Global economy in transition: where does Europe stand? - speech by Klaus Regling

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Ladies and Gentlemen,

The global economy is in transition.

This theme will occupy us throughout the afternoon today. Professor Fuest will go into it in detail.

I will make some comments on what this global transition means for Europe.

First, let me say a few words about the current economic situation.

According to the latest forecasts of the International Monetary Fund (IMF), growth in the euro area will reach 2% this year. This means that the euro area continues to grow significantly above long-term potential growth.

According to the Eurobarometer, 50% of the respondents consider the economic situation in the EU to be "good". In Germany it is even higher, at 90%.

Macroeconomic imbalances that arose from the crises have been removed and budget deficits have narrowed. Public and private debts are falling, while competitiveness in the crisis countries has been restored.

As a result, their high current account deficits have disappeared. The unemployment rate is at its lowest level since 2008. Spain, Portugal, Ireland and Cyprus have had particularly high growth rates since the end of their ESM programmes.

That is remarkable! Over the past decade, Europe had to master two crises: first, we had to overcome the effects of the 2008 global financial crisis. Then the euro crisis.

The economic activity in the euro area is set to slow down. After years of above-potential growth a "normalisation phase" should follow. The negative output gap will close this year. A cyclical slow-down is therefore entirely normal.

In the meantime, we are however confronted with new risks, while having to keep working on old, well-known problems.

The economic slowdown will be negatively influenced by an intensification of external risks that are partly new to us.

According to the IMF, short-term risks to the global economy have risen compared to the spring.

The world is experiencing a wave of de-globalisation and neo-protectionism. This is triggered above all by the US withdrawal from multilateralism. And it is a new phenomenon in the post-war period. The consequences are difficult to predict but by no means positive.

An escalation of protectionism would have significant consequences for the EU: Among the EU's trading partners, the US was the largest partner for EU exports last year and the second largest for EU imports.

As an export-oriented economy, American protectionism would hurt Germany in particular.

In addition to this, new populist movements are hampering governing or at least the formation of governments in several countries. They make costly promises to voters, and cause general insecurity when they challenge EU’s agreed rules.
Economic and political uncertainties in Italy, Brexit and crises in some emerging markets could also have a negative impact on European economic development.

A week ago, Italy submitted its budget to the European Commission. One thing is certain: the plans are certainly not in line with the Stability and Growth Pact. The markets reacted accordingly. Moody‘s downgraded Italian government bonds last Friday.

As part of the so-called "European Semester", the Commission will publish its assessment of the Italian budget plans at the end of November. There will certainly be a lively exchange between the Commission and the Italian Government until then. If necessary, the Stability Pact provides further steps.

But — despite all concerns — one should not overreact and start calling Italy the "new Greece".

Italy certainly has its strengths: it never lost market access during the last eight years of the euro crisis. In addition, there is a current account surplus, a relatively high primary surplus, long maturities in the financing of the budget and high domestic savings.

Nevertheless, there are risks: Italy is the third largest economy in the euro area. With a debt-to-GDP ratio of 130%, it has the second highest national debt in Europe. Even if it is predominantly domestically financed.

You see the mistrust of the markets reflected in the secondary market and that has a very rapid impact on the refinancing costs of Italian banks.

That is why, on the one hand, I think it is right to remind Italy of the commitments that apply to all member states of the euro area. On the other hand, there is no need to panic.

Also in the case of Brexit, whether a soft or hard Brexit, we are facing new challenges. The departure of a country from the EU will affect us economically.

Albeit much less than Britain itself.

And it will especially hit those countries that are strongly connected to the British economy. For Ireland, but also for the German industry, a hard Brexit — without a free trade agreement — would have negative consequences.

The weaknesses one sees in emerging markets have a lot to do with the normalisation of monetary policy and the strength of the dollar. And there are country-specific problems in places such as Turkey and Argentina. Spill-over effects onto other countries cannot be excluded.

However, as always, contagion risks can be avoided through sound public finances, an independent monetary policy and a more robust financial system.

Other new risks are the result of technological innovation: digitalisation and cyber-security. Of course, digitisation also offers opportunities. Artificial intelligence will be discussed during a later panel on “digital revolution”. And cyber-security is among the biggest risks for all financial institutions, including the ESM.

The old, long-standing problems in Europe remain:

Unfavourable demographics, alongside low productivity gains, lead to weak potential growth in many European countries. This is why we need structural reforms, investment in human capital and infrastructure, later retirement ages and intelligent immigration policies.

These are not the main topics of this event, but we should not forget them regardless.

What is the answer to the new risks?

Europe is actually well positioned. Today’s good economic environment is the result of a broad package of measures that took us out of the euro crisis: far-reaching reforms in the Member States that received financial support from the ESM and the unconventional monetary policy of the ECB have been essential crisis responses. At the same time, economic policy coordination at the EU level has been strengthened and broadened.

Two institutional changes have strengthened the structure of the monetary union: the banking union —with the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) — and the creation of the two rescue funds.

But further steps need to be taken in Europe to make the monetary union more robust and the euro area economy more resilient.

The Eurogroup is currently working on two main topics: completing the Banking Union and strengthening the ESM.

The first topic is the completion of the banking union and it consists of two steps:

Firstly, the creation of a backstop for the Single Resolution Fund (SRF) to ensure the fund has enough financial resources in case of a very large crisis. In June, it was decided that the ESM should provide the financial backstop to the SRF by 2024 at the latest. This could happen earlier, if risks in the balance sheets of European banks will be sufficiently reduced.

The second step towards completing the Banking Union in this direction is to set up a European deposit guarantee scheme. This is particularly controversial in Germany, but would have a number of long-term benefits.

With a credible European deposit insurance scheme, the savers' fears that deposits will be paid out not in euro but in another national currency would be erased. And the reason for national bank runs would disappear. A joint deposit insurance would help to ensure deposit protection regardless of the location of a bank and is therefore the best guarantee that it is practically never used. In short, risk-sharing reduces risks in this case.

A pre-requisite for the introduction of a European deposit insurance scheme however must be a significant risk-reduction for the banks. Progress has already been made: the Tier 1 capital ratio of euro area banks stood at around 16% in June 2018. And the share of non-performing loans fell by around 18% in the euro area last year, and even more in the problem countries. This trend must be continued. Similarly, the high proportion of domestic government bonds in bank balance sheets should be reduced.

Together with a Capital Markets Union, a European deposit insurance would make it easier to overcome the fragmentation of financial markets in Europe and to create a single European financial market. This could also reduce the TARGET imbalances again. In addition, a more integrated financial market would lead to a more effective monetary policy in the euro area. That would possibly also allow for higher ECB interest rates.

The second part of strengthening EMU concerns the further development of the ESM. The euro countries want to deepen and extend the mandate of the ESM. The following four new tasks are being discussed:

Firstly, as already mentioned, the ESM should make the backstop available for bank resolution by 2024 at the latest.

Secondly, the ESM could play a stronger role in future crisis programmes. Of course, together with the European Commission. The current creditor quadriga would then become a tandem. Of course, the responsibilities of the Commission arising from the EU Treaty will be fully respected.

Thirdly, the toolbox of the ESM will be revised, in particular concerning the precautionary instruments.

Fourth, there are suggestions on how to improve the involvement of private creditors in debt restructuring. The ESM is only allowed to lend to Member States whose debt is sustainable. The system has become very "ad hoc" in recent years and should become more transparent and predictable.

The ESM could play an important role here: we would perform debt sustainability analysis, when a country requests ESM loans, and moderate the dialogue between the requesting country and the creditors.

There are also numerous proposals to introduce fiscal instruments for macroeconomic stabilisation and convergence of living standards. Among the euro member states, there is still no consensus on this issue so far. So the discussion is controversial.

For many decades, the EU budget has existed to promote convergence. Transfers through the EU budget to promote convergence were not created because of the euro. But they also support convergence in the euro area.

Therefore, I see no additional need for transfers to improve convergence. There are of course also other opinions.

However, I think that additional instruments for macroeconomic stabilisation are useful for the following reasons:

Firstly, in a monetary union, there are two macroeconomic governance instruments missing: monetary policy and exchange rate policy. Therefore, if needed only fiscal policy remains as a macroeconomic instrument to counteract.

Secondly, monetary policy in a large economic area tends to always be pro-cyclical. Regions or countries with high economic growth and thus higher inflation rates tend to have low real interest rates. Low growth regions and countries tend to have high real interest rates. We see this in Europe as well as in the USA or China.

Thirdly, economic risk-sharing is much less developed in the euro area than in the United States. Financial market integration remains low. And in the euro area, there are no common tax and social security systems which permanently stabilise the economic cycle like in the US federal states.

Of course, before any fiscal macroeconomic stabilisation instrument can be used in the euro area, all euro countries should first make use of their national fiscal buffer. This is what the Stability and Growth Pact envisages. These national buffers have to be built up first. But these national buffers could be complemented by European instruments.

There are several proposals for this: stabilising investments, reinsurance of national unemployment schemes, rainy day funds, and short-term ESM loans. All these proposals could be designed so that they do not lead to permanent transfers.

Let me conclude.

The euro area economy is doing well and showing considerable resilience. Overall, Economic and Monetary Union is better positioned than before the crisis.

But this must not be a reason for complacency. Old problems persist, new risks increase.

The population's support for the euro is rising and is now at its highest level since 2004. This is a good basis, to agree now on the next steps to strengthen the EMU so that we are even better protected against future crises.

Thank you very much.

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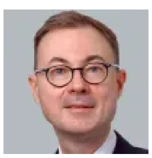

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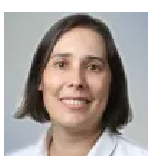

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