Benoît Cœuré: Short-term crisis management and long-term vision – how Europe responds to the crisis

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at CEMLA's 60th Anniversary Commemorative Conference "Central Bank cooperation at the beginning of the 21st century", Mexico City, 20 July 2012.

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I wish to thank Jonathan Yiangou for his contribution to this speech. I remain solely responsible for the opinions contained herein.

Ladies and gentlemen,

Thank you very much for inviting me to speak at this session on central bank cooperation in times of crises. From the euro area perspective, central bank cooperation has worked very well during the crisis. We have had continuous dialogue since the early stages of the crisis in 2007, which continues to the present day. Our network of currency swap lines with the Federal Reserve, the Bank of England, the Swiss National Bank, the Bank of Japan and Bank of Canada have helped ensure foreign liquidity for the euro area and euro liquidity abroad. There has also been successful international cooperation through the IMF. Overall, these measures have played an important role in easing strains in financial markets.

As the success of this cooperation is broadly recognized, I would like to use my intervention today to discuss a different and more contested issue: the management of the crisis by the euro area authorities. When I travel outside of Europe, I am often struck by the level of misunderstanding of the euro area's approach. The euro area is widely perceived as lacking a coherent strategy to calm markets and stabilise economic activity. It is also seen as the prime source of shocks affecting the global economy. Indeed, I sometimes have the impression that global volatility is solely attributed to the shortcomings of Europe, and that challenges to the sustainability of growth in other large economic regions are conveniently downplayed.

At present, three critical views are particularly prevalent.

- The first is that Europe does not have the right tools to fix the crisis.
- The second is that Europe focuses only on fiscal consolidation and not on growth.
- The third is that the euro cannot overcome its design flaws.

While I acknowledge the reasoning behind these views, you will not be surprised to learn that I fundamentally disagree with them. In all three areas the reality is more complex. Looking only at the outcomes of the European Council and Euro Summit on 28–29 June, these critiques do not hold up. Europe is making more progress than many external observers acknowledge.

1. Instruments of crisis management

Let me begin with the first criticism: that Europe lacks appropriate instruments to deal with the crisis. To start with, one needs an appropriate sense of perspective. It is unrealistic to expect the euro area to have the reaction-function of a nation-state like the U.S. The U.S. has spent more than 200 years establishing institutions to run a vast and diverse economic area and to manage crises. Even then, its political system sometimes struggles to take difficult decisions. The euro area, on the other hand, has existed for just 13 years. The strengthening of its institutions began only two years ago. Against that background, what has been achieved through the creation of the European Financial Stability Facility and European

Stability Mechanism, the entry into force of the “Six-Pack” legislation and the agreement on the Fiscal Compact, is already very significant.

On 29 June, the Euro Summit took a further series of steps to strengthen crisis management. They agreed that loans to Spain as part of its bank recapitalisation programme would not have a senior status, removing a key concern for investors about the programme and their continued purchases of Spanish government debt. They committed themselves to use the full range of EFSF and ESM instruments in a flexible and efficient manner. And most importantly, they decided that the ESM should have the ability to recapitalise banks directly, once a single supervisory mechanism is in place involving the ECB. These are all very significant developments. Let me elaborate.

First, the possibility for direct bank recapitalisation by the ESM is crucial to break the vicious circle between banks and their sovereigns that is at the heart of the crisis. It would allow for banks to be stabilised without increasing the debt level of the sovereign, thereby avoiding further damage to sovereign debt markets and banks’ balance sheets. This would move the euro area closer to the type of financial union we see in federations like the U.S. or Switzerland, where banking sector problems are dealt with at the federal level and have no implications on the finances of the federated units. Of course, this must be accompanied by appropriate incentives for banks to limit moral hazard. Policy conditionality should include restructuring plans in line with EU state-aid rules, and principles for orderly resolution of non-viable institutions and for limiting the use of public money.

Second, the commitment to establish a single supervisor is critical insofar as it facilitates direct recapitalisation. But it also has positive effects in its own right. Given appropriate powers, a single supervisor would produce greater transparency in national banking sectors and reduce regulatory capture, thereby increasing investor confidence. In addition, it would support financial integration by “Europeanising” supervisory priorities. For example, some supervisory actions we have seen during the crisis that have caused the single market to fragment, like requiring banks to match domestic assets and liabilities, would no longer be anticipated. In terms of design, this supervisory mechanism should have a clear euro area dimension, while remaining fully compatible with the single market and EU-wide supervisory harmonisation. The ECB stands ready to play a role, provided that there is no contamination between monetary policy and financial stability. Of course, extending the remit of the ECB should come with higher standards of democratic accountability.

Third, the decisions to waive seniority and make full use of the EFSF and ESM instruments send an important signal to markets. That signal is: policymakers have understood the complexity of the crisis and are prepared to exploit the flexibility of the rescue funds to address it. This is also evident in the decision by the Euro Summit to allow EFSF/ESM assistance for countries respecting their fiscal and structural reform programmes, reducing the stigma of requesting support. The ECB will play its part too by acting as agent for the EFSF and ESM to facilitate effective market operations.

Overall, it is difficult to uphold the caricature that Europe does not have the tools to handle the crisis. If anyone had known, in 2010, that within two years there would be a firewall of 700 billion euro usable for loans to sovereigns, bond purchases and bank recapitalisation, the euro area would have been called ahead-of-the-curve. Now that this exists, it is criticised for being insufficient. This is simply the nature of evolving expectations. But it should not distract us from the steps that have been taken. They are impressive both in historical comparison and in their own right.

2. Fiscal consolidation and growth

The second current criticism of the euro area is that its focus on fiscal consolidation is destroying growth prospects. The argument goes that in a weak economy experiencing private sector deleveraging, an active public sector is essential to maintain demand. Budget cuts will only lead to lower growth, higher unemployment and larger deficits.

I see no contradiction between fiscal consolidation and sustainable growth. In fact, the one is a pre-condition for the other. I do not deny that there are negative demand effects in the short-term. But for the longer-term, sound fiscal policies are essential to lower borrowing costs and encourage investment. Moreover, in those countries experiencing severe sovereign debt tensions, fiscal consolidation is unavoidable to maintain market access.

That said, there is clearly a need to take measures to strengthen the growth potential of the euro area's economies. These measures also need to have effect in the short-term so as to soften the short-term impact of fiscal consolidation. Recognising this, the European Council on 28–29 June agreed on a "Compact for Growth and Jobs". This Compact aims to free up to 120 billion euro for growth and investment, representing roughly 1% of euro area GDP. This comprises a 60 billion euro increase in the lending capacity of the European Investment Bank; 55 billion through the reallocation of structural funds to growth-enhancing measures; and 4.5 billion of investment financing through a "project bond" pilot phase.

On top of that, the European Council took a number of measures to improve the functioning of the Single Market and facilitate adjustment within monetary union. The single market in services will be completed, which is expected to yield economic gains of up to 330 billion euro. To improve labour mobility within Europe, an EU-wide recruitment tool will be developed and measures taken to strengthen the portability of pension rights and the recognition of professional qualifications.

This strategy confirms an important evolution in the thinking of European policymakers. They are acknowledging that the smooth operation of the single currency requires flexible markets for goods, services, and labour. They are aiming to maximise the gains of the world's largest single market, rather than acting as 27 national markets. And they are exploiting EU funds as a tool to support aggregate EU growth, rather than for *quid pro quos* between Member States. Reaping the full gains from economic integration in Europe, combined with structural reforms at the national level, will help lay the foundations for more sustained growth going forward.

3. Future of EMU

Some observers, of course, question whether such a forward-looking perspective is relevant. This is due to the third criticism I outlined: the belief that economic and monetary union cannot work due to institutional flaws. In the view of these critics, the euro area is too decentralised, too diverse and too disunited to function as a single currency area. They conclude that its survival cannot be guaranteed.

Clearly, there is an institutional gap in the euro area. In the aggregate, the euro area enjoys better fundamentals than the U.S. or Japan, and yet it is viewed as a much more risky place to invest. For instance, the IMF projects the aggregate euro area deficit for this year to be just over 3% of GDP, compared with around 8% in the U.S. and almost 10% in Japan. The equivalent figures for gross debt are around 90% of GDP in the euro area, compared with 106% in the U.S. and 235% in Japan.

The right response to this discrepancy between fundamentals and perceptions is not defeatism. It is to fix the institutional flaws that facilitate it. Again, the European Council took an important step in this direction at the recent summit. Building on the report presented by the Presidents of the European Council, Commission, Eurogroup and ECB, it called for a specific and time-bound roadmap for the achievement of a genuine Economic and Monetary Union. This roadmap will be presented by the end of 2012.

This is a very important development, for two reasons. First, it sends a clear signal of Member States' commitment to the euro and to making EMU work. This should help remove investor concerns about the future integrity of the euro area. Second, the report presented by the Four Presidents is far-reaching and comprehensive – it has been designed to address the key challenges facing EMU in all relevant policy areas. It therefore proposes work on four parallel tracks:

1. The first is a *financial union*, with a single framework for supervising and resolving banks and for insuring customer deposits. This would build on the single supervisory mechanism now under development and ideally lead to a European version of the FDIC, financed by contributions from the private sector.
2. The second building block is a *fiscal union*, with powers at the euro area level to prevent unsustainable fiscal policies and to limit national debt issuance. With these powers in place, a path towards common debt issuance would also be possible, but only at the end of the process.
3. The third building block is an *economic union*, which would help euro area members to remain fit and to adjust flexibly within monetary union. This could entail, for example, moving from soft coordination of structural reforms in Member States to an enforceable framework at the euro area level.
4. And the fourth building block is a *political union*, which aims at strengthening democratic participation. This final building block is equally important, as the other measures cannot be effective unless they are legitimate. This requires innovative thinking as regards the involvement of the European Parliament and national parliaments in decision-making on euro area issues.

4. Conclusion

The roadmap towards a stronger EMU, seen together with the decisions on the ESM and the Compact for Growth and Jobs, represents a comprehensive response to the crisis. The euro area has clearly understood that the time of partial solutions and piecemeal reform is over.

In implementing this response, there are sure to be difficulties along the way. This is the reality of operating in a union of 17 democracies. But I would caution those who have doubts about the euro, that they underestimate the political commitment to it at their own risk. The euro area is moving towards a more sustainable equilibrium, and comparably fast in international comparison. The ambition to provide long-term foundations for EMU in less than a decade is a historical step of great significance. It is faithful to the objective laid down by the European Treaties to create an "ever closer union among the peoples of Europe". The alternative would be the continuation of the current trend of market fragmentation, leading to protectionism and ultimately to populism.

Some of the proposals will imply a greater sharing of sovereignty among Member States. This is unavoidable to guarantee sufficient economic and financial convergence for EMU to function effectively. But it must be ensured that if sovereignty is elevated to the EU level, so is democratic control, and that steps are taken towards the emergence of a true European identity.

As central bankers, we all have an interest in global stability. I am confident that, with the measures I have described, the euro area will remain a cornerstone of the international economy.

Thank you for your attention.