Responding to uncertainty across Europe - speech by Pilar Castrillo

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(Please check against delivery)

Good morning,

We are living in a period in which global uncertainty (political, economic and policy related) seems to be the new normal, and shows no signs of abating. Look at the outbreak of the coronavirus, for example.

According to the European Central Bank (ECB)[1], the increase in uncertainty over the past year accounted for a third of the decline in global investment and for 40% of the decline in global imports.

Looking ahead, geopolitical and trade tensions, technological innovation and climate change are all factors that will weigh on growth in the coming years. And all of these will happen in a low growth scenario for the euro area [1.2% in 2020 and 2021[2]] in the near future.

In the long term, an ageing population and low structural productivity will prevent the economy from achieving a higher potential growth rate.

However, the future has not yet been written, and it is in Europe’s hands not only to address these challenges – by minimising their potential costs for society – but also to turn them into opportunities.

Structural reforms and higher investment are fundamental to boosting productivity and long-term growth. But no less important is improving the resilience of the economy to future adverse shocks. Further deepening of the European Economic and Monetary Union (EMU) will contribute to this goal.

Before going through what is missing, let us look back. The euro area has gone through a lot in the last 10 years. And, although not without costs, we managed to overcome the global financial crisis with a comprehensive response at both European and national level. This response had five essential components:

- First, euro area members with large economic imbalances received financial assistance and implemented deep and difficult reforms, adjusted their budgets, and improved their competitiveness.
- Second, the ECB played a crucial role, with a set of unconventional monetary policy tools to support the economy;
- Third, economic and fiscal policy coordination was enhanced and broadened at European level;
- Fourth, with the Single Supervisory Mechanism and the Single Resolution Mechanism, both the supervision of the systemic banks and resolution competences were transferred from national to European levels, and the cost of bank failures from taxpayers to investors.

- Fifth, the institutional architecture of EMU was significantly strengthened with the establishment of the two rescue funds: the temporary European Financial Stability Facility (EFSF) and then the permanent European Stability Mechanism (ESM).

These two rescue funds closed an institutional gap in the initial design of monetary union, becoming the lender of last resort for sovereigns in the euro area. Before the crisis, this function did not exist, as it was unthinkable that any of the euro area countries could lose access to financial markets.

In the last 10 years, the rescue funds have together disbursed close to €300 billion to five countries: Ireland, Greece, Spain, Cyprus, and Portugal.

Those countries benefit from budgetary savings because our loans have very long maturities and very low interest rates. For example, the Greek budget saved around €13 billion in 2018 which is 7% of Greek economic activity. Greece will benefit from these savings for many years to come.

After this broad set of measures, the euro area today is better prepared to deal with future crises, both in terms of policy coordination and institutional architecture. However, the process is not finished yet. There are still some additional steps needed to increase the resilience of the euro area:

The agenda for further deepening EMU must continue. We should not wait until the next crisis forces us to act. Strengthening the role of the ESM, along with completing banking union and developing a capital markets union (CMU) are three key milestones in this process.

- **What does the ESM reform mean?** Once the final agreement is reached and ratified by member states, the ESM will be more involved in the design of future programmes and country monitoring, in close coordination with the European Commission. The ESM will also act as a backstop to the Single Resolution Fund (SRF), meaning that if SRF resources are depleted, the ESM will be able to lend the necessary funds to finance a bank resolution. And the ESM precautionary credit lines will be made more effective.

In summary, with the reform, the ESM will be better positioned to provide financial stability to the euro area not only by helping countries to deal with a potential crisis, but also by preventing it in a timely way.

- **To complete banking union, we need a common deposit insurance, and the risks of a liquidity gap after resolution should also be addressed.** Both issues are quite controversial, and a consensus still needs to be reached on them.
- In addition, we need to progress on a CMU, which would lead to more diversified funding sources and to improve risk sharing within the euro area.

Two final pieces that are still missing in the euro area architecture, and are also quite controversial, is a **fiscal capacity for macroeconomic stabilisation and a European safe asset.** In a monetary union, country-specific macroeconomic shocks cannot be tackled with ad-hoc monetary policy measures or mitigated by exchange rate adjustments. In these cases, timely access to additional fiscal space – on top of national fiscal stabilisers – provided by a fiscal stabilisation function would help sovereigns to stabilise their economies, and reduce the need to enter into a crisis resolution framework. In summary, it could prevent small problems from becoming big problems, reinforcing the stability of the entire monetary union.

On this topic, there is a broad set of options on the table provided by both policymakers and academia: from reinsurance of national unemployment schemes, to a stabilisation fund to support investment, short-term ESM loans, or a rainy day fund[3]. All these proposals can be designed in a way that they don't lead to permanent transfers between countries.

A European safe asset would support financial stability and strengthen the role of the euro in the global economy. Here also there are different concepts being suggested. We need to invest further in this area to develop operational proposals but I think it is difficult to create a European safe asset without any form of mutualisation. Therefore, more trust among euro area member states is needed to take this step and the fiscal governance system has to be more effective.

To conclude: the best way to deal with uncertainty is to counteract it with a well-designed safety net, able to provide financial stability by adequately balancing the existing trade-offs between moral hazard, insurance, and contagion.

In the last 10 years, important steps have been taken in this direction, but, as I explained, the work is not finished. As the Five Presidents report[4] remarked in 2015, *"The EMU today is like a house that was built over decades but only partially finished. When the storm hit, its walls and roof had to be stabilised quickly".* We should not waste time completing it before the next crisis hits.

Thank you for your attention. I am looking forward to our debate.

References:

[1] See "Tracking economic uncertainty: implication for global investment and trade". ECB Economic Bulletin, Issue 1/2020.

[2] See "Winter 2020 Economic Forecasts". European Commission, February 2020.

[3] See Andreja Lenarčič, ESM Kari Korhonen, "A case for a European rainy day fund", ESM Discussion Paper 5

[4] See Five presidents' report

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