Europe's response to Covid-19 - speech by Klaus Regling

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Good afternoon from Luxembourg,

Seven years ago, I spoke at UniCredit's first European Investment Conference in Munich. In my speech today, I will explain the different policy measures that help mitigate the effect of Covid-19, how they are interlinked and how they complement efforts at country level. And I will describe what needs to be done on the road from recovery to resilience.

Since the first European Investment Conference, we managed to overcome the euro crisis quite successfully. Despite many doubts that existed early last decade. It is very clear that the current crisis is quite different from the earlier ones. Now we are experiencing without doubt the most challenging economic and financial crisis in our lifetime. Uncertainty is high and it looks like GDP in the euro area will not return to its pre-crisis level before 2022.

Economic activity in Europe came to a halt in March and April. After bottoming out in April, the economy entered into a strong recovery phase from May to July, alongside the gradual lifting of the lockdowns.

However, the recovery lost momentum in August and September, and may stall for a while as infection rates are increasing significantly in all European countries.

Crisis response without conditionality

When the pandemic reached Europe, EU policy-makers reacted swiftly with an array of different policy actions that calmed markets.

In spring, European finance ministers approved three EU safety nets to lessen the burden of this catastrophe for member states.

Each of the three safety nets has a different purpose: The ESM’s pandemic crisis tool has been tailored to the needs of sovereigns and supports countries to cover their health-care related costs. SURE is the backstop for workers managed by the European Commission, while the EIB’s Guarantee Fund helps businesses. This first support package amounts to €540 billion.

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 second support package, the "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 €360 billion in loans and €390 billion in grants. These funds will be channelled through EU programmes and will be repaid over a long period from future EU budgets – between 2028 and 2058. Siegfried Ruhl, ESM Head of Funding and Investor Relations, will join the EU Commission temporarily to advise colleagues on setting up the funding arm of the recovery plan.

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.

Looking at the ESM, the corona crisis has changed the way we work: unlike past ESM programmes, today we do not need “conditionality”. Conditionality is needed when policy mistakes and macroeconomic imbalances have to be corrected. That was the situation in 2010-2018, conditionality was needed and it worked. EFSF and ESM loans with conditionality helped five countries to regain market access and to have an above-average economic performance afterwards.

Today, there are no economic misalignments, no macroeconomic imbalances, no need for corrections. We do not need to correct past policy mistakes, we are responding to a common external shock for which governments are not responsible.

The Pandemic Crisis Support makes available, if requested, a precautionary credit line of 2% of a country’s GDP (Gross Domestic Product in 2019). Its mere existence has already calmed markets.

With this new support tool, we can provide loans to euro area countries to finance direct and indirect healthcare costs. The money the ESM can make available now is earmarked for health expenditures – that is the only condition. When member states request this credit line, the ESM will issue social bonds for the first time to finance the loans.

If all 19 euro area members were to request it, which I do not expect, the total amount would add up to €240 billion.

Countries can request the pandemic credit line until end of 2022. In this sense it differs e.g. from SURE, where countries need to hand in their requests now in order to receive financing next year.

In addition to the efforts at the European level, countries undertook swift and extensive policy actions at the national level, with substantial variation across countries. According to latest forecasts, fiscal deficits will reach 9-10% of GDP this year. Euro area countries adopted discretionary fiscal measures amounting to about 6% of GDP; automatic stabilisers are estimated to amount to about 4% of GDP. And governments provide guarantees totalling 22% of GDP on average of the euro area.

In my view, all these measures were adequate and necessary, as they will help to limit the economic damage of this crisis. The measures at the European level were designed to provide more assistance to countries most affected by the crisis, to protect the single market and to avoid divergences in the euro area. This provides an unprecedented degree of solidarity.

International financial markets have been positively impressed by the speed, volume and good cooperation of the different European measures. Market views about Europe and the euro area have never been as positive today as during the last ten years.

Challenges for the future

Nevertheless, it will be very important to ensure the efficient use and implementation of the unprecedented amounts of public money available. This is important, because I see four risks to future growth:

First, the **potential growth rate**, the output an economy can produce if it runs at full capacity and everyone is employed, is likely to be lower after the crisis than before the crisis. The recession destroys physical and human capital, it leaves investors reluctant to invest, given the high degree of uncertainty. Uncertainty has also led to much higher precautionary savings, depressing demand.

Second, the **collapse in world trade** means less competition and therefore smaller productivity gains. This implies lower trend growth. The collapse in world trade comes on top of the de-globalisation that started before the pandemic and deepened the problem.

Third, **European banks** are not as strong as US and Asian banks. Their capital position is much stronger than 10 years ago but banks continue to make too little profit in Europe, there is overbanking in some countries, 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 would also reduce growth.

Fourth, **higher public deficits and debt** are necessary and legitimate in response to the crisis. But higher debt can depress future growth as economic research has shown.

Given these challenges, it is important that Europe’s economic policies focus on enhancing competitiveness and investment while supporting the greening and digitalisation of the economy.

The objective clearly is to raise the potential growth rate of our economies through investment and reforms; that is the best way to maintain debt sustainability and that is exactly what the European Commission is trying to achieve with the Next Generation EU recovery fund.

In addition, the substantial national fiscal measures must be refocused from initially, rightly so, preventing an even deeper collapse of the economy to a more targeted support of healthy industries and sectors and the transformation of the economies towards digitalisation and green.

Going forward, deepening EMU is key

Seven years ago, I highlighted in my keynote speech “Beyond the Euro Crisis” at this conference the potential for further European integration, called for a fiscal capacity for the euro area and joint debt issuance. Today, I will do the same again.

Apart from all the necessary action at EU and country level to overcome the economic damage of Covid-19, we continue our work on deepening Economic and Monetary Union further. This also means that the ESM, which safeguards euro area financial stability, should be developed further.

Important steps have been taken the last decade to deepen the Economic and Monetary Union, like the creation of the ESM, the beginning of banking union, and stronger and broader economic policy coordination. The agenda for completing our monetary union is clear even if some of the items remain controversial. We should:

- Complete the ESM reform to ensure financial stability in the euro area,
- Complete banking union with a common backstop and a common deposit insurance,
- Create a capital markets union to harmonise all 27 national financial markets,

- Agree on a fiscal capacity for macroeconomic stabilisation of the euro area, something that is quite controversial among our member states at the moment, and
- Increase the volume of safe euro assets.
- What does this mean for the ESM?

In the future, with the ESM Treaty reform, the ESM can provide a backstop to the Single Resolution Fund and it will give the ESM a stronger role in future stability support programmes. We hope to start the ratification process for the revised ESM Treaty before the end of this year.

An important element of the ESM reform is the backstop to the Single Resolution Fund. This backstop is an important element for the completion banking union; the final element would be a joint deposit guarantee.

Progress on 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 the growth potential and make the euro more attractive to international investors.

A fiscal capacity for macroeconomic stabilisation in the euro area allowing for more risk-sharing among euro area countries is still missing. The Resilience and Recovery Facility now under preparation is not a permanent facility, and it is geared towards structural reforms. I believe a permanent facility, which should be a revolving fund and not a budget, would be useful. It would expand the fiscal space of a country in a downturn beyond the national fiscal buffers.

Finally, the need for European safe assets is increasingly recognised. A safe asset needs to be credible and liquid at all times. Two colleagues of mine at the ESM just published a blog post titled “Pandemic crisis as a catalyst for a common European safe asset”. My colleagues argue that the euro area would benefit from increasing the size of a common European safe asset. The European 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 the euro area – by comparison, the US has 90%. Perhaps this is a topic that we will take up in the discussion after my speech.

All the steps I just described will lead to a more integrated Europe, a better functioning monetary union and can also contribute to stronger growth. The role of the euro in the international monetary system could be strengthened as we move towards a multipolar currency system.

Let me close here. I am looking forward to the discussion with Erik now. Almost 37 years ago, I met Erik Nielsen in Washington, when we both worked at the IMF. It will be a pleasure to discuss with him some of the issues I touched upon in my speech and to answer your questions.

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