher number of corporate bankruptcies. The level of bankruptcies did not change much and in some cases even decreased slightly. We do not know what will happen in the future, but so far the policies to protect companies have been very successful.

Third, it was evident that the impact of the crisis on the labour market was much more moderate than in previous crises. Governments were very proactive with measures to keep workers on the job and avoid a rise in unemployment. This has helped significantly so far.

The measures taken at the European level helped greatly, on top of national governments' support measures. These measures offered additional funding at favourable conditions from the European Union.

We do not know exactly what will happen next. I believe, for example, that the number of company bankruptcies will increase when the support measures come to an end. But so far, a lot has been done to mitigate the effects of the crisis. This in turn gives us a relatively strong starting position for the recovery. Coordination of decisions at the European level has been crucial and has helped us.

You have already mentioned that the regulation of the financial system was a very serious focus after the last financial crisis. What should we try to "fix" after this crisis? What weaknesses did it show?

As far as the financial system is concerned, we benefitted greatly from the steps that were taken earlier – during and after the financial crisis – to make it safer and to create a European banking union. This process is still ongoing and should continue.

A major step that is being taken right now is the ratification of the amended ESM Treaty. The ESM will provide a common financial backstop for the Single Resolution Fund. This is a very important pillar that will strengthen the existing structure of Banking Union and make it safer. But we will need further steps as well. One of them is the introduction of a single deposit insurance scheme. An equally important step is the creation of a more integrated banking market in Europe. This means that many of the differences and barriers that still exist within the banking market in Europe will have to be abolished. Banks will then be more profitable and better able to serve the needs of the economy.

It should be stressed that the European economy is largely financed by banks. But bank loans are not enough. We need more capital financing for a faster recovery, and in particular small- and medium-sized enterprises should have better access to equity finance. We also need more start-ups to create a more productive company sector. Start-ups often have difficulties in receiving bank finance. The initiative to create a unified capital markets union is very important here.

To what extent do you think politicians and decision-makers are ready to move forward on these issues, because progress was quite slow before the pandemic and the pandemic generally shifted the focus to other issues?

Politicians have shown a willingness to offer support during the crisis and I think this trend will continue in several respects. All decision-makers have agreed that aid should be withdrawn carefully and gradually. This also applies to fiscal and monetary policy. On the fiscal side, the European Commission wants to extend the so-called general escape clause for government deficits until 2022, which gives governments room to manoeuvre. In addition, there is the NextGenerationEU fund, which is a tool to promote an equitable recovery and not leave countries behind. Furthermore, there are plans to complete Banking Union and to enhance Capital Market Union. Politicians and decision-makers have shown their willingness to take all these initiatives forward.

This does not mean that all the steps, all the phases, will be easy to pursue and implement; there will be challenges and delays. But the initiatives are there and there is a willingness to take them forward.

At the same time, in Latvia, for example, the Prime Minister has already raised the issue of ending the support measures that have been put in place so far. Is this the right time to think about it, or is it too early?

This is not an issue that is unique to Latvia. I think that all decision-makers agree that aid should continue for as long as it is needed and that we should be careful about ending it so as not to create a so-called cliff effect in the economy and hamper growth. But of course, a transition has to happen and aid measures will have to be phased out or redesigned.

One of the consequences of the crisis is the increase in the level of public debt. On average in the euro area, the debt level has risen by 14 percentage points in 2020, to around 100%. For Latvia this is probably not the most important issue, as Latvia's debt level is forecast to reach 47% of GDP this year, which is still relatively low. However, other countries have much higher debt levels and will have to think about how to ensure a smooth exit from support programmes on the one hand and at the same time implement fiscal policies that provide fiscal buffers against future crises, as well as ensuring their credibility in financial markets.

Another important element relates to companies, which I mentioned earlier. Businesses have received support to be able to survive this crisis. Now the aid must be modified to support not the survival of all companies, but those companies that are productive and better able to contribute to the growth of the economy as a whole. We would like to avoid having many so-called 'zombie firms', that are not viable and therefore hamper growth. Developing policies which support the right companies and sectors will be a new challenge for governments.

Alongside this, we need to think about employment measures. During the crisis, it was important to preserve jobs and prevent unemployment from rising. Now aid needs to be redesigned to incentivise people to find new and hopefully better jobs.

These are the main policy challenges that will have to be faced. Overall, the key issue is to promote recovery while ensuring that no one is left behind – not countries, not regions, not social groups. I think the European economy is relatively ready for this and we have a very powerful instrument at our disposal – NextGenerationEU – which will help lower income countries and countries that have been hardest hit by the crisis. Moreover, the money needs to be concentrated in productive investments. Countries have also drawn up recovery plans, including structural reforms that should also help growth. So we have all the tools we need to contribute to a sustainable recovery.

Has the crisis affected all regions of Europe in the same way, and how are the Baltic States and Latvia included?

All countries have been affected by the pandemic. While we are talking about the economy, we must not forget the impact it has had on health and the suffering it has caused. This cannot be measured and must not be forgotten.

However, if we look only at the economy, the consequences in the Baltic States are smaller than in many other countries in Europe. Latvia's economy shrank by 3.6% last year, while the euro area as a whole shrank by 6.6%. The fiscal situation is also relatively strong in the Baltics as a whole, and in Latvia as well, which allows us to look more confidently to the future. There are plenty of opportunities to ensure aggregate income growth.

In my view, therefore, the Baltic countries are coming out of this crisis in a relatively strong position.

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