Benoît Cœuré: Completing Europe's Economic and Monetary Union

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the Palestinian Public Finance Institute, Ramallah, 23 September 2012.

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I would like to thank Stefan Huemer for his contributions to the speech. I remain solely responsible for the opinions expressed herein.

Mr Governor, Mr Consul General, Mr Vice President of the Board of the Palestinian Institute for Fiscal Policy, Deputy Ministers, Heads of Public Administration, Directors General, Ladies and Gentlemen,

It is a great honour for me to speak at the Palestinian Public finance Institute. The establishment of the Institute marks an important step in the development of the economic governance framework in the Palestinian Territories. I wish this project every success. It relies on the commitment of so many dedicated people in the Ministry of Finance and in Adetef. As Jean Monnet, one of the founding fathers of the European Union, once put it: "*Nothing is possible without men; nothing is lasting without institutions.*" His words related to Europe but in fact they are relevant worldwide.

The Middle East and Europe have always had close ties. They are both part of the Mediterranean region, which is economically and financially interlinked. And currently, both are experiencing an institutional transformation. In this part of the world it has come to be called the "Arab Spring". In Europe, it is the consequence of an economic and financial crisis resulting from weaknesses in the architecture of Europe's Economic and Monetary Union (EMU).

Institution-building takes time. Even though European integration started over six decades ago, the building of those institutions remains a work in progress. But to understand the challenges that Europe is currently facing, we should take a step back and look briefly at the origins of the Europe's integration process. I will then share with you my thoughts on what I believe to be the main shortcomings in the current EMU framework. Finally, I will give you my views on the short- and longer-term measures that the euro area should take to overcome the crisis.

1. Building Europe after World War II: the path towards economic and monetary union

In 1945, Europe emerged from the Second World War as a devastated continent, economically broken and politically divided. But even during the darkest days of the war, there were some Europeans who were convinced that Europe would eventually overcome its divisions and unite in peace.

One of them was Robert Schuman, a French statesman, who in 1950 made a declaration that became a rallying cry: he proposed that Europe should aim for closer economic and political cooperation. The declaration was well received, also by West Germany. This was a crucial point because Germany and France had been rivals in a century-long quest for dominance over the European continent. The Schuman Declaration paved the way for a new era of peaceful cooperation between the two nations, as well as with other countries.

A new type of Europe began to emerge from the wasteland of World War II. What was about to take shape was indeed "revolutionary" – because the fathers of a united Europe moved beyond the concept of the nation-state with a jealously guarded sovereignty. They placed coal and steel production – the two industries which were crucial to the war effort – under a new supranational authority. Six European countries – France, West Germany, Italy, the Netherlands, Belgium and Luxembourg – took this first and important step towards closer

cooperation in 1951. A process towards creating durable conditions for peace in Europe had been set in motion.

The six founding countries came to realise that there were substantial benefits in closer cooperation and agreed to deepen it further. In 1957, they signed the Treaty of Rome, which created a customs union and established the European Economic Community. Its overall aim was to promote harmonious economic development, raise living standards and develop a common market.

However, the founding fathers of Europe saw European integration as more than just an exercise in economic cooperation. They shared a larger vision for the future of Europe. Thus, in the Treaty's preamble, the signatories committed to lay the foundations for an "ever closer union" among the peoples of Europe. This commitment has become the leitmotif of the continent's integration. Indeed, the initial group of six countries that started this process has now expanded to become a group of 27 countries, with another one, Croatia, joining next year. Others are currently negotiating to become members.

Proposals for deeper monetary integration date back to the Werner Report of 1970 and gained political momentum in the second half of the 1980s. At that time, Member States were taking steps towards establishing a single market. This included also the liberalisation of capital movements. As a consequence, Europe became captive to what Robert Mundell and other economists have called the "impossible trinity" – in other words, the impossibility of simultaneously achieving the three goals of financial liberalisation, exchange rate stability, and national monetary policy. One of the three goals had to be abandoned. The choice as to which one became increasingly clear after the failed attempt to secure exchange rate stability through the Exchange Rate Mechanism.[1] Given that a single market, including capital account liberalisation, had been a stated goal since the Treaty of Rome, and given that exchange rate stability was needed to reap the full benefits of the single market, Member States agreed to renounce monetary sovereignty. Moreover, sharing a currency makes sense for countries with close trade ties. This is especially true for the euro area countries which, since the start of EMU, have conducted almost half of their overall trade among themselves.

The Maastricht Treaty, which was signed in 1992, made monetary policy a euro area competence but left economic and fiscal policies under the responsibility of national governments. The concept of economic union relied essentially on the single market, with few binding constraints on economic and fiscal policies. Over time, this turned out to be a significant institutional shortcoming.

Moreover, the transfer of a core sovereign prerogative like monetary policy to the supranational level is a highly political act which entails important political commitments for the future. In particular, the participating countries must undertake to conduct fiscal and economic policies in a way that allows monetary union to work properly. This is a responsibility that the euro area countries share, a responsibility that governments have to fulfil vis-à-vis their peers and vis-à-vis their own citizens.

Seen from this perspective, it is clear that the concept of EMU goes beyond economic and monetary integration. Let me add that the single market itself has a political dimension as the proper functioning of markets requires strong institutional underpinnings, such as enforcement of contracts, consumer protection and competition policy. It has mandated the creation of a federal executive (the European Commission), legislative (the European

[1] In the late 1970s, European countries agreed on closer exchange rate cooperation by setting standard fluctuation bands of plus/minus 2.25% for their bilateral exchange rates. This Exchange Rate Mechanism (ERM) functioned well for a decade or so but it ultimately fell apart due to the divergences in the economic and fiscal policies of the participating countries. Speculative attacks ensued and ultimately triggered a crisis that forced two large countries – the United Kingdom and Italy – to leave the ERM in 1992.

Parliament), and judiciary (the EU Court of Justice). The creation of the single currency is an act of further political integration. Under the Maastricht Treaty the European Economic Community became the European Union, a proper reflection of the fact that the ultimate aim – the *finalité*, as we say in French – of the European project is more than just economic. The EU is a real, albeit limited, political union.

2. The Maastricht framework and its shortcomings

Let me now review briefly what I consider to be the three most important shortcomings of the Maastricht framework – the ones on which we need to achieve progress urgently: i) stronger fiscal institutions; ii) real convergence across the euro area; and iii) the establishment of a financial market union.

The Maastricht Treaty created the European Central Bank (ECB), which took up its monetary operations on 1 January 1999. The monetary dimension of the Maastricht Treaty has worked very well. Since the start of EMU, the ECB has kept annual inflation rates on average very close to 2%.

As regards economic policies however, no new institutions or competences were created. The Maastricht Treaty includes a general clause that economic policies should be treated as a matter of common concern and coordinated within the EU Council of Ministers. Member States are also required to run their economic policies in accordance with ECB's primary goal of maintaining price stability. The underlying philosophy was to prevent what economists call "fiscal dominance": namely, that the misguided policies of governments force the hand of the central bank, and hinder it from pursuing its objective: safeguarding price stability.

However, surveillance of economic policies rested chiefly on non-binding guidelines and recommendations. In 1997, this architecture was complemented by the Stability and Growth Pact, which foresaw binding commitments to fiscal rules, backed up by sanctions. These were however not enforced when cases of fiscal slippage arose later on, and not backed by sufficiently strong national fiscal institutions.

Outside the realm of fiscal policies, coordination was sought but no specific rules were foreseen. This is another weakness of the Maastricht framework: the absence of a surveillance mechanism for the timely detection of macroeconomic imbalances and their resolution. Those countries with a history of elevated inflation rates and exchange rate devaluations benefited, at the start of EMU, from unprecedented low levels of real interest rates. Over time, these led to wage and price increases that undermined competitiveness. This development showed up in increasingly deteriorating current account positions as well as in bubbles, particularly in the financial and real estate sectors, fuelled by capital flowing from countries with current account surpluses. When the bubbles burst after the global financial crisis of 2007, governments stepped in to support growth and some of them were called to rescue ailing banks. In this way, private indebtedness turned into public indebtedness, with disastrous fiscal consequences even for countries that had run fiscal surpluses prior to the crisis, such as Ireland and Spain, and even more for those that had not, such as Greece.

A further shortcoming of the Maastricht framework was the inability to deal with what is now being called the "bank-sovereign nexus". When systemically important banks run into trouble, governments are expected to step in and provide fiscal support to contain the spillovers. Beyond that, banks are typically the largest holders of government debt from their respective sovereigns. These ties, or nexus, between banks and their governments can lead to a dangerous downward spiral

Another effect of this downward spiral, under way since the euro area crisis erupted in 2010, is the fragmentation of capital markets. The bank-sovereign nexus has led to a situation whereby cross-border lending of banks has gone down significantly, as banks retreat more and more to their domestic markets, encouraged by their shareholders and, sometimes, by

national banking supervisors. The crisis is undermining a key achievement of the euro, the integration of capital markets.

A fundamental problem of the Maastricht Treaty was its over-reliance on the assumption that market discipline and peer pressure would provide sufficient incentives for national policy-makers to conduct sound fiscal and economic policies. This did not prove to be the case. As Jacques de Larosière, the former IMF Managing Director, once remarked, what was supposed to be a system of "peer pressure" too often turned into a system of "peer concessions" or "peer arrangements".

On the whole, the Maastricht framework proved unable to deal adequately with the high degree of economic and financial integration in the euro area. It was not fully understood that sharing a currency means much more than sharing the same monetary policy. It is a commitment to ensuring sound fiscal, economic and financial conditions. Euro area countries largely overlooked the substantial spillover effects that national policy decisions would have on their fellow countries in EMU euro area partners. The ongoing crisis has brought these shortcomings into sharp focus.

3. Short and longer-term solutions to the crisis: going beyond the Maastricht framework

3.1. The ECB's contribution to resolving the crisis

Let me now turn to Europe's policy response to the crisis. The EMU framework relies on a strict separation between monetary policy on the one hand, and fiscal and economic policies on the other. The monetary policy function is carried out by the ECB under a clear mandate: maintaining price stability over the medium term in the euro area. To achieve this goal, the ECB has been given full political and operational independence.

Since the start of the crisis, the ECB has reacted forcefully. Since 2008, it has lowered its policy rate from 4.25% to 0.75% now. However, the increasing fragmentation of capital markets which I described above, and which sometimes has led to a complete drying-up of certain financial market segments, has impaired the monetary transmission channel in the euro area. Monetary policy signals are no longer being transmitted properly to the real sector.

The divergence in bank funding conditions is certainly a key factor, in addition to the country-specific economic situation, in explaining the differences in bank lending rates to non-financial corporations across euro area countries. These divergences are leading to a weakening of the pass-through of monetary policy decisions in some euro area countries. For example, among the five largest euro area countries, the maximum difference between short-term lending rates to non-financial corporations (for short-term loans over €1 million) reached more than 100 basis points in recent months. Across all euro area countries, the dispersion of such lending rates is greater now than it has ever been. In other words, conventional monetary policy has lost its effectiveness in some parts of the euro area. For the ECB, the singleness of its monetary policy has been at stake.

Against this background, the ECB has resorted to so-called non-standard measures to ensure the effective transmission of its monetary policy across the euro area. Without a properly functioning transmission channel for its monetary policy, the ECB's capability to maintain price stability is at risk. The ECB has modified its allotment procedures and its collateral policy. It has also lowered the rate of the minimum reserve requirements and introduced very longer-term refinancing operations.

Importantly, the ECB has also decided to resort to outright purchases of bonds on secondary markets. Following the so-called Securities Market Programme, which has now been terminated, the Governing Council of the ECB agreed at its meeting on 6 September on the

modalities for undertaking Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds in the euro area.

The OMTs will enable the ECB to address severe distortions in government bond markets which originate from, in particular, fears on the part of investors of the reversibility of the euro. Monetary union is sometimes misunderstood as an exchange rate system which the participating countries can enter and leave, as was the case with the ERM. Such a perception of reversibility would imply that, ultimately, one euro would not be worth the same in different euro area countries. In other words, the single currency would no longer be single. This perception is fundamentally flawed. Let me be very clear: the Maastricht Treaty refers to the "irrevocable fixing of exchange rates" when a country enters monetary union. The euro is irrevocable.

With the OMTs, under appropriate conditions, EMU will now have a fully effective backstop to avoid destructive scenarios with potentially severe consequences for price stability in the euro area. A necessary condition for the OMTs is that the country concerned adheres to strict and effective conditionality attached to an appropriate programme under the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). IMF involvement will be sought for the design and monitoring of conditionality. The OMTs are an instrument in the ECB's toolbox to help it fulfil its mandate, maintaining price stability. They will be conducive to the monetary authority restoring its power to control credit conditions in the euro area and, through that channel, inflation in the medium term.

3.2. Government actions to fight the crisis

Ultimately, however, the current crisis is the result of the lack of incentives in the Maastricht Treaty to pursue sound fiscal, economic and financial market policies. This can only be amended by the Member States, not by the ECB. The key to resolving the crisis thus lies first and foremost with governments, individually and jointly.

Since the start of the crisis, the Member States have adopted a number of important measures to strengthen the institutional framework of EMU. A procedure for the surveillance of excessive macroeconomic imbalances has been established in order to detect and correct divergences at an early stage. In the case of non-adherence to agreed fiscal and economic rules, sanctions will be applied in a more automatic manner to reduce the potential for political interference and delay in the process. Further improvements are currently under consideration, such as the mandatory submission of draft national budgets to the group of euro area finance ministers – the so-called "Eurogroup" – for vetting before those budgets are submitted to national parliaments for adoption. The vetting should ensure that divergences from the fiscal rules can be identified and corrected at a very early stage.

Moreover, earlier this year, 25 out of 27 EU Member States signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, more generally known as the Fiscal Compact. The Compact further improves the EMU framework by introducing a cyclically adjusted balanced-budget rule which the participating countries need to transpose into national legislation.

Finally, a temporary crisis resolution mechanism was created, the European Financial Stability Facility (EFSF), which will remain active until July 2013 despite being replaced by a permanent organisation this autumn, the European Stability Mechanism (ESM). With a combined maximum firepower of €700 billion, these two mechanisms will help to build effective firewalls to stem contagion from the crisis.

What has been achieved so far is impressive. Prior to the crisis, very few would have expected that Member States would reach a consensus on such fundamental changes in the way EMU works. But these changes are not enough. EMU now needs a longer-term vision to confront its challenges.

3.3. *The way ahead – deeper integration*

In order to restore confidence, policy-makers in the euro area need to resolutely push ahead with fiscal consolidation, structural reforms to enhance competitiveness and European institution-building. Recently, the President of the European Council, in close cooperation with the Presidents of the Eurogroup, the European Commission and the European Central Bank, put forward proposals for a genuine EMU.

The four Presidents are proposing that a *genuine* EMU should be built on integrated frameworks for budgetary policies, economic policies and financial market policies, which in turn must be underpinned by greater democratic legitimacy and accountability.

When we look at the options to establish budgetary policies in a monetary union, and exclude any uncoordinated conduct of fiscal policy by Member States, three possible models come to mind. First, there could be a fully-fledged fiscal union, with a central budget and federal debt issuance. It is not on the cards in the short run as important steps would need to be taken to establish the necessary euro area-wide political legitimacy and governance. The second model would involve sharing sovereignty on national fiscal policies, with reciprocal control of public expenditures serving as a basis for common debt issuance by governments. Such reciprocal control would also require strong democratic legitimacy, involving national parliaments. The third model would only rely on unqualified adherence to fiscal discipline by Member States, without risk-sharing.

None of these three models alone is possible in the short run. There will be a combination of the three. The desirable mix has to be decided upon by the people of Europe with the appropriate democratic checks. EMU is a unique construct, tailored to European specificities, and it need not resemble any existing federation. Let me give some examples. First and foremost, euro area countries should regain their ability to save money for a rainy day by adhering to their fiscal commitments in the new framework of the Fiscal Compact. They have already agreed to limited mutual insurance through the EFSF/ESM. A centralised fiscal capacity could be considered too, provided it is not the basis for permanent transfers but is used to promote market integration and better resilience to economic shocks. For instance, a euro area unemployment insurance scheme could be set up, which would support much-needed cross-country labour mobility.

Indeed, an integrated economic policy framework is needed to boost economic integration and ensure that unsustainable policies do not jeopardise the stability of EMU. The framework should provide for a better enforcement of commitments to structural reforms, i.e. measures to increase a country's competitiveness and its capacity to adjust to economic shocks. Structural reforms make EMU more robust.

In addition, an integrated financial market framework is required in order to break the bank-sovereign nexus that threatens financial integration. This is another important element to make market-based risk sharing work effectively. While many euro area banks have benefited from the single currency, and significantly expanded their European business activities, they are still supervised at national level. Financial fragmentation, as I described above, has led to the perception that banks' liabilities, even though they are nominally the same, are in fact different from one euro area country to another. This is not acceptable: the currency union has thus to be complemented by a banking union. At their summit in June, EU Member States entered into a political commitment, and the European Commission is now proposing to create a single supervisory mechanism for banks in the euro area and to entrust this task to the ECB. This single supervisory mechanism should be implemented in a way that does not compromise the ECB's independence and does not constrain monetary policy. It should be complemented by a single regime to wind down failed banks and by a single resolution fund at euro area level.

Finally, building a deeper EMU requires a strengthening of democratic legitimacy and accountability. The people of Europe will only accept a further pooling of competences at European level if European policy-makers are subject to high standards of accountability.

The European Parliament, whose representatives are directly elected by citizens, already plays a central role in holding the ECB and other EU institutions to account. As a consequence of deeper economic and political integration in EMU, the euro area will become, in my view, more and more a "political space" in its own right and, as such, it will require proper euro area accountability mechanisms. Political legitimacy is vital to build popular support for further integration.

4. Conclusion

Ladies and Gentlemen,

When Robert Schuman drafted the declaration that started the European integration process, he predicted that "*Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity*". When looking at Europe's progress since the Second World War and the step-by-step building of EMU, we can indeed see that what holds Europe together, what has been its engine, and the reason for its success, is the notion of solidarity.

Solidarity is sometimes narrowed down to mean one-way support, from donor to recipient. Of course this has always been a key consideration in the European construction. The EU structural funds, which go to Europe's poorer regions, are a very tangible measure of this kind of solidarity. Likewise, the European crisis mechanisms EFSF and ESM are a symbol of euro area solidarity. Solidarity is not just a catch-phrase in EMU; it is essential for all.

Let me come back to Schuman's insight that "*concrete achievements first create a de facto solidarity*". We have reached a point in the history of Europe where *de facto* solidarity has created a need for concrete achievements. In recent years we have made impressive progress in putting EMU's architecture on a sounder footing. The euro area countries now need to continue on their path of policy reform and to strengthen their governance. The report of the four Presidents in October will provide further guidance in this regard. If these efforts are maintained, I am confident that the crisis will be overcome.

Thank you for your attention.