Q&A

PASCHAL DONOHOE
President of the Eurogroup
and Minister of Finance of Ireland

Completing the Banking Union will be key to drive economic growth and fund the twin transitions

What have been the lessons learned from Europe's economic response to Covid-19? What is the appropriate policy mix for the euro area given current headwinds on the outlook?

The euro area economy performed remarkably well in 2021 and growth prospects for 2022 remain robust despite the difficulties created by the pandemic. Evidence suggests that the euro area response was well calibrated - sufficient to preserve productive capacity but not creating other imbalances, which could hold back growth in the coming years.

Budgetary and monetary policy have worked hand-in-hand since the onset of the pandemic and the benefits and effectiveness can be seen in employment and GDP data. The supportive monetary policy decisions were coupled with swift, decisive and coordinated actions by governments to cushion the impact of the pandemic at both national and EU level, not least with the implementation of the ground-breaking Next Generation EU recovery plan. Together with the rollout of vaccines and the easing of restrictions, it enabled the euro area to rebound strongly from Covid-19.

Output is rapidly returning to pre-crisis levels and at a much faster pace than previous crises. Latest GDP forecasts indicate that it will take approximately 8 quarters to return to pre-pandemic levels of output in the euro area. In contrast, it took the euro area about 29 quarters to recover lost ground from the financial crises. So while these shocks were inherently different, the recovery from Covid-19 - which had a bigger impact on GDP - looks like being approximately four times quicker than the financial crises.

Perhaps the most tangible evidence is in terms of our labour market performance. The latest data shows that the unemployment rate in the euro area fell for a seventh consecutive month to just 7.2 per cent in November – slightly below the unemployment rate when Covid-19 first hit. In contrast to the financial crises when we had stubbornly high unemployment rates - in double digits - of between 10 and 12 per cent for several years - this time around, we have protected jobs.

This data is encouraging as our focus progressively shifts from dealing with an emergency to ensuring a sustainable recovery.

Uncertainty remains high, and we are alert to the evolution of the health situation, the rise in inflation as well as other headwinds to the economic outlook. That is why we agreed at Eurogroup on the need for our budgetary policies to remain supportive, agile and coordinated whilst being increasingly targeted.

At the same time, we are all too aware of the uneven impacts of the pandemic. That is why we must continue to invest heavily and sustainably in our people, infrastructure and institutions. Next Generation EU will have a key role to play in helping repair the immediate economic and social damage brought about by the pandemic. It will also address our longer-term challenges by supporting reforms and investments to tackle the climate emergency and the digital transition.

How can the private sector complement public policy efforts to tackle the investment needs related to the green and digital transition?

In the wake of the financial crisis we implemented many economic, structural and financial reforms.

We benefited from this resilient banking system during the pandemic. Banks' risks continue to decline, with broadly stable capital and leverage positions, an improvement in their liquidity position, a decline in NPLs and a decrease in MREL shortfalls.

Loan moratoria, public guarantee schemes, borrower relief and liquidity support all contributed to the mitigation of

the impact of the pandemic on balance sheets. Of course, the impact of the pandemic will be revealed over time, as forbearance measures are wound down and public supports become more targeted.

The impact on banks' balance sheets will largely depend on the strength of the broader economic recovery. But as a result of the political and institutional strides we made in the early days after the financial crisis, we are now in a position to ensure that the banking sector can contribute to the recovery.

There are new challenges to face, in terms of financing the green transition and the increasing digitalisation of the sector and the wider economy, which will require enormous investment. For example, Europe will need an estimated EUR 350 billion in additional investment per year over this decade to meet its 2030 emissions-reduction target in energy systems alone, alongside the EUR 130 billion it will need for other environmental goals.

Governments cannot provide all of the funding for these transitions. We need to mobilise and direct private investment, through Banking Union and Capital Markets Union, to provide the majority of this funding. Well-functioning financial markets are critical to the future of our monetary union - as a shock absorber, to support the economic recovery and to drive the twin transition.

What are the missing pieces in the Banking Union? How can we move forward on this project?

All Member States agree that the completion of the Banking Union is important to drive economic growth and fund the green and digital transitions. As President of the Eurogroup, I am aiming to build consensus on the next steps take this project forward. We are aiming to agree on a work plan for Banking Union, which will be the political framework for holistic, stepwise and time-bound progress on our Banking Union.

This is a good opportunity to reflect on why the Banking Union we currently have may not suffice, and what we need to complete it.

Crisis management

- The establishment of a common European framework for the handling of large EU banks in a crisis - less than ten years ago - was a powerful outcome of the last financial crisis. To date, this EU crisis framework has only been applied once to resolve a bank. Mid-sized banks are considered not systemic enough to be resolved at EU level, but too big to be liquidated in an effective manner at national level. There is a gap in the framework here, which leads to different outcomes and use of public money depending on the country: this creates a risk for stability and distortion.

- There is broad consensus on the need to revamp the crisis management framework. The key questions relate to the scope of European resolution versus the national handling of failing banks, and to the common rules for the use of funds.

Integrated banking markets

- There is no single market for banking services today. Banks cannot allocate resources in a flexible manner across their entities, and deal with different corporate, tax and employment laws, and differences in consumer protection and insolvency laws.

- This weighs on banks' cost structure, their governance and their ability to offer efficient, cheaper and better services to customers. There is a low level of bank consolidation in the EU, and they lag behind in size, profit and innovation compared to global peers.

- However, as important as promoting market integration and bank consolidation is, it cannot come at the price of financial stability, neither at EU nor at national level. Strong safeguards have to be in place.

Depositor protection

- The protection of deposits is handled at Member State level today. In case of a severe bank crisis, the existing national funds, financed by banks, could be depleted. This is also an element of fragmentation for the banks, which have to deal with multiple funds. Finally, there are divergences in the use of national funds for measures other than direct payout to depositors in the event of bank insolvency which again risks an uneven playing field.

- A broader European safety net would offer a larger liquidity pool to absorb shocks. This is key to strengthening citizens' trust - to avoid bank runs and contagion in other Member States. It is also justified by the fact that a significant part of responsibilities for defining the rule book and carrying out supervision has been transferred to the European level.

Sovereign exposures

- The financial crisis highlighted that the feedback loop from banks to sovereigns can endanger the stability of the euro area. This loop between banks and the sovereigns was at the very heart of the Banking Union project. Sovereign concentration in banks could be further addressed in our assessment of bank risks. Again, steps to help mitigate the feedback loop should not disrupt sovereign bond markets in the EU, especially in times of crisis where there are high funding needs.

In conclusion, we need to get the framework right for EU banks to be competitive and in a position to support a thriving economy. All the missing elements to complete the Banking Union are closely linked.

I expect my colleagues to work in a constructive and compromising spirit over the coming months. I think there is a path for collective success and a window of opportunity to act now, to set out a political framework so that the Commission can bring forward legislative proposals and deliver tangible change.