"Building a stronger euro after the crisis" - speech by Christophe Frankel

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Building a stronger euro after the crisis
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(*Please check against delivery*)

Ladies and gentlemen,

It is no exaggeration to say that Europe today is at an important moment in its history. And this is especially true for the 19 countries of the euro area. With Emmanuel Macron in the Élysée, France is headed by an outspoken pro-European. And whatever the outcome of the coalition talks in Germany, I fully expect the new government to continue Chancellor Merkel's pro-European policies.

And so, the German-French twin engine driving European integration can accelerate again. It will provide Europe with a good opportunity to strengthen integration. Today, I will focus on monetary union. And I will mention some further reforms that are still needed to make the euro more robust. These steps are not only achievable, but they are already on the political agenda, and I expect to see results.

But let me first stress that Europe has now firmly put the crisis behind it. The euro area is doing well – whether you look at it from the macroeconomic, the fiscal or the financial perspective.

Let me give you some evidence of that, starting with the economy, which is staging a robust and synchronized recovery. Annualized growth was 2.5 percent in the second quarter, with each country recording positive growth. The economy is projected to continue to grow at around 1.75 percent this year and the next, well above potential, so that unemployment is coming down. Another interesting statistic: the euro area grew faster than the United States economy in 5 out of the last 8 quarters.

Per-capita growth is back in line again with that in the United States, at levels around 1.8 percent. This used to be the case for decades, but the relation was disrupted during the crisis. The fact that it is now back, shows that Europe’s capacity to create wealth for its citizens is as great as that in the U.S. Europe’s growth is often below that of the U.S., but that is because of poor demographics. Macroeconomic imbalances, which were a central reason behind the euro crisis, have now disappeared. Competitiveness has returned across the euro area, as nominal unit labour costs converged to more sustainable levels. As a result, current account imbalances have been considerably reduced across the region. To prevent such imbalances from building up in the future, Europe has put in place the Macroeconomic Imbalances Procedure.

Another strong point of the European economy is much better income distribution than in the U.S. In America, the top-earning 20 percent get paid more than 8 times as much as the bottom 20 percent. In Germany and France, they get less than 5 times as much. It is true that rising inequality is a problem throughout Western societies, but Europe’s starting position is far better. Our social model, with a strong safety net for those who need it, is superior.

Finally, let me say a word about unemployment, which is higher in Europe than in the U.S. This is particularly clear in countries such as Italy and Spain, and a pressing issue for too many young people. Still, the employment rate in Europe has improved by 2 percentage points since 2000. In America, it has dropped by more than 4 percentage points. So the trend is favourable for Europe.
But there is also still a list of things to do. Europe needs to address its low potential output growth rate. Structural reforms need to continue, and not just in the countries that took part in an ESM assistance programme. Europe needs to increase the participation rate of women into the labour force, and raise the retirement age.

Last but not least, countries need to make every effort to integrate immigrants into the work force. Politically, this can be a thorny issue. Yet without immigration, the population of countries such as Germany and Austria would already be shrinking.

A second issue the euro area needs to improve is economic risk-sharing. This is underdeveloped compared to the U.S., but also to large member states such as Germany. This means that, when an asymmetric shock hits a country, there are limited channels to share it with neighbouring countries – whether through fiscal means or capital markets. Widening these channels is an overriding priority for economic governance of the euro area.

Now let me turn to my second topic, fiscal policy. Here the picture is favourable. Debt is decreasing overall. The euro area debt-to-GDP ratio stood at 91 percent last year, and is projected to continue to drop in the coming years. Public deficits have shrunk after the crisis, and have converged to a narrow range. The fiscal balance of the euro area is much better than that of the UK, the U.S., or Japan, which gives the region more policy room should the next crisis hit. High debt levels in former programme countries are helped by the favourable lending terms of the ESM. In the case of Greece we have calculated that this saves the budget €10 billion each year, or 5.6 percent of GDP. The ESM, which finances itself in the bond market, can provide these favourable lending conditions because of its strong credit rating, which is due to the strong guarantees and the high paid-in capital by the euro area member countries. And so, the large budget savings Greece realizes through the programmes of the ESM are a clear example of solidarity inside the euro area.

Despite this good situation, the euro area needs to make progress in the way it runs fiscal policy. The fiscal rules were tightened after the crisis, but are now too complex, and hard to understand. It is good to see that efforts to simplify the rules are now under debate.

An important gap in the euro area fiscal tools is a mechanism to counter asymmetric shocks. Fortunately, a discussion about a limited fiscal capacity that would take on this role has now begun. This would form an important new fiscal channel for economic risk-sharing. It will be designed without debt mutualisation, and without permanent transfers between countries. This is possible, as is shown by examples in the U.S., where most states have rainy day funds, or participate in complementary unemployment schemes.

A European Monetary Fund is another idea to improve euro area economic governance. The three programmes in Greece have shown that Europe is becoming increasingly independent from the IMF. If the ESM were to provide another assistance package in a next crisis, it is unlikely that the IMF would participate, at least not financially. Many people have suggested that the ESM could be developed into an EMF, and the political debate is addressing this possibility.

Thirdly, I’ll say a few words about the financial sector, which has strongly recovered after the crisis. Capital has doubled, and capital ratios continue to increase to much safer levels. Profitability is returning, though it is still below the levels in the U.S. Through the Banking Union, important competences have been transferred to the European from the national level. With the Single Supervisory Mechanism, day-to-day oversight of the 130 most critical banks now takes place centrally. With the Single Resolution Board, Europe now also has a central institution to wind down failing banks.

Non-performing loans have been gradually coming down from a peak in 2013, and are well-provisioned. Still, at a total of €800 billion across the euro area, they are clearly still too high, particularly in some individual countries. This is a point that must not be underestimated. Banks that are dealing with legacy issues have no time to expand either organically or through strategic acquisition strategies. This means financial sector efficiency is sub-optimal, and that little happens to address overbanking. It is also clearly reflected in the lack of euro area financial integration, which is still well below its peak reached just before the crisis. Fixing these problems would foster financial integration and unblock an important channel for economic risk-sharing through the private sector. In this light, it was welcome news that EU finance ministers adopted an action plan to deal with non-performing loans in early July.

At the same time, Banking Union needs to be completed by setting up a backstop for the Single Resolution Fund to lend it more credibility. A European Deposit Insurance Scheme, the so-called third pillar of Banking Union, will also need to be put in place, though this will only happen once countries have sorted out the legacy problems of their banks. It can never be the case that banks in a country where the sector is healthy should have to pay their neighbours for their past mistakes. Still, it is an essential step that needs to materialise.

Capital Markets Union, a comprehensive harmonisation of bankruptcy, corporate and tax law would make it easier to invest across borders. This would open new ways for companies to fund themselves, help reduce Europe's dependence on bank financing, and at the same time increase economic resilience.

Let me sum up. Europe has come out of the crisis much stronger than before, both economically as well as institutionally. Some further steps need to be taken to make the euro more robust. But this work is small in comparison to what we did over the last 10 years. The good news is that the popularity of the euro is at its highest level since 2004. This shows that citizens have understood that monetary union brings more jobs, greater financial stability, and higher living standards. It is also a strong mandate for politicians to continue to work on making the euro more robust.
Thank you for your attention

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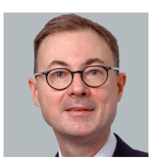

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