POST-COVID ECONOMIC AND FINANCIAL PRIORITIES

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Post-pandemic fiscal priorities for the euro area

The Coronavirus pandemic came as an unprecedented common external shock, it has been the most severe and widespread economic contraction of our lifetime. Countries have spent huge amounts on healthcare, and on containing the economic consequences of the pandemic.

To support countries' efforts and avoid growing divergences between Member States, the EU rolled out a huge package to support workers, businesses and countries. As part of this, the ESM offers all euro area countries a precautionary credit line to cover direct and indirect healthcare costs related to the pandemic. Additionally, the extraordinary €750 billion 'Next Generation EU' recovery fund was designed to mitigate the impact of the pandemic on economic growth and to provide further financial assistance to the most affected countries.

Without these public sector measures, the recession would surely have been deeper and there would be a greater risk of divergences between countries within the euro area. When the EU makes this comprehensive public funding available, we need to ensure its efficient use. All the more so, as the fiscal situation will remain challenging for many countries in the medium term amid uncertain future economic developments.

I see four additional risks for future growth:

First, the potential growth rate is likely to be lower than before the crisis unless the recovery fund is highly successful.

Second, companies may survive in the short term by taking out loans, but high debt loads may impair their future ability to invest. An increase in insolvencies seems unavoidable.

Third, banks, although safer than in the past financial crisis, are still struggling with persistent low profitability and may see an increase in non-performing loans due to the pandemic. So, although encouraged to continue to support the economy, they may not have the capacity to continue providing sufficient credit for investment going forward.

And finally, higher public deficits and debt are a necessary response to the crisis, but it will not be easy to reduce fiscal deficits over the next few years to sustainable levels. Given these challenges, government measures need to be targeted, cost-effective and focus on longer-term growth. Next Generation EU rightly fosters competitiveness and investments while supporting the greening and digitalisation of the economy to create a stronger, more innovative and sustainable EU.

Furthermore, EU fiscal rules are rightly suspended until next year to accommodate the large increase in government spending and the decrease in revenues. Let me stress that the Stability and Growth Pact has worked better than widely believed. Just before the pandemic, the euro area was doing significantly better in fiscal terms than the rest of the world, providing more budgetary leeway when the crisis broke. However, the pact needs to be reformed to make it less complex and to improve its implementation.

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Nowadays, the capacity of governments to service debt is higher than the levels envisaged in the EU Treaty, although by how much is a matter for debate. Like many others, I would argue that we have to rely more on observable variables. It would be useful to have an expansion path for expenditures, for example, to prevent public expenditures from growing faster than trend growth. I would also argue that the overall 60% debt limit could be reconsidered while the annual 3% deficit limit remains relevant.

The discussion has been overshadowed by the ongoing pandemic crisis, but we must take the opportunity to think ahead, about how our fiscal rules can help governments, parliaments and markets understand how fiscal policies will evolve in future.

As a final point, the agenda for deepening the Economic and Monetary Union (EMU) remains even more valid than before the crisis: completing banking union, creating a capital markets union, setting up a fiscal capacity for macroeconomic stabilisation and implementing the ESM reform. All this serves the longer-term objectives of creating a safer, more robust euro area and of promoting the international role of the euro.

ANDREJ SIRCELJ

Minister of Finance, Slovenia

Post Covid-19 Recovery Plan for Europe

The EU should continue with the coordinated political reaction, enhancing the EU added value.

In the current times, we are rethinking our health systems and business and economic practices. Achieving a successful recovery will require harnessing all the potential of the green and digital transitions.

The COVID-19 pandemic has led to a need for emergency liquidity in large parts of the economy to cope with the economic consequences. Many insolvencies, bankruptcies, and redundancy of workers were prevented by the support measures. But eventually, we will have to switch to the recovery measures. This means that some companies might also exit the market. However, we need to create conditions for new entries and provide viable companies with an access to R&D stimulations, upgrading employee skills, and flexible working schemes.

The historic agreement on the EU fiscal stimulus is a starting point for the recovery. Hence, efficient implementing of the investments and reforms envisaged in the recovery plans is the top priority. A successful recovery will provide the best basis for discussions on the fiscal stance. Designing the appropriate path to the recovery and sustainability is parallel to the top priority. An agreement on dynamics is required. With smart investments, we need to design a path to a sustainable recovery, look beyond 2022, and not repeat the mistakes from the previous crisis. But the recovery cannot happen overnight. After 2022, we should focus on simple but politically sensible solutions.

As restoring debt to pre-crisis levels is essential in the short term, it requires a better market ecosystem for issuing new equity. Government support packages and monetary policy and regulatory flexibility have in many ways ensured that short-term finance is available to businesses, but further steps are needed. Guaranteed loans have covered emergency liquidity needs for companies, but solutions to restore solvency must also be provided. Yet, in such a demanding COVID-19 environment of elevated public debt, it is paramount for sovereigns to improve the risk metrics and the debt structures. In this context, in the environment of strong demand for duration and given elevated funding needs, the long-term funding is the logical choice.

To make our economies more efficient, competitive, and sustainable, the access to funding, especially non-banking, must become easier. Our aim should be to improve Europe's capital market effectiveness and increase its resilience while keeping it competitive and attractive to market participants. The importance of a rapid recovery should not neglect the importance of an adequate risk management, systemic stability, and resilience while ensuring better protection for customers and investors.

Hence, one of the priorities is the revision of the Basel III standards in the EU banking legislation, which will provide improved rules to further reduce banks' exposure to risks: credit, operational, market, and other risks. It is important that banks maintain their capital adequacy for the real economy, especially for SMEs. Securitization of loans would allow the banking sector to free up bank capital for further lending, allowing a wider range of investors to finance the economic recovery.

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The revision of Solvency II framework is among the most important steps toward the completion of the Capital Markets Union. Improvements to prudential rules are necessary to provide further implementation of a risk-based prudential regime. Therefore, we need to complete the Banking Union and the Capital Markets Union. Compromises will be necessary to achieve these goals, but if we take a constructive approach, we will be able to fulfil the vision and move on to even more ambitious goals to achieve higher levels of prosperity, innovation, and environmental sustainability.

We are entering a new reality of rising inflation, low interest rates, high debt, and different forms of economies facing large investment needs to further improve our health systems and to pursue our goal to prepare Europe for the green and digital transitions. Thus, the EU should continue to work together – a prosperous future lies in the strength of unity, and this is an opportunity that we must not miss.

WERNER HOYER

President, European Investment Bank (EIB)

Recovery and cohesion through green and digital transformation

Europe needs to wake up to the potential for digital technologies to achieve sustainable growth. The digital revolution has already transformed industries, production processes and ways of living and working, but many of these shifts are only just beginning. Most European firms surveyed by the European Investment Bank (EIB) think that the COVID-19 pandemic will accelerate the use of digital technologies even further.

On digital adoption, however, Europe lags behind other regions, notably North America and Asia-Pacific. With the "winner takes all" tendency of digital technologies and digital platforms, Europe risks being left behind for good. After the pandemic, Europe will need a digital transformation to underpin its green transition.

The adoption of digital technologies by EU firms is growing, but it has not yet closed the gap with the United States. In 2020, 37% of European firms had still not adopted any new digital technologies, compared with 27% in the United States. There is a risk of polarisation within Europe, too, because its small businesses are creating the lag. And while some countries and regions are at the global forefront, others risk being left behind. The downside risks to jobs and growth from both automation and the climate transition are not evenly spread. In fact, some of Europe's least developed regions are most at risk, often aggravating structural weaknesses.

But digitalisation is mainly an opportunity, not a threat. Our data shows that digitalised firms are more productive and foresee higher wages and more employment growth. By taking action to help firms, notably SMEs, to adopt the new technologies they need to thrive, we can spur sustainable growth and help close the divides that exist within Europe and strengthen cohesion.

Innovation will also be vital. Unfortunately, the United States still dominates in the sphere of digital innovation, with China – not Europe – catching up. But Europe has a chance, thanks to the green transition. Digital technologies will play a critical enabling role in the green transition, and Europe is a global leader in green innovation. We lead specifically at the intersection of green and digital, latest data showing that we registered 76% more patents combining green and digital technologies than the United States. This lead is fragile. Building on it will be critical for future sustainability and competitiveness.

To accelerate the pace of digital innovation and adoption, we need above all three things: an enabling ecosystem, the right kind of financial support and a European vision to counter the imbalances across our Union. The EIB Group plays an important role in all three regards.

Skills and management capabilities are proving key barriers to digital adoption. Digital innovation hubs, such as those supported by the Innovation Finance Advisory service of the EIB's European Investment Advisory Hub, can be game-changers in overcoming these barriers. At the same time, access to very high capacity digital infrastructure (i.e. 100 Megabits/second or above) is critical, not only in urban but also in remote areas. 16% of European firms say that lack of digital infrastructure is still a major impediment to digitalisation, compared to only 5% in the US. Data show that digital adoption rates are higher where local municipalities claim good digital capacities and infrastructure.

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The constraints facing municipalities are financial and technical, requiring the combination of advisory services with adequate financial instruments. The EIB has financed telecom infrastructure projects with €10 billion over the last four years. The Bank estimates that the total investment needed to achieve the European Commission's goal of Gigabit Society is about €380 billion, but the market can deliver only about one third of this. An investment gap of €50 billion per year remains. This may be exacerbated by COVID-19.

Digital innovation by firms, meanwhile, requires risk-absorbing finance that is still hard to obtain from private investors in much of Europe. Here again, the EIB Group is part of the solution. We spur innovation through our RDI lending, and the European Investment Fund catalyses the Europe-wide market in equity finance and venture debt. This is just what the continent's most innovative and growth-enhancing firms need.

PABLO HERNÁNDEZ DE COS

Governor, Banco de España
and Chair, Basel Committee on Banking Supervision (BCBS)

Securing a robust recovery: how can banks be part of the solution?

Much has been said about how the banking system has remained broadly resilient thus far during the pandemic, and how banks have not been part of the "problem" to date in exacerbating the economic crisis. This is in no small part due to banks entering the pandemic on a much more resilient footing than was the case during the Great Financial Crisis (GFC), thanks to the initial set of Basel III standards and ongoing cooperation among Basel Committee members. In addition, the unprecedented range of fiscal and monetary policy measures to support the real economy have largely shielded banks to date from losses and the crystallisation of risks.

While the trajectory of the pandemic continues to be highly uncertain, it is clear that risks to the global banking system may heighten over the coming period. Bank losses could begin to materialise as a result of the unwinding of support measures and broader macroeconomic dynamics. The potential permanent economic "scarring" from the crisis, alongside rising debt levels, could increase the longer-term structural fragilities of banks' balance sheets. It is therefore critical that banks and supervisors remain vigilant to these risks.

Looking ahead, how can banks and authorities best ensure a robust and sustainable recovery?

A crucial factor to achieving this outcome is the full, timely and consistent implementation of the outstanding Basel III reforms. These reforms tackle some of the glaring shortcomings in the banking system exposed by the GFC, including the excessive degree of variability in banks' modelled capital requirements, the lack of robustness in mitigating banks' operational risks, and, ultimately, the credibility of banks' reported capital ratios.

Recall how, at the peak of the GFC, investors lost faith in banks' published ratios and placed more weight on other indicators of bank solvency; when asked to model capital requirements for the same hypothetical portfolio, banks' capital ratios varied by 400 basis points. In a similar vein, banks' operational risk models lacked robustness, with losses incurred by some banks far exceeding their estimated capital needs.

Covid-19 has only further reinforced the importance of addressing these fault-lines. It has underscored how a functioning banking system is one that is resilient and capable of absorbing shocks instead of amplifying them. A banking system underpinned by prudent global regulatory standards is also better placed to maintain the provision of critical services to households and businesses. Yet structural flaws and frailties in the banking system would remain unaddressed if jurisdictions do not implement Basel III in full and consistently.

The Basel III reforms have benefited from an extensive consultation process with a wide range of stakeholders. They are by design a compromise that reflect the different views of our members. They have been calibrated based on rigorous quantitative analyses and meet the Committee's objective of not significantly increasing overall capital requirements at the global level; capital requirements would increase by less than 2% in aggregate. Of course, some "outlier" banks may face higher requirements as a result of aggressive modelling practices, for example. Even in those instances, the implementation timeline includes sufficiently long transitional arrangements: the final element of these reforms will be implemented by 2028, fully 20 years since the GFC.

> **Frailties in the banking system would remain unaddressed if Basel III is not fully implemented.**

And it is increasingly clear that the Basel III reforms will have a positive net impact on the economy, as highlighted by a growing set of robust empirical studies. Safeguarding the resilience of the banking system through prudent and credible global standards will help reduce the likelihood and impact of future banking crises. Moreover, as the current crisis reminds us, it is healthy and well-capitalised banks that are best able to support the recovery by lending to creditworthy households and businesses.

Combatting infectious diseases and safeguarding financial stability are both global public goods which know no borders and require collaboration among countries. It is in all of our collective interests to lock-in the benefits from the Basel III framework by implementing the outstanding standards in a full, timely and consistent manner.