

Challenges for the European recovery - speech by Rolf Strauch

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Ladies and Gentlemen,

Good morning from Luxembourg, it is a pleasure to meet you today, if only virtually. I would like to say a big thank you to the Riga Graduate School of Law for hosting this event. It would have been great to visit your beautiful city in person but we are all adapting to these challenging times.

The pandemic crisis has deeply affected the health and safety of many people and created huge societal and economic disruptions in Europe and around the world. I am an economist and economic policy aims to enable sustainable wealth and equitable prosperity. While we cannot recover the human loss suffered during the pandemic, we can certainly do our best to recover the economic loss. This is what I

would like to focus on today, I will map out the challenges and opportunities for recovering the economic losses incurred in the European Union during the pandemic crisis.

To do so, I will first take a brief look back at the last crisis, the global financial crisis ten years ago, and explain why the current pandemic crisis is different. Much wealth and prosperity was destroyed in the financial crisis in a **vicious cycle** of financial and fiscal imbalances, loss of confidence and balance sheet adjustments, which damaged growth and income for many years.

In this current crisis caused by the Covid pandemic, we are taking the opposite approach. I will explain that this time, we are creating a **virtuous cycle** of public initiatives and private sector investment, which will lead to strong growth for all countries. I will then discuss how to address the policy challenges.

A look back at the financial crisis

So let's start by taking a look back at the financial crisis. Most people in Latvia have strong memories of the financial crisis and its fall-out in your country. From 2008 to 2010, Latvia faced one of the most severe recessions in modern economic history, losing around 20 per cent of its output.

At the time, the government and the Latvijas Banka faced some very difficult policy choices. On the one hand, they had the option of maintaining the peg with the euro and of defending the prospect of joining the euro area one day, and on the other hand, they had the option of abandoning the peg to the euro and to instead implement an independent monetary policy to buffer the blow of the recession. In defiance of well-meant advice from some economists, Latvia stuck to its guns and pursued an internal devaluation strategy. Thanks to this, you were able to introduce the euro in 2014.

This was a hard-earned success, which the country can be proud of to this day. These efforts formed the basis of a strong recovery, with the unemployment rate declining from 19.5% in 2010 to 6.3% in 2019, which was below the euro area average. Despite the current pandemic and some vulnerabilities, the Latvian economy is fundamentally sound today.

Creation of the ESM

Several other euro area countries were also deeply affected by the great financial crisis and the European sovereign debt crisis. During the financial crisis, Ireland, Greece, Cyprus, Portugal and Spain lost market access at affordable rates and they needed financial assistance.

In these countries, the interconnectedness between banks and sovereigns resulted in a spiral of financial and fiscal distress – the so-called ‘doom loop’ between banks and countries. The link between national debt and domestic banking sectors intensified during the financial crisis. Bank problems led governments to take over banking sector risks, while banks had incentives to increase their domestic holdings of government bonds. This turned into a vicious circle, as we witnessed knock-on effects from the banking sector to sovereign debt and from sovereign debt to the banking sector.

In response, euro area governments set up a euro crisis mechanism. The temporary European Financial Stability Facility (EFSF) was created in 2010, followed by its permanent successor, the European Stability Mechanism (ESM) in 2012. The ESM has since established itself as a lender of last resort for euro area countries with the capacity of raising significant funds in the market in a short period of time.

Over the last ten years, the ESM disbursed €295 billion in loans to Ireland, Portugal, Greece, Spain, and Cyprus. As part of the conditionality attached to the loans, countries committed to reforms. These reforms were necessary to repair their economies and make the financial support effective. These reform programmes were often difficult to implement - and even politically and socially painful, which is not very different from Latvia - but they addressed underlying imbalances and reduced risks in the banking sector.

All countries supported by the ESM eventually regained market access and returned to economic growth. This was possible thanks to reduced public debt burdens, improved competitiveness and a more resilient banking sector.

Divergence after the financial crisis

However, additional effort is necessary to strengthen growth and fully overcome the legacy of the financial crisis to catch up with past trajectories for increasing incomes and prosperity. While Latvia, like the countries that had received ESM support, was among the reform champions in the EU, old problems persisted in some countries, holding back long-term growth potential. That is why the euro area as a whole never

caught up with the trend of income growth prior to the financial crisis, and some countries never even regained their pre-crisis level of income.

One of the key factors holding back growth after the financial crisis was that economic uncertainty was putting off investors while at the same time firms and banks needed to deleverage and address crisis legacies. In many countries, companies did not invest sufficiently, meaning that private investments were subdued. Moreover, in some European countries, public spending was scaled back which led to infrastructure challenges and constraints on productive capital, including in the area of digitalisation.

As a result, the vicious cycle of the financial crisis caused a longer-term drag on economic growth in some European countries and regions. The question is to what extent the pandemic is different, and how we can better recover from the initial shock and move towards equitable, sustained growth.

The EU response to the coronavirus pandemic

There are several reasons to be optimistic that we can avoid the dire consequences of the financial crisis this time. While the economic impact of the lockdown measures to fight the pandemic was even bigger than the knock-on impact of the financial crisis, the EU was fortunately better prepared this time, and policymakers reacted swiftly and decisively to contain the economic fallout.

It is important to note that the origin of the current crisis is very different from the financial and sovereign debt crisis. This time, we do not need to correct excessive macro-economic imbalances in the euro area. Instead, we are responding to a common external shock for which governments are not responsible.

A key difference between the last crisis and the current one is the changed role of banks: they went from 'shock amplifiers' ten years ago, to 'shock-absorbers' this time around. Two factors are at play here: first, thanks to the prudential measures taken after the past crisis, banks entered the pandemic crisis with larger capital buffers and a stronger capacity to absorb bad loans.

Second, supportive prudential and monetary policies, as well as budgetary measures such as guarantee schemes, facilitated the extension of credit to firms despite the deteriorating economic environment. These two factors, stronger banks plus extra support measures, meant that banks could continue to lend to companies during the

pandemic crisis to help them bridge income losses.

Debt moratoria and direct transfers to firms, in the form of tax rebates or contributions to social insurance, provided further support while furlough schemes and other forms of support prevented a massive rise in unemployment.

To complement these national measures, the EU quickly rolled out a large support package of €540 billion to support workers, businesses and EU countries. As part of this, the ESM has offered all euro area countries a precautionary credit line of two percent of their GDP, to cover direct and indirect healthcare costs related to the pandemic.

This ESM support for countries complements support for companies provided by the European Investment Bank and support for workers by the European Commission. At the same time, a special ECB monetary policy programme (PEPP) continues to stabilise markets.

In addition, the extraordinary €750 billion Next Generation EU recovery fund is designed to boost investments and reforms in all EU countries to mitigate the impact of the pandemic on economic growth and to finance the digital and green transition.

The €540 billion package as well as the €750 billion Next Generation EU package are designed to particularly help the countries that are most affected by the pandemic. This represents an unprecedented degree of solidarity in Europe. It also protects the single market and prevents greater divergences in the euro area, which is in the interest of all.

As I mentioned in the beginning, economic policy is about the creation of sustainable wealth and equitable prosperity. Let me formulate this more precisely to define an economic, post-pandemic policy objective for the euro area. All euro area countries should catch up and even surpass the pre-pandemic growth path in the course of the next years - none should be left behind. This is an ambitious objective although it is supported by recent data which suggests a fairly strong emerging recovery. Let me outline the challenges we need to overcome to achieve this objective in the coming years.

Post-pandemic bank financing and banking union

Unlike the financial crisis, the banking sector was not the cause of the problem this time, it was part of the solution. As they were better prepared, banks played a major role in mitigating the impact of the pandemic and increased their lending. Looking ahead, the banking sector needs to continue to play a vital role in the recovery phase after the pandemic as the euro area economy is largely bank-financed. To fulfil this role, banks need to become more profitable and remain resilient.

In particular, policymakers need to strengthen the banking sector through completing the European banking union. The early introduction of the common ESM backstop to the Single Resolution Fund from 2022 onwards is a key element. Having the backstop ready as soon as possible ensures that sufficient funds are available in case a bank needs to be resolved. A strong and well-financed resolution mechanism reassures and stabilises markets, prevents spill-over effects and thereby protects savers. It will contribute to the robustness and resilience of the Economic and Monetary Union as a whole.

The ESM backstop to the Single Resolution Fund is part of a wider ESM reform, which also strengthens our precautionary tools and gives the ESM a larger role in future country programmes. The reform was agreed upon by all 19 euro area finance ministers and it will enter into force once it has been ratified by national parliaments, a process that is scheduled for completion this year.

That said, further important reforms are needed to complete banking union. The Eurogroup agreed to work on four key elements: the European Deposit Insurance Scheme, cross-border integration, the crisis management framework, and the regulatory treatment of sovereign exposures. Completion of banking union could support the necessary further consolidation in the banking sector to improve profitability and provide financial services more efficiently.

Beyond these measures, countries should look at national insolvency frameworks. Corporate insolvencies need to be addressed efficiently, so that the bad loans associated with failing companies do not hold back the banks' capacity to provide new financing for good companies and growth going forward.

Capital markets union and equity finance

Since bank financing - which mostly takes the form of loans - is the main source of financing for small and medium-sized enterprises, completing banking union is a good start to support economic growth, but we cannot stop there.

Some countries may emerge from the crisis with too much debt, and the resulting need to deleverage risks holding back investment. Moreover, standard loan financing is often not available to start-ups which are inherently more risky. Therefore, we need to strengthen equity or equity-type financing.

In the medium term, a better integration of capital markets through the creation of a capital markets union is necessary to facilitate cross-border investments, increase risk sharing and open up new ways of financing for companies. A capital markets union would increase the sources of capital needed by companies to recover from the crisis.

While it may be possible to rely more on capital markets to provide companies with the necessary funding in the medium term, public support may be needed to fill the short-term capital requirements. To this end, some countries have already set up public equity funds or provided equivalent schemes. Governments can also convert some of their existing loans into equity.

The fiscal framework

So we need to complete banking union and create a capital markets union to create a sustainable framework for economic growth in the euro area. In addition, I would like to say a few words about the work that still lies ahead of us on the fiscal side.

The EU support schemes helped to finance crisis needs, and the Next Generation EU package will to give additional support to the recovery. This latter type of support is qualitatively different from the support provided in the past crisis, and in my view it currently presents the biggest opportunity to raise income levels and enable prosperity.

Next Generation EU has three key features:

- First, the redistribution of resources across countries particularly helps those with less income and those hit more severely by the crisis. Latvia is benefitting in a similar way as Italy and Greece, which were hit harder by the pandemic. Moreover, Next Generation EU includes a substantial amount of transfers and therefore does not add to the debt burden of countries. This leaves countries with more fiscal space to respond to future shocks if needed, which is critical for individual countries as well as for the coherence of the union.

- The second feature of Next Generation EU is that it is directed towards the structural transformation of our economies. It is investment-oriented, supporting both public and private investment. It aims to help economies to get fit for the future, to become more digital and “cleaner”, more sustainable and less polluting. We are increasingly realising that this path towards sustainable growth is the only one that can be successful in the age of climate change.
- The third feature of Next Generation EU is that it links financial support to reforms. Each country’s national recovery plan includes investment priorities and reforms as identified under the European framework for policy coordination. I noted before that, in the financial crisis, many reform efforts were required by a few countries. With Next Generation EU, this challenge is broader. This is not only helpful in pushing growth in many individual countries, but can also create positive externalities across countries.

So, to repeat, the key features of Next Generation EU are a redistribution of resources, including through transfers, the target of creating cleaner and more digital growth and the condition of reforms in all countries.

In the coming years, it will be a key challenge for governments to seize the opportunities provided by this programme. In the past, the capacity of some countries to absorb and use European funds productively has been weak. This needs to improve. And, of course, reform fatigue often sets in quickly, which makes it difficult to follow up on commitments or even to strengthen reform efforts. Since Next Generation EU provides positive incentives for reforms through disbursements, I hope that we can overcome some of those obstacles.

In addition, we need to look at the European fiscal framework. The general escape clause of the EU fiscal framework was activated in March 2020 to accommodate the large increase in government spending in response to the pandemic. As a result, EU countries are currently not bound by the normal budgetary requirements.

While we are closer to controlling the pandemic, fiscal support cannot be withdrawn abruptly until the recovery is firmly under way. The European Commission therefore proposes to extend the general escape clause until next year. Even after that, a smooth fiscal transition will need to be ensured and some countries are still expected to be far from the 3% deficit limit at the end of 2022.

Moreover, the present macroeconomic situation with increased public debt, low interest rates and higher investment needs, changes the parameters of debt sustainability compared to the 1990s when the EU fiscal framework was designed. Interest rates can be expected to increase, but not to the levels seen at the time. This implies a higher debt carrying capacity of countries which needs to be reflected in the fiscal rules. We also need to simplify the fiscal framework to make it more transparent, credible and operational. This would make it easier for countries to comply with the rules once they are reapplied after the crisis. Overall, the fiscal framework needs to provide a credible and transparent guide for a smooth fiscal path. Countries need the fiscal space to invest, build up buffers to react to future crises and have the trust of financial markets.

On the fiscal side, I have mentioned Next Generation EU and the need for an overhaul of the EU's fiscal rules so far. Another element that would strengthen Economic and Monetary Union is a fiscal capacity for macroeconomic stabilisation in the euro area. It should not rely on permanent transfers, but would allow for more risk sharing between countries. Next Generation EU, which will be financed by bonds issued by the European Commission, is not a permanent facility, and it is geared towards structural reforms in the wake of the pandemic.

I believe a permanent facility, in the form of a revolving fund instead of a budget, would be particularly useful for euro area countries. It would give countries more fiscal space in a downturn than is currently the case. This would be a critically important, stabilising tool in the euro area, as individual countries in the common currency area cannot conduct an independent monetary policy.

Concluding remarks

Allow me to conclude with a recommendation for a path towards economic recovery, and a call for further deepening of Economic and Monetary Union. A combination of public and private sector support would enable a sustained recovery, support convergence and strengthen resilience to better equip the euro area for future economic challenges. This would encourage a virtuous growth cycle delivering sustainable and equitable prosperity.

Strong and supportive economic policies by individual countries will be much more effective under a revised legal and fiscal framework for the euro area. This would in turn strengthen the Economic and Monetary Union by boosting sustainable growth.

The accompanying deepening of banking union and capital markets union is essential for encouraging much-needed cross-border private risk taking and investing.

Meanwhile, Next Generation EU is putting euro area countries on the right track towards a more digital and greener economy, for which Latvia, and the Baltic countries more broadly, are already in the vanguard.

Thank you. I look forward to your questions.

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