“Are we ready for the next global downturn?” - speech by Klaus Regling

View PDF
26/04/2018
Speeches
Sofia
Klaus Regling, ESM Managing Director
“Are we ready for the next global downturn?”
13th Asia-Europe Finance Ministers’ Meeting
Sofia, 26 April 2018

(*Please check against delivery*)

Ladies and gentlemen,
Thanks for inviting me to this panel. After David gave a global perspective, and before Hoe will focus on Asia, I will mainly look at the European situation, knowing that we are all more interconnected than ever today.

Is Europe ready for the next global downturn? Europe has its strong points and its weak points, and there was a growing consensus at the IMF meetings last week that there are downside risks in the medium term, which would also apply to Europe. But let me begin by mentioning the strong points of the European economy.

As far as the real economy is concerned, 2017 was a year of solid growth. The real growth rate was almost twice the potential growth rate. On a per-capita basis, growth in Europe outpaced the U.S. in the last two years, and is projected to be almost identical this year and the next – just as it was for decades before the crisis.

Unemployment rates have continuously been falling since the height of the crisis. Employment and labour force participation rates are at record highs. Income equality in Europe is better than on any other continent. Consumer and business confidence indicators reflect optimism, though the high levels are starting to ease.

A particularly important point is that the macroeconomic imbalances in the euro area, which played a crucial role in causing the crisis, have largely disappeared. Current account deficits decreased as competitiveness returned, and unit labour costs converged to a large degree across the euro area. Still, there are some countries with large current account surpluses. ESM programme countries - Cyprus, Greece, Ireland, Portugal and Spain - have worked very hard to modernise their economies, and are now being rewarded with high growth rates.

The euro area fiscal space has been substantially increased thanks to extensive consolidation efforts. Debt levels are decreasing and the euro area fiscal deficit has fallen below one percent of GDP. Compared to other regions, this gives more policy space when the next crisis hits.

On the financial side, banks have doubled their capital since the crisis, and profitability has increased continuously since 2012, although it remains well below that of U.S. banks. The first two pillars of the Banking Union – the Single Supervisory Mechanism and the Single Resolution Board – are in place.

Banking Union was a major institutional improvement in the euro area and a quantum leap in the deepening of EMU. The other innovation after the crisis was the establishment of the EFSF in 2010, and the ESM in 2012. With these two new institutions, the euro area now has a lender of last resort for sovereigns. They have disbursed €280 billion to five countries since 2011, and have almost €400 billion in uncommitted lending capacity.

In summary, I would say, Europe is better prepared for the next downturn for the following reasons:
- Strong growth currently,
- Low fiscal deficits,
- Fewer macroeconomic imbalances,
- Comprehensive reforms in programme countries,
- A stronger banking system, and
- New institutions in the form of the Banking Union and the ESM.

However, there are also risks and weaknesses in Europe. In terms of the real economy, growth rates will inevitably slow down, as the output gap is expected to close this year. A cyclical slowdown at some point in the future is inevitable. There are signs that labour markets are already tight in some countries, while some monthly indicators are easing – even though from high levels.

Low productivity gains are another weak point. Together with unfavourable demographics, this results in low potential growth rates. Immigration is politically difficult, and can contribute to labour supply only slowly.

Weaknesses on the financial side are perhaps the most acute. Profitability at European banks remains too low, and returns still do not cover the assumed cost of equity. Overbanking in some countries, outdated business models in the age of digitalisation and non-performing loans (NPLs) contribute to low profitability. NPLs, a legacy from the crisis, remain high, especially in some countries, although they fell by 15 percent last year on average in the euro area. Banking and capital markets in Europe continue to be fragmented along national borders, with a strong home bias. This stands in the way of financial integration, and prevents more private risk-sharing across borders.

There are also risks coming from outside Europe. Geopolitical risks, and the risk of protectionism are highly relevant for Europe and Asia. The same is true for risks in financial markets – not only in Europe, but also globally: valuations are overstretched, corporate credit conditions are deteriorating, and many large banks face liquidity mismatches. Cybersecurity is another risk.

What needs to happen to better prepare Europe for a possible next global downturn? First, like all advanced economies, we need to promote productivity through structural reforms, more investment, and better education systems.

Another important point is to complete the agenda for deepening monetary union that Europe is currently working on. One of the main goals of this agenda is to increase risk sharing – through private channels, but also with public tools. The concrete steps on the agenda are completing the Banking Union, and developing the ESM.

Completing the Banking Union consists of two steps. First, the Single Resolution

Fund needs a financial backstop, so that it is able to deal with a big crisis. The ESM could provide this backstop.

The other step to complete the Banking Union is a common deposit insurance for Europe. This would largely eliminate the chance of a national bank run during a crisis. Many agree on the need to establish this insurance, but the timing is controversial. Legacy problems must be sorted out first.

Strengthening the role of the ESM is not a goal in itself. But it could also help to make the monetary union more robust. The ESM is likely to play a more prominent role in future assistance programmes, together with the European Commission. This will happen without overlap of institutional responsibilities, and respecting the competences of the two institutions.

Finally, there is a debate about a number of fiscal issues, which are quite controversial. They include:
- Reforming the fiscal framework and the Stability and Growth Pact,
- An increased EU budget to finance public goods, such as defence, border protection or measures to fight climate change,
- A euro area budget to finance investment,
- A facility for macroeconomic stabilisation, in the form of a rainy day fund - as proposed by the IMF - or as a new ESM facility.

As I said, these ideas are controversial. It will require more time to put them in place than the other steps I mentioned.

To conclude, Europe has made good progress in recent years – economically and institutionally. There is no doubt that it is better prepared for future crises than in 2010. It is true that some challenges remain. But Europe is addressing these with a political agenda that stands a good chance of succeeding.

Thank you for your attention.

Author

Klaus Regling
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

George Matlock
Senior Financial Spokesperson
+352 260 962 232
g.matlock@esm.europa.eu