

Rolf Strauch in interview with South China Morning Post

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Interviews



Interview with Rolf Strauch, ESM Chief Economist

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South China Morning Post: Mr Strauch, you have mentioned in your work that climate change is the next big financial threat. Why do you think this is significant to the financial sector and are global institutions adjusting

enough to meet this new threat by referencing the European situation and its climate target?

Rolf Strauch: Climate change is indeed one of the three major mega trends affecting the global economy. The other ones are demographics and geoeconomic fragmentation.

We need to recognise that the financial sector is a connecting sector within economies because it can be either an absorber and a mitigant, or it can be an amplifier of what happens to the economy through climate change.

That depends very much on whether financial flows will help smoothen out the impact of climate change, or if they will be more disruptive.

I generally distinguish between transition risks and physical risks emerging from climate change.

Transition risks are related to a more sustainable and carbon neutral economy. That requires a lot of changes in policies. And these changes bring about reputational risks, operational risks, legal risks. Assets may get stranded. They may lose their value in that context.

Then, there are physical risks. Obviously, physical destruction may be hugely disruptive. The damage and the value destruction that may happen in the advanced economies may be bigger.

For emerging markets and developing countries, the impact may be more significant, because agriculture and tourism play a bigger role. The economies are less diversified. That makes them more exposed to climate change risks, and damages.

At the same time, they may be less ready to address those damages. So, if you look at the numbers for 2023 based on information from a global reinsurance company, damages from natural disasters were about US\$290 billion, a bit more than 1/3 of that happened in Europe, of which 25 per cent were insured and covered. About US\$50 billion pertain to Asia, of which 16 per cent were insured, which means that the insurance gap that exists in emerging markets and in developing countries is bigger. And the rescue falls on the government, the public sector, which may be less prepared to take this up.

You also asked what international institutions are doing and can be doing. One is to address this insurance gap in helping countries to build up this insurance and backing it up with resources. And that happens with different development banks. A second level of support is facilitating green finance. And that is directing financial flows toward green finance, but also facilitating the private sector to come in and take up some of that financing.

The third level, and that is very important, is supervision and regulation: To make the financial sector fit and more robust for what can happen through climate change. And there are various initiatives here, among others by the Financial Stability Board and by global institutions like the IMF that support this objective.

When it comes to supervision and regulation, Europe is regionally and globally in the lead of developing this approach.

In terms of climate stress tests, it pushes the frontier very far. That's done by the European Central Bank and the European Banking Authority.

When it comes to regulation, which is part of the European Green Deal, regulation on climate change is developed in terms of classifying production as being green or more climate friendly; and also in terms of reporting requirements for corporations.

The EU and China have committed to become climate neutral by 2050 and carbon neutral by 2060. In order to carry out the ESM's mandate of safeguarding financial stability in the euro area, is there more room for collaboration between the two in dealing with climate change? If so, which areas do you think would be most effective?

In terms of cooperation, there are various initiatives where we participate and where we also see Chinese counterparts being engaged.

One is that we are part of the global financial safety net and regional financing arrangements. Our Asian counterpart is the Chiang Mai initiative and the ASEAN +3 Macroeconomic Research Office (AMRO) in Singapore, which is the research arm. China, Hong Kong are also members.

A second initiative is the Network for the Greening of the Financial System, known as NGFS, which was created by central banks and supervisors in order to push for the achievement of the Paris Agreement.

We are part of that network, and we are participating as observers. The People's Bank of China and the Hong Kong Monetary Authority are also part of the NGFS.

It is a global hub of expertise and a global learning exercise that tries to derive concrete policy scenarios and measures to address climate change related risks.

The third area are the UN principles of responsible investment, which the ESM signed up to. We did that relatively shortly after the Hong Kong Monetary Authority.

For example, China International Capital Corporation (CICC) is also signatory of this initiative that commits themselves to live up to certain standards and reporting requirements, where they invest in a way that is accessible to long-term sustainability.

Beyond these, we are active within Europe to support European initiatives. The ESM takes its responsibility to work on its carbon footprint and to create the necessary transparency about how it works on sustainability.

Given banking events in Europe last year and the current situation, what is your view on financial stability that matters to resilience? How does the EU single market help build resilience and become Europe's future strength and potential? And how would the EU use the budgetary resources of its recovery fund more efficiently to attain resilience?

The euro area has shown great resilience over the past years when it was hit by severe shocks. Also more recently, during the energy, or the cost-of-living crisis, that was brought about by the war of Russia against Ukraine.

If you think back to spring 2023, you saw financial constraints in the US financial sector, when the Silicon Valley Bank went down and other regional banks were dissolved. And you saw the problems with Credit Suisse in Europe.

The euro area banking sector went through this period rather strongly and was only affected to a very limited extent, which showed the strengths that it had built up since the great financial crisis between mid-2007 and early 2009 and the sovereign debt crisis from late 2009 until 2012.

In recent years, due to the interest rate increase, banks have been very profitable. And that strengthens their capital position. So, from that perspective, there is substantive resilience in the financial sector.

Does it mean that there are no risks? Obviously, as a crisis resolution mechanism, we are monitoring the situation closely. And, there are some risks emerging from real estate, particularly from commercial real estate. But this is very limited. And there is no point of comparison with what we saw in earlier crises, because exposures are less concentrated.

In earlier crises, there was a huge excess supply of real estate. That didn't happen this time around. There is, from the banking side, a significant buffer. And I do not expect at all those risks would emerge in a systemic way. Some difficulties for an individual institution could emerge, but nothing that would be of a systemic nature.

Can we do more? I think the deeper integration of the EU Single Market in the area of finance can help very much to secure better finance and more risk sharing across the euro area.

Overall, more financing sources available to corporations should lead to higher growth and more risk-sharing because financial flows can help smoothen economic developments and that also should support overall stability.

What do you think are the biggest risks facing financial institutions in Europe? What would be your advice in handling a property market crisis?

First, it is good to restructure or allow banks to recover and offload the non-performing assets quickly to repair their balance sheet. If they stay too long on those balance sheets, they impair future lending.

Second, bad banks can be very efficient tools in facilitating this. You need a proper structure for a bad bank to make it work, but then it can be a good vehicle for cleaning bank balance sheets and allow banks to work properly.

Third, you need to have efficient systems to resolve profitable banks that have run into trouble and liquidate those that are not profitable to make resolution and liquidation efficient.

Now we are much better prepared for those cases than we were in the past, but further progress in this regard needs to be made. There are two points still on the treatment of non-performing loans - you need to have an efficient insolvency regime to work them out quickly, and you need to have an efficient secondary market to trade them.

If this is the case, then you can actually turn around and securitise properly significant volumes of non-performing loans, which helps the overall workout. That is the final condition that we have learned makes efficient dealing with the worst real estate crisis possible.

Despite more efforts to bolster, China is seeing persistent deflationary pressure as well as weak confidence from businesses whilst it has to handle the fallout from a property market crisis. How do you evaluate its economic transition so far? What is the view of ESM on the growth prospects for China, key financial stability problems and its implications?

The ESM, as a European crisis mechanism, looks at the global environment to detect financial stability risks that could affect the euro area. In that context, we also look at China. Besides, we have a base of about 1,800 investors. Investors buy our bonds, many of them coming from Asia.

In terms of overall growth trajectory, the IMF notes that growth performance at this stage is rather resilient. They expect growth this year to be 5 per cent, which shows still quite some resilience.

But then we also hear from markets that growth will go down in the longer-term towards 4 per cent. The IMF even says slightly below 4 per cent.

The main drivers of that are demographics and productivity. The productivity decline is also related to the higher importance of the services sector. There are some constraints on growth coming from that side.

Another factor that plays a role in the longer-term growth trajectory is the evolution of trade. And, obviously, Chinese growth has been strongly driven by its inclusion in the world economy and its role as a trading nation.

The prime destination historically of its export has been the US. That has changed in recent years and Chinese trade has been redirected to other countries. From a global perspective, less trade between the US and China is a factor that constraints growth, and redirection affects Europe.

Europe is among the big advanced economic blocs, the most open one, and it has close relationships to both the US and China. Against that background, there is quite an interest in having good relationships and having a strong Europe.

There are some concerns that the eurozone might be heading towards a financial crisis and a recession. Do you think these concerns are justified? What is your view on the outlook for Europe and what are the implications for the rest of the world?

At this stage, Europe is on the way to a recovery. This is what the short-term indicators and what the forecasts show. Growth has been very low last year. It is increasing somewhat this year, and it is expected to be 1.4 per cent next year.

The main driver of growth next year is increased real incomes. From that perspective, there is no reason to believe that we are entering a recession.

Also, if you look at inflation and monetary policy, we expect monetary policy tightening to have reached its peak. For the moment, there is no reason to expect further tightening from the European side.

Despite the sharp rise in interest rates that we have experienced, we also see that the balance sheets of the household and corporate sectors in Europe are rather healthy.

If you look at the debt-to-GDP ratio for the corporate sector, it is 67 per cent, which is the lowest since 2007. If you look at the debt ratio for households, it is the lowest since 2005.

That overall shows some resilience in those sectors, and there is still a lot of excess savings that were built up during the Covid pandemic. That has not yet been spent - about 12 per cent - of GDP, which creates a buffer for the economy and supports the recovery.

One of the questions that arises is that this recovery is relatively weak. The underlying reasons for this soft recovery are rather structural and indications of lower growth in the longer term.

That relates to longer-term issues emerging for Europe, which is not only demographics, but also the question of how much productivity Europe can generate.

Europe can do more. And that relates to the EU Single Market.

By further developing the single market - for the real economy, for energy, for services - there can be significant growth potential unleashed. There are estimates

that the growth potential could be increased by 7 to 10 percentage points. There are different estimates, but it is significant.

On top of that, having a more integrated energy market can help greatly improve energy security, and therefore also stability.

Beyond the single market, there is the issue of how Europe can use available resources to address the challenges that are out there, dealing with climate change and economic fragmentation at the European level.

This will require substantive investment. One of the issues that has to be addressed is how the European level can contribute to the efforts done at the national level.

The ESM at this stage has about €420 billion of unused lending capacity. Our thinking is that we should do our best to make the most efficient use of these resources within our mandate to safeguard financial stability, to address challenges.

Next generation EU, Europe's pandemic recovery fund, has not yet been spent, it is a €750 billion package. The most immediate challenge is to implement this as forcefully and speedily as possible to facilitate what it is meant to address. That is the green and digital transition.

But still, we must think about what will happen afterwards and how Europe can organise itself and have the necessary resources to facilitate this transition and safeguard stability.

In a recent interview, you outlined demographics and ageing related costs as among the key issues facing Europe. What policies do you think need to be in place to meet these challenges in the next decades? Do you think China may wish to consider planning for such changes because its population is also ageing faster than previously anticipated? Any lessons China can learn from Europe on this front?

Demographic change is one of the global challenges. It affects Europe. And it does affect China. If you take a simple comparison on the demographic change that is expected in Europe, at this stage, you have three workers in relation to one retiree.

In China, according to my information, this relationship [ratio] is 5 to 1. By 2050, both the euro area and China will have a relationship [ratio] of two workers per one retiree, which is to say that the development in terms of demographic change and

active working population as compared to the retired population is very binding in Europe. But it will also be very binding in China.

Now what can be done about that? Let me first talk about Europe because I think Europe has done a lot already. You can obviously work on the cost of pension systems. You can work on labour markets. And I think Europe has already done a lot in this respect.

People have a tendency to stay in the labour market and not go into early retirement, but more could be done to further increase participation rates, for example, participation rates of women.

And that would help on the pension side. The pension system has changed. They have been more adjusted to mirror demographic change and longevity.

A third way you can try to address it is through migration. Some European countries have now modernised their migration laws in order to facilitate labour migration, just to make labour markets work more. But there are refugee waves which create their own political and social problems.

What we notice is that if you look at demographic projections, even if you maintain current migration, you would still experience significant ageing of the population.

To keep the current structure and counteract the demographics of ageing, you would need to go to levels of immigration that may not be politically digestible, which is to say you also need other solutions to kick in.

Obviously, technological progress allows for some complementarity or substitution to labour.

The question is what artificial intelligence, for example, can do to make labour more effective, efficient, work better, and allow for the substitution of labour.

This is still an open question because it is in a very early stage of the development to know what the full potential is. But it is one of the key issues that needs to be addressed looking forward, how much technological development can help.

I would not dare to say this is a recipe or this is what China has to do or can do.

First, it is not my role to give policy advice to the Chinese government.

Second, it is also difficult in a sense that I think the specific answers that can be given for an economy depend very much on the economic circumstances that exist, the magnitude of the problem, and also the political constellation, and what the political preferences are to allow for one or the other institution.

Commercial real estate markets have been under pressure in Europe for a very long period of time and has been viewed as a weak link of the euro zone's financial system. Do you think they are recovering and do you see any similarities in China's property market right now?

For example, in the US, the recovery of office usage is less than it is in Europe. So, we believe that European markets in a comparative perspective are somewhat better positioned.

The other part is where you are in the monetary policy cycle. In Europe, we think that we have reached the peak of monetary policy tightening. While, for example, this is much less evident in the US and in that regard also China is in a very different position.

There was the question of supply over time and how it has evolved. Obviously, the Chinese market has grown very strongly over the past decades, while there has not been the same kind of supply growth in Europe in recent years.

How to address those problems? Again, it depends very much on the possibilities and the constellation in each economy. And I think a commonality is clearly that leverage creates risks - excess leverage of landlords, and excess leverage of developers is a risk - whether you are in Europe or whether you are in China.

But beyond this, it may be very different in the specific role that individual institutions have, that public authorities have.

What we found is that efficient means of addressing real estate problems in Europe may apply differently in China. So, I cannot say: Look, here is a recommendation or package on how to address the Chinese situation.

The IMF makes some recommendations in this regard. We know that the Chinese government has moved into that direction, for example, in facilitating or wanting to promote the completion of housing projects. But how this will evolve is up to the government to see.

How is the cooperation between ESM, AMRO of Southeast Asia and Latin America Reserve Fund that formed regional financing arrangements and global financial safety net help mitigate geopolitical fragmentation and global uncertainties?

The ESM is part of the multilateral layer of the global financial safety net, which consists of the International Monetary Fund and the regional financing arrangements.

In Europe, we needed to create an institution like the ESM because the resources of the IMF would not have been sufficient to address the sovereign debt crisis. Regional financing arrangements are complementary in terms of providing financial support in either financing earlier than the IMF or complementing the financing of the IMF.

They have also shown great adaptability to adjust to the type of crisis that emerges, for example when Covid hit Europe.

We developed a specific facility in how we could help governments to finance healthcare-related costs. And other regional financing arrangements have taken similar steps to facilitate financing.

There is great cooperation between these institutions, and in times where political discourse becomes more difficult, keeping that cooperation is a sign of strength and certainty.

There are regular meetings. There is an exchange of best practices to which we greatly contribute. We are committed, which helps to make this overall part of the global financial safety net work effectively in securing financial stability.

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