

The Economic and Financial Environment in Europe and Cyprus - speech by Klaus Regling

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Speeches

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Klaus Regling, ESM Managing Director
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(Please check against delivery)

Thank you for your interesting speech, Minister. It is a pleasure for me to be here again.

It has been two years since I last attended the Economist conference in Cyprus. At that time I said “Cyprus is one of Europe’s best performers”. Two years later, this is confirmed. This is due to the determined reform commitment of the Cypriot government and to the willingness of the Cypriot people to accept change.

Is Europe close to a new recession?

Our panel today covers the economic situation in Europe and in Cyprus. Let us first take a look at Europe.

The slowdown in euro area growth since last year has been sharper than expected, and there are downside risks ahead. But this does not necessarily mean that we are heading into a new recession. Overall, we have strong economic fundamentals sustained by favourable financial conditions. And growth in the euro area is still close to its potential.

In my view, we have to remember that not every cyclical slowdown leads to a recession, and not every recession implies another crisis. It is important to look at the underlying dynamics. This slowdown in growth relates mainly to external factors, while domestic demand remains resilient.

Looking ahead, the persistence of trade uncertainty and its impact on global growth, Brexit and geopolitical conflicts are the main external risks. These vulnerabilities are the reason why I would like to see progress in some areas to make the EMU more resilient – I will come back to that in a moment.

Before that let me turn to what lies in store for Cyprus, the second theme of this panel.

Are there any clouds in the Cypriot economy?

As part of the ESM's early warning system the ESM closely monitors developments in Cyprus. Overall, our conclusion is that Cyprus faces no major risks in meeting its loan service payments.

Cyprus' growth is expected to remain robust, with moderate risks in the medium-term. Consumption and investment are expected to provide positive contributions to growth.

Although growth is now projected to slow down as rates converge to the country's long-term growth potential, this is not a reflection of economic weakness. It is a moderation in growth as part of a normalisation phase after years of "above-potential growth". And it is not a Cyprus-specific phenomenon.

Cyprus presented a balanced budget for 2020 to the European Commission in October. This is the right strategy, in my view, as balanced budgets will reduce high debt ratios. The budget also includes an early repayment of the remainder of the

loan to the International Monetary Fund (IMF), which is intended to generate savings. An early repayment to the IMF, as in similar cases like Portugal or Greece, requires the ESM to waive its own early repayment rights. And that, in turn, requires an assessment on our side, which we are happy to start. I am sure the process will go smoothly as our collaboration with Cyprus has always been excellent.

Cyprus is a small, open economy and therefore exposed to external risks. External risks such as Brexit, protectionism and high exposure to financial market volatility may affect the country's growth. Countries that are able to diversify their economic structure reduce vulnerabilities and can stay on a good growth path. A number of structural reforms have been submitted to the House of Representatives and are designed to strengthen the growth momentum.

There are also other vulnerabilities. Cyprus is still grappling with high public and private debt, and a high level of non-performing loans (NPLs). Coupled with the banks' low profitability, the pressure of non-performing loans remains a constraint on credit and investment growth. I believe it is important to maintain a credible framework for NPL reduction. I know there will be a separate panel on banking later this morning, where this will be discussed in more detail.

Cyprus is an important part of the euro area. It is therefore also part of the current reform debate. Once per month the Eurogroup, the group of 19 euro finance ministers - including Minister Georgiades since 2013 - meet and work on how to improve and safeguard the euro area.

The current reform debate

As part of this work, the EU Heads of State and Government endorsed a reform package last December. This involves the completion of banking union, the strengthening of the ESM, more work on a European deposit insurance and a fiscal capacity.

This summer, the Eurogroup broadly agreed to enhance the ESM's role. This decision will imply the following steps for the ESM.

First, the ESM will provide the backstop to the Single Resolution Fund.

Second, the ESM will play a stronger role in future economic adjustment programmes. Together with the Commission, the ESM will design, negotiate and monitor future programmes.

Third, the ESM's has reviewed its financial instruments, in particular its precautionary credit lines.

Fourth, the ESM could facilitate the dialogue between a euro area country and private investors if a debt restructuring is needed.

The enhanced role of the ESM will strengthen its mandate of ensuring financial stability in the euro area.

Future vision

I have argued many times that the euro area today is better equipped to deal with a future crisis than ten years ago. But it is also true that more can and should be done to further strengthen the euro area's financial architecture.

There are three important areas where I would like to see progress in the coming years. They are controversial among member states but I believe it is important to discuss them.

First, a **common deposit insurance**. With an identical level of depositor protection across the euro area and a weaker link between banks and sovereigns, financial fragmentation would decrease, and so would the risk of bank runs in a crisis. If we had had a European deposit insurance in the last ten years, all ESM programmes could have been substantially smaller. Obviously, legacy problems in the balance sheets of some banks need to be sorted out before a common deposit insurance becomes possible. It would complete banking union.

Second, a **fiscal capacity for macroeconomic stabilisation** is needed in my view and in the view of all European and international institutions. This is again a controversial topic. But in my view it is a key element missing in the architecture of our monetary union. This would be useful because countries that are members of a monetary union have given up two key macroeconomic policy instruments: monetary policy and exchange rate policy. Moreover, monetary policy can often be

pro-cyclical for individual countries. Such a tool could be designed without creating additional transfers. And we do not need an annual budget for macroeconomic stabilisation, in my view, but a revolving fund.

Progress in these two areas and in creating a capital markets union, I believe, would improve risk-sharing within the monetary union significantly. That can be done without creating permanent transfers and would really help to avoid small problems from becoming big problems where an ESM programme would be needed. I want to avoid that.

Third, and finally, we should begin to think about a **European safe asset**, even though this is even more controversial. A safe asset would increase the volume of highly rated assets, which is now limited to a few sovereign and supranational issuers, and is actually shrinking. It would provide a common benchmark that could be used to price debt throughout the euro area. A safe asset would also allow Europe's banks to reduce their holdings of national debt, and to attract international capital to Europe. Safe assets would be a crucial step to integrate markets, and to make the euro more attractive for international investors, thus strengthening the international role of the euro. It may take a decade or two to get there, but it is worth starting the debate.

Conclusion

Let me conclude. Is Europe close to a new recession? My answer is "No, we are in a phase of slowdown but we are not in a recession." Are there any clouds in the Cypriot economy? As I argued, Cyprus has solid growth but it is like any other economy subject to overall and country-specific vulnerabilities.

We know that there will be crises from time to time. That is why we must do everything to try to prevent it. So we should not assume that there will never be another crisis, despite all the efforts.

And to prepare, we need to see progress in deepening our monetary union.

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