José Manuel González-Páramo: What has Europe learnt from the crisis?

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the OMFIF Conference "On the cusp: the world economy at a turning point. Strengthening stability at a time of challenge and change.", Frankfurt am Main, 15 March 2012.

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The euro area's "missing institutions"

From its conception the euro was and has been a unique and ambitious project. It combined a centralised monetary policy with decentralised economic policies, and to paraphrase Tommaso Padoa-Schioppa, created a currency that did not belong to a single nation-state. A key finding for the euro area, arising from the crisis, is that this construction was not complete. In particular, the euro area did not have certain institutions we associate with political federations and that act as shock-absorbers against the negative effects of imbalances. The key lesson from the crisis, therefore, is that the euro area needs to compensate for these "missing institutions" by establishing a much stronger economic and financial union.

A central area where the absence of shock-absorbing institutions has been felt is via intra-euro area current account imbalances. These imbalances existed for many years prior to the crisis, but were largely ignored as theory told us that they could always be financed through cross-border financial flows. However, it is now clear that current account imbalances – while not being the only proximate causes of the crisis – are not benign and imply vulnerabilities which can be transmitted to the euro area as a whole.

On the financial side of the current account, persistent intra-area imbalances imply that some public or private sectors are living beyond their means, year after year. If, as was the case in some euro area countries, these imbalances are also linked to the large build-up of external liabilities by an over-leveraged domestic banking system that engages in excessive risk taking, this may also create the conditions for the kind of twin sovereign-bank crises which we have witnessed over the recent period. Private liabilities can quickly become sovereign ones when governments are required to recapitalise banks or guarantee bank funding, leading to sovereign debt crises. At the same time, sovereign liabilities can undermine domestic banking sectors given the high exposure of euro area banks to their own governments' debt and the link made by markets of the cost of funding of banks with that of their respective sovereign.

Such negative effects may potentially be better mitigated in political federations given their stronger shock-absorbing institutions. For example, if a particular state in the U.S. were to experience a build-up in private sector liabilities that threatened its local banks, the responsibility for recapitalisation and deposit insurance would fall on the federal government – through institutions like the U.S. Treasury and the Federal Deposit Insurance Corporation. This means that a U.S. state cannot be brought into financial difficulties by a mismatch between the size of its banking sector and that of its local economy, whereas a euro area country can – as we saw in Ireland.

On the real side of the current account, persistent trade imbalances within the euro area also reflect accumulated competitiveness losses in deficit countries. The problem may be masked while growth is driven by credit and consumption, as was the case in some euro area countries before 2008. But when there is a reversal in financial flows and foreigners are no longer willing to finance the further accumulation of external debt, accrued competitiveness losses come to the fore. This can result in particular regions suffering sustained low growth and unemployment.

Again, these negative effects may be more manageable with the shock-absorbing institutions of a political federation. A homogenous language and culture may facilitate labour mobility, providing one channel for adjustment – although recent evidence suggests this effect is not as significant in the U.S. as previously thought. At the same time, having a large federal budget creates a natural stabiliser as federal spending on "big ticket" items like social security, healthcare and defence redistributes incomes between rich and struggling regions.

Constructing a *sui generis* response

It is clear that the way ahead for the euro area cannot involve trying to construct the institutions of a political federation overnight. This implies that the euro area needs a different approach to ensure the smooth functioning of monetary union that can compensate for some of these "missing institutions". This approach has two main pillars.

The first pillar is to strengthen fundamentally the governance procedures which prevent imbalances from arising. With fewer shock-absorbing institutions to mitigate crises when they arise, the euro area has learned that it must become more effective at preventing imbalances. This process has involved tightening the rules for fiscal policies and creating a much needed framework to monitor broader macroeconomic imbalances and competitiveness.

On the fiscal side, the reform of the Stability and Growth Pact and the new Fiscal Compact are specifically designed to catch imbalances earlier. A key focus of the SGP reform was to strengthen the so-called "preventive arm" – for example, sanctions are now possible for non-compliance with medium-term budgetary objectives. The Fiscal Compact supports this focus on prevention by creating a new "first line of defence": balanced budget rules with a constitutional status. Importantly, this shifts the onus for enforcement away from Brussels and onto national institutions, encouraging greater ownership. Indeed, if applied properly, this Fiscal Compact would correct imbalances before the EU level rules ever need to be activated.

On the broader macroeconomic side, the new Macroeconomic Imbalances Procedure allows for early monitoring of – amongst other things – competitiveness trends, private sector credit flows and house prices. If excessive imbalances show up in these areas, sanctions[1] can be applied to euro area countries that do not follow recommendations to correct them. Under this framework, the kinds of credit booms and competitiveness losses we witnessed in the first years of the euro would be "flashing red" much earlier.

I am aware that some criticise this process as asymmetric. While it is clear that the vulnerabilities created by large current account deficits are greater than those of surpluses – and therefore require more urgent remedies – the structural drivers of current account imbalances in surplus countries are also partly being addressed, even if not to the same extent as those in deficit countries. In parallel to the Macroeconomic Imbalances Procedure, for example, the Commission intends to undertake further analysis on the drivers and possible policy implications of large sustained current account surpluses, including trade and financial linkages between surplus and deficit countries. It will also examine ways for further rebalancing current account imbalances, particularly at the level of the euro area, and within the global context. A key theme of the crisis response has also been a renewed focus on structural reforms as embedded in the Euro Plus Pact and Europe 2020 Strategy, which apply to all participating Member States equally.

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[1] Under the MIP, an interest-bearing deposit can be imposed after one failure to comply with the recommended corrective action. After a second compliance failure, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP). Sanctions can also be imposed for failing twice to submit a sufficient corrective action plan.

It would be naïve, however, to believe that with better governance crises could always be prevented. The second pillar to compensate for the euro area's "missing institutions", therefore, is to strengthen the way in which the euro area as a whole manages crises. Having witnessed how imbalances in one euro area country – no matter how small – can become systemic and create financial obligations for other taxpayers, the EU institutions, national governments and national parliaments are now playing a much stronger role in demanding and monitoring economic reforms.

This shift is visible in much more active role of the euro area Heads of State or Government in the economic management of the euro area – now institutionalised in the form of the Euro Summit. It is also visible in the greater scrutiny applied by national parliaments to the economic policies of other Member States: for example, to approve financial assistance programmes a number of national parliaments now require EU-IMF compliance reports and debt sustainability analyses. This changing role of national parliaments underscores the recent observation by Herman Van Rompuy that national parliaments are increasingly EU institutions.

The Commission is also gaining a much stronger crisis management through the new "two pack" legislation. The current proposals would allow the Commission to put any Member State under enhanced surveillance if it is experiencing or threatened with financial difficulties – regardless of whether it has requested financial assistance. This would imply stress tests of the banking sector by the EBA, monitoring of macro imbalances and regular review missions by the Commission in liaison with the ECB. Moreover, the Commission would be able to send back budgets that did not comply with the SGP before they had been adopted by national authorities.

In other words, the euro area is responding to the crisis by creating a new and more comprehensive model of economic governance. This is aimed at preventing imbalances in all policy areas before they can trigger crises – and managing crises more effectively when they do arise. In many ways, this response is sui generis and departs from the template we associate with political federations. For example, the "two pack" gives the Commission the power to demand the kind of reforms that the U.S. federal government could not demand of a U.S. state. Moreover, the federal government would not be able to sanction a state if, for example, its tax code was leading to a local housing bubble. This is now not excluded in the euro area under the Macroeconomic Imbalances Procedure.

This new model is under development and still needs to be perfected – in particular in the financial sector, more work still needs to be done. That said, problems of regulatory arbitrage created by national level banking supervision are being addressed through an increasing harmonisation of supervisory standards and the establishment of a European System of Financial Supervisors with new European Supervisory Authorities. Europe is also exceeding international benchmarks in transposing the new Basel III rules. We may be seeing the beginning of a euro area framework for banking sector recapitalisation and resolution with the decision to allow the ESM to recapitalise banks in non-programme countries. Indeed, a modest first step that will be followed by others in the future.

Conclusion

To conclude, the euro area has learned that the original design of EMU was incomplete, and is now working hard to complete it. For various reasons, the euro area is not in a position to adopt in the near term the institutions of a political federation. This means that it has to take a different road to increase overall stability and – in true European tradition – a *sui generis* approach is being developed that focuses on preventing imbalances and improving collective management of crisis.

It is clear that this approach implies a loss of sovereignty. The crisis has proved that the euro area is a political entity which is not self-adjusting; it needs to be actively governed, and this

cannot happen without Member States sharing more powers with each other. In other words, there has been a belated recognition that monetary union entails political union. This shift has profound implications for the involvement of all levels of governments in the European project: EU institutions, national governments, national parliaments, and even local governments are all required to participate in the common governance of the euro area. Managing this process represents the next great challenge of European integration.