

Implications of globalization and international uncertainty for EU growth

The Chair explained that up until the past few weeks, the euro area's monetary policy environment had become relatively benign as past shocks were slowly but surely moving to the rear-window. The European Central Bank (ECB) had successfully brought inflation down to close to target and interest rates are close to neutral. However, large shocks had now brought new challenges for monetary policy. Germany is planning a substantial increase in infrastructure investment, and across Europe—including Germany—higher defence spending is being envisaged. And of course, the US administration's recent package of tariffs will have major implications for Europe's economy.

The first round of interventions focused on the consequences of fragmentation, increased defence spending and tariffs for growth, inflation and monetary policy. In the second half of the discussion, panellists were asked to consider the potential structural reforms and fiscal policy responses to these developments.

1. The macroeconomic impact of US tariffs

1.1 As trends in globalisation, demographics and digitalisation are changing, the global economy is undergoing a structural shift

A Central Bank official suggested that a structural shift is happening in the global economy. Globalisation, the growth of world trade and demography have helped central bankers keep inflation in check by mitigating price pressures. From 1980 to 2010, the world's labour force expanded from 700 million to over 2 billion. This is the largest positive labour supply shift in history. Increasing digitalisation has also boosted productivity and helped dampen inflation. However, most of these trends have started to reverse. The nature of global demography is no longer providing the same benefits to monetary policy. Population and labour force are declining everywhere except Africa, where the labour supply will continue to grow. However, Africa is unlikely to experience the kind of rapid productivity growth seen in Asia or Central and Eastern Europe (CEE).

1.2 The US balance of payments deficit is poorly understood by the Trump administration

1.2.1 The US current account deficit is a product of excessive credit and insufficient savings

A Central Bank official stressed that the current US administration may misinterpret the structural nature of the US current account deficit. This imbalance primarily reflects the fact that the US spends more than it saves leading to higher consumption, growth and

investment. As Robert Triffin pointed out many years ago, any country with a dominant global reserve currency is required to run a current account deficit to provide global liquidity. However, aspects of the Chinese and European economies support Trump's arguments. The Chinese economy is still based on production and exports rather than consumption, which increases its trade surpluses. The peace dividend has freed up Europe's defence spending for other uses and the German economy maintains, to some extent, a strong manufacturing base. A former Central Bank official (Marek Belka) added that the ECB's monetary strategy will need to take into account the potential for US pressure to weaken the dollar in the coming years.

A market expert explained that the new US administration believes that Germany's trade surplus is hurting America economically. As Jacques Polak of the IMF made clear, a current account deficit is a national phenomenon caused by excessive domestic credit. The provision of excessive credit to government and the private sector bumps up against a country's productive capacity. While this stimulates some domestic production, it also means the country will need to import additional production. Ultimately, the US will have to start saving.

1.2.2 The US imposition of high tariffs will undermine the interconnected global economic system

A market expert stated that the United States is risking significant damage to the global economy. Current US policy is seeking to imitate the time when the US developed its industries around the turn of the 20th century. This is a profound mistake. The world economy in 1900 was nowhere near as interconnected as it is today. Increasing tariffs will not improve domestic competitiveness; it will destroy the interwoven fabric of the system.

1.2.3 The US savings deficit has the potential to spark a financial crisis

A market expert emphasised that the US balance of payments deficit is the inevitable consequence of its savings deficit. The US will eventually face the Triffin dilemma, where confidence in the dollar is undermined by its excessive current account deficit. If America continues to borrow without restraint, doubts about the durability of its economic model will trigger a financial crisis. It is time for those who understand economics and monetary policy to speak out.

1.3 Tariffs will not reduce trade deficits and may damage both the US and EU economies

1.3.1 Tariffs are not the solution

A Central Bank official agreed that tariffs will do little to address trade deficits. Tariffs will likely raise prices in

the US. If Europe retaliates, inflation will also rise, and GDP may fall. The factor that could trigger a change in US policy is the reaction of financial markets, particularly regarding US Treasury yields. Establishing the Savings and Investments Union (SIU) should be a priority for the EU. The discussions at the Eurofi conference have made clear that Europe is not currently doing enough to achieve this goal.

1.3.2 US tariffs will misallocate global resources, reduce productivity and increase inflationary pressure

A Central Bank official noted that the United States' tariff policy appears to signal the start of something akin to a trade war, though there is considerable uncertainty about what the US administration will decide to do from day to day. In the medium to long term, tariffs will not alleviate inflation. Tariffs are a tax on cross border goods and services. Even if this tariff policy achieves some of the administration's goals, it will inevitably lead to a misallocation of resources in the global economy, which will lead to falling productivity and higher price pressures in the medium to long term.

1.3.3 The necessary investments in decarbonisation and defence will contribute to inflationary pressure

A Central Bank official highlighted that spending on decarbonisation should make renewable energy cheaper in the long run, but in the medium term it will require huge investment, which puts pressure on prices and usually involves some form of carbon taxation. The additional investment in defence also has the potential to mildly affect inflation.

2. International uncertainty: an opportunity to refresh EU economic and financial policy

2.1 Lessons to learn from recent years

2.1.1 Excessively low interest rates have discouraged long term savings and productive investment

A market expert noted that the easy monetary policy of the last 20 years has had a profound impact on productive investment. The policy of lasting very low real interest rates has shortened the savings horizon. People are discouraged from saving for the long term because the return is very low. The reward for long term investment has disappeared. As Keynes warned, this has eroded long term productive investment. If the importance of productive investment continues to be ignored, Europe will continue to favour speculative investment and real estate investment in existing goods, which does not create additional space.

2.1.2 Productive investment will not return to Europe if interest rates in the EU remain below US rates

A market expert added that productive investment will not return to Europe if its interest rates remain 150 basis points below US rates. Every year €350 billion leaves Europe. If the EU wants to develop its capital markets, it

needs capital. European capital is fleeing Europe because of the systematically lower interest rates.

2.2 Building a European defence industry

2.2.1 State led investment in defence should boost high tech innovation and competitiveness

A former Central Banker and Prime Minister explained that the military build up could spur industrial growth in Europe by driving technological innovation and creating high tech jobs. The development of unified defence infrastructure could deter external threats and improve Europe's economic competitiveness. Coordinated defence investments should also lead to cost efficiencies, better resource allocation and greater resilience against external economic pressures. Investing in the European defence sector could create high tech jobs and spur industrial growth. Despite Europe's over indebtedness, financing military expenditure is a geopolitical necessity. Europe must take control of its security through greater integration, common debt issuance and fiscal reform.

2.2.2 The issuance of common European debt could help to finance military reinforcement

A former Central Bank official and Prime Minister highlighted the key role that common European debt could play in financing military expenditure. A degree of military build up appears existentially indispensable. This should be formed of a national pillar and a common pillar. To fund the national pillar, member states will need to increase defence spending. The exact level of expenditure should be differentiated according to the challenge faced by each state. The Scandinavian countries, Germany, Poland, Romania and the Baltic states will have to spend more. Fortunately, these countries have some fiscal room for manoeuvre.

The common pillar should be formed of a European fund to develop the defence industry. The EU defence industry is fragmented and uncoordinated. The way to finance this fund will be to leverage the capital markets and issue joint debt. This would allow member states to pool resources without exacerbating national debt burdens. If structured properly, the issuance of common debt will maintain fiscal discipline while enabling the modernisation of Europe's defence capabilities. This initiative could also strengthen the euro's role as a global currency by creating a stable and liquid European asset that attracts international investment. This common fund will require a stable source of funding, which can only be the EU's own resources.

2.2.3 Reforming EU macroeconomic management

A former Central Bank official and Prime Minister stressed that further reform of the EU's Stability and Growth Pact will be essential to ensure that military investments align with long term financial sustainability. Shifting from strict deficit targets to an expenditure-based rule would provide more flexibility while preserving economic stability. The current system of deficit limits is based on unobserved variables. Instead, EU policymakers should take a more holistic view of macroeconomic management and adopt strict, clear and simple expenditure rules. The simpler the rule, the harder it is to circumvent.

2.2.4 Implementing the SIU seems more difficult than supporting the European defence industry.

A former Central Bank official emphasised the difficulty of making the changes necessary to implement the SIU. It is much more practical to undertake a programme of state enabled military spending. The US and Israel have both benefited from this kind of investment, which should develop high tech industries and potentially increase competitiveness. Instead of waiting decades for the capital markets to grow, Europe should look to stimulate its defence industry with smart investments. The economic challenges are serious but a geopolitical necessity because the situation is not hopeless.

2.3 Implementing a genuine Savings and Investments Union

2.3.1 The integration of EU financial markets will require major pension reform

A Central Bank official noted that the key ingredient of a US style capital market is the proper investment of lifecycle savings. To achieve a similar depth in European capital markets, pension funds would need to play a much bigger role in the investment landscape. Pension funds play a key role in every single well developed capital market in the world. Currently, only a few EU countries have significant pension funds. Without significant improvements and substantial reforms of Europe's pension systems, it will be difficult to mobilize the long-term savings needed for a functioning SIU and to make real progress on the SIU. In this context, aligning the tax framework is a key priority to support well funded pension systems. The EU has many challenges to address, but the current set of policy measures may fall short of achieving its objectives.

2.3.2 The potential for a 'safe asset' based on mortgage backed securities

A Central Bank official suggested that the EU could strengthen market integration by creating an EU 'safe asset'. While politically sensitive, especially in light of high public debt levels across several member states, such an instrument could increase certainty and improve the effectiveness of monetary policy transmission. As exemplified, he stated a paper from the 2024 Jackson Hole conference about assets based on mortgage backed securities (MBS) in the US. Developed for Europe, this would offer a better way to conduct monetary transmission and would be a common European asset based on a private asset.

2.4 Without sound public finances, Europe will not be able to finance essential infrastructure, defence and the green and digital transitions

2.4.1 Recovering budgetary margins

A market expert stressed that the EU will not be able to finance all its spending needs while maintaining a highly unbalanced fiscal position across the Union. Further fiscal reforms will be needed. If Europe continues to finance its expenditure and debt with more borrowing, it will create a financial crisis. There is no reason to pursue fiscal stability dogmatically, but it will be necessary to create fiscal space to finance these new

expenditures. The currently 'crazy' fiscal policies in some countries will need to be normalised in order to finance Europe's environmental and military objectives.

2.4.2 Both public and private debt are largely unproductive and unsustainable

A market expert noted that the EU is in a bewildering state of instability. Europe's enormous public borrowing only finances current spending and deficits. It does not generate future returns. The same applies to the private sector. A recent report by the Organisation for Economic Co operation and Development (OECD) found that most corporate borrowing is not used for productive investment. It is used to finance financial operations such as share buybacks, which do not generate returns. It is a very sobering to realise that both public debt and private debt are not self financing and do not generate returns. It should not be the case that European policymakers lack the intellectual capacity to deal with today's challenges, but this argument is certainly worth considering. The Chair agreed that fiscal space must be created to finance additional spending. This involves both fiscal policy measures and structural reforms to boost potential growth. Higher growth is crucial to solving Europe's fiscal challenges.

2.4.3 The banking system is resilient, but market volatility does pose risks to financial stability

A Central Bank official noted that the banking system has proven resilient to recent market developments. It is much better capitalised, more liquid and generally more robust due to the supervisory and regulatory reforms implemented after the global financial crisis. However, there are many opaque exposures in the non banking sector, and market turbulence can have unexpected effects. The recent correction in equity markets has been welcomed by some, but such abrupt moves can bring a degree of danger, particularly in unusual situations where there are simultaneous falls in equity markets and bond prices. These situations can lead to rapid unwinding of positions and margin calls.

2.5 Euro adoption and the digital euro

2.5.1 The euro is a political phenomenon

A former Central Bank official emphasised that the euro is a political phenomenon, but it is still important for economists to make the right economic arguments for euro adoption. In the CEE region, these arguments are always about the Balassa Samuelson effect and the risk of stagnation. This has never happened in any CEE country. The claim that the introduction of the euro will create trade is impossible to prove. EU trade has been booming with or without the euro. In the case of Poland, the depreciation of the zloty was a shield against the trade crisis in 2008, but this was only made possible by the speculative bubble that happened two or three years previously. When a small currency is next to a large one, capital flows are prone to instability. Additionally, the cost of maintaining a national currency is reflected in growing foreign exchange reserves. Poland has accumulated reserves of around €200 billion. If it were to join the euro, it would only need reserves of €15 billion. The remainder of these reserves

should instead be spent on importing arms to facilitate the military build up.

A Central Bank official noted that Croatia's experience of euro adoption was very positive. During the Covid crisis and Russia's invasion of Ukraine, Croatia had lower inflation than the rest of CEE and lower interest rates than the rest of the eurozone. As a small central bank next to the second largest central bank in the world, Croatia's monetary policy could never be truly independent from the ECB. When the ECB decided to implement quantitative easing (QE), Croatia was forced to prevent its currency from appreciating by purchasing euros and accumulating foreign exchange reserves.

2.5.2 If carefully designed, the digital euro has the potential to enhance EU strategic autonomy

A Central Bank official explained that the use of cash is declining as the adoption of digital payments increases. Cash is central bank money held by

households and citizens. All central bankers want some central bank money to be held by their populations. The digital euro will be central bank money held by households in an electronic digital wallet, and it will be the only European digital payment solution for the whole of Europe. In the current geopolitical circumstances, this kind of European payment solution offers a form of strategic autonomy, but it must not create any additional risks to financial stability. The use of a holding limit will guarantee that the banking system is not drained of savings and that people do not use the central bank to save.