

The Economic and Financial Landscape in Europe and Cyprus - Speech by Rolf Strauch

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Rolf Strauch, Chief Economist ESM

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Many thanks for inviting me. It is wonderful to be back in Cyprus. The title of the panel invites us to speak about Cyprus, but also about Europe. Of these two, I will opt for the European perspective.

Cyprus was the fourth country receiving support by the ESM. The loans package amounted to 40 percent of the Cypriot economy.

We are proud to see that Cyprus has mastered its difficulties, and is now standing on its own feet again. It is one of the success stories of the ESM. This was not always clear from the start, given the severity of the problems in the banking sector, and the unique nature of the rescue measures, which included capital controls.

Let me describe the Cypriot experience as part of the overall crisis response in Europe, with a particular eye on the problems the European financial sector was facing during the euro debt crisis.

To protect the single currency, Europe came up with a robust answer. Two quantum leaps stand out. The first was the creation of the ESM, a crisis resolution mechanism for sovereigns.

The second was Banking Union. Before the crisis, the authority to supervise and resolve Europe's largest banks was held at the national level. Now it has been transferred to the Single Supervisory Mechanism and the Single Resolution Mechanism.

This second quantum leap helps cut the "doom loop" between banks and governments. The lessons from Cyprus, some of which were painful, were relevant for the development of the Banking Union. At the beginning of the crisis, governments needed to bail out banks at a moment they could least afford to do so. Banks in turn saw steep losses on the bonds they had regularly bought in large quantities from their sovereign.

We have moved away from this approach. What was a need not to overburden the sovereign in Cyprus, became a general principle. Institutional investors and banks have to participate in bank rescues, and the burden should no longer be put on the shoulders of taxpayers and households.

To make this principle work, banks have to be prepared however - precisely to avoid the troubles Cyprus had to go through. Higher capital and liquidity requirements, and the build-up of bail-inable liabilities -that exclude those funds provided by small depositors - is real progress Europe made after the crisis.

But Europe's banks are not completely out of the woods yet - this holds in Cyprus as well as elsewhere. Ten years after the collapse of Lehman, Europe's banks are still

facing challenges. The first is that the ratio of non-performing loans remains too high, even if it is diminishing. Problem assets are mainly a legacy from the crisis, and Cyprus is one of the countries where the reduction of these legacies needs to remain high on the agenda.

Low profitability is a related concern. Many banks are earning less than their cost of equity. This makes them less attractive for investors, and undermines their ability to generate capital as an additional crisis buffer.

Because of this incomplete recovery, banks are often not in a strong position to deal with competition from firms which operate as so-called shadow banks, and from Fintech companies. Unless banks can become more efficient and invest in new technologies, they may lose their competitive edge against these less-regulated players. Banks should also use the opportunities to become more efficient offered by Fintech, though of course without become unsafe.

Finally, a number of prominent money laundering scandals has revealed possible gaps in the supervisory framework of the EU. This is at the same time a threat to financial stability.

Banks should address these challenges vigorously. Without a solid effort to reduce risk by the private sector itself, Banking Union cannot succeed. I cannot underscore enough how important a healthy banking sector is for the resilience of the euro area.

Nevertheless, these challenges also show that it is important to complete Banking Union on the policy side. Two steps are required.

The first is a financial backstop for the Single Resolution Fund, to make sure that it has enough money to deal with a big crisis. It has been agreed that this will be a new role for the ESM.

A second is a common deposit insurance. It is a more controversial step, due to a lack of trust in the banking systems in the different countries. That is why more progress needs to be made in reducing risks in banking sectors before we can take this step.

Nevertheless, a common deposit insurance is a crucial plank of the Banking Union. If

it had been in place at the start of the crisis, the size of the ESM rescue programmes would have been much smaller.

Completing the Banking Union is one important element of the current agenda to deepen EMU. The goal is to make the monetary union more robust, and the euro area more resilient.

Another important point on this agenda is strengthening the ESM. It could be useful to subsume a number of new tasks to the ESM, which has gained valuable expertise for Europe during the crisis, notably in the areas of debt sustainability and market access.

One of these possible new tasks is a bigger role in the rescue programmes, together with the Commission. Policy makers are also reviewing the ESM's toolkit, in particular to make it easier to use precautionary tools without attaching stigma for a country.

On a more distant horizon, politicians may decide to set up a fiscal capacity for the euro area. This is the third topic on the agenda to deepen the monetary union. There are many different ideas of what such a capacity could look like, including short-term ESM loans.

The outcome of this debate is still uncertain. Let me just say that, in my view, a central stabilisation function would be useful, given that countries in a monetary union no longer have interest rate or foreign exchange policies available to counter shocks that hit only a single country.

The heads of State or Government will meet in December to discuss the deepening of EMU. I hope that they will take tangible decisions on the completion of Banking Union and the ESM. As Jacques Delors said recently "It is time" - I think we should use it.

Author



[Rolf Strauch](#)

Chief Economist and Management Board Member

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