Europe in crisis: The European Recovery Plan and the role of the ESM

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Ladies and gentlemen,

It was in Potsdam at the beginning of November 2012 that I last spoke to members of the European Ministerial Conference. I presented the European policy response to overcome the euro crisis. At that time the EFSF programmes for Portugal, Ireland and Greece had already been running and the ESM programmes for Spain and Cyprus would start shortly after. The lowest point of the Greek crisis was still ahead of us and nobody thought of a pandemic.

I. Then and now: rescue funds as part of the response to the crisis

As you know, with the creation of the two rescue funds, the temporary EFSF and the permanent ESM, a gap in the architecture of the Economic and Monetary Union

(EMU) was closed. The ESM was not part of the original institutional architecture of the EMU. There was no lender of last resort for euro area countries, no so-called lender of last resort for states. At the start of the EMU, it was unimaginable that a country in the currency area could lose market access once it had overcome the hurdles to joining the monetary union.

The ESM has proven to be a permanent institution with sufficient financial resources. To finance the programmes, the ESM issues bonds on the financial markets. So we do not use taxpayers’ money for our lending, as was often wrongly claimed in the past.

Over the last eight years, both rescue funds have disbursed around €300 billion to five countries: Ireland, Greece, Spain, Cyprus and Portugal.

This led to five success stories, because loan disbursements were always tied to the implementation of agreed-upon reforms ("conditionality"). As a result, these countries worked on the problems that led to the loss of market access, and in the following years, had a better economic development than other European countries.

In addition, these five countries benefit from budgetary savings over many years because our loans have very long maturities and very low interest rates. Last year, for example, the Greek budget saved around €13 billion in debt service payments, which corresponds to 7% of Greece's economic output.

II. Where do we stand today?

But the euro crisis cannot be compared to the current crisis. Six months ago the coronavirus reached Europe. We are undoubtedly experiencing the worst economic crisis ever. There is a great deal of uncertainty, and economic performances in the euro area will not return to pre-crisis levels until 2022 at the earliest.

Between March and May, the European economy suffered a brutal collapse. Supply chains and production lines were disrupted, international trade fell dramatically, and spending on private consumption and investment shrank like never before.

After the economy reached its lowest point in April, there was a clear recovery from May onwards. Many indicators improved significantly in the following three months, with some almost reaching pre-crisis levels. However, the recovery lost momentum again in August, as uncertainty about the prospects of a second wave of infection remains high in some euro area countries.

Investors are holding back their investments, many consumers prefer to save rather than to consume. In the euro area, the savings rate is forecasted to be 19% this year, compared with around 13% last year. In Germany, the savings rate is expected to be almost 25% this year, up from almost 19% in 2019. However, I expect these estimates to be revised upwards. This change in savings behaviour is from the point of view of the uncertainties individually understandable, but is problematic for the economy as a whole.

The pandemic has had different impacts in different member states, which increases the risk of growing economic fragmentation between countries. It was therefore important that measures were taken at the European level to prevent distortions in the EU’s single market and divergence in the monetary union.

III. Europe's common response to the pandemic

In spring, Europe responded quickly to the pandemic with an array of policy measures designed to help the most affected countries, which also had a calming effect on the financial markets.

To mitigate the economic impact of Covid-19, the euro area’s finance ministers agreed on three safety nets worth a total of €540 billion at the beginning of April.

Each of the three safety nets serves a different purpose: The ESM's Pandemic Crisis Support helps countries to cover direct and indirect health care costs. SURE is the European Commission's safety net for workers, while the European Investment Bank's new guarantee fund can be used to finance corporate investments.

At the same time, monetary policy measures by the European Central Bank, and in particular the announcement of the new Pandemic Emergency Purchase Programme, have stabilised financial markets.

The €750 billion "Next Generation EU" recovery plan was adopted in July. To finance it, the Commission will issue bonds on the markets on behalf of the EU. The funds can reach up to €360 billion for loans and up to €390 billion for grants. These additional funds will be channelled through EU programmes and will be repaid over a long period from future EU budgets – between 2028 and 2058.

To strengthen countries' resilience and competitiveness, support from the Recovery Fund is accompanied by reforms linked to the European Semester for Economic Policy Coordination. The Commission provides loans and grants under the Reconstruction and Resilience Facility to EU countries, who then use it to finance their reform and resilience plans in accordance with the objectives set out in the European Semester.

In addition to the measures at EU level, euro area countries responded with very extensive national fiscal policy measures. All euro area countries supported their economies through discretionary fiscal policy measures, guarantees and liquidity support and deferrals for taxes and social security contributions. In total, these measures amount to more than one third of the gross domestic product (GDP) for the euro area, and even more than 40% in the case of Germany.

Automatic stabilisers amount to around 5% of GDP. The budget deficit for the EU as a whole is estimated at around 10% of GDP this year and around 5% next year, but this depends, of course, crucially on the progress of the pandemic, the strength of the economic upswing next year and the extent to which the state guarantees will then be called upon. At the same time, a budget deficit of 20% of GDP is expected in the USA this year and 10% next year.

IV. Challenges for the future

The current crisis is very painful, but it has the potential to accelerate structural changes in our economy and in European integration. As former German Finance Minister Wolfgang Schäuble recently said: “If this crisis is not big enough to drive integration forward, what is?”

Reforms in member states will be particularly important in the coming years, because I see four problem areas that could negatively affect future growth:

First, potential growth, i.e. the possible growth rate of an economy at full capacity utilisation and full employment, will probably be lower in the future than before the crisis. The pandemic is destroying capital – including human capital; it is causing businesses to invest less given the high degree of uncertainty and has led to much higher private savings, which is reducing overall economic demand.

Second, the collapse of world trade means less competition and thus lower productivity gains. The collapse of world trade comes on top of the trend of deglobalisation already visible before the pandemic, which also dampens potential growth.

Third, I am concerned about the banking system. Banks continue to make too little profit, there is overbanking and there will be an increase in non-performing loans due to the economic downturn. All this can affect the credit supply to the economy. This in turn reduces growth.

Fourth, higher public debt, which is now indispensable, can have a negative impact on growth in the long term. The return to sustainable deficits will not be easy.

Given these challenges, I believe it is vital that the EU focuses on strengthening productivity and competitiveness in the future, while promoting a green and digital economy. What we need is a "stronger, more innovative, more sustainable Europe" as Schäuble said.

V. Deepening EMU remains on the agenda

Still according to Schäuble, this also includes the further deepening of our monetary union. It is right that the EU should now focus on averting the pandemic. But we should not lose sight of deepening EMU even in current times – this will help us face future crises with even greater strength.

The agenda contains the following points:

(i) Completion of the ESM reform to ensure financial stability in the euro area,
(ii) Completion of banking union with a backstop and a common European deposit insurance scheme,
(iii) the creation of a capital markets union to harmonise all 27 national financial markets,
(iv) the creation of a fiscal capacity for macroeconomic stabilisation to cushion economic downturns; and
(v) increase the volume of safe euro assets to improve the monetary transmission mechanism in the euro area and to strengthen the international role of the euro.

An important element of the ESM reform is the backstop to the Single Resolution Fund. The backstop to the SRF would – together with a joint deposit guarantee – complete banking union.

Progress in capital markets union would facilitate cross-border investments and open up new ways of financing for companies. All this would improve the allocation of capital in the EMU, increase growth potential and make the euro more attractive to international investors.

In addition, a fiscal capacity for macroeconomic stabilisation in the euro area would be very useful because countries of a monetary union give up two important macroeconomic policy instruments: monetary policy and exchange rate policy. This may require the use of the remaining macroeconomic instrument, fiscal policy, more frequently than before. The ESM could add such a facility to its toolbox. This would allow countries to expand their national fiscal buffers and thus give them more fiscal space in a crisis.

In addition, the need for European safe assets is increasingly recognised in this crisis. The EU measures I mentioned at the beginning of my speech can increase the volume of European debt issued by the European Commission, the European Investment Bank and the ESM from today's €800 billion to almost €2 trillion. Together with the sovereign debt of the top-rated euro area member states, euro safe assets would then amount to around 40% of the GDP of all euro area countries – the US has 90%.

VI. Where is the exit?

When I was at a conference in Italy last weekend, I was asked about the "exit strategy" from the current fiscal policy. Next year we should think about when we will return to the EU fiscal rules. A premature return to these rules could trigger another recession, as EU Commissioner Paolo Gentiloni mentioned at the same meeting. A return too late could lead to over-indebtedness for some countries.

At the same time we should deal with the question whether the old rules fit the new reality. The Stability and Growth Pact needs to be reformed in order to become more credible again. Simpler and more effective rules would help to stabilise and guide political decisions and market opinions. Investors have little confidence in the current framework with its many exceptions.

The other reason why a reform is necessary is that one of the key variables for assessing fiscal policy must be estimated. This requires estimating the output gap (i.e. the difference between possible and actual production) and the potential growth rate of each euro area country.

We should therefore use the current situation – with the suspension of EU fiscal rules for budget deficits in 2020 and presumably also in 2021– to agree on an improved, simpler and more credible framework for fiscal surveillance.

Let me conclude here. I am now looking forward to a lively exchange with you. Thank you very much.

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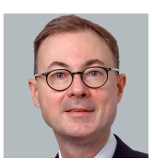

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