

Deeper integration, greater strength. The post-pandemic recovery in the euro area

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“Deeper integration, greater strength. The post-pandemic recovery in the euro area”

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By Klaus Regling, Managing Director, European Stability Mechanism

Further integration will be necessary to strengthen cohesion in the euro area and to make it more resilient.

As vaccination campaigns are being rolled out across Europe and business is picking up again after months of lockdowns, policymakers can focus on how to adapt support for the economic recovery, even though uncertainty continues with the emergence of new variants. To sustain the growth momentum, much will depend on a smooth transition from short-term emergency support measures to long-term support, in particular via the Recovery and Resilience Facility (RRF) under the Next Generation EU programme (NGEU).

The ESM as part of a comprehensive EU response

During the pandemic, swift and extensive government support measures were immediately complemented by a European fiscal safety net of €540 billion. As part of this effort, the ESM continues to offer all euro area countries a precautionary

credit line of up to two percent of their GDP until the end of 2022 to cover direct and indirect healthcare costs related to the pandemic. This ESM support for countries complements measures for companies provided by the European Investment Bank (EIB) and aid for workers by the European Commission. At the same time, the European Central Bank's (ECB) debt-purchasing programme (PEPP) continues to stabilise markets since the early days of this pandemic.

All these measures were aimed at closing the economic and financial gap caused by this crisis through temporary, targeted measures. Combined, initiatives taken by all 27 national governments (including discretionary fiscal actions, automatic stabilisers, government-backed guarantees) and European institutions (ECB, European Commission, EIB and ESM) totalled around €5 trillion in 2020.

Fostering sustainable growth

The €750 billion NGEU programme was launched in a second phase to move beyond the emergency measures and to make the EU greener and more digital in the long-term. Under the NGEU, the RRF is designed to make the economic recovery as lasting and as sustainable as possible to improve the resilience of the economy to future shocks.

Concretely, the RRF targets mostly the supply-side of the economy and aims to improve long-term growth with a combination of investments and reforms. Country-specific recommendations provide guidance for national reforms. The principal aim is to reduce carbon emissions sustainably and to boost digitalisation, while training workers would complement product and labour market reforms to increase competitiveness.

Overall, the EU has deployed a broad range of measures to encourage sustainable growth. These measures were designed to benefit, in particular, the countries most affected by the pandemic. This not only represented an unprecedented degree of solidarity in Europe, it also protects the single market and will prevent greater divergences in the euro area, which is in the interest of all.

The euro area recovery is on the right track and the comprehensive EU and national economic policy responses to the pandemic remain adequate, as national governments have extended their fiscal measures and have pledged to keep them in place if the economy does not recover as swiftly as expected.

With the right fiscal and monetary strategy, euro area countries should be able to prevent permanent economic damage and catch-up with their pre-pandemic growth trend already in 2022. Well-implemented recovery plans have the potential to boost economic growth even beyond pre-pandemic trends. With the right implementation, the recovery plans will not only mitigate the asymmetric consequences of the pandemic in the euro area but could also yield positive supply-side effects in the medium-term. To maximise these benefits, many countries need to improve their absorption capacity for funding significantly, which will be challenging.

In the coming months, policy-makers will also need to decide on the right timing and pace for withdrawing support. Support measures should not be lifted prematurely at the risk of hurting the ongoing recovery, but at the same time an excessive debt build-up must be avoided: it is a delicate balance of risks that needs to be found for each member state.

In particular, measures to facilitate financing of companies should not be withdrawn abruptly. Instead, they should become more targeted and complemented with private sector initiatives to direct capital towards sectors and companies with the highest growth potential, to enable the necessary restructuring of the economy.

Deeper European integration needed

The pandemic has shown once again that EU countries are stronger when they act together and that further integration will be necessary to strengthen cohesion in the euro area and to make it more resilient.

One additional step with which European integration will be deepened further next year is the broadening of the ESM's mandate. Once the amended ESM Treaty is ratified, the ESM will act as a common backstop to the Single Resolution Fund. This is an important move towards the completion of banking union, adding firepower and credibility to the bank resolution regime in Europe.

In addition, the reform gives the ESM a stronger role in future economic adjustment programmes and reinforces crisis prevention in the euro area. In collaboration with the European Commission, the ESM will design, negotiate and monitor future assistance programmes.

While these are very welcome developments, more steps are needed to make the euro area more robust and less vulnerable to future shocks: Banking union should be

completed, which requires better cross border integration, a comprehensive crisis management framework, a common deposit insurance and an agreement on the regulatory treatment of sovereign exposures; capital markets union (CMU) should see real progress in order to diversify sources of financing for the economy, increase cross-border capital flows and reduce market fragmentation; the fiscal surveillance framework needs to be reformed to become more credible. And this should be complemented by a macro-economic stabilisation facility to equip the euro area with extra fiscal space when countries are facing temporary strain.

European and international institutions, as well as many economists, support these measures but they remain politically sensitive. They would not only make the euro area more resilient in a future crisis but also promote the international role of the euro.

In sum, Europe responded well to the economic consequences of Covid 19. The NGEU programme will certainly boost the economic recovery in Europe, potentially even leading to a higher growth path than before the pandemic. Measures taken during the last 1 ½ years have made Europe more credible for market participants around the world. When the health crisis is over and the recovery fully established, debt sustainability concerns need to be taken into consideration once again. At the same time, we should also continue to strive for deeper economic ties among member states, particularly in the euro area, in order to reap the full benefits of our single market and the single currency, thus reinforcing our credibility on the world stage.

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