How to move towards a more resilient and sustainable European economy? - speech by Klaus Regling

View PDF
09/05/2022
Speeches
ESM
Lisbon, Portugal

Klaus Regling, ESM Managing Director
“How to move towards a more resilient and sustainable European economy?”
Jornal de Negocios/Catolica University
Lisbon, 9 May 2022

(Please check against delivery)

Good afternoon,

I am very pleased to be here on Europe Day! It is always a perfect occasion to celebrate what Europe has achieved. But more importantly, also to look at the lessons we have learned and to look into the future: what is ahead of us and what Europe should do next.

I am looking at the many young attendees in the audience today. You will make the future of Europe happen whatever awaits us. It is you who will help shape this future.

In the early 1950s, the French Foreign Minister Robert Schuman launched the idea for the European Coal and Steel Community. It was the first step towards what would become the European Union. A union that we all benefit from, every day.

It was an idea of great vision: creating a European institution to control and manage coal and steel production, resources needed for war, would reduce the chances of conflict between Europe’s nations. It has shaped the history of Europe, our role in the world and allowed for a prolonged period of peace in the region.

In a speech in Washington, Jean Monnet put it very simply: we are not forming a coalition of states, we are uniting people. This “community” is turning 70 this year, has grown true to its founding fathers’ wishes, expanding and deepening, even creating a common currency for Europe.

Of course, it has not been a journey without obstacles. As Jean Monnet also predicted, Europe has been mostly forged in crises. We have indeed faced our share of crises in the last years. And with every crisis, we have learned. We made our institutions stronger and more efficient, created new institutions and new tools and always found ways to overcome our difficulties, together rather than apart.

Monetary integration and the euro have been part of my professional journey for four decades. And I believe that the euro is an essential element of European integration and of Europe’s future because its role is crucial for strengthening European sovereignty.

Only a few years ago though, some economists and market analysts were predicting the collapse of the euro. This was a consequence of two crises that hit Europe. First, we had to deal with the US subprime crisis, which entailed a credit crunch and caused great upheaval among banks, including in Europe. Some banks had to be bailed out by governments at great cost.

Soon afterwards, the euro area went through the home-grown euro crisis, a sovereign debt and competitiveness crisis, which brought several euro area member states to the brink of bankruptcy.

But our monetary union prevailed. We recognised the weaknesses in some member states and in the architecture of the monetary union, gradually corrected them and created new institutions to improve the prevention and management of crises.

This is how the European Stability Mechanism (ESM), the institution I lead, and its predecessor the European Financial Stability Facility (EFSF), were born. They filled an institutional gap in the monetary union. Until their creation there was no one that could provide emergency financing to its members when markets closed. The ESM therefore became the lender of last resort for countries in the euro area that had lost, or nearly lost access to the markets to refinance themselves.

As you may recall, together, the EFSF and the ESM provided a total of nearly €300 billion in loans to five countries: Ireland, Greece, Spain, Cyprus, and Portugal. These countries reformed their economies and improved their fiscal situation and competitiveness, thereby regaining confidence of investors and, ultimately, market access.

Without the ESM, some countries might have been forced out of the monetary union and Europe would look very differently today. Instead, over the past decade, significant progress in reducing macroeconomic imbalances has reinforced the stability of the euro area. And after their programmes, all these countries had a good economic performance with stronger growth and employment creation than the average of the euro area.

Taking Portugal’s example, the government in 2019 had a budget surplus for the first time in 40 years. This was quite a significant achievement and a good starting point to face the economic consequences of what would come next: a global pandemic that would spur the most serious economic crisis since World War II.

This time, despite the problems that Covid brought, we had some advantages compared to the euro crisis, where we faced a situation that major macroeconomic imbalances had to be corrected in a few countries, while the euro area had some institutional gaps. All this had changed for the better.

The Covid debt shock was a symmetric external shock that hit all euro area economies. Fortunately, as I said, they were better prepared than 10 years before. Countries were able to recover and reverse the economic consequences of the extensive lockdowns faster than expected and were heading for a strong recovery last year.

After a budget deficit of 5.8% in 2020, Portugal’s government was able to reduce that to half last year [2.8% of GDP]. This was better than initially projected by the government [4.3% of GDP]. And at the same time annual growth was 4.9% last year, the highest in the last 30 years.

Also, the banking system in most European countries, including Portugal, is much stronger today. Certainly, banks this time were not part of the problem, as they were during the euro crisis. On average, they entered the pandemic crisis with a much stronger capital base and better liquidity positions and have continued to be part of the solution.

Finally, we have a much stronger institutional architecture in the monetary union, which we didn't have in 2010, including common supervision and resolution for European banks, and of course the ESM.

When the pandemic reached Europe, EU policymakers were able to react swiftly to help member states. The ESM together with other European institutions quickly agreed on measures, worth €540 billion, to lessen the burden for countries and their citizens. This complemented the enormous efforts that each country took nationally.

The €800 billion Next Generation EU (NGEU) recovery plan came on top of this and represented another structural development towards deeper European integration. Like the ESM, which raises money in the capital markets to finance its loans to countries in need, the European Commission now sells bonds and bills to finance the recovery fund.

These additional funds are channelled through EU programmes and are to be repaid over a long period from future EU budgets. Financing from the recovery fund supports reforms and investment which will ultimately lead to a greener and more digital Europe and strengthen the member countries' resilience, competitiveness, and growth potential. This will mostly benefit you, the younger generation in our audience today.

All these measures were designed to provide more assistance to countries most affected by the crisis. This solidarity was essential to protect the EU single market and to avoid divergences in the euro area. This also calmed markets, because financial markets were positively impressed by the speed, volume, and good coordination of the different European measures. They helped to limit the economic damage of the pandemic and showed an unprecedented degree of European solidarity.

Today, we are living in challenging times again. After the havoc caused by the pandemic, we are witnessing a horrifying war at our doorstep. Besides provoking a dreadful human disaster, it is also affecting economic developments.

If market projections become a reality, then Europe faces the prospect of having no growth within this year. Fortunately, we should remember that the growth last year, coming out of the pandemic, was extraordinarily strong, so the growth overhang from last year is substantial. This means that even if there is no growth within the year – quarter on quarter – the average GDP in 2022 will still be almost 2% higher than the average of 2021.

At the same time however, we are facing increasing inflation, as food and energy prices have risen strongly. That by itself is a huge loss of purchasing power. That means real consumption, which is a vital component for economic growth, will fall. Around two-thirds of the euro area's inflation can be attributed to soaring energy and food prices.

Higher energy prices also imply a decline in terms of trade – the difference between export prices and import prices. This effectively implies a transfer of wealth from energy importers to energy exporters. This loss so far is around 3% of GDP in the euro area. This means 3% of our gross domestic product is gone and that loss is higher than during the first oil crisis in the early 1970s.

In addition, confidence of consumers and investors is deteriorating strongly, according to all indicators available so far. Many businesses are reassessing investment plans.

But it is not all gloom and doom. There are also some positive factors. Reforms under the Recovery and Resilience Plans and financing under the Commission's Recovery Fund continue to counteract negative trends. Only a fraction of the funds available have been disbursed so far so there is still a lot of potential. Enforcing the green transformation and strengthening energy diversity was already a key objective for the future and will help Europe become less dependent on Russian oil and gas. Finally, consumers have a sizeable stock of accumulated savings from the last two pandemic years, which could be spent, as real income drops.

Coming back to Portugal, the economy is still expected to continue its recovery in 2022 and 2023 but at a slower pace than projected before the war in Ukraine. Even though the country has limited direct trade and financial ties with Russia and Ukraine, indirect effects will weigh on growth mainly through higher energy and food prices, supply-chain disruptions, lower external demand, heightened uncertainty, and declining economic confidence. Portugal's strong position in renewable energy is one positive point, which makes the country less vulnerable than others in the current energy crisis.

We need to see how long the war lasts and how it will affect confidence going forward. The increases in energy and food prices will surely affect the poorest most, who spend a large part of their earnings on these items. Governments in all European countries have therefore taken measures to cushion the impact of rising prices for the most vulnerable and that is appropriate if the measures are well targeted.

More broadly, the war in Ukraine could accelerate the trend towards a new world order, to deglobalisation, with potentially long-lasting economic and geopolitical consequences.

So, what lessons can we learn from past experiences and the current situation and what more can we do to make our monetary union more resilient in the longer term?

For me it is obvious that Europe's voice in the world needs to become clearer, our role needs to become stronger, we need to move closer together. To achieve that, the euro area and the EU will need to ramp up cooperation and strengthen integration further.

Last week, Italian Prime Minister Mario Draghi called for the EU to embrace "pragmatic federalism: one that encompasses all the areas affected by the transformations taking place — from the economy, to energy, to security", he said.

I believe a common budget to finance specific European public goods, e.g., for defence, migration, climate change, could benefit our union. Of course, this would require an EU Treaty change.

It is not possible for me to go into this in detail today, but it is nonetheless essential to debate them. Maybe we have time in the panel discussion later. I will focus on the euro area, on measures needed to make economic and monetary union more resilient and less vulnerable, and to strengthen the international role of the euro. With actions that do not require a change of the EU Treaty.

Such actions have been on the agenda for some time. The crisis we now face has made the need for these reforms even more evident. The key words are banking union. Capital markets union and a central fiscal capacity. In other words: more risk-sharing within the monetary union.

Banking union and a single market for financial services, a capital markets union – which does not exist today – would contribute to stronger potential growth in Europe.

A fully integrated financial market would also dampen cyclical divergences among member states through markets. This is what economists call “risk-sharing”.

Two out of the three banking union pillars are in place: a single supervisory mechanism that oversees European banks and a single resolution mechanism, which handles the winding down of the operations of a bank in serious financial trouble. This second pillar will be further strengthened when the ESM becomes the backstop to the EU bank resolution mechanism, lending it money if there is a severe banking crisis.

But we are missing the third pillar, a common system that can guarantee people’s bank deposits. A common deposit insurance would strengthen the resilience of the European banking sector as it helps to mitigate the risk of fragmentation, particularly in a crisis.

Capital markets union is the other big project to strengthen risk sharing in our monetary union and make the euro more attractive to international investors.

With banking union and capital markets union, risk-sharing would become much more substantial. Compared to the US, economic risk-sharing between the member states of the euro area is relatively limited, because we do not have a single market for financial services in the EU nor a common tax and social security system. Therefore, shocks in the US are shared to a much larger degree than in the euro area.

The same is true inside large euro area countries such as France and Germany, where risk-sharing is obviously much stronger than in the euro area overall. It is estimated that 80% of local shocks remain “unsmoothed” in the euro area compared to 20% in the US. As a result, and compared to the US, business cycles diverge more, and fragmentation is a real risk.

In the EU, some public risk-sharing has happened for decades via the EU budget, lending by the European Investment Bank, and more recently through the support provided by the ESM and EFSF in critical moments, and through the NGEU programme in the next few years.

Another way to strengthen public sector risk-sharing in the euro area would be a central fiscal capacity for macroeconomic stabilisation. In a monetary union, the exchange rate and monetary policy cannot be used to respond to country-specific shocks. There is one common monetary policy for all member states. Consequently, fiscal policy is the only macroeconomic policy instrument available to respond to country-specific shocks.

A euro area fiscal stabilisation function could make additional financial resources available to countries hit by a sizeable external shock if the national fiscal space turns out to be insufficient.

Considering the huge fiscal support in the last two years – and the energy crisis that countries are now facing - some member states of the euro area may struggle to use their own national fiscal policy to respond to a new shock, considering high public debt.

NGEU was an efficient response to the pandemic. However, it is temporary in nature, it was appropriately designed for all EU countries, and it is not an instrument for macroeconomic stabilisation within the euro area. It promotes structural reforms and provides financing irrespective of the position in the business cycle. For euro area members, it is worth analysing other instruments, a permanent fiscal stabilisation function. We can call it a “Stability Fund”.

As ESM economists explained in a paper that we just published last week, we could provide such a revolving fund that would provide loans to member states in a tough economic situation. The ESM could draw on its existing lending capacity. Therefore, no additional taxpayer money would be needed.

These shorter-term ESM loans, to be repaid within a business cycle, and with lighter conditionality than our regular programmes, could help tackle small crises before they become big crises.

Let me conclude.

We do not know how long the war in Ukraine – and the energy crisis that follows – will last. The economic consequences are therefore difficult to predict.

It seems clear that the war will accelerate a trend towards deglobalisation, with unfortunate economic consequences. Geopolitically, the world order may be changing.

For Europe, the need to integrate more and to make the monetary union more resilient is therefore more important than ever. It is the only way to strengthen European sovereignty and to maintain our role – a peaceful one – in the world.

As Robert Schuman said "Europe will not be built all at once, nor according to a single plan. It will be built through concrete achievements […]."

We have come a long way, but we still need some additional concrete steps to deepen the monetary union. They may not all take place at once. But the measures I mentioned are much needed. History shows that the concrete achievements Schuman talked about often took place during a crisis. Let us seize the moment.

Thank you for your attention.

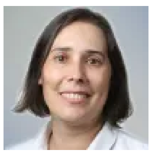
Author

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]