Jörg Asmussen: A European agenda 20…

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the "Welt"-Währungskonferenz ("Welt" currency conference), Berlin, 21 May 2012.

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Mr Eigendorf,

Professor Hennerkes,

ladies and gentlemen,

I am delighted to be speaking to you here today at the Axel Springer House as part of this year's "Welt"-Währungskonferenz ("Welt" currency conference).

Axel Springer once said: "Berlin is the heart of Europe, I know of no other". Many of my European colleagues would nominate other towns and cities as the heart of Europe, but I wanted to start with this quote because of the time from which it dates: 1973. Berlin was a divided city at that time, the symbol of a divided Europe. The Iron Curtain ran right through it. Today – almost 40 years later – Berlin is the flourishing capital of a reunified Germany, again at the centre of a united Europe. The only thing that is missing in this flourishing capital is a functioning airport.

Over the last 20 years, central and eastern Europe has become an integral part of a European Union which has grown ever closer over time. This is especially true with regard to monetary integration: the euro is now the single currency of 17 countries of the European Union, from Estonia to Portugal, from Ireland to Cyprus.

We were shown how much Europe has grown together just two weeks ago. On 6 May the people of Greece and France went to the polls. The clear reactions throughout Europe have demonstrated once again how close national and European politics are – particularly in times of crisis.

Recent developments show that many of the great political challenges require a European response. The answer to the crisis is not less Europe, but more.

It is crucial in this context that the indisputable advantages of a stable single currency are safeguarded by a Europe that is capable of action. The situation in Europe – and in Greece in particular – is difficult at present. However, the past few years have provided us with a number of insights which make me optimistic about the future development of Economic and Monetary Union:

1. The euro is good for Europe and good for Germany.
2. The ECB's monetary policy ensures a stable currency in the euro area.
3. Europe is capable of reforming.

I would like to add a question to this list:

4. How can we develop Europe further? What should be on the agenda?

1. The euro is good for Europe and good for Germany

The introduction of the euro in now 17 EU Member States has had clear political and economic advantages. We benefit on a daily basis from the single currency, and this is also true during the crisis. Allow me very briefly to run through the facts again.

The euro is a stable currency.

Over the period since the introduction of the single currency, the average inflation rate in the euro area has been 2%. In Germany, incidentally, the rate since 1999 has been 1.6%. Such results were not matched over a comparable period in the 50-year history of the Deutsche Mark. Confidence in the currency is also reflected in the fact that inflation expectations in the euro area are stable and in line with the ECB's definition of price stability, i.e. below but close to 2% over the medium term. In addition, the euro has established itself as a second important international reserve currency alongside the US dollar. Its international significance is greater than that of the legacy currencies combined.

The euro has supported economic integration in Europe.

The introduction of the single currency meant the end of exchange rate risk for cross-border trade within the euro area. Companies and individuals no longer have to protect themselves against this risk. The euro is estimated to have accounted for an increase in intra-European trade volumes of between 5% and 20%. Even the cautious estimates represent a remarkable increase. This stimulating effect on intra-European trade has made itself felt most of all in Germany. In the first ten years of Monetary Union, for example, real exports from German companies to other euro area countries rose from around 13% of German GDP to 20%.

The euro is an anchor of stability in the crisis.

Without the euro, there would have been high exchange rate volatility between the currencies of Europe during the crisis. In the past, Germany's European trading partners repeatedly devalued their currencies in order to remain competitive in price terms. The external value of the Deutsche Mark vis-à-vis the Italian lira, for example, rose by 50% in just five years during the oil crisis in the 1970s. Experience has shown that such volatility regularly results in high adjustment costs in the real economy. We need only look at Switzerland, which is currently having to contend with a strong appreciation of the Swiss franc.

This brings me to the institution that is inextricably linked with the success of the euro: the ECB.

2. The ECB's monetary policy ensures a stable currency in the euro area

The ECB has acted resolutely during this crisis to safeguard price stability in the euro area in line with its mandate and with full independence. On 9 August 2007, for example, the ECB was the first central bank worldwide to react decisively to the turbulence emerging in the financial markets.

However, the financial market situation deteriorated so dramatically in the course of 2008 that the transmission of monetary policy was significantly disrupted. Central banks across the world were repeatedly faced with a situation in which liquidity in short and longer-term money markets threatened to dry up. In this context, the conventional monetary policy of the Eurosystem also reached the limits of what it could achieve. Against the backdrop of this extraordinary situation, the ECB took a number of "non-standard" monetary policy measures. These mainly include refinancing operations with full allotment against collateral, longer-term refinancing operations with an extended maturity and the expansion of the list of assets eligible to be used as collateral. All these non-standard measures are temporary in nature and can in principle be withdrawn at any time if we see upside risks to price stability.

In Germany the ECB's two three-year longer-term refinancing operations in particular have made headlines.

The aim of these operations was to guarantee the refinancing of the banking system over the longer term in order to support the flow of credit from banks to the real economy. The demand from banks was high, with around 500 institutions participating in the first operation in December 2011. For standard longer-term refinancing operations, this figure is closer to 100. The second operation, in February 2012, had around 800 participants, including a large number of small credit institutions, more than half of which were German. These banks frequently grant loans to small and medium-sized businesses, which form the backbone of growth and employment in the euro area.

In these two operations the Eurosystem allotted around a trillion euro, although the net provision of liquidity was only about half that figure. These are large sums. I would ask, however, that you bear the following points in mind:

First, the interest rate in these two operations is linked to the rate in the ECB's main refinancing operations. If the ECB increases its rates, the costs will also rise for financial institutions over the remaining life of the operations.

Second, the ECB can at any point withdraw this liquidity through liquidity-absorbing operations. In addition, credit institutions have the option of early repayment of the liquidity to the ECB after one year.

Some still fear that the generous provision of central bank liquidity will lead to a considerable erosion of the value of money. Let me emphasise here that, in order to judge the liquidity situation in the economy, one should look not at the central bank's balance sheet, but at the aggregated balance sheet of the euro area banking sector. ECB liquidity is a very special form of money. It can first of all simply be used to make payments between banks with accounts at the ECB or to fulfil minimum reserve requirements.

There is no automatic mechanism which converts this liquidity into credit or asset purchases. Lending and purchasing decisions are made by the banks alone, on the basis of their financial situation, their risk aversion and the demand for credit from the real economy and households. We can also see that euro area inflation expectations remained stable both before and after the three-year operations.

It is true, however, that all central bank operations involve credit risk. This applies to both standard and non-standard measures, in economically good as well as bad times. For this reason, every central bank operation is covered by collateral. The quality of this collateral is very carefully evaluated on an ongoing basis by our internal risk management team. Large haircuts are made, and the credit amount is thus oversecured. In the case of the credit claims recently added to the list of eligible collateral, the haircut amounts to 53% on average, and reaches up to 75% in individual cases.

It is also true that the non-standard measures have resulted in an increase in the now much discussed ***TARGET2 balances*** of some national central banks in the Eurosystem. The Deutsche Bundesbank, for example. The TARGET2 net balance of the Deutsche Bundesbank vis-à-vis the ECB stood at €644 billion in April. Contrary to certain reports, however, the TARGET2 imbalances do *not* indicate that urgently needed funds are flowing out of countries such as Germany. In actual fact, excess liquidity is available at Germany's banks. Misunderstandings in this respect can thus lead to incorrect conclusions. For example, it has been suggested that TARGET2 balances should have an upper limit. But this would mean that the free movement of capital between euro area banks, which is guaranteed by the European treaties, would come to a standstill.

The TARGET2 balances are a symptom and show rather that the interbank market is not functioning smoothly as it did prior to August 2007 and that the Eurosystem central banks have to ensure that liquidity also reaches those areas with impaired money markets.

With dysfunctional money markets, the ECB would not be able to successfully conduct its monetary policy. Through its interventions in the money and near-money markets, the ECB has – fully in line with its mandate – also played an active and successful role in tackling the

financial and economic crisis in the euro area. Upside and downside risks to price stability could thus be adequately contained at any time.

Following on from this observation, I would like to turn to the role of governments and politics in the current crisis. The crisis has revealed a number of shortcomings in the euro area's economic policy management framework.

3. Europe is capable of reforming

Europe has proved, since the outbreak of the financial crisis, that is it capable of reforming and strengthening its ability to act.

- The creation of the European Systemic Risk Board and the three European Supervisory Authorities has brought into being a new financial supervisory architecture, responding to the need for macro and micro-prudential supervision at the European level.
- The Stability and Growth Pact has been strengthened, and a fiscal compact agreed in a very short period of time. It is now important that the fiscal compact be rapidly implemented, without changes, in at least all countries of the euro area.
- A procedure has been introduced to enable macroeconomic imbalances to be identified and corrected at an earlier stage.
- The agreement on the European Stability Mechanism (ESM) and the decision to effectively increase its size and bring forward its starting date will further improve the effectiveness of European crisis management. It is essential that the ESM be operational on 1 July.

The fiscal compact can be complemented by measures to increase growth. Such measures would be helpful additions, but the fiscal pact must not be renegotiated or weakened.

It is wrong to pit fiscal consolidation against growth. We need both. Talking about more growth does not mean moving away from the fiscal policy strategy pursued so far. It is not a matter of boosting growth over the next one to two quarters with credit-financed spending programmes, but of increasing potential growth. No one is against growth. The crucial and rather difficult question to answer is how, in ageing societies, to increase potential growth.

I think that the fiscal compact can be complemented by package of growth-enhancing measures with three components:

- product market reforms;
- labour market reforms;
- financing of reforms.

The product market reforms could include, for example, the completion of the internal market for services. 70% of the EU's GDP comes from services, but only 20% of services are provided on a cross-border basis.

Labour market reforms could be inspired by the Agenda 2010 programme in Germany. In particular, labour mobility needs to be increased in the euro area (the theory says, we remember, that an optimal currency area requires full mobility of labour). Mobility could be increased through broader recognition of qualifications within Europe, greater portability of pension rights, language courses and a European network of job centres.

The reforms could be financed with loans from the European Investment Bank (EIB) or EIB project bonds (which are not the same as Eurobonds). The prerequisite for this, however, is useful projects. In much of Europe there is no need for a complete overhaul of classical

infrastructure, but many places are lacking in modern digital infrastructure. It would also be possible to divert already available EU structural and regional funds.

These growth-enhancing measures will only have an effect once a critical mass of elements have been put into place. The form of the elements is less important.

As you will remember, the fiscal compact has been signed by 25 countries. For the EIB or the EU budget to be used, all 27 Member States are needed. This means that the form of the fiscal compact cannot simply be replicated in a comparable growth compact.

The results of such growth-enhancing measures will not appear for some time. In the meantime, I personally consider it necessary to pursue active labour market policies, to prevent major social tensions. Youth unemployment in the euro area was 22% in March 2012.

4. How can we develop Europe further? What should be on the agenda?

Jacques Delors famously said that Europe is like a bicycle: if it stops moving forward it falls over.

But European integration is not an end in itself. It must have a purpose for the citizens of Europe. It must offer them prosperity, security and freedom.

In Germany, European integration has thus far been largely a project for the political, economic and academic elites. Our constitution does not provide for direct referendums, so many people are now saying “I wasn’t asked”. This is made all the more important by the fact that a monetary union is ultimately also partly a political union.

I therefore suggest that we now engage in open political debate on what Europe should look like ten years from now. In this we face a trilemma, which Martin Höppner, Armin Schaefer und Hubert Zimmermann put well in an article on 27 April in the “Frankfurter Allgemeine Zeitung”: “Enlargement, deepening and democracy – the trilemma of European integration. Of the three aims of the EU, only two can ever be achieved at the same time, at the expense of the third”.

My choice would be deepening (of the euro area) and democracy. Others may have other ideas. This is something that can and must be discussed.

The advantages of Monetary Union are so great that we should stabilise them through deepening. This means a fiscal union and a financial market union (banking union) as well as a democratically legitimised political union.

My first ideas on this are:

i) In the area of ***financial market union***, Europe is facing two central challenges:

First, the close financial links between banking sectors and public finances in an environment of slowing growth has often led to a downward spiral. An economy that is barely growing or in recession has an effect on the budget situation and, as a consequence, on the prices and yields of the relevant government bonds, many of which are held on banks’ balance sheets. At the same time conditions for banks deteriorate. All this leads to the aforementioned liquidity shortages on the interbank markets. These, in turn, can cause solvency problems. But the loss of confidence means there are fewer and fewer private investors willing to give the banks the capital they need. And the government has less and less leeway to push the recapitalisation or restructuring of the banks forward itself – and so the situation spirals further and further down.

Second, European financial market regulation and crisis management suffer from a potential conflict of interest. While national supervisory authorities are supposed to ensure the functioning of the European financial market, they are politically accountable to national

taxpayers. A national supervisory authority will therefore ultimately tend to put the interests of its own taxpayers above the smooth functioning of the European financial market.

In order to be better prepared in a potential future crisis, therefore, the financial links between banking sectors and public finances must be loosened, and the conflict of interest between national crisis management and European rules must be removed. For this purpose the work on a European regulatory framework must first be concluded, particularly as regards the European capital requirements. Following the agreement by the EU economics and finance ministers on the "CRD IV" package on 15 May we have come a step closer to finding a solution here.

A financial market union also needs a joint financial market supervisory authority for systemically important, cross-border financial institutions in the euro area, as well as a settlement system for such institutions.

ii) With regard to ***fiscal union***, monetary policy has thus far been centralised, whereas the fiscal union has been organised in a decentralised manner by the 17 member countries and coordinated through the Stability and Growth Pact. We need to shape fiscal policy in such a way that it meets the stability requirements of a currency union. This applies to both how the institutions are set up and the actual fiscal policy strategy. A first step in this direction has already been taken in the form of the ESM, which could be followed by a special fund from the EU budget for the euro area.

iii) Concerning ***political union***, I would like to focus less on the executive and more on its democratic legitimacy. The crisis management over the last two years was conducted purely on an intergovernmental basis. This was the right way forward, as it enabled us to act quickly. However, it is now time to strengthen the European Parliament. In essence, the opinion of the Federal Constitutional Court of Germany was that the European Parliament is not a "proper" Parliament, as it does not have the right of initiative. This could be changed. Time and again, the European Parliament is accused of simply being a "spending" parliament. Generally, one is more cautious with regard to spending, if one is also responsible for raising the necessary funding. This could be introduced step by step for the European Parliament: for example, a financial transaction tax could feed into the special fund from the EU budget if it were levied in the euro area alone. Another idea, which would be quick and easy to implement, is that meetings could be held between the euro area members of the Economic and Monetary Affairs Committee of the European Parliament.

These are just some initial ideas, and I think an open discussion on where Europe should be in ten years would be worthwhile.

Thank you very much.