José Manuel González-Páramo: The European Union and the lessons from the crisis – the way forward

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the RBC Capital Markets' Central Bank Conference "Impacts and Implications of Integrated Global Markets", Madrid, 12 May 2011.

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Ladies and gentlemen,

I. Introduction

It is a privilege for me to participate in this conference dedicated to the very important topic of the "impacts and implications of integrated global markets". As we are all aware, from the very start of the current crisis, economic and financial distress has been transmitted around the world through a variety of channels that, together, have formed an unusually rapid and pervasive cross-border transmission mechanism.

The high degree of integration in today's global financial markets is generally seen as one of the factors that have contributed to the amplification and spread of the current crisis. However, the fact that integrated financial markets can contribute to the destabilisation of our economies is not intuitive. Economists usually believe that more integrated and innovative financial markets are conducive to sustained economic growth and reinforce economies' capacity to withstand shocks. The experience of the last four years shows though that, under certain conditions, financial integration and some types of innovation can increase the scope for contagion across institutions, markets and borders and contribute to the emergence of systemic risks.

This is one of the many lessons that we have learnt from the crisis, but certainly not the only one. There are also important lessons regarding the economic governance of the euro area, the sustainability of public finances, the regulatory reforms of the financial sector, etc. to be learned. In my address today, I would like to share with you some reflections on what we need to do in order to draw such lessons and what, in my view, represents the way forward for the European Monetary Union.

II. The state we are in

The idea that highly integrated financial markets are always conducive to macroeconomic and financial stability is not the only economic notion that has been challenged by the crisis. The current crisis was preceded by the "Great Moderation", a period of reduced macroeconomic and financial volatility and improved economic performance that began in the mid-1980s. During this period, the progression of economic history as a succession of cyclical booms and busts seemed to have come to an end in many advanced economies. Some economists even referred to specific countries as "Goldilocks" economies, with this term meaning their supposed ability to grow on a sustained basis at a rate that was neither too high to generate inflation nor to low to cause unemployment.

The trust in the ability of our financial markets and economies to smoothly overcome any disturbances came to an end in the summer of 2007, when the financial "turmoil" began. After the collapse of Lehman Brothers in October 2008, the turmoil mutated into a full-blown financial "crisis" and many market segments seized up. The "Great Moderation" gave way to the "Great Recession", characterised by a massive fall in industrial output and trade.

Policy interventions were made by central banks and other public authorities to restore and secure the orderly functioning of markets and economies. I like to think of the interventions by public authorities as "lines of defence" against the crisis. They proved successful in guaranteeing those authorities' ability to continue delivering macroeconomic and financial stability against the crisis.

Let me recall briefly the three main lines of defence: central banks increased their provision of liquidity and financial intermediation services; monetary and fiscal authorities adjusted their policies in order to mitigate the macroeconomic impact of the crisis; and governments implemented a variety of measures in support of the financial sector.

The government measures adopted in response to the economic crisis – both those related to fiscal policy and those in support of the banking sector – did not come cheap. This is true not only in the euro area, but – more generally – in all advanced economies. Together with the impact on government budgets of the massive economic contraction recorded during the crisis, they led to a significant deterioration in the public finances of a number of economies in the euro area.

The deterioration was particularly significant in countries in which: (1) pre-crisis growth had been of an unsustainable and unbalanced nature – typically as a result of an over-reliance on the expansion of private credit and the contributions of housing-related sectors (notably construction and housing finance) – and (2) in which governments had failed to take advantage of favourable developments in the years of booming growth in order to consolidate their public finances.

Over time, concerns about the size of government deficits and soaring debt-to-GDP ratios – combined with uncertainty about the ability of governments to design and implement consolidation plans in the context of reduced potential growth and massive implicit liabilities towards the financial sector – developed into uncertainty about the sustainability of government debt. Although the initial problems primarily concerned the Greek government debt market, contagion and spillover effects meant that the crisis quickly spread to the sovereign debt of other so-called "peripheral" countries and other market segments. In particular, financial markets turned their attention to the solvency of some "peripheral" economies that were perceived to have been hit particularly hard by the crisis because of long-standing structural and institutional weaknesses.

The deterioration of public finances in some euro area member States has impacted negatively on investors' confidence in government bonds issued by these countries, and thus led to further turbulences in the financial markets. This is also reflected in the sharp increase in the yields on the government bonds issued by those countries. This additional distortion has given rise to further instability in the financial system, both directly and through its interplay with the weaknesses of the public sector.

Given the central role played by sovereign debt in financial markets, its dysfunctional behaviour threatened both financial stability and the transmission of monetary policy. In this context, the Eurosystem launched its Securities Markets Programme (SMP), which entails the outright purchase of debt instruments to address the malfunctioning of securities markets and to ensure the proper transmission of monetary policy impulses to the wider economy and, ultimately, the general price level.

In addition, in order to mitigate the impact of the sovereign debt crisis on the banking sector's ability to refinance its activities, the ECB temporarily reversed the phasing-out of its non-standard measures. It also took collateral-related measures to support access to central bank liquidity by banks located in the countries that were committed to implementing economic and financial adjustment programmes negotiated with the European Commission, in liaison with the ECB, and the IMF.

There is no denying that the financial crisis has put the euro and the economy of the euro area to the test. During the crisis the euro area public authorities have proven their capacity and willingness to take the necessary emergency steps to maintain financial stability. However, the crisis has clearly shown the need to undertake a number of reforms in order to address some institutional and structural weaknesses in our economies. This is essential in order to map out the way forward for the European Monetary Union, which I will now briefly sketch.

III. The way forward

The way forward for the euro area and the EU requires a number of initiatives in key areas in order to guarantee the public authorities' ability to continue delivering macroeconomic and financial stability. In my view, the building blocks of any comprehensive plan of reform for Europe are the following:

- implementing fiscal consolidation and securing the sustainability of public finances;
- promoting sustainable growth and job creation;
- enhancing the crisis management framework;
- improving economic governance;
- strengthening the financial sector.
- Let me briefly elaborate on these points.

III.(a) Implementing fiscal consolidation and securing the sustainability of public finances

The financial and economic crisis has led to a very considerable deterioration in the fiscal positions of euro area countries, in terms of both large budget deficits and rising government debt. However, the economic recession amplified imbalances in fiscal policies that had built up gradually long before the crisis, reflecting the failure by many countries to implement sound fiscal policies during past periods of strong economic growth. On the institutional side, the EU's fiscal framework, which is embedded in the Stability and Growth Pact (and that had been watered down in 2005), proved to be too weak to enforce fiscal discipline and was not implemented with sufficient rigour.

As mentioned earlier, reflecting large fiscal imbalances and a loss of confidence on the part of investors, government bond spreads increased dramatically for some euro area countries and became very volatile in 2010. The willingness of investors to support governments' financing needs declined, with the result that the governments of three euro area countries have since then required financial support by means of joint EU/IMF programmes. These programmes are subject to strict conditions on fiscal adjustment in order to restore public finances to health.

However, the need to pursue more ambitious consolidation targets is more general. It is striking to see that there are currently only two euro area countries that are not subject to an excessive deficit procedure. Fiscal consolidation is essential to ensuring an environment conducive to output growth and price stability.

Looking ahead, implementing fiscal consolidation and securing the sustainability of public finances are among the major challenges faced by policy-makers. The consolidation of public finances requires a comprehensive policy comprising: (i) the timely correction of excessive deficits; (ii) the reduction of government debt to more sustainable levels; and (iii) the reorganisation of banks in order to limit strong links between the balance sheets of governments and financial sectors, which typically result in the socialisation of banks' liabilities in times of crisis. These measures need to be complemented by pension and healthcare reforms to alleviate the fiscal burden arising from population ageing.

Moreover, fiscal governance in the euro area needs to be reinforced by means of the strengthening of the Stability and Growth Pact. This means establishing stricter and more binding rules for fiscal policy, backed up by stronger sanctions or mechanisms to ensure compliance with the rules. At the same time, the effectiveness of budgetary institutions needs to be improved at the national level. In this context, effective rules on expenditure should be regarded as a means of promoting fiscal discipline and limiting fiscal vulnerabilities in the event of adverse economic shocks occurring in the future.

III.(b) Promoting sustainable growth and job creation

Euro area countries also need to increase their efforts to strengthen their growth potential and their ability to create jobs in a sustainable manner. European countries have made reasonable progress over the past ten years in the area of employment. Indeed, over 14 million jobs were created in the euro zone since the introduction of the euro, far more than in the previous ten years (around 8 million). The employment increase in the euro area since 1999 was even significantly larger than in the United States (7.6 million).

This is an important achievement, but it remains insufficient, especially against the background of the massive employment destruction observed in some euro area countries during the crisis. Unemployment rates have reached unacceptably high double-digit rates in some countries and segments of the population (i.e. the young workers), that, as a result, carry extremely large economic and social costs. This is socially unfair and economically inefficient.

European countries must made more efforts to resolutely pursue – and with far greater urgency than in the past – the necessary structural reforms in product markets, labour markets, pension systems and so on. In this respect, a key contribution to the strengthening of the euro area's long-term economic prospects will come from the thorough implementation of the Europe 2020 strategy, with its focus on key areas such as: (i) education, research and innovation; (ii) resource efficiency; and (iii) high levels of employment and social cohesion.

III.(c) Enhancing the crisis management framework

In response to the sovereign debt crisis, the euro area has recently armed itself with an important tool to safeguard area-wide financial stability. At the European Council meeting of 24 and 25 March 2011 the Heads of State or Government of the EU agreed to establish a permanent European Stability Mechanism (ESM) based on the existing temporary European Financial Stability Facility (which will remain in place until June 2013).

The ESM will grant financial assistance to countries in distress in the form of credit, with the assistance provided under strict conditionality and on the basis of a strict analysis – conducted by the European Commission and the IMF, in liaison with the ECB – of the sustainability of the relevant country's debts. The establishment of the ESM represents an important addition to the institutional fabric of EMU.

However, the existence of a mechanism to provide financial assistance to countries facing temporary distress should not be seen as a source of moral hazard. Such risks are prevented both by the strict conditions under which any assistance would be provided and by the fact that the mechanism will be activated only if deemed indispensable in order to counter threats to the financial stability of the euro area as a whole. In addition, the establishment of this permanent stabilisation mechanism will be accompanied by the strengthening of the framework for economic governance in the euro area, particularly as regards the framework for the multilateral vigilance of national policies in the areas of public finances and competitiveness.

III.(d) Improving economic governance

It is fair to say that the experience of the Economic and Monetary Union (EMU) over its first twelve years has been a historic success. At the same time, it is also fair to say that the credit should go, to a very large extent, to the achievements of the monetary pillar of Monetary Union (the "M" in EMU) rather than of its economic pillar (EMU's "E"). Yet, monetary policy alone cannot deliver all the benefits of EMU. The economic pillar must also play its part. Unfortunately, this has not always been the case so far. Indeed, national governments have not been sufficiently committed to fulfilling their obligation to guarantee macroeconomic stability and fiscal sustainability in the long term.

Therefore, a key lesson learnt from the crisis is that in order to fully reap the benefits of EMU, it is essential to strengthen the rules that govern macroeconomic policies in the euro area so as to ensure their alignment with (1) sound economic principles (such as fiscal discipline and a commitment to a market-based economic system) that foster macroeconomic and financial stability, and (2) with the needs of the single currency.

Some concrete legal initiatives in these areas have been proposed by the European Commission, on the basis of the final report of the task force chaired by the President of the EU Council Herman Van Rompuy. In a nutshell, the European Commission recommends strengthening the Stability and Growth Pact, which represents the framework of rules and procedures preventing countries from accumulating excessive public debts and deficits. In addition, the European Commission proposes the establishment of a broader macroeconomic framework for the monitoring of economic policies, which – if not sufficiently sound – can give rise to imbalances such as a loss of competitiveness, current account imbalances and excessive private indebtedness.

In addition to these EU-wide proposals at the legislative level, a separate pact (the "Euro Plus Pact") has been drawn up by the euro area countries and several other EU Member States in order to further strengthen the economic foundations of EMU.

The ECB is of the opinion that, in both areas, the current reform efforts are not sufficiently extensive. While the proposals tabled by the European Commission go some way towards improving macroeconomic and fiscal surveillance in the euro area, they fall short of the quantum leap forward that is needed in order to guarantee the smooth functioning of EMU.

The legislative acts implementing the reform of economic governance are now being discussed in the context of the "trialogue" discussions taking place between the European Parliament, the European Commission and the Hungarian Presidency of the EU Council. The purpose of these discussions is to produce a common set of proposals that accommodates the amendments requested by the various authorities involved in the legislative process. The ECB has called on these authorities to produce a strong and clear set of rules, including automaticity in the triggering of procedures and sanctions, in line with the ten key elements for the reform of economic governance published on its website.[1]

III.(e) Strengthening the financial sector

The financial crisis has also revealed a number of deficiencies and vulnerabilities in the regulatory and supervisory frameworks in our economies. The massive economic and financial impact of the crisis has clearly indicated that addressing such deficiencies through far-reaching reforms is essential in order to prevent similar crises in the future.

There is a relatively broad consensus as regards the nature of the reforms required. Indeed, following the deterioration of the crisis in the wake of the collapse of Lehman Brothers, the

[1] See Key Elements of the ECB Opinion on Economic Governance Reform (http://www.ecb.int/ecb/legal/pdf/key_elements_opinion_con_2011_13.pdf).

G20 rapidly identified some of the key areas for reforms and entrusted the task of drawing up concrete proposals to the Basel Committee on Banking Supervision and the Financial Stability Board.

Some progress has already been made in the area of financial market regulation, most notably as regards the “Basel III” capital accord. This calls for strong increases in the capital requirements of financial institutions and also introduces leverage requirements, as well as leverage ratios.

In Europe, important steps have been taken with a view to addressing the long-standing friction between, on the one hand, the international dimension of the operations of commercial banks and financial institutions, and, on the other hand, the national boundaries that constrain regulatory and supervisory measures. The Heads of State or Government of the EU have agreed on a new structure for financial supervision in the European Union – the European System of Financial Supervision – with a view to improving coordination and cooperation.

- As regards micro-prudential supervision, three newly established European Supervisory Authorities for banks, insurance companies and financial markets became operational at the beginning of 2011. These are designed to enhance coordination between micro prudential supervisors and to ensure the application of EU wide standards in the area of technical supervision.
- In addition, a new authority – the European Systemic Risk Board (ESRB) – has been established with a mandate to conduct macro prudential supervision within the EU.

Much has been achieved in the reform of financial market regulation and supervision since the onset of the financial crisis. But there are still many areas that require the attention of policy-makers – such as stricter regulation of all systemically relevant financial institutions, greater transparency as regards the “shadow” banking sector, better regulation of investment funds and credit rating agencies, and improvements to corporate governance models in the banking sector. These are just some of the key areas in which greater efforts are needed in order to strengthen the foundations of our economies.

IV. Concluding remarks

I have described the way forward for the euro area economy. Of course, I have only looked at what will happen if we take the high road out of the crisis. I haven’t even considered some of the “shortcuts” that, according to some commentators and economists, are supposedly available to countries unwilling to bear the costs of structural and fiscal reforms. In particular, it is often argued that Greece would be better off rescheduling or renegotiating some of its sovereign debt, rather than continuing to implement the adjustment programme negotiated with the international authorities as part of the financial assistance provided by the European Commission and the IMF.

The argument is typically presented as follows: “Greece’s key problem is not a temporary lack of access to liquidity, but rather a solvency crisis. The country is too weak to bear the economic and social costs of implementing the institutional and economic reforms foreseen by the adjustment package. The country may, therefore, be better off announcing some form of renegotiation or restructuring of its debts with private creditors. Of course, such a step should not be taken lightly, since it may be tantamount to a sovereign default, and the economic literature suggests that the costs of defaults can be both multiple (reputational loss, exclusion from financial markets, trade sanctions, and so on) and substantial. However, some empirical studies focusing on emerging economies have fortunately found that the impact that an inevitable – rather than a strategic – default has on the defaulting country's economy is typically smaller and less persistent than is commonly believed.[2]"

Let me stress that I am rather surprised to see the flippancy with which some commentators recommend that the government of an advanced economy should infringe its legal and contractual obligations, as though breaching the trust of investors and citizens were the simplest and least costly solution to the deeply-rooted structural problems in Greece.

Far from being a convenient means of minimising economic losses and dissipating uncertainty, a default would have extreme adverse consequences, many of an irreversible nature, for the Greek economy – particularly for its banking sector and for the welfare of its citizens. Those basing their arguments on past experiences in emerging economies fail to take into consideration the many differences in the case at hand: Greece is an advanced economy sharing a single currency with 16 other democracies which has signed up to a common set of rules, institutions and overriding objectives, notably macroeconomic and financial stability, together with the other countries of the European Union. Greece's euro membership rules out debt-devaluation spirals and ensures price stability in the medium term. Its economy is highly integrated – via a number of channels, such as trade and financial flows – with other advanced economies both in Europe and around the world that can potentially act as contagion mechanisms. Greater economic integration has been accompanied by an increasing degree of institutional cooperation. At the same time, the country's economy is affected by a number of structural weaknesses and rigidities that have resulted in the persistent accumulation of public and private sector imbalances.

The thorough implementation of the comprehensive programme of structural reforms and fiscal consolidation negotiated with the international authorities is the only way forward which is fully consistent with the long-term interests of the people of Greece. To paraphrase the title of a study by IMF staff,[3] the debate on debt restructuring in a euro area country is unnecessary, undesirable and unhelpful.

I would also add that this discussion represents a dangerous and unwelcome distraction from more important debates on issues such as how to enhance the euro area's economic governance, make our economies more dynamic, ensure the sustainability of public finances and strengthen the banking sector, which deserve our full attention and to which we must devote our energies.

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2 A recent study covering more than 200 cases of debt restructuring since 1970 finds that the impact of defaults on the ability of defaulting countries to access credit subsequently is larger and more protracted that previously believed. See Cruces, J. and Trebesch, C., "Sovereign defaults: The price of haircuts", unpublished mimeo, 2010.

3 Cottarelli, C., Forni, L., Gottschalk, J. and Mauro, P., "Default in Today's Advanced Economies: Unnecessary, Undesirable, and Unlikely", *IMF Staff Position Notes*, No 10/12, IMF, Washington, DC, 2010.