Luis de Guindos: Fostering resilience and convergence in Economic and Monetary Union

Keynote speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the conference "Five Years with the Euro", Latvia, 7 January 2019.

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It is an honour to have been invited here today to celebrate the fifth anniversary of Latvia adopting the euro. Of course, this year also marks the 20th anniversary of the euro. Such anniversaries are a good opportunity to look back and reflect on what has been achieved over these years, and to think about what steps we now need to take to ensure that the coming years will be prosperous for everyone in the euro area.

Latvia joined the euro area at a difficult time. Inflation in the euro area was low, and the risks of deflation and a de-anchoring of inflation expectations were high. Now, the monetary policy measures taken to foster recovery have paid off. Today the euro area can look back on more than five years of economic growth, with over nine million more people employed now than at the start of the recovery. In terms of growth, Latvia in particular has really shone during this time.

As a result of this continued growth, we in the Governing Council of the ECB confirmed at our meeting last month that we are confident the sustained convergence of inflation to our inflation aim will proceed. As a result, net purchases under our asset purchase programme ended last month.

The end of net asset purchases does not mean that monetary policy accommodation has ended, however. Substantial accommodation will continue to be provided by our forward guidance on key policy rates and our policy of reinvesting the sizeable stock of assets acquired.

Moreover, further efforts are required to reinforce structural resilience, boost productivity growth and sustain economic convergence within the euro area. Introducing structural economic reforms, building up buffers and completing the Single Market are all key here. I would therefore like to take this opportunity to draw some lessons from Latvia’s experience within the euro area to consider what specific steps can be taken to ensure the long-term success of the euro.

Five years of the euro in Latvia

Joining the European Union and the euro area has been a good experience for the Latvian economy overall. When the euro was introduced 20 years ago, GDP per capita in Latvia was around 30% of the average for the then 15 members of the EU. Today, that figure is around 60%. Although Latvia certainly suffered during the financial crisis, its economic growth in the five years since it joined the euro has been strong. During the first three quarters of 2018 growth was close to 5%, one of the highest rates in the EU and the euro area.

This convergence towards the European average is in no small part due to the process of accession to the EU and the euro area. Implementing necessary reforms and taking steps to reduce government indebtedness to meet the debt and deficit criteria have achieved results.

Latvian credit ratings have gradually, and stably, improved. Borrowing costs have fallen markedly, with spreads to German Bunds averaging around 40 basis points in 2018, compared with 170 basis points before the adoption of the euro. These lower funding costs have in turn resulted in significant government budget savings.[1]

More importantly, economic growth in Latvia is more balanced than in the past and based on a more resilient economy. Sustaining convergence, however, is a process, and cannot be ensured by a one-off set of reforms for accession. A comparison with peer Member States such as

Slovenia, Slovakia and neighbouring Baltic countries suggests that there is further scope for Latvia to catch up in terms of GDP per capita.

Reforms boosting productivity growth and investment in innovation are essential to sustain the high rates of wage growth currently seen in the economy – of close to 8% – and thus to prevent competitiveness losses in the future.

Improvements in overall institutional quality – a fundamental pillar of long-lasting economic growth – have been somewhat slow in Latvia since it joined the euro area compared with several other EU countries. Nonetheless, the recent policy measures taken by Latvian authorities are welcome.

In particular, measures taken to prevent money laundering and the financing of terrorism, as well as steps taken by banks serving foreign clients to refocus their business models, are examples of notable reform efforts which need to be continued with persistence and determination. These efforts should be buttressed by strengthening the foundations for sustainable economic growth, for instance by building up fiscal buffers and taking appropriate macroprudential measures.

Fostering structural resilience and sustainable economic convergence in the euro area

Looking at the need for structural reforms more broadly, more needs to be done in the euro area as a whole. The past 15 to 20 years show that euro area countries with sound economic structures from the outset have achieved much higher long-term real growth and are more resilient. Countries which adopted ambitious reforms during the crisis, such as Latvia, recovered faster than others, with these improved economic conditions leading to higher employment rates[2] – and the full effects are still materialising.

Nevertheless, over the past five years structural reform implementation in the euro area has, overall, been sluggish at best. Very few reforms identified in the European Semester have been substantially implemented. Reversing this trend and putting our economy on a higher convergence trajectory is thus a priority.

In parallel, national policymakers should make it a priority to build up fiscal buffers to ensure policy space for future downturns. This is particularly important in countries where government debt is high and for which adherence to the Stability and Growth Pact is critical for safeguarding sound fiscal positions.

National authorities should therefore be the first ones to step up their efforts. Nevertheless, European policies can be a significant catalyst and provide a strong engine for both growth and employment, in various ways.

First, there is scope for a better use of the EU's budget. The discussions on the 2021-27 multiannual financial framework offer an opportunity to enhance its role in addressing Europe's structural challenges, and I welcome the commitment made by leaders at the Euro Summit to pursue this avenue.

Second, the Single Market as an engine for convergence should be used to its fullest potential. This means expanding its reach into new areas, especially those relevant for innovation, such as the digital economy. This is an essential driver of economic progress, benefiting consumers, businesses and the economy as a whole, and will also provide a healthy ecosystem for financial services.

It also means increasing the depth of the Single Market. In the area of financial services, the completion of the banking union and the capital markets union agenda offer an opportunity to do this, and would also provide the cross-border private risk-sharing mechanisms required to underpin the resilience of our economy.

This is because deeper and more efficient bond and equity markets in Europe would allow economies of scale to be achieved and capital to be allocated to its most productive uses at the European level, in line with the Single Market objectives. In countries such as Latvia, this is particularly relevant because capital markets are less developed and intermediation remains largely bank-based, which results in fewer options for financing business start-ups and expansion.[3]

Creating a genuine banking union where banks operate across borders and diversify their sources of income would also enhance cross-border private risk sharing, with the result that banks would be able to continue lending to the real economy even when faced with localised shocks.

For these benefits to materialise, we need to pursue a more ambitious long-term approach to the capital markets union agenda. At the local level, decisive action is needed to develop the scale and depth of capital markets in countries with large catching-up potential, such as Latvia.[4] At the EU level, measures need to be prioritised in areas which will make a real difference to the development of capital markets, notably measures to address barriers in national insolvency frameworks and in taxation.

We also need to be ambitious in our endeavours to complete the banking union. The statement of the Euro Summit adopted in December paves the way for operationalising the backstop to the Single Resolution Fund, which will create market confidence that bank resolutions will take place in an orderly fashion. There is also recognition that it is time to start political discussions on the missing third pillar of the banking union – a European deposit insurance scheme.

This does not mean that we do not need to make further progress in risk reduction. Substantial risk reduction has been achieved, and the process is ongoing and should continue. The European regulatory framework is already making Europe's banks more resilient and gives authorities the tools to act when risks build up. Banks now hold more and better-quality capital,[5] and have improved their liquidity positions and leverage. Progress in tackling legacy issues such as high levels of non-performing loans, which have fallen by 30% since 2014, and the framework for resolution, including the implementation of the minimum requirement for own funds and eligible liabilities, have also helped to increase buffers and reduce risk and thereby the scope for risk sharing.

The crisis demonstrated how important it is for banks to build up capital buffers in good times. In my view, the current economic and financial conditions call for more action by macroprudential authorities to enhance the resilience of the banking sector and ensure the system has buffers in place that can be released in times of stress. In an increasing number of countries, authorities are considering activating a countercyclical buffer, as it hedges against economic and financial shocks, further contributing to risk reduction.

Conclusion

Let me conclude.

There are numerous reasons to celebrate the success of Latvia's first five years in the euro area. And there are numerous reasons to celebrate the euro as a powerful convergence tool that brings tangible benefits to the lives of European citizens.

But ensuring the longer-term success of the euro requires continued reform efforts to reduce risks in the financial and public sectors and measures to reform our economies to boost productivity. It requires building up the necessary buffers so that public authorities have the fiscal leeway to act in times of crisis and the financial sector can continue to finance the economy throughout its cycle.

Importantly, it also includes risk sharing across national borders: through the pooling of resources at the EU level to face shocks, through integrated financial markets, and through a complete banking union.

This is essential to build up the resilience of the euro area, foster stability and growth, and improve the lives of the people of Europe.

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1 According to Latvijas Banka this has resulted in savings of around 0.6% of GDP, or €150 million, in the government budget over the five-year period. See the article entitled "Four years in the euro area – have the promises come true?", Latvijas Banka Monthly Newsletter, January 2018.

2 See "Competitive adjustment and recovery in the Spanish economy", *Annual Report 2015*, Banco de España, pp. 39–63; Vansteenkiste, I., "Did the crisis permanently scar the Portuguese labour market? Evidence from a Markov-switching Beveridge curve analysis", *Working Paper Series*, No 2043, ECB, April 2017; and Sestito, P. and Viviano, E., "Hiring incentives and/or firing cost reduction? Evaluating the impact of the 2015 policies on the Italian labour market", *Questioni di economia e finanza* (Occasional Papers), No 325, Banca d'Italia, March 2016.

3 For instance, Latvia's total stock market capitalisation was 4% of GDP in 2013, which was the lowest rate among the EU Member States. See "Capital Markets Union factsheet", European Commission, 30 September 2015, p. 2.

4 See, for instance, the recommendations included in the "Report by the Working Group on Capital Markets Union", EBCI Vienna Initiative, March 2018.

5 The fully loaded CET1 ratio of significant institutions was 13.8% in the second quarter of this year, up by 2.6 percentage points compared with the last quarter of 2014.