Economic challenges in the euro area during the green and digital transformation - speech by Rolf Strauch

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“Economic challenges in the euro area during the green and digital transformation”
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(Please check against delivery)

Good morning,

it is a great pleasure for me to open the Handelsblatt Retail Banking Summit.

I will kick off this conference by looking at Europe’s transition towards a greener and more sustainable economy and how you can have an impact on this transition in your daily business.

The double shock

We are currently experiencing a “double shock” – first the Covid pandemic, and now a war in Europe. Both are unprecedented experiences for many of us.

The first shock – the pandemic – has put our focus on the need to transform Europe’s economy to make it more sustainable and more digital.

The second shock – the war in Ukraine - has made Europe’s energy dependence clear.

The war in Ukraine has also magnified inflationary pressures. Due to the war, the price of commodities has increased significantly, and we now export a part of our wealth or our income abroad. This loss is bigger than during the oil crisis of the 1970s. Particularly people with low income are affected.

These developments imply three things for Europe’s economy:

First, to compensate the income loss, we need to find ways to improve productivity. The most effective means of achieving that is through investment in modernising our economies. Digital technologies and innovation will play a key role in this process.

Second, we need strategic independence also in digitalisation. That is why digital investments are part of Europe’s €750 billion recovery fund. Member states must allocate at least 20% to digital investments until 2026. [1]

Third, the best way to address the energy dependence is to diversify energy sources and accelerate the transition to green energy. Europe has set ambitious climate goals for itself: to reduce greenhouse gas emissions by at least 55% below the 1990 level by 2030, and 20 years later Germany wants to be ‘climate-neutral’. [2]

How can we stay abreast of digitalisation?

One of the many changes brought by the pandemic is that our lives have become more digitalised. In many respects this has benefits – it means better and more efficient services. But at the same time, Europe is increasingly relying on US-based companies and services.

This is also true for the banking sector, and it poses some challenges, but also provides opportunities.

First, the rapid growth of neobanks (fintech firms) and bigtech platforms risks diverting a high share of payments and financial services to non-regulated or lightly regulated competitors.

In addition, different regulatory treatment can lead to regulatory arbitrage; this increases risks throughout the banking system and poses a major challenge to existing banks that are less technologically advanced than their new competitors.

The International Monetary Fund showed that digital banks engage in higher risk-taking in both their loan origination, and asset allocation in their investment portfolios. This means more competition in a regulatory environment that still seems to leave some gaps.

Second, the war in Ukraine has brought again to the forefront the need to promote cybersecurity. This has been a recurring topic in recent years. But we know that the frequency of cyberattacks is increasing and in a more hostile or conflictual international environment, the risk of malign attacks is certainly higher. Banks need to make all the necessary investments to be better prepared for cyberattacks.

While there are several risks, at the same time, digitalisation is an opportunity, and one can even say it is a necessity for banks.

An important way to address long-term profitability challenges is to reduce operating costs through further digitalisation. It is a key element in creating a future-proof business model. Compared with US banks, euro area banks have invested much less in information technology. During the pandemic, banks were therefore forced to start making the necessary investments.

Digitalisation creates opportunities for new products and business. The European Commission estimates that we need €125 billion per year to close the investment gap in Europe – only a fraction of this will be covered by public money, the lion's share must come from the private sector. Significant investments from the private sector will be needed if companies want to access more advanced digital infrastructure and want to expand their business. This means lending business for banks.

The digital euro

But we cannot talk about digitalisation without mentioning one of the most ground-breaking European projects currently envisaged – the digital euro. The European Central Bank (ECB) is currently in the "investigation phase", to be followed by the "realisation phase". The European Commission intends to present legislation a legislative proposal for a digital euro in early 2023. [3]

Digital innovation and the declining use of cash are changing the dynamics of payments. The digital euro would offer the possibility for everyone to use central bank money for digital payments. It would be a sound, reliable means of payment. And it would preserve the co-existence of sovereign and private money.

Current developments – with tumbling crypto assets, stablecoins that turn out to be less stable than promised – underline the need for digital central bank money as a safe asset. Europe imposed sanctions on Russia using its financial infrastructure power – SWIFT is a European company. However, in the past, there were cases when European bank operations were affected by US sanctions, and we do not know what the future will bring.

Strategic independence and ownership of payment infrastructure will be important. A digital euro will enable us to play a major role in the international financial system while also offering financial autonomy and protection.

There are concerns in the banking sector, maybe also in today's audience, that the digital euro will take away business and lead to disintermediation. The ECB has made clear that, in its view, the digital euro should not lead to excessive disintermediation, and it will consider these issues in its design.

At the same time, more improved payment processes offer the opportunity to provide a wider range of services more efficiently and cost-effectively. Banks may bundle the provision of digital euros to their clients with other services.

Climate change: risks and opportunities for the banking sector

Next to digitalisation, the other big transformation is related to climate change. Climate change can lead to operational risks, market risks and increased credit risks for banks. An example of increased credit risks are mortgage portfolios, which can be impacted by climate-linked physical risks. In addition, the need to transition to a low-carbon economy implies that certain sectoral portfolios such as coal mining, power generation, oil and gas may be exposed to transition risks.

The banking and financial sectors have an important role to play in addressing climate change. The challenging opportunity is to mobilise investment and finance to support the green transition and target net zero emissions.

How can banks seize the full potential of green finance and be prepared for climate change risks?

First, they need to elevate climate change to a key element of their business strategy. This means embedding Environmental, Social, and Governance (ESG) considerations in the design of financial services, strategic planning and financial projections, risk management, disclosure, and reporting; in short, by integrating ESG throughout the balance sheet.

On the investment side, this includes setting up an ESG framework for investment that allows for mapping portfolio exposures and developing strategies for more sustainable portfolio management where needed.

On the funding side, banks should set up ESG frameworks and align financial products with ESG standards.

Green is the new gold

Meeting the EU climate and energy targets by 2030 will require the mobilisation of substantial investments from the public as well as the private sector. The EU faces an estimated investment gap of more than €350 billion per year. [4]

While the public sector will contribute to this endeavour, the bulk of investments will have to come from the private sector. The banking sector in Europe must play an essential role in mobilising the required private investments – by bringing capital users and providers together. For that to happen, banks need to provide more and better financial intermediation services including market-making, both nationally and cross-border.

More concretely, banks could increase their involvement in green bonds. Even though this market doubled in size last year, it still has lots of room to grow; judging by the fact that green bonds made up a mere fraction of the total volume of bonds issued last year worldwide, I think there is a huge need and a huge potential. [5]

Green Taxonomy

The continued development of global standards on sustainable finance is critical to encourage further investments.

Thanks to the EU´s Green Taxonomy, more climate-related data will be available in the public domain – for example, from 2024 European banks will have to report a “green asset ratio”, i.e., the proportion of assets in their banking book aligned with the Taxonomy.

The lack of standards and “greenwashing” would severely undermine these efforts. I am aware of the industry’s concerns regarding the costs involved and the need to have globally coordinated standards. The efforts to find a common ground globally, be it in the public sector through the Financial Stability Board, or the International Sustainability Standards Boards as a private sector organisation here in Frankfurt, are therefore existential.

Conclusion

As the European crisis resolution mechanism, we safeguard financial stability in the euro area. This will increase Europe’s capacity to recover from the “double shock” of the pandemic and war.

From a European perspective, both the digital and green transformation entail several risks for you in the European banking sector, but also opportunities that you should seize to help foster sustainable growth. European governments, citizens, banks, and the real economy need to work together and develop joint solutions to preserve our wealth and security and to have a real impact on a global scale. Borrowing the words of the previous European Commission president Jean-Claude Juncker: “Europe shows that the whole is more than the sum or its parts”.

Thank you.

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[1] Council of the European Union (2022), “Recovery and Resilience Facility”, available: https://www.consilium.europa.eu/en/infographics/20201006-recovery-resilience-rrf/

[2] EUR-Lex (2020), Communication “Stepping up Europe’s 2030 climate ambition Investing in a climate-neutral future for the benefit of our people”, COM/2020/562 final, available: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC0562

[3] European Central Bank (2022), “Progress reporting on the investigation phase of a digital euro”, Letter from Fabio Panetta to Irene Tinagli, ECON Chair, on progress on digital euro investigation phase (europa.eu)

[4] Europe needs to increase its investments from €683 billion per year (which was the average over the last decade) to around €1 trillion per year. Bruegel (2021), „How much investment do we need to reach net zero?“, available: https://www.bruegel.org/2021/08/how-much-investment-do-we-need-to-reach-net-zero/

[5] In 2021, green bonds made up 0.4% of the total volume of bonds issued last year worldwide and 2.6% in Europe. Denis Beau (2022), Banque de France, available: https://www.banque-france.fr/sites/default/files/media/2022/04/15/2022_04_14_universite_saint_etienne_slides_ven.pdf

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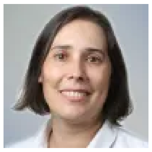

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