France, Germany and the Future of Europe - speech by Rolf Strauch

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Ladies and gentlemen,

I’d like to congratulate the organisers of this conference for their excellent sense of timing. The bankruptcy of Lehman Brothers is now almost exactly 10 years ago. It is a good moment to think about how Europe has recovered from the global financial crisis, and the subsequent euro debt crisis of 2010-2012.

Monetary union went through a difficult period. There was a serious risk the euro could have broken up. That this was avoided, was due to Europe’s comprehensive policy reaction. But it took investors much longer to buy into that view. Market sentiment on Europe turned positive on a lasting basis only last year, after the election of President Macron, here in France.

One sometimes hears the view that a range of setbacks this year has ended that recent optimism about the political and economic outlook for Europe. But that is not how I see things. Of course there are challenges - there always will be – but our view at the ESM is overall more positive. Let me explain why by looking at three topics: deepening the monetary union, the current economic situation and my view on public opinion and populism.

Political efforts to deepen monetary union have become more concrete since President Macron came into office. The Eurogroup is preparing the next decisions which will be taken at a Euro Summit of political leaders later this year. The Meseberg declaration outlines the path towards a more ambitious Europe, and was signed by Germany and France. The document, amongst others, reconfirmed the will to deepen monetary union and formulates some fairly far-reaching projects, such as a common unemployment insurance scheme. The document came out only a few months ago. So there is no doubt that Europe is on its way to strengthening the monetary union, and making it more robust. Exceptionally, this is happening at a time that we are not forced by a crisis. Europe is “fixing the roof while the sun is out”. I will say more on the specific elements of the agenda after talking about the economic outlook, and public opinion.

The current economic baseline scenario shows that growth is expected to remain benign, even if the balance of risks to growth is shifting to the downside. The euro area will benefit from strong global growth, which is likely to remain close to 4% in 2018 and 2019. Global indicators signaling future growth – such as the PMIs or global trade – are weakening, with the negative impact of protectionism on trade being the main risk. Overall, in Europe, the picture is bright, if also softening. Europe has been growing above potential since 2014 and is expected to do so in the next years. However, the growth prospects are somewhat weaker now than at the start of the year. After a phase of expansion, growth will have to come down almost inevitably, something we at the ESM have been saying for some time now. However, there is also divergence across countries as to short and long-term growth prospects.

Let me also say a few words about Italy, which many in markets and media see as the weak spot of the euro area. There is frequent speculation that Italy could be Europe’s next problem case, and require official support. However, it is worth noting that Italy has never lost access to capital markets in its recent past, even at the time of the deepest recession. Yields are currently well below levels at which market access tends to become problematic, and Italy continues to successfully issue bonds in the markets. The country has a current account surplus, and a track record of sustained primary surpluses. Its current budget deficit is well below the 3% limit.

That does not mean that the Italian economy faces no challenges. Growth has been only half the euro area average during the last 20 years. In 2018, the country is expected to have the lowest growth rate in the euro area, while unemployment is the third-highest, and well above the euro area average. It has the second-highest debt-to-GDP ratio, after Greece. Finally, the ratio of non-performing loans on the books of Italian banks is more than double the euro area average, although it is declining at a fast pace. These are problems that the Italian government needs to tackle through reforms and modernising the country's economy.

At the moment financial markets are focusing on the future budget proposal. Finance Minister Tria has said that Italy will respect the fiscal rules of the EU, and other government members have confirmed this. We think this is the right way to go, and market participants should give the government the time to properly do its job, instead of speculating. Markets also had great doubts about Portugal's fiscal policy course when the new government came in place. Portugal then regained much trust among international investors due to the fiscal stance taken by Mario Centeno, the Minister of Finance and current President of the Eurogroup. We very much hope that the Italian government will take the same route.
The work on the European agenda and the benign economic outlook are two reasons to remain positive about Europe. A third reason is public sentiment, which continues to be in favour of Europe. Support for the single currency is at its highest level since 2004 in the Eurobarometer poll – three-quarters of Europeans support it. A large majority of people also believe in the economic freedoms of the EU, including the ability to move across the union and trade freely.

At the same time, one has to note that people identify migration as the most important problem of the EU. More than unemployment and social security, migration is seen as an issue that needs to be addressed at the EU level. Fears over an influx of foreigners are strongest among those groups which feel left behind economically and socially. On the positive side, Europe's more equitable growth model is one factor why populism has so far been kept in check – and I believe this will remain the case. The European social model is more inclusive than elsewhere and more citizens benefit from the recovery after the crisis. Income inequality is much lower in Europe than in the U.S., whether you look at the Gini coefficient or at a comparison of the top and bottom quintile earners. Moreover, the employment rate in Europe is now well above the level of the year 2000, and rising. In the U.S., the rate is still well below the 2000 level.

Despite this relatively favourable situation, it is paramount that Europe makes political progress towards defining an adequate and coordinated answer to the migration issue. It is not enough to point at the fact that immigration figures have been drastically reduced from their peak in 2015, and that it is therefore less of an acute economic or fiscal crisis issue. Migration pressures will stay, and the task remains to define a socially and economically sustainable migration regime. A number of countries will face economic limitations and costs of ageing societies. Migration can help to maintain their future prosperity. Those have to be assessed against the economic and social costs of integration. As President Juncker pointed out in his recent State of the Union speech, this is an important area of future joint action, in which it will be important that European countries and European institutions act together.

Let me now say a few words about the agenda to deepen the monetary union that I began my remarks with. There are three chapters: completing the Banking Union, strengthening the role of the ESM, and a possible euro area fiscal capacity.

As an economist, if you ask me what is the one area where Europe needs to be doing better, I would respond: in economic risk-sharing. This is underdeveloped in the euro area when compared to the U.S., but also compared to large euro area economies. Risk-sharing can take place through public and private channels. These two are complementary: the more risk-sharing through the private sector, the less one needs to rely on fiscal tools. The private sector is not well-developed as a channel for risk-sharing in the euro area, because financial fragmentation is too high. Markets and banks still face too much home bias, ring-fencing and legal barriers across the EU. This is why it is so important to complete Banking Union. Two pillars of Banking Union already stand: the Single Supervisory Mechanism and the Single Resolution Board. It has now been decided that the ESM will provide a backstop for the Single Resolution Fund to complete the financial structure. This is a good next step to make the process of bank resolution more credible for the market. The SRF will have funds of €55 billion once it is fully loaded. The ESM backstop will roughly double that size by providing a credit line. That means the SRF will have enough money to act.

The other missing element of Banking Union is a common deposit insurance scheme for Europe. Without it, Banking Union is not complete. To my mind, there is no doubt that we will have a common deposit insurance scheme in Europe. There is consensus that it would be a useful addition. If Europe has a common deposit insurance scheme, clients would no longer worry that their government could not support the bank that they have put their money in. They would know that all of Europe is behind the insurance scheme. This would have a strong positive effect on people’s confidence in banks. Therefore, the risk of a national bank run would be much lower. In other words, it is very unlikely that a common deposit insurance would ever be needed once Europe has put it in place. However, the mutual trust in the banking systems in different countries needs to increase. Therefore, problem loans on the balance sheets of banks need to be cleaned up before we can put a common deposit insurance in place, more so in some countries than in others. Non-performing loans have been dropping since a peak in 2013. Last year, the stock of NPLs decreased at more than twice the rate of 2016. The NPL ratio and the stock of NPLs is now at their lowest since 2011. What is true for all euro area countries is that the business models of many banks need to improve and banking sectors must become more efficient. Profitability is improving but still too low. European banks need to find better answers to the challenge of low interest rates, high operating costs, and increasing competition from shadow banks and Fintech companies.

Capital Markets Union will be another important driver of financial integration. It will reduce the home bias of investors by harmonising bankruptcy, tax and corporate law. Politically this is not particularly sensitive. But in practice it is complex, because the differences between countries in many of these areas are considerable.

A more important role for the ESM is the second chapter on the agenda to deepen the monetary union. I already mentioned the role as a backstop to the SRF. The Eurogroup is now working on a larger role for the ESM in designing, negotiating and monitoring future assistance programmes. This will happen together with the European Commission, in full respect of its competences in the EU Treaty and without any redundancies. A greater role for the ESM makes sense, as we have gained substantive experience and expertise and the IMF is unlikely to participate in future programmes to the same degree as it has done in the past. It is good that Europe shows it can solve its own problems, and there had also been criticism from the IMF’s non-European members that it was too involved here.

It is also worth revising the lending toolkit of the ESM. We have six lending instruments, but only two have been used. We want to ensure that precautionary credit lines can be used effectively, without attaching a stigma. The direct bank recapitalisation instrument will be abolished when the common backstop is in place, as banking problems can then be addressed in a different way.

Finally, there is a third area of EMU deepening which can be broadly termed “the creation of a central fiscal capacity”, where the ESM could potentially play a role. Many ideas are out in this area – importantly also in the Meseberg Declaration. The Commission has also put forward a concrete proposal to use EU budget funds to stabilise euro area economies, and set incentives for reforms. Alternatively, short-term ESM loans with clear eligibility criteria could help to stabilise economies when they face asymmetric shocks and go into recession. Looking at the chances of success for euro area reform, it is fair to say there is more consensus - and actual progress - on the first two points of the agenda – completing Banking Union and strengthening the role of the ESM, than on this last one.

To conclude, 10 years after Lehman, Europe can look back with some satisfaction. Europe successfully overcame the crisis, and – in many respects – is now stronger than it was before the crisis. At the same time, we still have some homework to do, to attain better protection for future risks – both political and economic. Migration will need to remain high on the agenda. As regards the structure of the euro area, some very concrete steps are in the making. Others – particularly in the fiscal area – may take longer to materialise.

Thank you for your attention.

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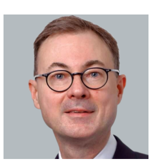

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