

## Yves Mersch: The evolution of the European model of integration

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the AMCHAM (American Chamber of Commerce) Financial Services Committee's Networking, Luxembourg, 15 February 2005.

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The year 2005 in Europe should be marked by the ratification of the European Constitution. This provides an opportunity for trying to assess the quality of European integration over the last 50 years, especially in view of a comment I have recently read in an American newspaper published in Europe, which describes this integration process as shaky and unsure.

Before forming an opinion it is important to recall that the views we might have on our surroundings are deeply influenced by the historical dimension, as well as by the various systems of governance in our different countries and continents.

We must not forget that for the United States an overriding event in its history was the Civil War (1861 – 1865), which was followed by well over a century of peace on its own territory. That does not mean that the United States was not involved in wars overseas. But that is very different from having war on your own territory.

A second essential element of difference concerns personal or family history. The vast majority of people living in the United States stem from the immigration of economically weak classes or people who were persecuted because of their religion or other ideological beliefs. This has led to a strong feeling of distrust vis-à-vis central government and also to a feeling of strong individualism that is expressed in the national laws and the institutional framework, as well as in the prominence of moral values.

Europe, on its side, has a quite different pattern of collective and family memories. In order to understand, one has to go back as far as the feudal Middle Ages, when there were many small states in Europe, which tried to gain power or wealth in 2 ways so as to achieve mergers and take-overs with other States: one way was to marry, another was to wage war.

The consequence was a permanent state of war on the continent. This led to great poverty and ultimately to revolutions, out of which came a new concept, that of the Nation State, which is also familiar to the US, as Madame Secretary of State so eloquently recalled at IEP in Paris a week ago. This Nation State also meant in many cases the end of feudalism and the transfer of sovereignty through marriage. The policy of acquiring lands through marriage was so successful in the case of the Habsburgs that the saying was: "Tu felix Austria, nube", or "Thou happy Austria, marry"?

But it did not mean the end of war. Even though many small states coalesced to form larger Nations in the 19th century (for example Germany and Italy), that did not mean the end of war, but the start of more or less "holy alliances" that were continuously shifting. Thus larger Nations tried to grow even bigger by grabbing up smaller nation states, and we had at least one war per generation on this continent.

After World War II we tried another way. As a consequence, larger states were to give up their sovereignty in two key areas, which used to be important for the war industry, coal and steel. They thus vowed to renounce war and yielded a disproportionately large share of decision-making in common affairs to smaller countries. Above and beyond that a referee was appointed, a European centralized executive, even though its power was to be limited.

As a consequence we now have inside the European Union a totally new situation in which for the first time in centuries, in Europe, one generation has been able to accumulate wealth and transfer it to the next generation, so creating a very strong sentiment of support in most countries of the continent and a quest for yet more progress in this sense which is still present in the agenda that Europe is pursuing right now.

Of course the question could be asked whether this equilibrium of power can still be maintained in an enlarged Union, since the Union at the outset was not designed for such a large number of countries, and especially since many of the new countries belong to the category of small Member States. Further, they have only recently recovered their sovereignty and might be rather reluctant to yield it again so soon to a super-power. Don't forget that the latest new member countries represent less in economic terms than previous enlargements from 6 to 9 or 9 to 12. All the new countries have also

been very closely associated with the history of "core Europe". This question will of course be even more valid for future enlargements.

But the divergences in Europe are not only due to the different histories of the countries of the continent, but also because different paths for development were taken by different nations, which brought about different policy approaches.

In this respect the role of ideology is prominent. In most countries history shaped the understanding that each people has of the role and rights of the individual versus the role and rights of the collectivity. Do not forget that the 2 most forceful concepts of ideology have their cradle on the European continent; nationalism and socialism, which have galvanized many million people, while creating problems for the whole continent.

Though these 2 concepts are still embraced by many people in Europe; many others reject both of them. Others adhere to nationalism and reject socialism; yet others are internationalists and socialists at the same time. In the heads of people it is still very heterogeneous.

This of course has an influence on how people organize themselves, how the institutional framework is shaped. We have had some very centralized states, like France for example, and to some extent even the UK. And after World War II the Americans imposed an extremely decentralized constitution on Germany, whose efficiency is now put into question. Italy is also a country that, moving from a federal state, came closer and closer to a centralized state, while now moving again in the direction of decentralization.

How does this affect European integration? I take monetary policy as an example. In the UK the central bank acts through a certain small number of money centers which are large systemic banks, which act as primary dealers, while in the case of Germany the central bank has contacts with every single small bank and every single small bank feels also entitled to be part of this national framework. When we defined European monetary policy, we had to bridge these differences and invent compromises between the two. As a result we have centralized decision-making, but decentralized preparatory work and also decentralized implementation of decisions.

The different views of the role of the individual and the collectivity are also reflected in our legal systems, which are very different. Again I would like to take my examples from the area of finance. Financial assets and their utilization in a sophisticated financial and monetary system depend very largely on the attitude a country has vis-à-vis bankruptcies. This attitude is very different from one country to another. The protection you give either to the debtor or the creditor can hugely influence the amount and the availability of collateral that is so much needed in order to leverage an economy.

Another example is accounting. You have the French system, which is ruled like the legal system by concepts and where a credit is a credit whether it is given to a bank or to an individual, and the same goes for a debt. In the UK you have a functional approach. You have very different systems for consumer credit or for corporate credit, and different levels of protection.

It also depends on what you consider as more important, and this came to the fore once more again with the debate on the IAS 39 Fair Value rule. The International Accounting Standards Board (the members of which are dominated by people originating from the UK and from the US) considered in their logic that the information given to the investor about the financial value of an asset is paramount.

In the rest of Europe we consider that there are other values to be respected. For example, we consider that companies are not only financial assets; companies are also corporate citizens that give jobs to people and pay taxes to buy public goods. We consider that the fair value could be extremely destabilizing for the financial system, because it would favor erratic results and procyclical behaviour by banks.

I will limit myself to some examples, which are interesting in the context of the pension system. In Germany the social laws were part of the nation-building effort aimed at fostering cohesion. In a fast growing nation a pay-as-you-go pension system creates inter-generational solidarity, while in other countries the responsibility of the individual to behave irresponsibly is his own decision, and it is accepted therefore that his fate ought to depend on his own decisions to save and invest or not. In consequence, in these countries poverty is not considered a collective responsibility but a moral one. In other countries where poverty led to civil war, regime change and a loss of influence of religion, Governments had to step in.

Progressive income tax was also part of social cohesion, for example in Germany, invented under Bismarck. In France more than half of all households do not pay direct taxes, and most of the income

from the budget has traditionally come from indirect taxation. France has also always had a tradition of taxing wealth, or the stock rather than the flow. Is what is appropriate after most of the stock has vanished, more appropriate today? All these decisions are influenced by history, and you imagine the difficult debates you have among nation states to harmonize any of these areas at European level.

But it is not only history. It is also the diversity of economic thinking. And as I mentioned before, in the seventies in many French universities, economics meant a centrally planned economy. I remember when I first went to working groups in Brussels, the discussion was on fine-tuning the economy. Not surprisingly, when the first oil shock created havoc on a global level, some EU countries resorted to financing deficits thinking this situation was temporary, while other countries resorted to a structural adjustment.

The consequence of this was the implosion of the first attempt to create a monetary union in Europe. The Werner Plan (1970) failed largely, among other reasons, because of this difference in economic thinking. And in 1982, the beginning of the Mitterrand years, there was even a plan by a nationalist and socialist element within the French Government to resort to competitive devaluation, to control capital and goods at borders, and to resort to protectionism vis-à-vis other European countries, the end of the Union.

Fortunately Mitterrand sided with Delors, and the Union continued, but the Germans were deeply distrustful of the ability of France to abide by a social market economy. And it was not until several years later, in 1989, that the first study to embark on an Economic and Monetary Union was completed, because since the middle of the eighties, a true "pensée unique" in economic terms, a true belief in the same economic values, namely a social market economy had developed, that allowed the establishment of a single currency.

In order to proceed you need agreement on the underlying objectives. Do we see a market economy as an instrument to achieve the individual's quest to maximize his happiness expressed by his financial balance? Or is, alternatively, the market economy a way to improve collective happiness measured by the Gini factor (wealth distribution), peace, culture and quality and quantity of common goods available to the largest number? The answer will hugely influence your tax system, your social security system, your accounting system and so on.

In the US the democratic debate is not about socialism or a market economy, not even a social market economy, at most about the size of deficits or jobs. What decides elections is abortion, gay marriages, God. Do you recognize there the roots of US history? In Europe however, religion and its issues are a non-event as electoral movers. What is moving Europeans is war, and what is moving Europeans, is welfare. That is the agenda of Europe.

If you use this grid of an explanation, it explains many of the gridlocks that are depicted with great pleasure in some newspapers. But it also explains some of the difficult moments of the transatlantic dialogue. However, I am not pessimistic. By being aware of our diversities and sensibilities, we still can squeeze a lot more of shared positions out of our relative societal frameworks, both inside the EU and between the EU and the United States. This is what we should concentrate on.