Lorenzo Bini Smaghi: Monetary and financial stability in the euro area

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Europe Festival Conference on "The state of the Union", Florence, 10 May 2011.

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Introduction

It is a great pleasure for me to contribute to this Europe Festival Conference on "The state of the Union".

Before turning to my assigned topics, which concern the euro and the monetary policy of the Union, I would like to start with a few general comments.

There can be no doubt that these are challenging times for Europe. But the current crisis does not just affect Europe, it affects the whole of the West. Problems such as the sustainability of public finances and the role of the state in the economy, immigration and burgeoning income inequality, concern not only Europe and the euro area, but the whole of the industrialised world. Moreover, this is not a cyclical crisis but a structural one, resulting from the profound changes now sweeping the world. Hundreds of millions of people have risen over the survival threshold, over two-thirds of the world's population has opted for the market economy model, and there is a perception of a lack of progress in economic and social development and also in civil rights in a large part of the world.

There is probably no historical precedent for the speed at which these changes are taking place. But this is not to say that history is not instructive and no useful lessons can be drawn from it. To understand how to face the challenges ahead of us, it may be useful to understand how similar challenges were faced and overcome in the past, and particularly how some were able to make progress while others lost ground at times when the pace of globalisation accelerated.

Much has been written recently on this subject. Niall Ferguson and Ian Morris, for instance, examine the reasons why the West has "ruled" the world – at least until now.[1] In essence, they assert that civilizations developed and rose to dominance when they were open to innovations from abroad and were able to develop and use them to their advantage. This applies to both migratory flows and imports of agricultural or manufactured goods, ideas and scientific innovations, in a context of competition. Those who were closed to globalisation declined, even if they had achieved a leading position in economic, technological or military matters.

That is the reason why, according to Jared Diamond, a European, rather than a Chinese explorer, discovered America at the end of the fifteenth century, even though China's economic development was much more advanced and had a much greater army and navy.[2] I would like to quote briefly Diamond:

> "Christopher Columbus, an Italian by birth, switched his allegiance to the duke of Anjou in France, then to the king of Portugal. When the latter refused his request for ships in which to explore westward, Columbus turned to the duke of Medina-Sedonia, who also refused, then to the count of Medina-Celi, who did likewise, and finally to the king and queen of Spain, who denied Columbus' first request

1 Niall Ferguson, *"Civilisation: The West and the Rest"*, Allen Lane, 2011; Ian Morris, *"Why the West Rules – for Now"*, Farrar, 2010.

2 Jared Diamond, *"Guns, Germs and Steel"*, Norton, 1997.

> but eventually granted his renewed appeal. Had Europe been united under one of the first three rules, its colonisation of the Americas might have been stillborn.”

The spirit of competition and the decentralised decision-making mechanism that characterised Europe in past centuries explain, for example, why European navigators strove to discover new routes; how the foundations of commercial dominance were laid; and how scientific discoveries, which often originated abroad, were turned into innovations and new production processes. Again, using Diamond’s words:

> “Once Spain had launched the European colonisation of America, other European states saw the wealth flowing to Spain, and six more joined in colonizing America. The story was the same with Europe’s cannon, electric lighting, printing, small firearms, and innumerable other innovations: each was first neglected or opposed in some parts of Europe for idiosyncratic reasons, but once adopted in one area, it eventually spread to the rest of Europe.”

Europe rose to dominance over the centuries to the extent that the positive effects of competition prevailed over the negative effects associated with the recurrent conflicts between states that stemmed from the inability to resolve the tensions generated by competition. The European Union was created precisely in order to ensure that the spirit of emulation and competition could operate within a framework of peace.

There is no doubt that there are currently substantial differences within Europe, with some countries demonstrating a strong capacity to adapt to the new global conditions, while others are finding it hard to implement the changes that are necessary to maintain their level of prosperity and continue to grow. These differences are not confined to Europe. Contrary to what some observers say, I think that the anti-Europe movements that have emerged in some countries are a symptom of a more general dissatisfaction linked to the structural factors of the crisis. In the United States too, society is deeply divided on how to face the challenges of globalisation.

Although European institutions provide an easy scapegoat, they represent an element of extraordinary strength in the current circumstances, not only for Europe, but also for the Member States, giving them – I believe – a great advantage. In a severe crisis, which requires prompt action with long-lasting effects on the lives of citizens, the risk of a mistake is enormous, particularly if decisions are taken in a monolithic society or there is a tendency to share a common mindset. The existence of European institutions does not eliminate the possibility of error, but forces together the different cultures and opinions that form the Union in the decision-making process. As a result, decisions may be wiser, even if taken in a cumbersome way and in a context of deep discord. One example is the decisions to support the three countries which experienced economic difficulties. Opinions differed within the Union. Some were tempted to leave the countries to their fate, to pay for the mistakes they had made. But others were prepared to help – even unconditionally – thinking that in future they might benefit from the same assistance if needed. In each case it was difficult to forge an agreement, but finally a balanced solution was found with a view to creating the appropriate incentives for adjustment.

Resorting to European institutions does not mean that all decisions need to be centralised at the Union level. Maintaining decentralised decision-making and some form of competition in some sectors can be an important factor in encouraging less competitive countries to emulate more efficient ones. In several European countries, for instance, the reform of the labour market to align it with best practice has become a priority in the adjustment process.

Overall, I believe that Europe has the ability to meet the challenges that the western world faces, if it is able to make full use of its own experience and institutions. Changes are nevertheless needed. And this brings me to the questions specific to Economic and Monetary Union.

In this regard, I would like to make two main points: first, the global economy is becoming increasingly "multipolar" and the euro will have to stand its ground alongside at least three – and possibly more – other major international currencies. Second, the euro can only be assured of a major role in a multipolar currency world if the architecture underlying the single European currency is sufficiently strong. The task of achieving this cannot be delegated to financial markets and requires appropriate institutional steps.

The euro in a multipolar world

When the idea of the single currency was first mooted in the 1980s, the global economy was dominated by three countries: the United States, Germany and Japan. Since then, the global economy has seen major changes. With the ongoing integration of global markets, we have witnessed the rise of emerging market economies. China, in particular, has led to a progressive shift in the centre of economic gravity and is expected to overtake the United States in terms of GDP at market exchange rates sometime from 2025 onwards.

The US dollar has remained the main international currency, as a result of the predominance of US financial markets and also the inability of several emerging economies to pursue independent policies (for example by de-pegging their currencies from the US dollar). But there is little reason to believe that these factors will not change over time. The renminbi, in particular, should be in a position to relatively quickly emancipate itself from the dollar and become a major international currency if the Chinese authorities were to consistently pursue capital account liberalisation, greater exchange rate flexibility and all related policy measures in the years to come. The international role of some other emerging market currencies is also likely to increase over time.

We are clearly moving towards a multipolar currency world. The question is whether the euro will be one of the poles – so to speak – of the new system. I will not dwell on the advantages for Europe of being one of the poles, but rather I invite you to reflect upon what would happen if it were not. To be sure, the euro, like any other currency, would be affected by economic and political developments in the countries issuing the leading reserve currencies, and would suffer severely from external shocks. Consider, as an illustration, the recent experience of the Swiss franc, a currency which is renowned for its stability. After the onset of the global financial and economic crisis the franc appreciated by 17% vis-à-vis the euro in 2010 alone, driven by the reallocation of global capital on a massive scale. This has fuelled deflationary risks and slowed economic growth. To counter these effects, massive unilateral interventions were conducted, leading de facto to a closer alignment of monetary conditions with those in the euro area.

This points to the conclusion that in a multipolar world having appropriate domestic macroeconomic policies is not sufficient to absorb external shocks. Unless a country or an economic region also has a deep and liquid capital market and its size is sufficient to absorb large capital flows, it is bound to become subordinate to the existing poles, or to be squeezed between them. The prosperity of the euro area countries is inextricably linked to the success of the euro.

The euro: a unique construct

The euro is the only major currency that is not issued by a single sovereign state, but by a union of states. As this is a totally unprecedented monetary framework, it is fair to ask whether it has what is needed to become one of the poles of the new system – in other words, is it sufficiently robust to ensure sound economic policies at the euro area level and in the individual countries, and does it have a large and deep financial market?

Decisions are about to be taken on strengthening the governance of the euro area with a view to achieving these objectives. The aim is not only to strengthen the institutional architecture but also to advance the implementation of the single market. The ECB's position in this respect is well-known.

Here today I would like to warn against an illusion which seems to be spreading among policy-makers in Europe. The illusion is that the economic governance of the euro area can be strengthened not by increasing the responsibilities of policy-makers, which would mean stronger European institutions and stronger rules, but rather by delegating to financial markets the task of selecting the appropriate policies that authorities must abide by, in particular with respect to budgetary policies.

One avenue that has been advocated by some is to make more explicit the conditions under which countries, like companies, would not repay their obligations and would restructure their debts or even default. The proponents argue that such explicit rules would improve the ability of markets to price sovereign risk and, thus, to exert discipline on governments with a view to achieving sounder fiscal policies. This view is predicated on the general principle that investors should bear the consequences of their decisions.

Although at first sight this may seem reasonable and fair, it is wrong not only in theory but also in practice. The reasons are simple and include the following:

First, as over 50 years of IMF experience have proven, market assessments of the solvency of countries tend to be wrong. In the vast majority of cases, sovereign risk is overestimated or underestimated over a long period. This is because sovereign risk does not depend only on debt sustainability, but also on the political will to implement adjustment programmes, including privatisations and structural reforms.

Second, at times markets have perverse incentives. In particular, large investors who have bought insurance against sovereign default, often without holding the underlying asset, stand to benefit greatly from the default and lobby in favour of it. They tend to encourage naïve governments to believe that debt restructuring can be done in an "orderly way", distracting them from implementing the appropriate policy adjustment.

Third, default or debt restructuring is a dramatic economic and social event for the country which experiences it – I would call it political "suicide" – which leads many into poverty, as experience has shown. It is thus rather peculiar for policy-makers to design policies mainly with the aim of punishing (or rewarding) certain categories of investors, rather than considering the ultimate consequences for the people.

Finally, if the euro area were to go down the path of leaving it entirely up to the markets to decide which countries are solvent and which are not, it would put the euro at a disadvantage compared with all other major currencies. This is confirmed by the fact that since mid-October 2010, when the idea of private sector involvement in programmes to assist countries experiencing difficulties was voiced at the highest political level, and in spite of subsequent clarification that in fact no change had occurred in prevailing practices, some euro area market segments have severely suffered. The benefits of a deep and liquid financial market where international investors feel safe to invest have been jeopardised, undermining the competitiveness of the euro.

The alternative is for policy-makers to take responsibility and strengthen the economic governance framework of the euro area, in at least three ways.

First, the governance framework underlying budgetary policy requires bold changes, with greater automaticity and stronger commitment on the part of policy-makers to ensure full compliance with the Stability and Growth Pact.[3]

[3] The ECB published a long article on its views in this regard in the March 2011 issue of the Monthly Bulletin.

Second, further progress should be achieved in the implementation of the single market, strengthening the “economic leg” of EMU.

Finally, we need to further integrate regulatory and supervisory institutions for the financial sector at the European level, either by reinforcing efforts to harmonise practices across Member States, or by further strengthening European authorities.

A great deal has been achieved over the past few months, but much remains to be done to put the Union in a position to meet the challenges which have emerged as a result of the crisis.

Conclusions

Let me conclude by quoting David Marquand’s recent book, “The end of the West”:[4]

“The economic crisis itself, like its predecessor in the 1930s, is political, not technical….The world’s economic blocs will have to find painful answers to urgent problems; and the allocation of the pain will be a supremely high-political matter. It will raise profound questions of distributive justice, of the obligations that the present generation owes to future ones, of the proper balance between the claims of poor and rich nations, and of the proper relationship between the human and other species. Such questions are quintessentially global in character, and the answers will have to be global too. But for the Union’s leaders to opt out of the global search for answers would be a betrayal of their citizens. And they will be unable to opt in if they cannot speak with one voice and lack the democratic legitimacy to carry their people with them.”

Lastly, I would like to praise the organisers of this Festival of Europe Conference for having chosen Florence as the place to debate such important issues related to the future of our continent, as I like to think that one of the best way to symbolize Europe is the David (by Michelangelo): young, vigorous but also gentle, his gaze fixed fearlessly on the challenge; he can triumph, against all odds. That’s the way Europeans should be.

Thank you for your attention.

[4] David Marquand, *“The End of the West – The Once and Future Europe”*, Princeton University Press, 2011.