The euro area: Building up resilience in face of challenges

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Introduction

Professor Mo, thank you very much for your introduction and the opportunity. Ladies and gentlemen, good afternoon. I am very honoured to speak at the Research Institute of the People’s Bank of China.

In my previous role as Luxembourg’s Minister of Finance, I visited China many times, and I had the privilege of meeting many leaders of Chinese financial institutions. I am very happy to be back in my new capacity, as Managing Director of the European Stability Mechanism.

China plays a key role in the global economy and is an important trading partner of the European Union. China is the European Union’s third largest export market, and its largest import market, making the EU one of China’s largest trade partners over the last decade.

This mutual market access is crucial for the economic well-being of businesses in both regions. At the same time, how our economies perform and how resilient they are also has mutual implications.

Speech overview

In my speech today, I will:

- Focus on the euro area and explain how it has emerged stronger from multiple crises that it has faced in recent years.
- Present the current economic outlook for Europe and discuss how that outlook compares with the forecasts for China and the United States.
- Share the latest developments and the current state of play in strengthening the legal and institutional framework of the euro area.
- Explain the new tasks that the institution that I manage – the European Stability Mechanism (ESM) – will take up following the ratification of the revised ESM Treaty.

European economic integration – from humble beginnings to monetary union

I would like to start by highlighting that today’s level of economic integration in Europe is a remarkable fact. In 1957, six countries [France, Germany, Italy, Belgium, the Netherlands, and Luxembourg] created the European Economic Community –

the precursor of the European Union.

Today, the EU comprises 27 countries, and more countries would like to join. At the moment, there are eight candidate countries that have applied for membership. When the euro was launched in 1999, it became the common currency in 11 countries. Today, there are 20 countries in the euro area, with a total population of nearly 350 million.

Greater resilience as a result of crises

The growth in size has certainly contributed to its increased strength and significance. But most of all, the reforms and changes implemented by the EU and the euro area have had a decisive impact.

Over the years, when facing economic challenges and crises, the euro area has not only weathered the storm, but emerged stronger and more resilient. Through adversity, member countries have fostered greater unity. Each crisis resulted in additional integration steps and reforms that have incrementally boosted the framework upon which European integration is built.

The euro first came under severe threat as a consequence of two crises that hit Europe within a short time. First, we had to deal with the effects of the global financial crisis that in 2008 and 2009 spread from the United States to other parts of the world.

Financial markets became dysfunctional and the banking system in Europe came under stress. Shortly afterwards, several euro area countries lost market access as a result of excessive public debt levels and the loss of competitiveness. They needed urgent financial assistance to cover fiscal deficits and refinance maturing debt.

In the original institutional architecture of the Economic and Monetary Union, there was no lender of last resort for euro area countries. Once a country had fulfilled the necessary criteria to join the euro, it was unthinkable it could lose market access.

Also, central banks are not allowed to finance States and member countries are not allowed to take up each other’s debts. The only existing international institution at that time with a mandate to act – the International Monetary Fund – had insufficient resources to cover the financing needs of the affected countries.

Strengthening the euro’s institutional architecture

Euro area countries responded by creating the European Financial Stability Facility (EFSF) in 2010, as a temporary institution. It was the predecessor of the European Stability Mechanism, or ESM, the institution that I manage, which was established as a permanent institution in 2012.

The EFSF and ESM played a crucial role in preserving the integrity of the euro area by providing around €300 billion in loans to five countries [Ireland, Portugal, Greece, Spain, and Cyprus]. As part of their programmes, these countries implemented reforms to address the weaknesses that had led to their economic and financial problems.

While the required conditionality led to hardship at times, the adjustment programmes contributed to stronger economic growth and a fall in unemployment to the lowest levels ever recorded in the euro area. The recent upgrade of Greece to investment grade by the major credit rating agencies is a testimony to this success.

After the euro crisis, further steps were taken to strengthen the euro area's institutional architecture. The most notable action was to move the supervision of Europe's systemically important banks from national to European level. The European Central Bank has performed this task since 2014. This is called the Single Supervisory Mechanism (SSM).

This has enabled the harmonisation of supervisory practices, and as a result, led to the reduction of pockets of vulnerability that existed in certain national banking sectors.

In 2015, the resolution of failing banks covered by the SSM also came under a central European authority (Single Resolution Mechanism). This protects taxpayers from state bailouts and contributes to financial stability.

In addition, the euro area banking system has benefitted from a strong regulatory backbone - the full implementation of Basel IV standards - which has been instrumental in strengthening the system's resilience.

Notably, during the recent banking turmoil involving the collapse of several US regional banks, as well as that of Credit Suisse - a globally systemically important bank - the euro area banking system was unaffected. This is a reflection of the robust regulatory framework the EU has in place.

Thanks to the high degree of implementation of the Basel standards, European banks significantly strengthened their capital and liquidity levels. They also managed to greatly reduce the ratio of non-performing loans.

Covid and war in Ukraine

As a consequence, the euro area was in a better position to withstand the double shock of the Covid pandemic and the economic consequences of the war in Ukraine. These include an energy crisis, a cost-of-living crisis, disrupted global supply chains, and levels of inflation that had not been seen in generations.

Backed by public guarantees, bank lending helped European economies endure this difficult period. Apart from this, European institutions created aid programmes worth billions of euros to secure jobs and provide support to businesses. The most notable is a programme called “Next Generation EU”, which amounts to €800 billion in grants and loans for EU Members. It is a temporary recovery instrument to help address the immediate and serious economic and social issues brought about by the coronavirus pandemic.

But this financial support is also designed to help countries finance the green and digital transition. This will be crucial for Europe to become more resilient and better fit for current and new challenges. EU financial support comes on top of fiscal measures by EU countries, such as energy subsidies to shield households from rising energy costs. These EU and national measures, combined together, have significantly limited the scope of the economic damage of the two recent crises.

Economic outlook

The actions undertaken to strengthen Europe’s ability to withstand crises are a solid foundation for the challenges that we face. After a challenging year, with economic stagnation and possibly a light recession, economic activity is expected to modestly recover going forward.

Although euro area GDP growth is expected to improve somewhat, it remains below the growth of its peers. The European Commission forecasts that real GDP growth in the euro area will be 0.6% in 2023 and 1.2% in 2024. This is lower than (IMF) growth forecasts for the United States (2.1% in 2023, and 1.5% in 2024) and China (5.4% and 4.6%).

The difference between growth in the euro area and the US can be partly explained by different demographics, but different approaches to fiscal policy also play an important role. Fiscal support in Europe is being gradually scaled back in a prudent way. Yet, fiscal policy is still expansionary in the US. This supports the higher growth in the US for now, but such a fiscal impulse may be difficult to sustain.

Economic activity is clearly affected by high levels of inflation. Inflation creates uncertainty for firms and reduces the purchasing power of households. It needs to be addressed firmly. After a long period of low interest rates, monetary policy tightening is increasing borrowing costs, which helps to dampen inflation. In the euro area, headline inflation is declining, but the process will take time to consolidate.

According to [European Commission] forecasts, we expect lower inflation next year than this year (3.2% from 5.6% in 2023), and in 2025 it should ease to 2.2%. This would be very close to the ECB's target level of 2%. It should be noted that risks on energy prices are on the upside, due to the ongoing geopolitical tensions. The expected path of inflation is comparable in the US. Inflation in China is lower, closer to deflation, and this helps global disinflation.

Turning to labour markets, the EU and euro area labour market continued to perform strongly in 2023, despite the slowdown in economic growth. In the second quarter of this year, activity and employment rates reached their highest level on record, and the unemployment rate remains close to its record low.

Policy measures to further strengthen the euro area

Despite the resilience that the euro area has shown so far, there is no room for complacency. The importance of crisis prevention is growing as the number of shocks is increasing, while the nature of shocks will be different from the past.

Possible shocks to financial stability may come from geopolitical tensions, deglobalisation, or from well-known but slow-moving trends like population ageing. Another challenge is mitigating the effects of climate change.

There is an urgent need to finance the transition to a low carbon economy. To meet the investment needs linked to this goal, public investment in Europe will need to increase significantly in the coming years, complemented by private investments

Reform of EU fiscal rules

During the pandemic, monetary and fiscal policy were reinforcing each other. Since inflation has surged, monetary policy has been tightening. However, fiscal policy, notably because of energy-related subsidies, contributed to inflationary pressures. Fiscal policy and monetary policy have to become more aligned.

This requires fiscal consolidation, a phasing out of energy-related subsidies. Building fiscal buffers is required to make investments, to face longer-term challenges. But fiscal consolidation still needs to make room for sustainable growth.

To make that possible, the EU is close to reaching an agreement on the reform of its fiscal rules. The reform addresses shortcomings in the current framework. It takes into account the need to reduce much-increased public debt levels and builds on the lessons learned from the EU policy response to the Covid crisis.

The reform will support and prepare the EU for future challenges by facilitating progress towards a green, digital, and resilient economy. Fiscal adjustment will be required for countries with a budget deficit above 3% of GDP, and debt-to-GDP above 60%. These are levels which have been applied since the euro was launched.

However, after the reform, these levels will be enforced in a more consistent way. In addition, the rules will be less complex, and member states will have greater ownership in setting their fiscal adjustment paths. Debt sustainability analysis will play a central role in the new framework.

Completion of banking union

I mentioned that after the euro crisis, bank supervision and resolution was brought under the authority of EU institutions. This was a huge step forward in terms of crisis prevention for Europe’s banking sector.

The two institutions that were created for this purpose form two pillars of what is called ‘banking union’. However, EU members are discussing how to implement a third, currently missing pillar, in our banking union, namely a common European deposit insurance scheme.

At the moment, each EU country relies on its national deposit insurance authority. Proposals focus on creating a European scheme that would contribute to risk reduction in the financial sector by providing a backstop to national deposit insurance systems.

This would boost confidence among depositors and investors, which in turn would increase confidence in the EU banking system as a whole and enhance financial integration.

Capital markets union

The financial sector in Europe would also greatly benefit from the completion of the capital markets union (CMU) project. Currently, Europe's capital markets are segmented; they consist of 27 national capital markets.

The main aim of the CMU initiative is to remove barriers, harmonise regulations, and deepen integration to achieve a common European capital market. This would improve liquidity in financial markets, attract more investors, and increase market activity. For the business sector, the key advantage would widening the possible sources of funding for companies.

At present, bank lending is the main source of funding in Europe. This is different in the US, where the majority of funding is drawn from capital markets. The European equity market is less than half the size of the US equity market.

By making it easier for businesses to raise capital throughout the EU, we could boost economic growth in Europe. This would naturally contribute to improving its resilience and enhancing its competitiveness among global financial markets.

ESM reform

The ESM also plays an important role in strengthening the resilience of the euro area. In 2019, ESM Members agreed to reform the institution by assigning it several new tasks that would help to consolidate financial stability in the euro area.

The most important part of our new mandate is related to the stability of the euro area banking sector. The ESM will act as a backstop to the Single Resolution Fund – a fund operated by the EU's bank resolution authority.

"Backstop" can be understood as a safety net: it means the ESM will provide a credit line to the Fund so that it can carry out its activities in case its own resources are not sufficient. This will reassure financial markets and limit contagion effects in times of crises.

The ESM's tools will be better equipped to prevent economic and financial shocks from turning into major crises. Countries that are financially sound and at risk of financial distress will be able to access the ESM's precautionary instruments in a more transparent and predictable way. These instruments – two types of credit lines – are modelled after the International Monetary Fund's precautionary facilities.

The ESM will also be better prepared to respond to crises by monitoring economic and financial risks in all 20 euro area countries. These new tasks strengthen the preventive role of the ESM, and of course it will also continue to perform its crisis resolution functions whenever needed. At present, the ESM has an available lending capacity of €417 billion.

The ESM's expanded set of responsibilities will come into effect when a revised version of the ESM Treaty is ratified by all 20 of its Member States.

Conclusion

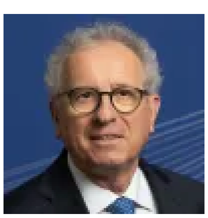
Ladies and gentlemen, in conclusion, I would like to say that in an interconnected world, China and the European Union stand as pivotal actors on the global stage. The developments in one of our regions resonate far beyond their respective borders.

I believe that our collective efforts are needed - not merely a matter of cooperation but a shared responsibility for the stability and prosperity of our countries and regions, as well as the entire global community.

We can shape policies that not only benefit our nations individually but contribute to a harmonious and resilient global economic ecosystem. This should be the legacy that we want to offer to our future generations.

Thank you for your attention.

Author



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