Risks and resilience in the euro area

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Pierre Gramegna, ESM Managing Director
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Dear distinguished guests,

Allow me to contribute to this prestigious conference by presenting my take on the risks and resilience in the euro area to you.

Introduction

For the past three years, our economies have been shaped by two large exogenous shocks: the pandemic and the energy crisis triggered by Russia's unacceptable war on Ukraine.

We are at a moment of "radical uncertainty"[1] – not only in Europe but globally.

Wars have devastating effects on citizens. And can affect economic growth and financial stability.

The picture is not rosy. And at times it feels as if crises become the new normal. Some even speak of "permacrises".

A question comes to my mind: is Europe well prepared for this new "radically uncertain" world and the unforeseen shocks that it might face?

I will argue that Europe is resilient but that there are a few challenges that we need to be mindful of.

Lessons learnt and state of play of challenges

We entered the pandemic in a relatively strong economic position compared to the great financial and the sovereign debt crises.

And when the virus faded, our economies recovered much faster than many had expected.

We reaped the benefits of many of the reforms taken in the years before.

Macroeconomic imbalances, which had led to the sovereign debt crisis, had declined.

Banks entered the pandemic crisis with stronger balance sheets.

That is why, unlike during the global financial and euro crises, the banking sector became part of the solution, not part of the problem.

They helped keep our economies afloat by upholding their financing.

For both the pandemic and the energy crisis, national governments took comprehensive measures to support the economy.

Importantly, governments united their efforts at European level to design innovative schemes to overcome the risk of fragmentation and support citizens.

First by providing liquidity and then by embarking on structural reforms to strengthen potential growth across all EU countries.[2]

The EU's recovery and resilience facility played a vital role as funds were directed mostly towards countries that were the hardest hit.[3]

European initiatives also relate to the functioning of energy markets, energy saving agreements, and the redirection of EU recovery funds toward energy independence.

The fiscal and financial packages were successful.

The euro area economy recovered faster from the pandemic than from the great financial and the sovereign debt crisis – certainly due to the nature of the economic shock but also due to the concerted measures taken.

In fact, many households and firms came out of the pandemic with excess savings, also due to strong support from governments.

The public sector benefited from well-coordinated action at European level, although it had to take up additional debt.

The flip side…

These elements are a good basis to face challenges going forward.

Yet there is another side to this story.

Europe is likely to suffer a stagnation for a few quarters and may – according to markets – dip into a light recession. For the whole of 2024, we expect, at best, a rather modest recovery.[4]

In this context I see a few obstacles ahead of us.

After a long period of low interest rates, monetary policy tightening is having its effects on households and businesses, which are facing increased borrowing constraints.

Higher interest rates may last for a long time. And tighter financial conditions weigh on economic activity.

Headline inflation is declining, but the process will take time to consolidate. At the same time, risks on energy prices are on the upside, due to the ongoing geopolitical tensions.

Although this winter supplies of energy, and lasting savings of energy by companies and households have kept prices at a reasonable level up to now. Still core inflation is still stubbornly high, above 4%.

The private sector has financial buffers but not all players are in the same position. Vulnerable households who do not have savings, as well as firms with energy intensive production, will feel the pressure of higher interest rates.

And, in any case, the buffers may fade if the economy does not grow. The shape and pace of the recovery is still highly uncertain.

The euro area banking sector is robust due to the work done in the past.[5] But we should not underestimate vulnerabilities of individual financial institutions, especially those more exposed to commercial real estate.

We have seen in the United States earlier this year, that non-systemic banks may prove to be particularly vulnerable.[6] While the events in the US and in Switzerland sent shockwaves to financial markets in the euro area too, they were limited thanks to past reforms. But turmoil can occur unexpectedly. We need to remain vigilant.

The public sector has extensively used its “fiscal firepower” during the last two crises.

This has increased public deficits and debt, and now rising interest payments will gradually absorb a higher share of government revenues – fiscal space in the national budgets has therefore declined (in some cases quite substantially).

Given higher interest rates, there is limited fiscal space for policy reactions in the magnitude seen during the past two crises.

The robustness of private sector balance sheets came at the expense of the public sector, which made great efforts during the pandemic and the energy crisis to support the economy.

We need to rebuild fiscal buffers to be able to respond to future shocks, and to have sufficient means to handle the persistent challenges of climate change, ageing population, modernisation of our economies, and deglobalisation.

And what will happen after the EU recovery fund expires in 2026?

What we do know is that there is a non-negligible chance that we will find ourselves in a drastically different geopolitical environment than before.

One important question, for example, is how the war in Ukraine and in the Middle East will affect the supply of energy and reconfiguration of supply chains.

But not only that.

Trade relationships with China will also play a role.

If the global economy were to fragment further from here, this would pose a threat to the growth of the euro area economy.

Geopolitical changes will affect prices, economic resilience, and the speed at which the European economy needs to transform.

I believe that the institutional innovations at the European level over the past decade will need to play an increasingly important role in the future.

A new and more effective rules-based fiscal framework is necessary to support policy coordination and instil market trust.

This is why a timely agreement on the new economic governance remains essential.

The ongoing review should increase effectiveness of the framework through transparency, credible commitments that convince markets and people, strong governance, equal treatment, and enforcement.

But only rethinking the EU fiscal rules is not enough.
Beyond this, we Europeans need to have a broader discussion on how to provide public goods for European citizens.

How to prepare for the future?

I see three areas where Europe could usefully pool its resources and where actions of one Member State are not enough.

First, completing our journey towards crisis resilience.

Second, staging up the fight against climate change and the need for green transition.

Third, gaining more open strategic autonomy, while not hampering international trade.

Let me focus on crisis resilience.

The ESM and the European Financial Stability Facility (EFSF), its predecessor, emerged from European solidarity and members will have to face challenges collectively.

Both the EFSF and the ESM provided financial support of around €300 billion to five countries: Greece, Cyprus, Ireland, Portugal, and Spain.

The ESM was used to solve crises that were driven nationally and made it difficult for these five countries to access financial markets. These were crises of these countries' own making.

Reforms were agreed and introduced to boost economic recovery in the five countries.

Today, these countries are among the fastest-growing countries in the euro area.

In this way, the ESM has applied its mandate and preserved financial stability in the euro area.

Both crisis prevention and resolution are at the core of the ESM mandate.

We are the only permanent euro area crisis management fund with the mission to prevent and resolve financial crises.

The ESM has the highest paid-in capital of any international institution, slightly more than €80 billion.

Besides, the ESM benefits from additional callable capital of about €620 billion.

This strong capital structure allows it to have a maximum lending capacity of €500 billion. Currently, €417 billion is available.

After decades of working in European policy, I know there will be more crises further down the line.

The challenge is that we do not know what they will look like and when they will occur.

A lesson that we have drawn from past crises: preventing crises at an early stage is less costly.

Crisis prevention will increase in importance as the number of shocks will increase while the nature of shocks will be different from the past.

Possible shocks to financial stability may come from geopolitical tensions, climate change, or from well-known but slow-moving trends like ageing.

That is why we should not lose sight of the importance of finalising the reform of the ESM, and the benefits this would bring to our institutional architecture.

Once the amended ESM Treaty is ratified, the banking union would be one step closer to completion.

The revised ESM Treaty offers a strong safety net in case of distressed banks, the backstop to the Single Resolution Fund.

But that's not all. The Treaty gives more room for crisis prevention, and further enhances the resilience of the euro area to large shocks in the future.

In conclusion, the EU has proven to play a crucial role in mastering past shocks, also due to the work of the two crises funds, ESM and EFSF.

Addressing formidable new challenges in the medium to longer future

However, future crises will be different to past crises. Some crises might be nationally driven, others might be external, such as the pandemic or climate change.

For all crises, which are different in nature, the ESM can be the answer.

Future challenges ahead will test our ability to successfully prevent and avert crises in the future.

I see three threats, which are already in the making, and which will shape Europe's growth in the future:

Deglobalisation:

- Geostrategic fragmentation will increase the risk of fragmentation of world trade.
- World trade was the main engine of growth over last the past decades but will contribute less to growth in the future.
- The IMF expects that greater international trade restrictions could impact global economic output by as much as 7% over the long term. This is equivalent to the size of the French and German economies together.[7]

Climate change:

- CO2 emissions and climate change can hardly be tackled by countries alone, and a global, coordinated effort is needed.
- Member states might face constraints in terms of political willingness and fiscal space.

Ageing:

- Ageing is expected to come to countries differently, although the overall direction of travel is the same: the continent is ageing, which can lead to less innovation and less productivity.
- This complex phenomenon will require a multi-pronged response both at the national and at the European level, focusing on immigration, technological change, and innovation.

Although the need to tackle these challenges is crucial, Member States are currently constrained in their action by a limited fiscal space.

To master these challenges to me the answer is clear: to prosper in a shock-prone world, we need a strong Europe.

As we will enter a new institutional cycle soon, it is up to us to shape the discussions, to think long-term.

Conclusion
Dear Ladies and Gentlemen,

These days we are talking about strategic autonomy, countering the consequences of an energy crisis, and we are worried about wars – all of which creates “radical uncertainty”.

We will always face crises. Then, now and in the future. And we will grow stronger out of them.

That is why Europe’s resilience – not only externally, but also among member states – is more important than ever.

Thank you.

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[1] IMF Managing Director (2023), A Story of Hope and Opportunity for the Next Generation, IMF Managing Director’s 2023 Annual Meetings Plenary Speech.
[2] The immediate safety net introduced in May 2020 was provided by the European Stability Mechanism, the European Commission, and the European Investment Bank. This emergency package of €540 billion was designed to support firms, households, and governments.
[3] The EU’s recovery fund, which followed during the summer of 2020, amounts to €750 billion and has a deliberate “redistributive” setup as it promotes the digital and sustainable transformation of our economies with a multi-year investment programme. Disbursements are linked to milestones and structural reforms.
[4] European Commission (2023), “European Economic Forecast. Autumn 2023”
[5] The latest stress test by European Banking Authority (EBA) confirms this. EBA (2023), “EBA launches 2023 EU-wide stress test”
[6] European Central Bank (2023), “The CMDI package: a vital building block to improve our crisis management framework”
[7] IMF (2023), “The High Cost of Global Economic Fragmentation”, The High Cost of Global Economic Fragmentation (imf.org).

Author

Pierre Gramegna
Managing Director

Contacts

Cédric Crelo
Head of Communications and Chief Spokesperson
+352 260 962 205
c.crelo@esm.europa.eu

Anabela Reis
Deputy Head of Communications and Deputy Chief Spokesperson
+352 260 962 551
a.reis@esm.europa.eu

Juliana Dahl
Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu