The economic landscape in Europe and Cyprus: opportunities ahead - speech by Klaus Regling

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(*Please check against delivery*)

Good afternoon,

It is a pleasure to be back in Nicosia and to speak to you today.

Almost two years since the outbreak of the pandemic, it continues to cause hardship around the world. Looking at Europe, we have experienced, without doubt, the most challenging economic and financial crisis in our lifetime.

Containment measures have improved the health situation and helped opening up economies. With rising vaccination rates, the number of new infections has subsided in many countries and economic activity has picked up. But uncertainty remains as we are in the fourth infection wave.

After a 5.2% drop in economic activity in Cyprus last year, the latest European Commission forecast points to a recovery of 5.4% in 2021 and 4.2% in 2022.

The revival of economic activity, in Cyprus and in the rest of Europe, was possible thanks to a comprehensive policy response to the pandemic. The response to the pandemic at the national and European level to the pandemic was fast, powerful, and well-coordinated.

EU response to the pandemic

At the EU level, three institutions were part of the initial crisis response in April last year: the European Commission, the European Investment Bank and the European Stability Mechanism. The most important measure was decided last summer and will be implemented over the next five years, the €750 billion Recovery Plan "NextGenerationEU" (NGEU) of the European Commission supports economic reforms as well as the green and digital transformation.

If countries successfully implement the reforms that they proposed in their Recovery and Resilience Plans, they could sustainably raise their growth potential and transform their economies. Going forward, the efficient and effective implementation of these plans is the key task for all EU Member States over the next 5 years.

Cyprus is no exception. The proposed measures should help achieve some key long-term macroeconomic goals, strengthening the resilience and competitiveness of the economy. Implementation is now essential. Let me only mention the importance of the judicial and administrative reforms.

In addition, Cyprus continues to have challenges in its financial sector. Non-performing loans of the Cypriot banking sector have decreased by over 80% since 2015. This is positive but efforts to reduce them further should continue. An effective application of the insolvency and foreclosure framework will be important in this context.

Deepening EMU further

For Europe as a whole, while the recent crisis has been very painful, it also provides the opportunity to accelerate structural changes in our economies and to make further progress towards deeper European economic integration. This is, I believe, crucial to position Europe better in a changing world, make it more resilient to future crises and to strengthen the international role of the euro.

In response to the euro crisis a decade ago, important initiatives were taken to make our Economic and Monetary Union (EMU) more resilient: we set up several new institutions – like the SSM, the SRB, ESRB, EBA, ESMA and, of course, the ESM – that increase the effectiveness of crisis prevention and crisis management.

During the pandemic, we benefited from this stronger institutional framework.

But to strengthen the monetary union further and to complete the process of deepening EMU, we need to work on three key areas:

- Completing banking union;
- Making progress towards a capital markets union; and,
- Appropriate management of fiscal policies.

Progress in these areas would increase economic risk-sharing in the euro area – via market channels as well as via public channels, thus strengthening convergence.

Completing banking union and creating a capital markets union would have many other benefits: fewer obstacles to cross-border investments can facilitate a better allocation of capital, open up new ways of financing for companies, strengthen competitiveness and thus raise Europe’s growth potential. This would also make the euro area more attractive for global investors and elevate the euro’s international role.

Although there is broad consensus around the benefits of these reforms, I am fully aware that the steps needed to complete them remain controversial. The ministers of the euro area – who meet regularly in Brussels to decide on these matters - are working hard on these matters.

Several difficult decisions need to be taken to complete banking union, including a European deposit insurance scheme, improved cross-border integration of the banking sector, a broader crisis management framework that includes medium-sized banks and the regulatory treatment of banks' sovereign exposure.

The next important step towards a full banking union is the ESM's backstop to the Single Resolution Fund. This is agreed and will happen at the beginning of the next year when the revised ESM Treaty is ratified.

Creating a capital markets union is technically complex. The euro area today consists of 19 different capital markets with their own rules and barriers to cross-border capital flows. An integrated European financial market would require the partial harmonisation of insolvency laws, the alignment of the tax base for companies, more supervisory convergence, and a long list of other measures.

Lastly, risk-sharing in EMU also happens through public channels. This is already the case today through the EU budget, through loans from the European Investment Bank, through the financial assistance of the ESM and through "NextGenerationEU" in the coming years. However, "NextGenerationEU" is limited in time and tailored to the needs of all EU countries, not just the euro area.

For the euro area, there are other possible options on how to share risks. A new instrument for macroeconomic stabilisation could provide additional fiscal space, not transfers, to euro area countries hit by an asymmetric shock. As euro area countries have given up their own monetary and exchange rate policies, the remaining macroeconomic tool, fiscal policy, may be needed more from time to time.

Reform of EU fiscal rules

My final remark is on the need to reform the Stability and Growth Pact. This pact coordinates budgetary policy and ensures the debt sustainability of euro area countries.

The policy response to the pandemic came at a cost. Higher deficits and a drop in economic activity last year have led to substantial increases in public debt-to-GDP ratios. Nevertheless, public debt currently is sustainable in all member states of the monetary union.

To a large extent this is the result of the long-term, secular trend towards lower interest rates that we observe globally. Countries now have a higher debt carrying capacity than what was assumed in the Maastricht Treaty. And while interest rates will increase from today's low levels, economic research indicates that equilibrium interest rates will remain lower than 20-30 years ago.

Some elements of the Stability and Growth Pact, as they stand now, do not reflect this changed macroeconomic environment. Going forward, a simplified EU fiscal framework could be built around a 3% deficit limit and a higher debt-to-GDP ratio.

If we succeed in deepening our Economic and Monetary Union with a banking union, a capital markets union, and more public and private risk sharing, EMU would become more robust and less vulnerable and the euro's international role would be strengthened, enhancing Europe's sovereignty.

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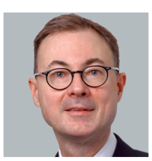

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