The evolution of Europe’s financial response to challenges: what should come next? - keynote by Pierre Gramegna

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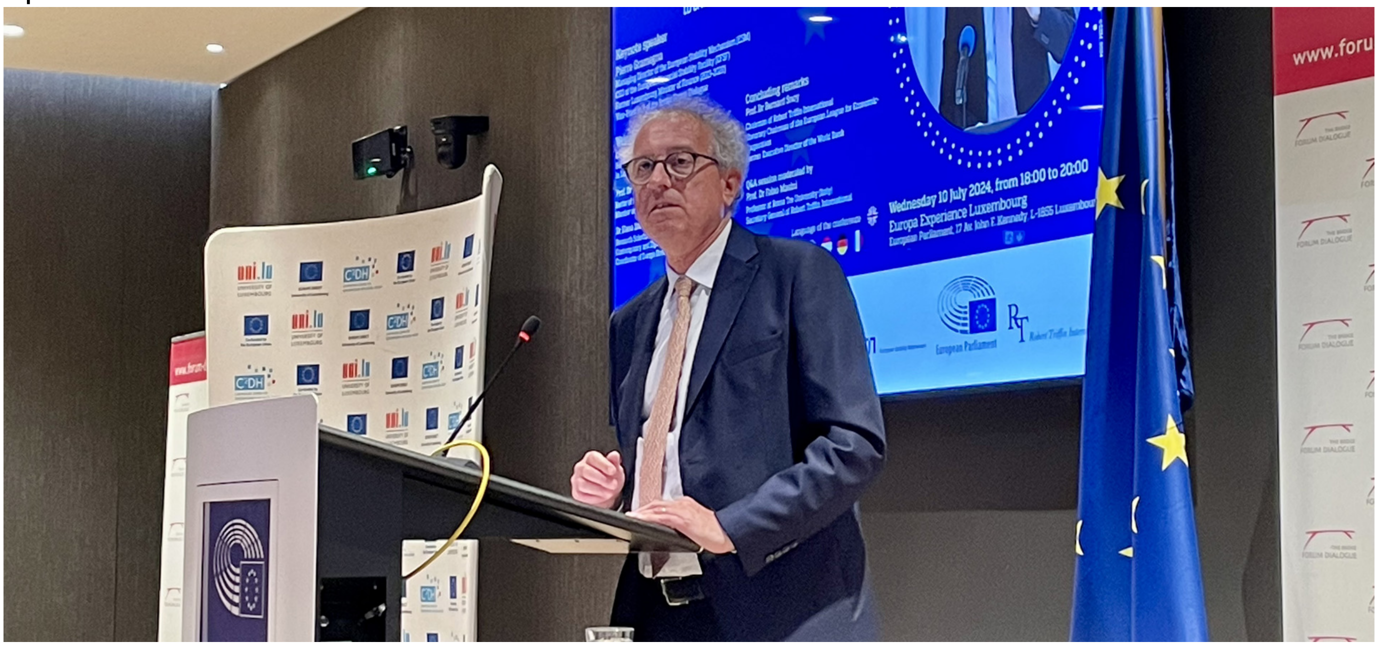

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2024 Robert Triffin Lecture
The evolution of Europe’s financial response to challenges: what should come next?
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(*Please check against delivery*)

Ladies and gentlemen, good evening. I am delighted to address you again this year at the Robert Triffin Lecture.

I am also particularly pleased to do so in the European Parliament's new interactive exhibition centre on the EU called "Europa experience". It is a great initiative. It is important for all citizens to understand how Europe works. Especially as Europe is not always easy to understand.

Unfortunately, answers are not always easy. Unfortunately, simplistic arguments, arguments that deliberately deceive, often win the day. Pedagogy, clear explanations are key in this respect. It helps instil trust. It helps explain that the European project is a peace project. It helps explain that European institutions work for the benefit of citizens and businesses, not against them. It helps explain that sovereign countries and European institutions together create better, safer, and more prosperous environments for their citizens.

According to the Spring 2024 Eurobarometer[1] , European citizens' perception of the situation of the European economy has improved over the past months. 47% of respondents were rating it as 'good', the highest level since 2019. But 41% were rating it as "bad". Indeed, when you look at actual economic growth, it remains rather muted.

For this year, economic growth in the EU is forecast to be at around 1%. This is about 1/3 of economic growth forecast in the US for 2024. The good news is that the recovery seems to be firmly on track. But I think the overall positive sentiment may stem from a different concept, which is resilience. Resilience is the capacity to withstand or to overcome difficult situations. It is the capacity to bounce back.

I. Lessons from history

A. From World War II to the introduction of the euro

After World War II, European economies were in shatters. The European Recovery Program, better known under the name "Marshall Plan", played an essential role in helping Europe rise from the ashes. Under that plan, about US$13 billion, back then, was appropriated, supporting 16 countries, including Luxembourg. This is equivalent to about US$170 billion today. This amount corresponded to nearly 10.5% of their GDP.[2]

The post-war economic boom was also driven by trade integration, trade liberalisation. This led to the “golden age of capitalism” or Trente Glorieuses as it is often referred to in French. This period characterised by high growth ended with the recession of the mid-1970s. The 1970s were challenging for Europe, marked by economic turmoil caused by the oil crises of 1973 and 1979. This period was marked by stagflation. In other words, by high inflation and low economic growth.

The next decade was key for Europe, as it sowed the seeds for the creation of a single market. With the Single European Act of 1987. Ultimately, it materialised 6 years later.

During the 1990 and mid-2000s, Europe had to face new shocks. The near-collapse of the European Monetary System in 1992 and the tech bubble, which was a more global phenomenon, in the early 2000s. But, at the same time, it integrated further. The Single Market was completed in 1993, and the euro was introduced by 11 countries in 1999.

Both the EU and the euro area have enlarged over time, with the notable exception of Brexit. Today, 27 countries are part of the EU, and 20 countries are part of the euro area. And Bulgaria is making great efforts to become the next member of the euro club.

B. Recent history

Looking at the last 15 years, Europe faced another set of major challenges:

- The great financial crisis,
- The euro sovereign debt crisis,
- The pandemic.

But an increasingly united Europe managed to navigate these storms. As Jean Monnet predicted, Europe has been forged in crises and will be the sum of the solutions found. These crises were not wasted. In fact, they ultimately helped the euro area and the EU to make significant strides in bolstering their resilience. The integrity of the euro area was preserved. Banking sectors, which remain the main bloodline of our economies, have been strengthened.

The pandemic, an unexpected external shock, demonstrated the importance and effectiveness of rapid and well-coordinated cooperation, at both national and

European levels. It also showed that Europe is capable of unprecedented acts of solidarity. Next Generation EU (NGEU) best exemplifies this. It was created to support Europe's economic recovery from the pandemic, and to help Member States finance the transition to greener and more digital economies. It is remarkable for several reasons.

First, it is large. The NGEU programme is a €750 billion package. Second, nearly half of it consists of grants. The other half is composed of loans. There are still some funds available. Third, it is tilted towards the most vulnerable countries.

If you had asked me five years ago if such a scenario could ever materialise, I would have been doubtful. And people who know me know that I am a born optimist.

Additional measures were put in place. On 9 April 2020, the euro area finance ministers decided on a comprehensive economic policy response to the COVID-19 crisis. The European Commission, the European Investment Bank, and the European Stability Mechanism created instruments to help workers, businesses, and Member States.

In the case of the ESM, it was the Pandemic Crisis Support instrument, which I will get back to in a moment. When adding the support measures from the ESM, the EIB, and the European Commission, the European recovery plan was of a similar magnitude as the Marshall Plan, almost 10.1% of the EU's GDP.[3]

Since Russia's aggressive war in Ukraine, Europe is facing another tragedy. First and foremost, a human one. But it also generated new major economic challenges, with the energy crisis at its core.

Yet again, in the face of adversity, the EU's response was steadfast. In response to the energy market disruptions sparked by Russia's invasion of Ukraine, the EU announced a plan – known as REPowerEU – to reduce its dependence on Russian gas and oil.

This helped diversify energy supplies, save energy, and accelerate the transition to clean energy. Natural gas consumption was reduced by 18% between August 2022 and March 2024. The share of gas imports coming from Russia dropped from 45% to 15% between 2021 and 2023. This has helped overcome our dependence on Russian fossil fuels.[4]

To support Ukraine, the EU and the Member States have provided or committed financial aid close to €145 billion[5] in financial, military, humanitarian, and refugee assistance. Most recently, European leaders have pledged €50 billion for a new Ukraine Facility to aid Ukraine in its recovery, reconstruction, and modernisation efforts.

This commitment also supports Ukraine's reform initiatives as it progresses towards EU accession. Funding is available until 2027.[6] The help provided by the United States has also been pivotal in this respect.

Once more, Europe has proven more resilient than many expected.

II. Challenges of today

Now, Europe is at a new crossroads. Ahead of the European elections, a European Parliament Eurobarometer survey showed that 37% of EU citizens put defence and security as first priorities in reinforcing the EU’s position globally.[7]

Another Eurobarometer survey by the European Commission showed that 77% of Europeans are in favour of a common defence and security policy among EU countries.[8] According to the same survey, the war in Ukraine is considered by Europeans as the most important issue currently facing the EU. At 35%, this is 7 percentage points more compared to autumn 2023.

At the ESM, we also see this as a major challenge. With the war in Ukraine, we have rediscovered the horrors of war. Not within the EU or the euro area, but at our borders. We had taken peace for granted. While Europe is a peace project, recent events have shown us that we should not take peace for granted. This raises the question around Europe’s defence and security.

Then, we see three mega-trends at the ESM, Damocles swords floating over our heads over the medium to longer term:

- Geo-economic fragmentation,
- Climate change, and
- Population ageing.

1. Geo-economic fragmentation is affecting trade.

It is particularly relevant for the euro area. Total trade with the rest of the world amounts to more than 60% of euro area GDP, which is significantly more than China (38%) and the US (27%).

Geo-economic fragmentation also affects finance. In stable times, Europe attracts investors. Some euro area assets tend to have safe-haven characteristics. But in a geopolitically tense environment, there is a higher risk of capital outflows from the euro area.

Fiscal policies and the reduction of asset purchases by the ECB have led to stronger bond supply in financial markets. And this has been taken up by foreign investors. This change in investor base can lead to an increased sensitivity to political uncertainty and market volatility. We have seen this recently in market developments following the European elections.

2. Climate change is a global phenomenon, and its consequences are unfolding before our eyes.

Climate change causes extreme weather events like heatwaves and floods. These can devastate areas that are not adequately prepared for their severity and frequency. These physical risks can result in capital and productivity losses, as well as significant challenges for the population.

Then, there are transition risks. They stem from policies developed by governments and supranational entities to curb climate change by incentivising households and firms to cut greenhouse gas emissions. Uncoordinated and sudden policy changes can strand some assets and disrupt production networks. This can result in job losses and threats to financial stability.[9]

3. Population ageing is another significant challenge.

It is slowing down productivity and becomes increasingly expensive in terms of health care and pensions. Currently, Europe has a ratio of three workers for every retiree. By 2050, it is projected to have only two workers per retiree.[10] This indicates that the demographic shift and the shrinking active workforce will be a pressing issue.

There are several ways to tackle this. Pension systems need to be reformed to better reflect demographic changes and increased life expectancy. More can be done to further increase participation rates, for example, participation rates of women.

Migration is another avenue to boost labour markets. But it needs to be manageable. Migrants need to be well integrated. According to the European Commission Eurobarometer survey I mentioned earlier, immigration is the second concern (24%) of Europeans, after Ukraine (35%).[11] Even though this is less compared to autumn 2023 (- 4 percentage points). Let us find inspiration from countries that have done well in this respect, both inside and outside Europe. Without immigration, Europe cannot grow sufficiently.

Finally, technological advancements, particularly in artificial intelligence, may offer potential remedies to make labour more efficient.

III. Possible solutions and potential role of the ESM

The challenges Europe faces require substantive financial resources. According to Mario Draghi, an additional €500 billion per year is necessary to close the investment gap for the digital and green transition alone. The key question that arises is: where will these financial resources come from?

The new fiscal framework of the EU will provide space for reforms and investment. It will be more growth-friendly, which is positive. But fiscal consolidation will be necessary in some countries to ensure public debt remains sustainable.

Recently, an Excessive Deficit Procedure, abbreviated as EDP, was opened against seven countries to take corrective action. Among euro area countries, these are: Belgium, Italy, France, Malta, and Slovakia. And other EU countries: Hungary and Poland. The Excessive Deficit Procedure is an action launched by the European Commission against any EU Member State that exceeds the budgetary deficit ceiling imposed by the Stability and Growth Pact.

Consolidating public finances is also imperative to create buffers to tackle potential future shocks. Against this backdrop, fresh perspectives have been offered over the past weeks and months to address our current and future challenges.

There have been calls for additional common financing schemes at the European level. This has notably been the case for defence and security, which has become a major topic with the war in Ukraine. There have been several calls, notably by the President of the European Council, Charles Michel, to issue European defence bonds.

Enrico Letta, in his recent report called “Much More Than a Market”, suggests that the ESM could establish a credit line to help its member countries finance their defence and security expenditures. Olli Rehn, the Governor of the central bank of Finland, suggested allocating funds from the ESM to fund aid to Ukraine. Jean-Claude Juncker also suggested using the ESM to help Ukraine.

More recently, on Ukraine, a broader solution has been found. Beyond the European scope, the G7 has agreed to use proceeds from frozen Russian assets to give Ukraine US$50 billion in loans. But other proposals have also been made to support the European economy and to strengthen the institutional architecture further.

In his latest Sorbonne speech, President Macron suggested to use European financial stability mechanisms to finance investments. President Macron also called for a doubling of the EU budget.

The Letta report also recommends marketing safe assets of EU institutions under a same name to create a common European safe asset. Commissioner Gentiloni called for an EU-wide central fiscal capacity. Fabio Panetta, Executive Board member of the ECB, called for a permanent fiscal capacity in the euro area.

I think that focusing more on EU-level financing to tackle these major challenges is now unavoidable. Let me elaborate on three points:

- What the ESM can do.
- The importance of private investment.
- The importance of economic growth and how to foster it.

First, what can the ESM do? The ESM’s current lending capacity is €422 billion. In these challenging times, there is an opportunity to make good use of it. Now, you may ask: what can the ESM concretely do?

In this respect, I would like to underline a few points. Concerning the proposals to support directly Ukraine: the ESM is always ready to support its Members. That’s its mission. But it can only support its Members, which are the countries that belong to the euro area. The ESM cannot help a country outside the euro area at this juncture. This would require a Treaty change.

Let us therefore analyse what the ESM can do within its existing Treaty and mandate. I would like to highlight four ideas that have come up.

1. A credit line for defence and security expenditures

Enrico Letta's proposal was inspired by the Pandemic Crisis Support (PCS) instrument set up by the ESM in 2020. This credit line was put in place to help euro area countries finance health-related costs. It was clear that the pandemic, with the human and economic havoc it was causing, could trigger financial stability risks. And the mandate of the ESM is to ensure financial stability. Its interventions need to be linked to its mandate. The PCS was set up to help alleviate that risk.

Regarding the proposal for the ESM to create a credit line for defence and security expenditures, there would need to be consensus among the 20 ESM Member States that defence and security matters trigger financial stability risks.

Let's take a concrete example. Because of a country's mere geopolitical situation, its proximity to Russia, markets require a risk premium. If this situation persists and is penalising a country too much despite having good economic policies in place, it could consider asking the ESM to get access to a credit line.

This so-called precautionary instrument would reassure markets and help prevent a crisis. It works like an insurance. The ESM is ready to work with its member countries on this.

2. Proposal to aggregate all European issuances under the same name, without changing capital structures

This proposal would require several operational, financial, and legal changes, which I won't analyse here now. Nevertheless, it would reinforce European safe assets, constituted by the issuances of the European Commission, the European Investment Bank, and the ESM. In aggregate, they recently broke the €1 trillion mark.

3. The financing of investments

Could the ESM finance investments? Again, this would likely require a Treaty change unless the scope of the loans was narrowed for the purpose of addressing financial stability risks, as this was the case under the PCS. From a risk perspective, this would be positive, as it would present an opportunity for the ESM to diversify its loan portfolio.

4. A central fiscal capacity

Could the ESM provide a central fiscal capacity? In November 2022, the ESM proposed the creation of a stability fund. It would basically have the same function. Such a stability fund would provide loans on favourable terms and be activated in the event of external shocks. The ESM could take up such a task. But it could only do so for euro area countries. No Treaty change would be required. And it would be relatively easy to set up administratively, not least because existing ESM infrastructure could be used.

Finally, let me add one element. The ESM has just reviewed its toolkit. It was mandated by our Board of Governors, the euro area finance ministers. It is a normal process all international financial institutions go through. It is important that financial support instruments remain fit for purpose throughout time. Crises and their nature change over time. The IMF just did it for its precautionary instruments.

As I mentioned earlier, these instruments work like insurance. Countries with good economic policies get access to a credit line they can tap if they are hit by an external shock. The ESM has them in its toolkit. The Board of Governors has asked us to do further technical work to potentially sharpen and better target these tools, in particular the precautionary instruments. Next to the example I used earlier, it could also help, for example, a country hit by a climate related shock. This is work in progress.

I would now like to turn to my second point, the importance of private investment. All these proposals I just mentioned involve public money. Clearly, finding all the necessary resources to face our challenges will not be possible without the contribution of the private sector.

When Mario Draghi mentioned the yearly investment gap of €500 billion, he added that about two-thirds of that would have to come from the private sector. Therefore, it is urgent to make progress on the capital markets union. The Eurogroup recently agreed on a roadmap to achieve this.

Third, the importance of economic growth. Economic growth is another key variable to solve the equation. Europe needs to generate more growth. To stimulate economic growth, besides structural reforms at the national level, we need to focus on the EU Single Market.

Created a bit more than 30 years ago, it remains one of Europe’s major achievements. But it needs to be fully operational and modernised. We need a

Single Market 2.0. Europe needs to become more productive. It needs to become more competitive. Unlocking the Single Market's full potential would foster economic growth and raise EU citizens' welfare over the long-term.

Ladies and gentlemen, let me now conclude.

The resilience of Europe is a testament to its ability to navigate crises and emerge stronger. Leveraging both public and private investments is crucial for addressing current and future challenges. Fostering economic growth through initiatives like the capital markets union and a modernised Single Market is essential in this respect.

Embracing new financing mechanisms at the EU level will help tackle significant challenges, ensuring a safer, more prosperous future for all. But we must focus on the resources that are at hand first. The ESM is committed to playing its part and supporting the euro area and its members as effectively as possible.

Let us be inspired by the words of Winston Churchill: "The pessimist sees difficulty in every opportunity. The optimist sees opportunity in every difficulty."

The ESM definitely is an optimistic institution.

Thank you.

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[1] European Commission: Standard Eurobarometer 101, Spring 2024, https://europa.eu/eurobarometer/surveys/detail/3216.

[2] J.-B. Gossé et al. (2021): "Lessons from the Marshall Plan for the European Recovery Plan", Eco Notepad, Banque de France.

[3] J.-B. Gossé et al. (2021): "Lessons from the Marshall Plan for the European Recovery Plan", Eco Notepad, Banque de France.

[4] European Commission (2024): "Two years of REPowerEU: Strengthening Europe's energy resilience", News Article, 17 May 2024.

[5] European Council of the EU, March 2024: https://www.consilium.europa.eu/en/infographics/eu-solidarity-ukraine/.

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[7] European Parliament Spring Eurobarometer, April 2024,
https://europa.eu/eurobarometer/surveys/detail/3272.

[8] European Commission: Standard Eurobarometer 101 – Spring 2024, May 2024.

[9] M. Bellon et al. (2024): "Assessing climate risks at the ESM", European Stability Mechanism (blog post), March 2024.

[10] Interview with Rolf Strauch, ESM Chief Economist, by South China Morning Post, May 2024.

[11] European Commission: Standard Eurobarometer 101 – Spring 2024, May 2024.

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