Mario Draghi: Europe's pursuit of "a more perfect Union"

Lecture by Mr Mario Draghi, President of the European Central Bank, at Harvard Kennedy School, Cambridge (USA), 9 October 2013.

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Introduction

Ladies and gentlemen,

I am delighted to have been invited to give this year's Malcolm Wiener lecture on international political economy. It is always a pleasure to be back in this country, particularly here in Cambridge where I studied for my PhD back in the 1970s.

The United States has often been described as a young nation, but the institution that I have the honour of leading is considerably younger. The European Central Bank (ECB) and the single currency began operations nearly 15 years ago at the beginning of 1999. Today I would like to give you a flavour of both the circumstances of our beginnings and the challenging environment of our teenage years.

As you will all be aware, Europe is currently engaged in a far-reaching process of reform.

Many of those reforms are taking place within the Member States of the European Union (EU) – to make their public finances more sustainable; to make their economies more competitive; and to strengthen the balance sheets of their domestic banks.

But there is also an important stream of reforms taking place at the European level – the counterpart of what you call the federal level here in the US. New rules and institutions are being created that will change the relationship between the Union and the Member States.

It is this process and its implications on which I want to focus in my remarks today.

The preamble of the European Treaty makes "ever closer union" a goal of the EU. For some people, this creates anxiety. It seems to promise an inexorable movement towards a future super-state. Many Europeans, with different national histories and cultures, feel that they are not ready for that.

So it is important to understand that the agenda facing Europe today is not adequately captured by the phrase "ever closer union". In my view, it is better encapsulated by wording borrowed from the Constitution of the United States: the establishment of a "more perfect union".

By this, I mean that we are "perfecting" something that has already begun – namely, the economic and monetary union that was launched in 1999. Policy-makers are following through the consequences of the decision to create a genuine single market supported by a single currency.

In what follows, I would like to describe several of those consequences. In doing so, I will explore two broad themes.

First, I will argue that a single market necessarily has political implications, in which a partial sharing of individual and national sovereignty can be the best means to preserve that sovereignty.

Second, I will explain how the concepts of banking union and a strengthened fiscal setup are supportive of the single market and the single currency.

The political implications of a single market

To understand the EU and the euro area, it is important to appreciate the difference between a free trade area and a true single market.

A free trade area is a partial and reversible arrangement. A single market, by contrast, is a universal and permanent union. This is a distinction with fundamental implications.

Because a single market is universal and permanent, governments and parliaments forfeit, both in principle and by Treaty, the ability to reinstate border controls. This means that, unlike in a free trade area, they cannot act alone to protect their constituents from unfair or unlawful competition from abroad.

Yet such underpinning at the political level is vital for a market to function. There cannot be a free market without such fundamental elements of law as the protection of property rights and the enforcement of contracts.[1]

So while a free trade area can be managed through intergovernmental cooperation, a single market requires a supranational organisation. There has to be a judiciary with the power to enforce competition law at the level of the market. In Europe, this authority is devolved to the European Commission and the European Court of Justice.

If there is a judiciary, there naturally has to be a legislature, to write the law enforced by the judiciary. In Europe, the EU Council and the European Parliament jointly perform this role.

And if there is a legislature and a judiciary, then there also has to be an executive able to implement their decisions. Here again, in Europe, the European Commission is entrusted with executive responsibility.

This is what I mean when I say the single market necessarily has political implications. Indeed, it is well known that the short commerce clause of the Constitution of the United States, which grants Congress “power to regulate commerce (…) among the several states”, forms the basis of a considerable body of federal legislation governing economic matters.

Sharing sovereignty in a single market

The more difficult question in Europe is *what degree of powers* must be transferred to the supranational level to support the single market – or put differently, how much sovereignty needs to be shared. In my view, one way to approach this question is by considering more carefully what we mean by sovereignty.

One way to look at sovereignty is normative, and was historically favoured by absolutists such as Jean Bodin in the sixteenth century. Sovereignty here is defined in relation to rights: the right to declare war and treat the conditions of the peace, to raise taxes, to mint money and to judge in last resort.

Another way to look at it is positive. Sovereignty relates to the ability to deliver in practice the essential services that people expect from government. A sovereign that is not capable of effectively discharging its mandate would be sovereign only in name.

This second approach is more consistent with the writings of the political philosophers who most influenced our modern democracies. John Locke, in his second treatise of government, affirms that the sovereign exists only as a fiduciary power to act for certain ends. It is the ability to achieve those ends that defines, and legitimises, sovereignty.

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[1] There is a large literature on market development and the protection of property rights and the rule of law. For example, in an environment where property rights are well-defined and protected, entrepreneurial activity is focused on innovation rather than on predation. An early reference is W. J. Baumol (1990): “Entrepreneurship: Productive, unproductive, and destructive”, Journal of Political Economy, 98, 5, pp. 893–921.

The same argument is made by James Madison in federalist paper 45, in which he states that "no form of government whatever has any other value than as it may be fitted for the attainment of [the public good]".

I see this positive view as essentially the right way to think about sovereignty. And I think it needs to be the guiding principle when deciding which powers should be at national or European levels. We need to look at effectiveness, not at abstract principles that may be empty in today's world.

Such an approach moves us away from a zero-sum view of sovereignty as power, where one body loses sovereignty and another gains it. Instead, by placing the needs of citizens at the centre, it allows us to view sovereignty in terms of outcomes – and this can be positive-sum.

This way of thinking is in fact already embedded in the EU Treaty under the principle of subsidiarity. This states that powers cannot be transferred to the level of the Union unless action is more effective at that level than at a lower level of government. In other words, it places the emphasis squarely on the efficacy of policy.

In my view, it is this pragmatic focus on policy efficacy that should be the motor of further integration.

From a single market to a single currency

Policy efficacy was indeed one of the main motivations for monetary union – in particular, to maximise the potential gains from Member States forming a single market.

A first argument in favour of the single currency related to the desirability of a single means of payment and unit of account in a single market. A single currency is not necessary for trade, but it is helpful, to the extent that it eliminates currency conversion costs and increases price transparency.

A second argument related to the conditions for fair competition in a single market. In a system of floating exchange rates, individual governments may be tempted to manipulate their currency to pursue "beggar thy neighbour" policies, which constitutes a distortion of competition. An economy that increases productivity and competitiveness can be deprived of the benefits it should enjoy in terms of increased market share because of currency depreciation in competing countries.

Indeed, the instability of exchange rates post-Bretton Woods has arguably vindicated the views of economists such as Ragnar Nurske, who, in an influential study commissioned by the League of Nations and published in 1944, warned of the economic losses resulting from currency volatility.[2]

It is also worth remembering that Nobel laureate Robert Mundell developed his theory on optimum currency areas as a critique of flexible exchange rates in a single market, not in support of such an arrangement. He said that he "could not see why countries that were in the process of forming a common market should saddle themselves with a new barrier to trade in the form of uncertainty about exchange rates".[3]

In any case, the desire to limit exchange rate volatility in the EU was formulated very soon after the collapse of the Bretton Woods system in the early 1970s. It has been reflected in successive fixed exchange rate arrangements, such as the European Monetary System and its successor the Exchange Rate Mechanism.

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[2] R. Nurkse (1944). "International Currency Experience". Geneva: League of Nations.

[3] R. Mundell, "Optimum Currency Areas", Columbia University (extended version of a luncheon speech presented at the Tel Aviv University, December 5, 1997).

And it has been reflected in the Treaty requirement that each Member State treat its exchange rate policy as a matter of common interest.

Free trade and capital movements could clearly not be sacrificed in a true single market. Also, Europeans saw fixed exchange rates as an important component of fair competition. It was thus the national sovereignty over monetary policies that would have to be let go. In this sense, the single currency became a way of maximising the benefits of the single market. And the empirical evidence suggests that sharing a currency has indeed boosted trade, although the effect may be smaller than was earlier suggested.[4]

Let me also add that, for several Member States, joining the single currency implied not only greater policy efficacy, but paradoxically, greater national influence.

Whether Austria before 1999 or Latvia today, many Member States pursued a fixed exchange rate policy or currency board vis-à-vis a bigger neighbour – Germany in the past, the euro area today. This meant that they were effectively importing a monetary policy over which they had no say. Now, as members of the euro area, they have a say. When Latvia will adopt the euro on 1 January next year, my colleague the governor of the central bank of Latvia will partake fully in the formulation of the ECB's monetary policy. The same cannot be said of the countries that peg their currencies to the US dollar, some of which are considerably larger.

From a single currency to a banking union

The implications of the decision to set up a genuine single market are not limited to the creation of the single currency. The single currency itself has consequences, of which the most pressing is banking union.

The establishment of a banking union has been agreed by Heads of State and Government in Europe and is now being delivered in stages, starting with the single supervisory mechanism. This has been entrusted to the ECB and has recently been approved by the European Parliament. We trust that a single resolution mechanism will enter into force by the beginning of 2015.

To understand why banking union is a consequence of monetary union, it is worth recalling that only a small fraction of money is "outside" money, meaning the liability of the central bank. The bulk of money used in the economy is "inside" money, meaning the liability of a commercial bank.

For money to be truly single within a currency area, there has to be full substitutability between its different forms. This means that one euro in a bank in any euro area country has to be fully substitutable with a euro in another. The only way to achieve this is to remove the differences in the banking system that can create fragmentation along national lines – and the most important difference is the way banks are supervised and, when necessary, resolved by national authorities.

We are thus moving these functions to the European level to ensure that the single currency is matched by a single banking system. And this is consistent with the positive definition of sovereignty I gave earlier: a genuine banking union can give citizens more trust in their money than can different national approaches.

Moreover, there is an important positive feedback effect here. While there is a chain of logic from the single market to the single currency to banking union, banking union in turn

[4] See, among others, P. Lane (2006): "The real effects of EMU", CEPR Discussion Paper No. 5536. The paper states that "EMU has indeed contributed to greater economic integration – however, economic linkages with the rest of the world have also been growing strongly, such that the relative importance of intra-EMU trade has not dramatically increased".

supports the single market. When fragmentation of the banking system takes place, it does not only undermine the singleness of money, but it also undermines the conditions of competition. This is because it results in a dispersion of bank lending rates among national lines, as we have seen in recent years.

Let me be clear here: there is no reason *per se* why a Spanish firm should be able to borrow at exactly the same price as a Dutch firm. If the operating environment of both firms is different, then this can reasonably affect their credit risk and therefore the rate at which they borrow.

But in a single market, a Spanish firm should be able to borrow from a Spanish bank at the same price at which it would borrow from a Dutch bank. If that is not the case, if the risk premium paid by a bank client in one country is not idiosyncratic but systemic, then there no longer truly is a single market for capital. Location would matter. And this is what banking union aims to reverse.

In Europe, such banking union is even more important than in the US because over two thirds of firms' external financing takes place in the form of bank loans. For small and medium-sized enterprises this share is even higher. In the US, by contrast, the role of banks in firms' external finance is only about one-third or even less. Hence, a banking union is crucial also for the euro area real economy.

But, it can reasonably be asked, if a banking union is so important, why did this only become apparent in the last few years?

The main reason is that the potential for financial fragmentation in the euro area was not recognised. Policy-makers and observers did not fully appreciate the extent to which diverging fundamentals between different economies could feed through to the banking system. This applies notably to sovereign debt, and the two-way interaction between sovereign distress and bank distress.

Certainly, a banking union can play a major role in breaking the vicious circle we see in Europe between banks and their sovereigns. But there is also a strong onus on governments to ensure that sovereign debt performs its expected function in the financial system – that is, as a risk-free, safe asset. Let me therefore briefly turn to fiscal policies.

The implications for fiscal policies

It is welcome that governments in the euro area have made significant progress in consolidating their budgets, and hence removing some sovereign risk from the financial system. The primary fiscal deficit for the euro area has fallen from 3.5% of GDP in 2009 to around 0.5% in 2012. In the United States, by comparison, it was around 6% of GDP in 2012.

That said, we need to ensure time consistency. We all know the experience of the first decade of the euro. Fiscal rules enshrined in the Maastricht Treaty were not sufficiently binding; market discipline likewise did not work in an effective way.[5]

For this reason, the ECB has long argued in favour of moving towards more effective rules in the fiscal domain. We are convinced that they are crucial for the stability of the common currency in the longer term. I am therefore encouraged that policy-makers in Europe have been taking significant steps to strengthen the common fiscal rules.

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5 To quote the Delors Report: "To some extent market forces can exert a disciplinary influence […] However, the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive." Bayoumi et al. (1995) however provide some evidence in favour of market discipline on US data; see T. Bayoumi, M. Goldstein and G. Woglom (1995): "Do credit markets discipline sovereign borrowers? Evidence from U.S. States", Journal of Money, Credit and Banking, 27, 4, pp. 1046–1059.

These steps include new ways of dealing with countries that do not comply with recommendations from the European Commission. They include giving the Commission the right to inspect national budgets before they go before national parliaments – a power the US federal government does not have over the states. And they include inserting balanced budget rules into their national constitutions or equivalent. We look forward to a full and transparent implementation of this new regime.

These changes do to some extent represent a transfer of powers to the European level. But as with banking union, I do not view it as a loss of sovereignty. Rather, I see the strengthening of the fiscal pillar in a manner that lends credibility to fiscal policies as a way to restore the efficacy of policy: for the Union as a whole, as countries are less affected by spillovers from fiscal difficulties in an integrated financial market; and also for the Member States themselves.

This budget stabilisation capacity through the automatic stabilisers is diminished if governments are unable to run a deficit at the low point of the cycle – or put differently, if the credit of the government deteriorates to the point where its debt is no longer regarded as a safe asset. Indeed, if the credit of the government is impaired, and behaves like private credit, then government's relative cost of borrowing increases at precisely the time when it needs to borrow.

One can see this as the real loss of sovereignty. It prevents national governments from using normal fiscal policy for macroeconomic stabilisation. In this sense, steps that restore faith in public credit, such as more credible fiscal rules, restore the ability of governments to exercise the functions that citizens expect from them.

This is particularly important in a monetary union where the burden of macroeconomic stabilisation cannot be entirely shifted onto the shoulders of the central bank. Our monetary policy mandate is to deliver medium-term price stability in the euro area as a whole. Fiscal policy has to absorb idiosyncratic or asymmetric shocks at a national level.

And unlike in the United States, as fiscal policies are decentralised, such stabilisation takes place entirely at the sub-federal (or national) level in the euro area. However, if the fiscal rules and institutions are credible, there is ample scope for national policies to perform this role.

Looking forward

Overall, the changes taking place in the euro area are making our monetary union more robust. At the national level, consolidation and structural reforms are helping most countries reach a more sustainable external position.

At the European level, we are approaching a balance of competencies which, taken in combination, should provide more effective stabilisation.

That said, it would seem misplaced to exclude that over time the euro area may move to a new equilibrium. Integration is a dynamic process and we need a certain degree of humility about where it will lead. If we look at the US, we see that it strengthened its union in different stages, with each stage eventually begetting the next. The creation of the Federal Reserve System in 1913, for example, was followed twenty years later by the creation of the FDIC, a key pillar of America's banking union. The federal budget also developed significantly at this time.

In Europe today, we are in some ways undergoing an analogous process. It is not analogous in the sense that the destination is the same. We do not know this. What is analogous is the guiding principle. Like the US, our orientation is pragmatic and driven by a desire for policy efficacy and to provide the functions citizens expect of government. We are then drawing the policy conclusions that follow, at the time when they are relevant.

In the dark days of the crisis, many commentators on this side of the Atlantic looked at the euro area and were convinced it would fail. There were wrong in their medium term macro view. The euro area has created 600 000 more jobs than the US since 1999. And while the unemployment rate has increased more in the euro area than in the US during the crisis, the employment rate in the US has fallen further than in the euro area, which makes the figures difficult to compare.

But they were wrong in a more fundamental way. They had underestimated the depth of Europeans' commitment to the euro. They mistook the euro for a fixed exchange rate regime, when in fact it is an irreversible single currency. And it is irreversible because it is born out of the commitment of European nations to closer integration – a commitment which, as the Nobel committee recognised last year, has roots in our desire for peace, security and transcending national differences.