

STEADFAST IN TURBULENCE: A VIEW OF THE EURO-CRISES AND THE ROLE OF INSTITUTIONS

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“

*You learn to know a pilot
in a storm*

Lucius Annaeus Seneca

”

AGENDA

- I. The euro crisis and its roots
- II. Institutional developments in response to the euro crisis
- III. The pandemic crisis - fiscal & monetary policy response
- IV. Looking ahead: short and medium-term risks

SUCCESSIVE CRISES AND THE EVOLVING EUROPEAN ARCHITECTURE



A EURO CRISIS WITH DEEP FOUNDATIONS

In the **euro area**, **falling interest rates** during the first years of the EMU incentivized governments to borrow

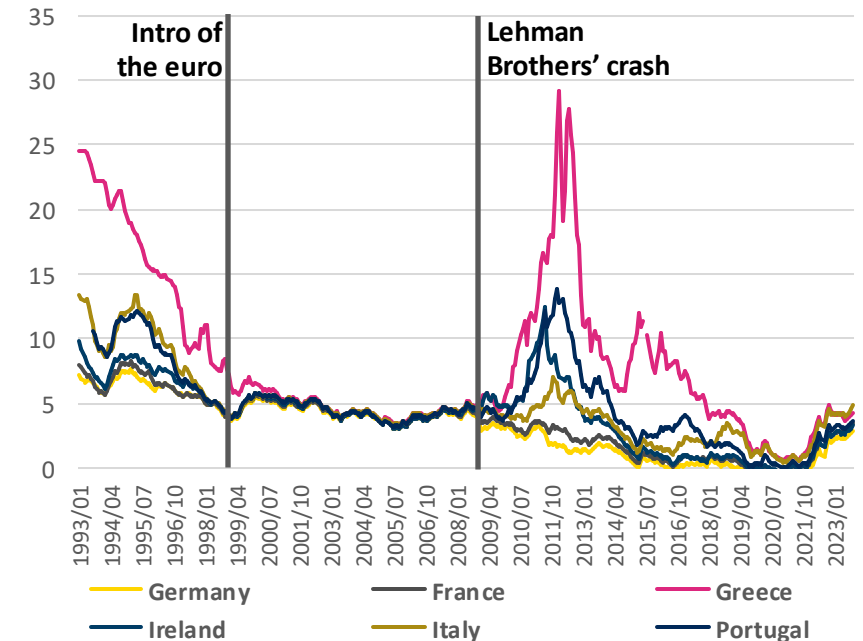
Over time, the **lack of fiscal policy coordination** led to

- *the accumulation of (twin) deficits*
- *the formation of real estate bubbles, and*
- *weaker competitiveness*

Banks took more risks, facilitating the **contagion** of the fallout to the euro area

- The banking crisis swiftly became a sovereign debt crisis

The convergence process led to favourable interest rate developments in the periphery....
(long-term interest rates, 10Y gov. bonds)



THE FLAWS OF MAASTRICHT DESIGN

- With the sovereign debt crisis dominating headlines, solvency considerations came to the forefront. The **euro area** had fundamental issues to address:



The common currency required a **common monetary** policy, and the coordination of **economic and fiscal** policies



However, the original set-up of Economic and Monetary Union did not foresee a **crisis resolution framework** for euro area countries

- Some EA countries could **no longer borrow** at sustainable costs to finance their budgets
- The shortcomings of Maastricht design were unveiled: countries failing to meet their financial obligations, were at risk of **exiting the common currency**

Currency's Days Feared Numbered

Investors Prepare for Euro Collapse

The Coming Crash of the Euro

Why huge profits await investors who position themselves for the euro's inevitable bust!

When will the euro collapse? It's already dead

[Actual press headlines]

INSTITUTIONAL DEVELOPMENTS IN RESPONSE TO THE EA CRISIS

MONETARY POLICY

Non-standard monetary policy measures: Outright Monetary Transactions (OMT) to safeguard monetary policy transmission



SUPERVISION

Supervision framework: macro- (ESRB) and micro-prudential (EBA: Banks, EIOPA: Insurance and Pensions, ESMA: Securities)



FISCAL POLICY COORDINATION

'6 pack' and '2 pack': EU fiscal framework reform to ensure debt sustainability, identify and correct risks, and efficient co-ordination.



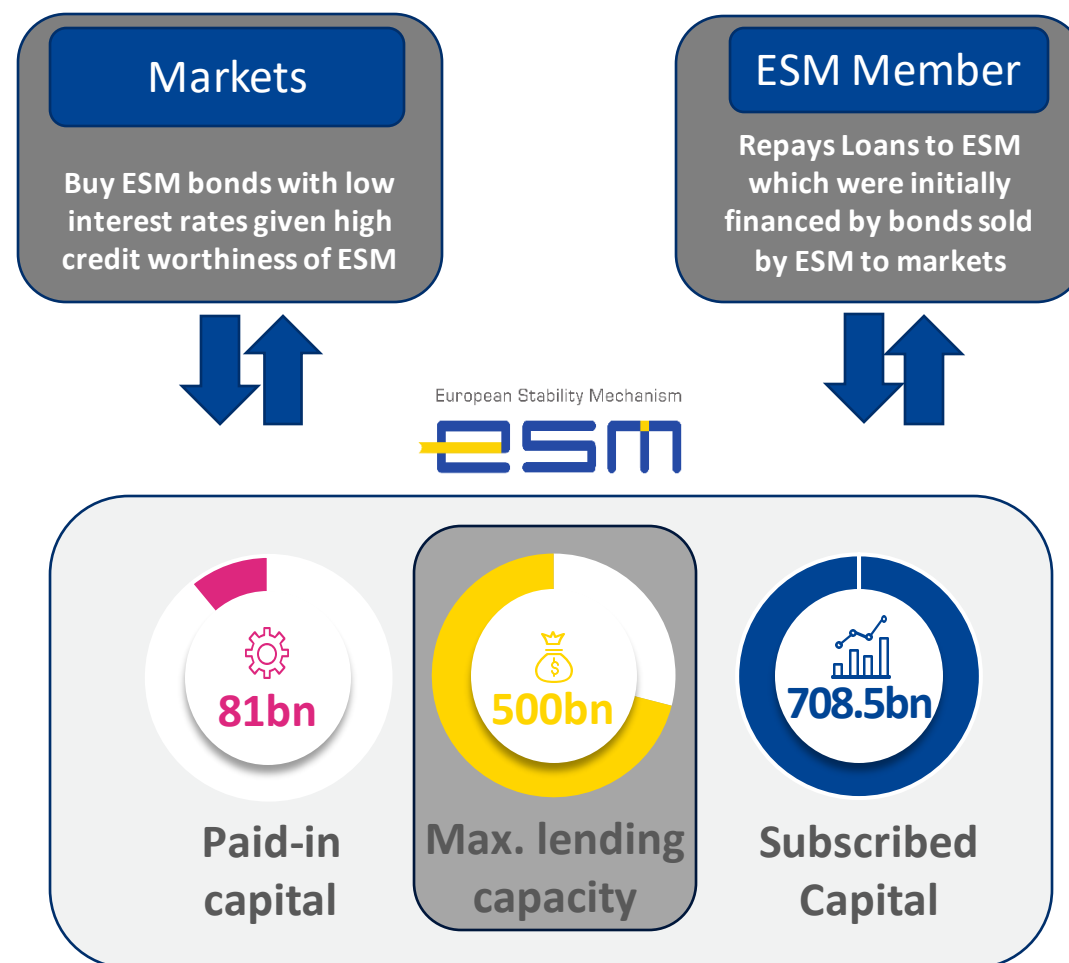
RESCUE FUNDS

2 rescue funds: For euro area sovereigns (ESM) and for banks (SRF). ESM preceded by EFSF.











FOCUS ON THE ESM: THE CRISIS PREVENTION AND RESOLUTION MECHANISM OF THE EURO AREA

- The ESM was inaugurated as an **intergovernmental institution** in 2012, succeeding the EFSF.
- The ESM's mission is to prevent and **overcome financial crises**, by aiding countries experiencing or threatened by financing problems.
- To finance its loans, the ESM borrows money by **issuing bonds** which are bought by **institutional investors** at **very low rates**.



ESM'S FIREPOWER: FINANCIAL ASSISTANCE INSTRUMENTS

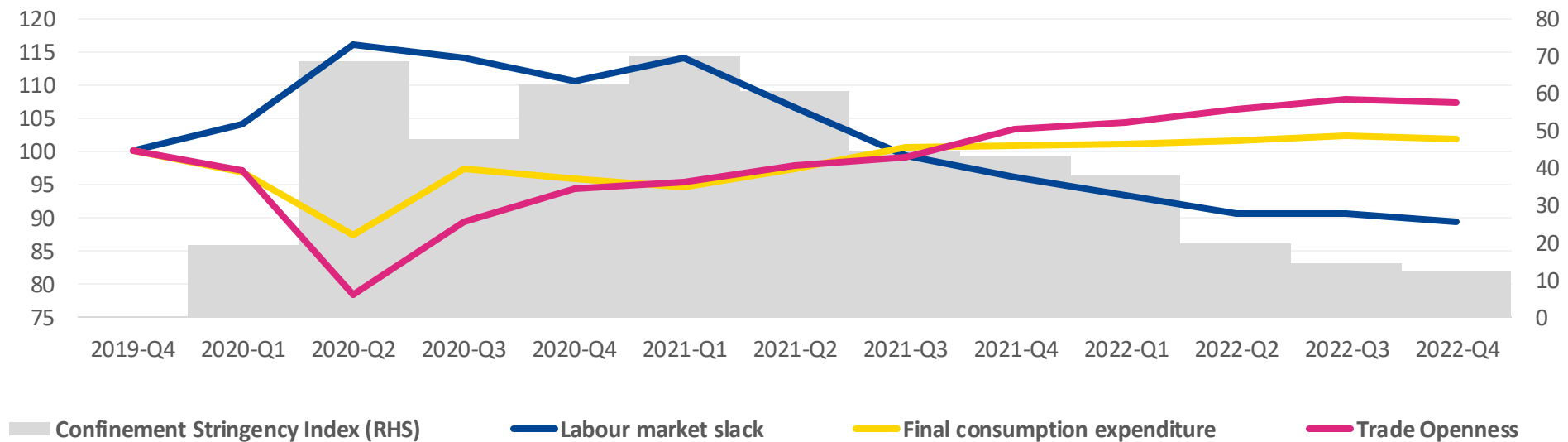
 <p>Loans within a macroeconomic adjustment programme</p> <p>Used</p> 	 <p>Primary market purchases</p> <p>Unused</p>	 <p>Secondary market purchases</p> <p>Unused</p>	 <p>Precautionary credit lines</p> <p>Unused</p>	 <p>Loans for indirect bank recapitalisation</p> <p>Used</p> 	 <p>Direct recapitalisation of institutions</p> <p>Unused</p>
<p>To assist ESM Members in need of financing, which have lost market access</p>	<p>Engaging in the primary markets to assist ESM Members</p>	<p>Engaging in the secondary markets to assist ESM Members</p>	<p>For ESM Members with sound economic health but risks of market loss</p>	<p>To assist ESM Members when their financial sector is at the root of a crisis</p>	<p>To assist ESM Members address risks of contagion from the financial sector to the sovereign</p>

THE COVID CRISIS: CHANNELS OF PROPAGATION AND FISCAL POLICY RESPONSE

The euro area economies grappled with yet another crisis, marked by disruptions in both demand and supply with pressure on government budgets to preserve social and economic stability

Government support measures mitigated the consequences of slack in periods of high uncertainty...

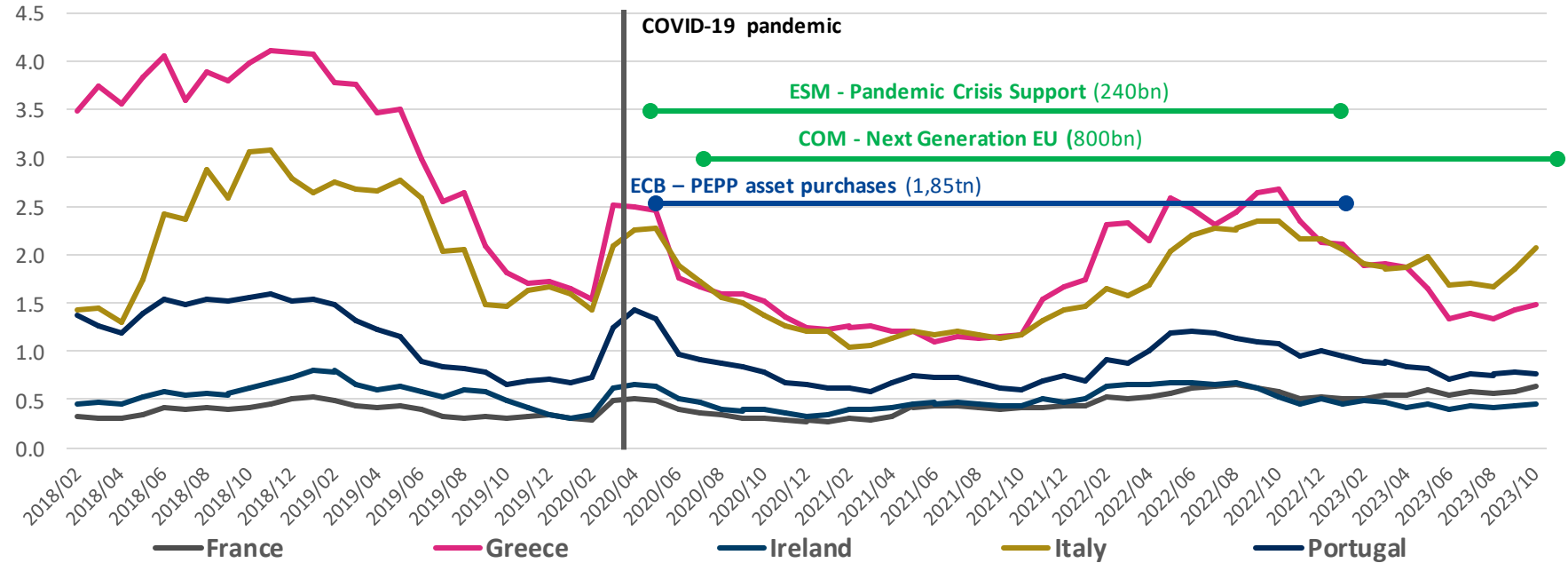
(euro area, base period: Q4-2019)



THE COVID CRISIS: CHANNELS OF PROPAGATION AND MONETARY POLICY RESPONSE

The ECB adopted a comprehensive package of complementary measures

Joint fiscal and monetary response made euro area stronger and calmed down markets...
(euro area 10-year sovereign spreads)

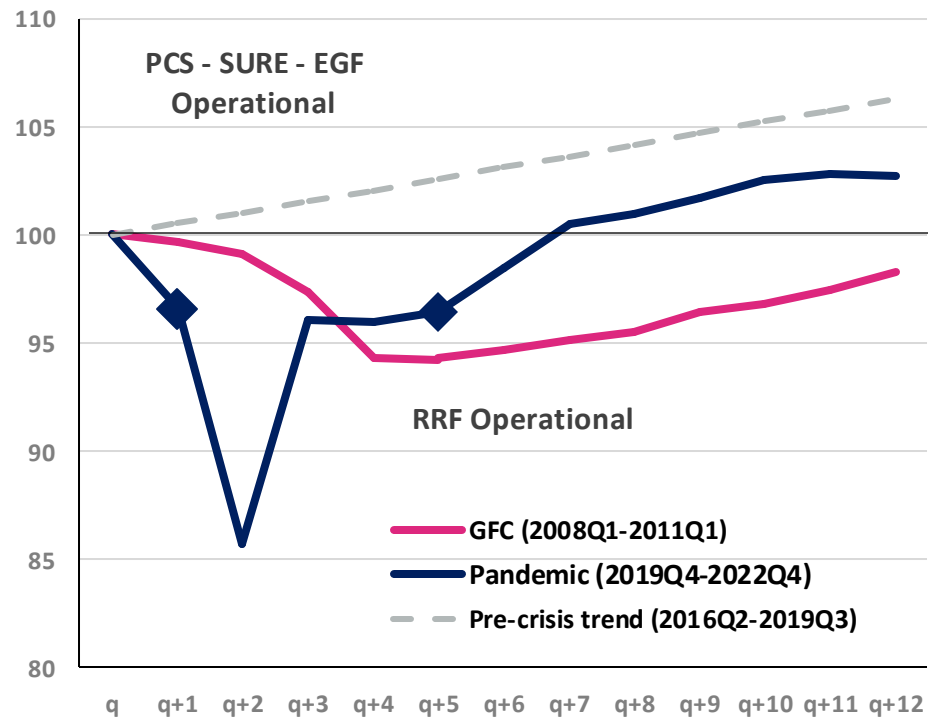


Source: European Central Bank, European Stability Mechanism

THE COVID RESPONSE PLACED AN EMPHASIS ON PREVENTIVE ACTION

A swift response to ensure short term stabilisation and long-term growth...

(euro area, real quarterly GDP, period preceding crisis = 100)



Stabilisation

SURE - Labour

Support to mitigate Unemployment Risks in an Emergency

€100 billion



PCS - Health

Pandemic Crisis Support

€240 billion

European Stability Mechanism



EGF - Business
European Guarantee Fund

€200 billion



Securing Long Term Growth

NEXT GEN EU

Next Generation EU

...and its centrepiece

Recovery and Resilience Facility
(€385 billion in loans,
€338 billion in grants)



WHAT LIES AHEAD FOR THE EURO AREA AND THE ESM



SHORT AND LONG-TERM RISKS PREVAIL FOR THE EURO AREA

Short term risks as interest rates are expected to stay 'higher for longer'

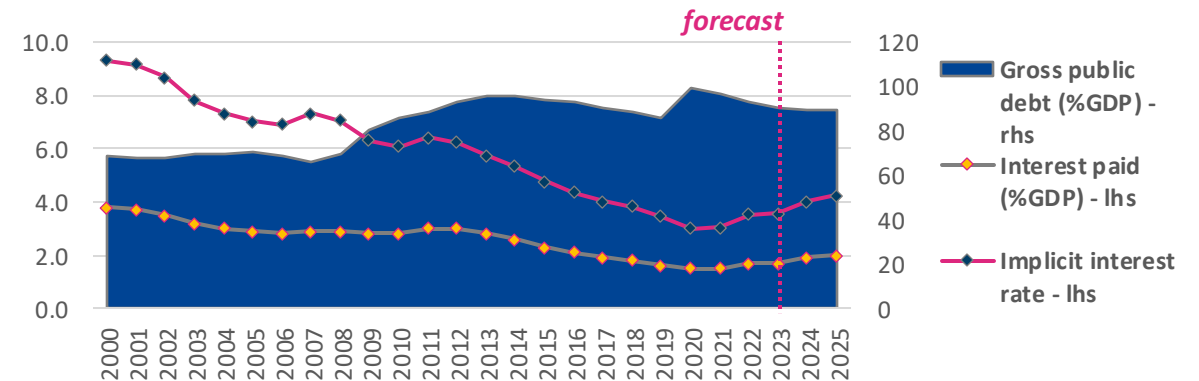
Higher borrowing pressure governments who must return to prudent fiscal policies

In the long term, ageing and climate change add to the balance of risks and budget pressure

- *Russia's war on Ukraine*
- *More effort and investments are needed towards reaching the Green Deal agenda*
- *Population ageing and further geopolitical risks*

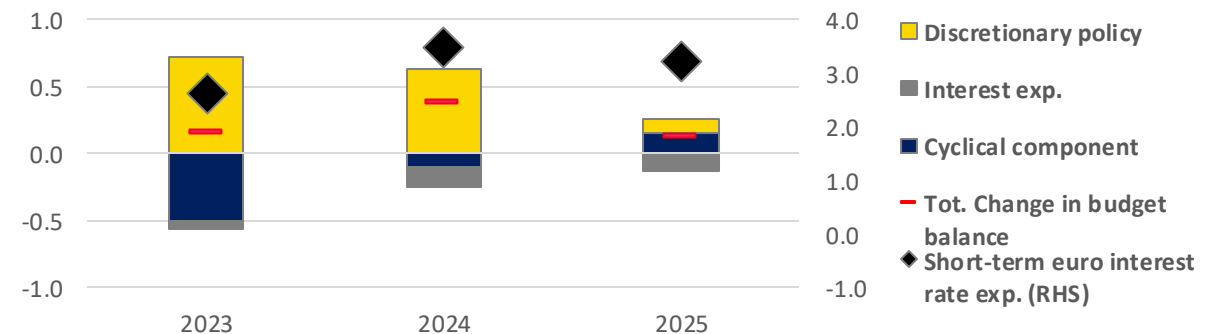
A. Inflation eroded the real value of debt....

(euro area, LHS: %, RHS: %)



B. ...but rising interest rates are squeezing fiscal space

(LHS: pp of GDP, RHS: %)



Source: (top and bottom) European Commission forecast

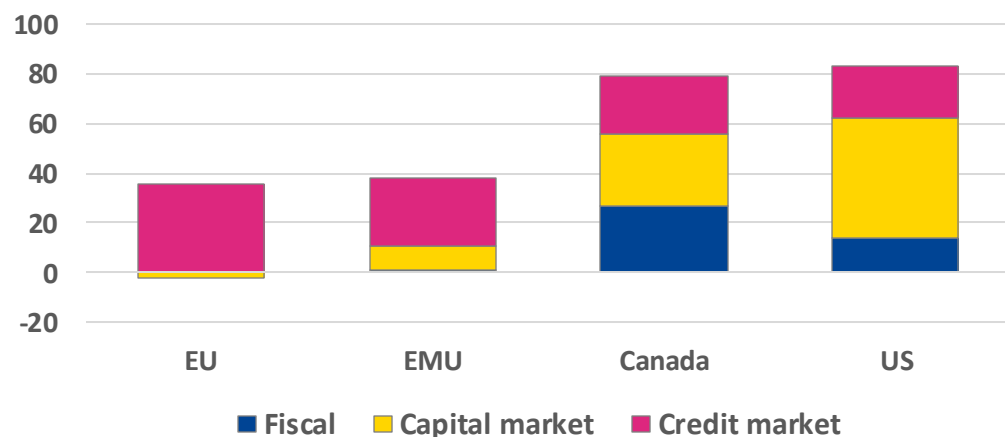
Note: (Bottom) Interest rates: 3 months Euribor, based on future contracts, March of each year taken (23 and 24 SF23 cut-off) 25 AF cut-off

SHIFTING THE FOCUS ON CRISIS PREVENTION

Risk-sharing channels in the euro area are limited...

- *Banking and Capital Markets Union not completed*
- *Stronger fiscal risk-sharing can safeguard against spillovers and asymmetric shocks*

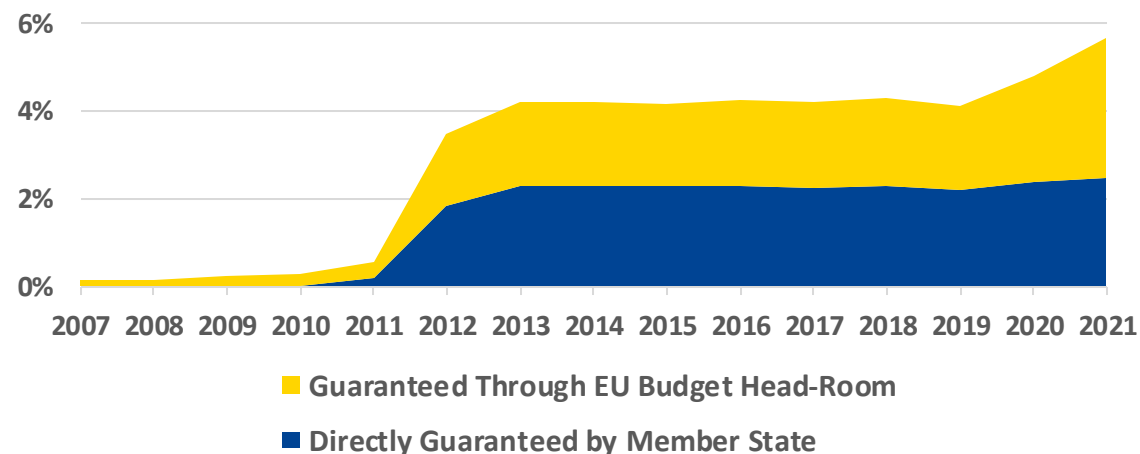
Shock absorption in EU, EMU, Canada and US (% of shock absorbed)



Preventive stabilisation actions could ensure that long term targets are met...

- *Climate change, an ageing population and the risks of fragmentation pose important financing needs*
- *Turbulence may affect members' ability to consistently maintain these projects*

Total EA members' contingent liabilities for support initiatives: 2007-2021 (% of EA GDP)



ESM REFORM

Common backstop



The Common backstop : ESM will serve as the permanent backstop to the Single Resolution Fund (SRF).

This common backstop will allow the use of ESM resources to contain banking crises when the resources of the SRF will be depleted.

ESM precautionary instruments (PCCL & ECCL)

More effective precautionary credit lines: The eligibility process for the precautionary credit lines will be made more transparent and predictable

Stronger role

ESM more involved in the design of policy conditionality, monitoring and debt sustainability analysis with the European Commission. Outside programmes, the ESM will follow macro-economic and financial developments the euro area.

CONCLUSIONS

- ✓ The euro area's resilience to crises has improved during the last decade due to an improved institutional architecture.
- ✓ Economies face short-term challenges – high inflation and interest rates – and longer-term threats - climate change, ageing, geopolitical instability – while fiscal space is constrained in some countries.
- ✓ ESM's crisis prevention instruments provide protection against external shocks.



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