José Manuel González-Páramo: The sovereign debt crisis and the future of European integration

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the Oxford University European Affairs Society, Oxford, 24 November 2011.

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Introduction

Ladies and gentlemen,

Thank you very much for inviting me to speak here this evening in the "City of Dreaming Spires". The aims of the Oxford University European Affairs Society – fostering understanding of political, social and cultural issues across Europe – have never been more relevant than today. In the sovereign debt crisis, Europe faces one of its greatest ever challenges. The question is how to confront it. We should learn from the present and the recent past. And we should look forward, since future prosperity in Europe depends on our collective success in overcoming the crisis. Citizens in both creditor and debtor countries have to look beyond national interests. Ultimately, this can only be sustained through deeper common understanding and stronger sense of what it means to be European.

The sovereign debt crisis will be the theme of my remarks today. I do not want to engage in the minutiae of the issue or signal any particular policy stance by the ECB. Instead, I would like to take a step back from the crisis and reflect on what it has taught us so far about economic and monetary union in Europe. Obviously, I concentrate explicitly on the euro area, i.e. the seventeen countries sharing the single currency. The status and role of the United Kingdom, the dynamics of the British domestic debate on Europe, and the cooperation with the Continent in addressing the crisis are not the focus of my remarks.

I have three main propositions.

First, membership of EMU entails much deeper policy changes than were originally realised. In 1991, Hans Tietmeyer, the former President of the Bundesbank, remarked that "*monetary union is not just a technical matter. It is in itself, to some extent, a political union*". What has become clear is that countries that adopt the euro as their currency are required to adjust fundamentally the way in which they conduct their economic and financial policies. At the same time, ensuring overall stability requires far-reaching coordination in economic and financial governance. It would be difficult to understand that in the world's second largest monetary area governance is outsourced solely to the markets and ratings agencies. Effective governance of an economic area of such importance requires much closer economic and financial union.

Second, in response to the crisis, a much more radical change in euro area governance has taken place than many observers seem to acknowledge. Europe tends to reform incrementally, at times creating frustration at the pace of change. But those increments now add up to a fundamental overhaul of its economic management. The reasons this has not been more effective in calming the crisis are complex, but communication stands out among them: In "selling" their reforms, euro area authorities are forced to walk a tightrope between the expectations of national electorates and financial markets, and risk satisfying neither. The only solution to this democracy-market dialectic is, again, much closer economic and financial union.

Third, and contrary to a strand of current thinking, the Treaty prohibition on monetary financing is supporting rather than threatening euro area integration. In the euro area, the central bank is "doubly removed" from the political systems of individual countries: it is not only constitutionally independent, but also elevated to the supranational level. Euro area

governments cannot expect the ECB to finance public deficits. As a result, they must be commensurately more ambitious in their economic policies and more disciplined in their management of public finances to support their debt levels. Moreover, given the prohibition on monetary financing, having a banking sector which can support growth and provide adequate financing to the real economy in Europe requires a stronger regulatory and governance framework, so as to prevent negative feedback loops between banks and sovereigns. By forcing policymakers to focus their reform efforts on the right priorities the monetary financing prohibition offers an incentive to closer economic and financial union.

First proposition: The need for radical changes in national economic policy-making

Let me begin with my first proposition, that membership of EMU entails much deeper policy changes than were previously acknowledged. The crisis has shown very clearly that countries that adopt the euro have to alter the conduct of their economic policies. These changes are fundamental. Among them, three are particularly relevant.

First, in a monetary union fiscal and supervisory authorities have to adopt policies that counteract the emergence of private financial imbalances at the national level. This is a consequence of the ECB's legal obligation to maintain price stability in the euro area – defined as an inflation rate of below, but close to, 2% over the medium term. Private debts denominated in euros cannot be "inflated away".

Second, fiscal and other national macroeconomic policies have to ensure competitiveness by resisting increases in nominal trends. This is the implication of sharing an exchange rate; devaluation cannot be used as a tool for any one country to regain competitiveness. Benchmarking against other euro area countries is unavoidable.

Third, fiscal authorities have to build up sufficient buffers in good times to withstand adverse conditions. This follows from the prohibition on monetary financing which prevents the central bank from directly financing governments as well as the so-called "no bail out clause" of the Treaty which prohibits a Member State to assume the liabilities of another Member State. The failure to build adequate fiscal buffers during times of economic growth means that during recessions governments are forced to implement fiscal policies that are more pro-cyclical than would otherwise be the case.

Some in this audience may respond that these policy requirements were evident to sharp-eyed observers. Indeed, the ECB had been making these points for many years. But they were not so widely acknowledged as to make a difference. For every economic argument in favour of policy adjustment, a contrary one could be found justifying the path taken. This meant many euro area countries did not internalise the policy requirements of monetary union. In fact, almost the opposite policies were pursued in some countries.

The lack of an adequate regulatory and macro-prudential framework meant that in many economies the banking sector supported an unbalanced and unsustainable expansion of credit during the period of low interest rates. The financial sector also became over-leveraged and engaged in excessive risk taking. Although at the time many in the financial industry justified this with arguments about how financial engineering created possibilities for sophisticated risk diversification, *a posteriori* it has become evident that risk was seriously mispriced in the period before the crisis.

National wage-setting and labour market regulatory frameworks have also proved to be inadequate. Rather than resisting nominal trends, before the crisis strong wages put pressure on price competitiveness, often justified by theories of catching-up effects. Fiscal discipline also proved too lax. Rather than building up buffers during "the good times", increased tax revenues associated with the pre-crisis housing booms were treated as structural rather than cyclical, justified by models demonstrating new growth trends.

Taken together, this meant that some of the euro area countries entered the global financial crisis in an unnecessarily vulnerable position. This explains to a large extent the situation we are now in.

However, these policy failures were also made possible by a general failure to acknowledge the new governance responsibilities associated with membership of EMU. Put simply, "keeping your own house in order" is necessary, but not sufficient, in a highly integrated monetary union. It is the responsibility of every euro area government to exercise vigorous and effective mutual surveillance over others' policies. As a crisis in a country like Greece representing only 2% of euro area GDP can become systemic, disregarding EMU governance may come at a high cost to taxpayers.

Yet the latter was the attitude prevailing prior to the crisis. The Stability and Growth Pact – the set of EU level rules for guiding fiscal policies – was never properly implemented. Member States tended to adopt a principle of "non-interference" over each others' policies. Peer pressure, on which the framework was predicated, gave way to peer support. By watering-down of SGP in 2004–05, the largest euro area countries signalled that they had no stake in the rules. This allowed a certain country to run deficits over 3% of GDP every year it was in EMU and never face corrective action.

Moreover, the euro area surveillance framework was "blind in one eye", with no formal framework for monitoring macroeconomic and financial imbalances. The Lisbon Strategy focused on the structural level, but on policy implementation rather than imbalances. Eurogroup discussions on imbalances had no enforcement mechanism. The Lamfalussy framework for financial supervision did not use the concept of systemic risk. Thus a situation prevailed where countries could be congratulated for strong headline fiscal numbers when these data in fact reflected substantial imbalances that were building up in the private sector.

To a certain extent, the weakness of these governance procedures was linked to a misplaced faith in market discipline. The institutional design of EMU gave market discipline a central role in economic governance. The absence of a transfer mechanism between Member States was supposed to encourage markets to actively discriminate between euro area issuers. This was based on the assumption that financial markets would always have perfect incentives to enforce the "rules of the game".

This assumption, in retrospect, looks somewhat naïve. It is well established in the academic literature that markets have complex incentives and dynamics. Market psychology tends towards pro-cyclicality. Perceptions converge around certain information sources, such as ratings, or certain benchmarks, such as indices, which creates herd behaviour. Structural features of the financial system, such as the role of ratings in financial regulation and investment mandates, create an embedded non-linearity in market reactions to news.

What we witnessed in the euro area, therefore, was not a rigorous analysis of sovereign risks but rather an undershooting followed by a dramatic, and perhaps excessive, correction. Spreads converged for all euro area countries before 2008, despite high debt levels in some countries and clear evidence of emerging imbalances. Now we have moved to the opposite extreme: some euro area countries are confronting phenomena like sudden stops and buyers' strikes that were in the past associated only with emerging markets.

As we have seen in recent months, market discipline can be a strong and useful force in encouraging countries to make long-needed reforms. But it is also, clearly, an unstable way to ensure good policies. Reform decisions have to be made hastily in dramatic meetings. Politicians lack time to explain the need for reform to their constituencies and build consensus behind them. It may even be the case that countries have to go "too far, too fast" to restore market confidence. There is also a serious risk of uncontrollable contagion to other countries.

In other words, we cannot completely delegate governance to financial markets. The euro area is the world's second largest monetary area. It cannot depend solely on the opinions of

ratings agencies and markets. It needs economic governance arrangements that are preventive and linear. This underscores my central point that a much more comprehensive approach to economic governance is now the priority for the euro area. And this means more economic and financial integration for the euro area, with a significant transfer of sovereignty to the EMU level over fiscal, structural and financial policies.

Second proposition: Significant governance reforms have already been taking place

Europe has responded to these policy, governance and market failures by undergoing a multi-year process of institutional reform. This leads me to my second proposition: that a much more radical change in euro area governance has taken place than many observers seem to acknowledge. There is a tendency to see the euro area response to the crisis as perennially behind-the-curve – as "too little, too late". I concede that national authorities have not always been effective in stabilising financial conditions. But I also think this assessment lacks an appropriate benchmark. Observers expect a new "silver bullet" every few months and when one is not delivered, they are disappointed.

But if we choose a more appropriate benchmark – say, the euro area in 2009 – a quite different picture emerges. The sum of the incremental steps taken since that date are, in fact, now a very big step.

Take for example economic governance. The EU Council and European Parliament have agreed on a legislative package that significantly limits the discretion of national authorities, even when imposing sanctions on themselves. This includes a framework for monitoring a wide range of macroeconomic imbalances, also backed by sanctions. Countries are expected to anchor fiscal prudence in national rules, creating a much more "vertically integrated" concept of governance. All these measures were unthinkable four years ago.

If we look at the conclusions of Euro Summit on 26 October – dismissed by some observers as insufficient – we see even more radical steps envisaged for the future. Euro area countries have committed to adopt balanced budget rules. They have agreed to base their budgets on independent growth forecasts. They have agreed to stick to the recommendations of the Commission when implementing the Stability and Growth Pact. Countries in the Excessive Deficit Procedure – which is currently 14 out of 17 euro area countries – will allow the Commission to examine draft national budgets and monitor budget execution.

Although some of the recent governance reforms, like those that formed part of the so-called "Six-pack" proposed by the European Commission, fall short of the "quantum leap" that the ECB had long advocated for the euro area, they still represent significant progress relative to the situation prevailing before the crisis.

The creation of the European Financial Stability Facility and future European Stability Mechanism could also not have been imagined in 2007. The euro area has institutionalised the provision of sovereign liquidity and agreed to a Treaty change to ensure its legality. As the new facilities have developed, they have acquired a range of tools. The current mandate of the EFSF not only allows it to extend temporary loans to euro area governments in need, but also to buy bonds in both the secondary and primary markets, to act on the basis of a precautionary programme and to finance bank recapitalisations through loans to governments including in non programme countries. The resources committed to the EFSF are substantial. The ESM, which will have a paid-in capital of €80 billion and callable capital of €620 billion, has a capital base around three times that of the European Investment Bank. At the 26 October Euro Summit euro area leaders also agreed on two schemes which will allow a significant leveraging of existing EFSF resources in order to increase the fund's ability to act.

But perhaps the most significant development, relative to past expectations, is the implementation of root-and-branch reform programmes in a number of euro area countries.

One should not underestimate the significance of EU-IMF programmes for structural changes in some economies. They are dealing with long-needed pension reforms, opening up closed sectors of the economy, modernising public administration. In terms of collective economic management, this development goes further than many federations. Can we imagine, for example, the U.S. federal government requiring a similar depth of reform in California?

Countries outside of EU-IMF programmes have also implemented major reforms. Spain has recently passed a constitutional balanced budget amendment, disproving the view that major policy changes are impossible in an election year. Italy has agreed to a technocratic government to ensure structural reforms are implemented, and invited the IMF to give extra credibility to this process. All euro area countries, except those under a programme, have committed themselves to bringing their budget deficits below 3% of GDP by 2013 at the latest. Overall, the forward commitments of euro area countries to fiscal sustainability go far beyond what has been agreed in the U.S. or Japan.

Each of these measures, seen individually, may not represent the "shock-and-awe" or "big bazooka" that some commentators and markets participants call for. But when seen collectively, they represent a comprehensive broadening and deepening of euro area economic governance. And relative to a reasonable benchmark – the *status quo ante* – they are very significant developments.

It is also worth noting that many steps have been taken to strengthen the financial sector regulation and supervision. Under the leadership of the G20, a remarkable amount of work has been done by the Financial Stability Board (FSB) and the Basel Committee in a demanding timeframe. Profound regulatory reforms need to be implemented to address the underlying deficiencies that have become apparent in our financial system.

In general, Europe is exceeding international benchmarks in implementing these reforms. The Commission issued a proposal in July 2011 aimed at transposing the Basel III framework into EU Law. By doing this, it is among the first to introduce the Basel III framework and is taking a leading role in delivering on the G20 commitments. In line with Basel III, the Commission's proposal (so-called CRD IV) provides for higher minimum capital requirements, a stricter definition of eligible capital and more transparency. It also introduces also entirely new concepts, such as mandatory liquidity requirements and a non-risk-based leverage ratio.

Beyond the micro-prudential dimension of regulation, the proposal introduces macro-prudential elements, most prominently the countercyclical capital buffer regime. This constitutes an important safeguard to protect the banking sector from periods of excessive aggregate credit growth. And on top of this, the European Council has recently decided that European banks need to have a 9% core tier one capital ratio by the middle of next year, instead of by 2018, as agreed by the Basel Committee.

Other important regulatory initiatives are underway. These include the establishment of an appropriate regulatory framework for over-the-counter derivatives, enhanced oversight of Credit Rating Agencies, the prevention of systemic risk coming from the "shadow banking sector" and an EU crisis management framework for bank recovery and resolution. As regards the supervisory framework, a new system of financial supervision has been established creating, for the first time, European level macro-prudential supervision through the European Systemic Risk Board (ESRB).

This discussion raises an obvious question: if so much has been achieved since 2009, why have euro area authorities not been more effective in halting the crisis?

In my view this is fundamentally a political question, related to making policy between 17 sovereign democracies. Unlike a unitary state, the euro area has 17 Heads of State, 17 Finance Ministers, and countless national parliamentarians. It can only be expected that their communication on difficult topics may sometimes diverge. As we have seen on many

occasions, this triggers difficult feedback loops between politics and markets which ultimately undermine the impact of agreed policy measures.

On one level this is a procedural problem: our institutions are not effective enough in ensuring political leaders speak with one voice. But on a deeper level, it is a problem deriving from the fundamentally different expectations of domestic populations and financial markets. Markets expect messages of confidence, of immediacy, of unlimited capacity to act. Domestic populations want to know the limits of their liability, to ensure that actions are just and fair, to make sure past mistakes are not repeated.

A classic example of this divergence has been the debate over private sector involvement. For a domestic audience, banks should internalise the consequences of their lending decisions and should be punished for their past behaviour. But from a financial market perspective, such communication is disastrous. It signals to investors that assets that were previously risk-free are no longer so, that the euro area is a market where their investments are not guaranteed. And as markets are forward-looking, they sell their assets today. This immediately undermines the progress I have just described.

A second example is the implementation of crisis response decisions. Markets expect quick, bold and "shock-and-awe" decisions on highly complex matters. They are exasperated that something can be agreed by leaders but take months to enter into force. Yet this is a necessary condition of operating in a system of 17 sovereign democracies. Decisions have to be explained, approval processes have to be followed, compromises have sometimes to be made. These dynamics were witnessed even in the US when Congress sent back the TARP in 2008. The net effect on the euro area, however, is that by the time decisions are eventually implemented the expectations of market have moved on. The impact of those decisions is then discounted.

These market-democracy dialectics provide a second reason why a more integrated economic and financial union is so essential for EMU. The rationale for the original design of EMU – with centralised monetary policy, but decentralised economic policies – was linked to principles of subsidiarity and democratic accountability. This was consistent with the environment that prevailed 20 years ago. But these same principles now imply more Europe, not less.

Subsidiarity is the principle that the centre should perform only those tasks which cannot be performed effectively at the national level. Can we really argue, in the current crisis, that the centre is not the more effective level to exercise, or at least coordinate, certain economic and financial policies? Democratic accountability is the principle that citizens should be able to hold their representatives responsible for decisions. If we need a stronger European centre, then to maintain this principle we also need profound improvements in democracy at the European level.

The justification for rethinking these principles can be found, I believe, by acknowledging that membership of EMU entails a significant degree of political union. We have seen that preventing crises requires that all countries exercise close and effective mutual surveillance of each others' policies. We have seen that correcting crises requires that decisions are taken jointly, with a euro area perspective. The need for institutionalised collective decision-making is, fundamentally, what defines a political union. And this is *de facto* the condition of all euro area countries.

Third proposition: ECB independence and the prohibition on monetary financing are essential for euro area integration

This condition of *de facto* political union raises questions about the proper role of the central bank in EMU. The ECB is very much in the focus at the moment. Some observers call for it to play the role of a "national" central bank like the Federal Reserve or the Bank of England, and emulate their policies. But these viewpoints are partial. They overlook what is my third

proposition: that the Treaty prohibition on monetary financing by the ECB, over the medium term, is a force in favour of euro area integration and greater stability.

The positive effects of the ECB's policies are fairly obvious in the case of the banking sector. Our standard and non-standard measures ensure price stability in the euro area. While our standard measures signal the monetary policy stance, our non-standard measures ensure the transmission of the desired policy stance to the real economy in those market segments in which the transmission is impaired. Our non-standard measures ensure that despite increased liquidity demand, financial institutions are able to continue lending to clients.

However, misconceptions persist related to the Securities Markets Programme, our programme for intervening in government bond markets. The SMP deliberately addresses the appropriate transmission of our monetary policy to the real economy in market segments which are impaired. Government bonds are crucial for the transmission of monetary policy, via their status as a benchmark for borrowing by banks. Put simply, left unaddressed, the malfunctioning of sovereign bond markets' could block the bank lending channel. An important difference with Quantitative Easing programmes is that the liquidity injected into the banking system via the SMP is sterilised by the ECB through regular liquidity absorbing operations.

The ECB has been widely recognised as an institution capable of timely, decisive and convincing action during tumultuous times. We see this as a mark of distinction. However, it would be erroneous to derive from this that it should be a political institution in charge of running the euro area economy. It cannot be and should not be. The ECB is a central bank, committed to its mandate to preserve price stability over the medium term. It is not the fiscal lender of last resort to sovereigns. Markets participants that call for the ECB to play this role may care only about the nominal value of their assets and the need to avoid losses. Whether or not the underlying asset – our currency as store of value – has been depreciated seems unimportant to them. But survey after survey shows that the people, the citizens of the euro area, want price stability. They care deeply about their purchasing power and the value of their savings. The ECB has been established with a clear mandate to meet these expectations.

Moreover, what these calls for more activism overlook is the positive effects of the ECB's stance over the medium term. There are some in the academic world that argue that one way out of the sovereign crisis would be for the central bank to act as a lender of last resort to the sovereign. These voices suggest that euro area countries are more vulnerable to liquidity stresses relative to the situation in economies where the central bank is supposedly prepared to backstop the government bond market.

Certainly the ECB, as the central bank of all EMU countries jointly, cannot act as the central bank of specific countries. But is this in fact a disadvantage for Europe? In a sense, euro area countries have given up sovereignty over their national currency. This implies that maintaining their public debts at reasonable levels requires commensurately more convincing fiscal and economic policies. It also requires that they "tie their hands" in a credible manner through stronger and more automatic economic governance. The monetary financing prohibition, in this way, is a spur towards better policies and better governance – in other words, a closer economic union.

Similarly, the monetary financing prohibition changes the relationship between sovereigns and their national banking systems. As sovereigns cannot monetise debt, they can only backstop large banking sectors at a cost to their own creditworthiness. Insofar as this may undermine the balance sheets of the banks they are trying to save, it could end up triggering a self-defeating vicious circle. This implies that the only viable route to support the euro area's integrated financial sector is through a more integrated system of supervision and resolution. The monetary financing prohibition, by constraining the resources of individual sovereigns, pushes the euro area in the direction of collective solutions.

Conclusion

Let me now draw to a close.

The key theme that has run through my remarks today is that, from every perspective, much closer economic and financial union is essential for the euro area. We have had this demonstrated in the clearest possible terms by the financial and sovereign debt crises. We have already taken important steps in this direction. Europe is ahead of others in addressing its imbalances. The challenge looking forward is to complete the process towards closer union and not settle for the “quick fix”.

The people of Europe want closer cooperation in economic and financial matters. Eurobarometer surveys find cross-country majorities in favour of closer cooperation to end the crisis. And this is ultimately unavoidable, given the state of political union between countries that monetary union *de facto* creates. It is now a time for politicians to be bold and courageous, to recognise these trends, and to complete as soon as possible the great project begun 60 years ago towards “ever closer union”.

Thank you for your attention.