Manuel Sánchez: The European Union ten years after the euro zone crisis

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the National Bank of Poland conference on "The future of the European Economy", Warsaw, 18 October 2012.

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I am pleased to be with you today in the culturally vibrant city of Warsaw, and to be a participant in this conference on the timely and important topic of the future of the European economy. I would like to thank President Marek Belka and the National Bank of Poland for the invitation to share my thoughts with you.

The process of integration in Europe has been long and quite remarkable, reflecting strong leadership and social consensus in favor of unity and cooperation. The process can also be considered an economic success on the basis of the expansion of trade, investment, and growth resulting from the reduction of barriers to international transactions.

Furthermore, the current stage of economic and monetary union in the EU shows additional economic benefits accruing to its members as a result of the elimination of transaction costs related to currency exchange in the area, the efforts by member countries to comply with the convergence criteria, and the price stability attained.

Notwithstanding this progress, the ongoing crisis has revealed crucial deficiencies in the design and operation of the EMU, engendering prolonged financial instability and casting doubts on its viability. The identified weaknesses have called for policy measures whose effectiveness will, to a large extent, determine the future of the monetary union. Given the importance of the EMU to the EU, in what follows, I will focus my comments on what I believe are the key policy issues in the euro zone, the opportunities for the Central and Eastern European countries, and the impact on the world economy.

As always, my comments are my own responsibility and do not necessarily reflect the views of the Bank of Mexico or its Governing Board.

Policy challenges and the future of the EMU

One of the most urgent policy tasks in the EMU is the end of the negative feedback loop between unsustainable public-debt paths and the weak conditions in the banking system prevailing in many countries. To this end, fragile banks must be recapitalized by the private sector which, exceptionally, may imply supplementary backing by corresponding national governments. Such a step requires an assessment of the "true value" of public-sector debt on the banks' balance sheets.

Efforts towards fiscal consolidation demand, in many instances, substantial corrections of primary deficits that have resulted from previous stimulus measures, automatic stabilization mechanisms, and bank support programs, among other factors. Borrowing costs for troubled issuers have risen significantly above pre-crisis levels, adding to the burden of fiscal pressures. Widening yield spreads on sovereign bonds, however, seem to better reflect the situation of individual credit risks in a manner which is consistent with the absence of a safety net, as originally envisioned in the "no bailout" clause of the Maastricht Treaty.

It is worth noting that actual and potential rescue programs seek to restore the confidence of investors in the EMU. As usual, these packages will have to be evaluated in terms of their effectiveness in containing the crisis and their possible unintended consequences. It is not unreasonable to expect that a bailout of one country may generate the speculation of a bailout of another country, provoking financial contagion.

In the context of the limited resources available and the tensions stemming from the distribution of funding costs for ever larger rescue plans, bailouts could become self-defeating. One possibility for limiting moral hazard is to incorporate in all programs some degree of debt restructuring, which in turn may affect banks' balance sheets. The implementation of such initiatives is itself very challenging, particularly when official institutions become significant holders of problematic debt.

A second urgent problem is the lack of competitiveness shown by some economies, especially in peripheral countries, reflected in the difficulties they have had correcting large current account deficits, which are inconsistent with capital outflows. Because the euro nations cannot resort to currency devaluation, wage flexibility and productivity-enhancing reforms are the only significant tools available. Labor mobility and the moderation of consumer lending are complementary means.

In view of the fact that labor mobility in the euro zone has been much lower than what is customary in a federation of states such as the United States, homologized labor laws in the euro area seem warranted. Indeed, aside from language and cultural problems, which may not be the most significant obstacles in light of other international migration experiences, the size, heterogeneity and lack of portability of labor benefits could be a major discouraging factor. Also, other structural reforms may require international coordination, such as unified liberalization of remaining trade barriers in the services sector.

For the medium term, three institutional issues stand out. First, the integrity of the European Central Bank should be respected given the key role the bank has played in the EMU and its excellent record on price stability. The absence of persistent attacks on the euro and its relative strength vis-à-vis other currencies even in the worst moments of the crisis suggest that markets believe in the permanence of the EMU.

It seems to be best that the central bank maintain price stability as its primary objective. In its role as a lender of last resort, it may be advisable that the bank abide by rules of liquidity provision strictly oriented toward solvent banks. Also, it is absolutely essential that no pressures be exerted for the ECB to engage in quasi-fiscal operations. Any new responsibility that may be assigned to the central bank should be carefully examined in order not to compromise the bank's credibility.

Second, the regulatory and especially the supervisory framework for financial institutions should be greatly enhanced. Credit and real estate bubbles created with traditional unsophisticated bank products led to a severe type of crisis even in countries where banking regulations were widely regarded as exemplary. Financial policies need to be more prudent in the future, potentially including an active, though not necessarily discretionary use of macro-prudential tools.

It is not clear which regulatory model can yield the best results. But if the centralization of powers is the preferred option, as seems to be the case at present, then some caveats should be examined. Centralization will have to be limited to a general level, leaving micro supervision to local supervisors. Furthermore, if overriding authority is conferred to the ECB, the bank may have to face possible conflicts between supervisory and monetary policy tasks. For example, outright sovereign bond purchases in secondary markets, justified as a means of restoring the monetary transmission mechanism, may compromise the ECB's credibility as a bank supervisor, given that financial institutions are large holders of sovereign bonds.

Third, governments should have sufficient inter-temporal resources to face cyclical fluctuations and long-term obligations, thus making rules for sustainable fiscal surpluses indispensable. Yet, many coordination efforts for the sound functioning of the monetary union necessarily carry fiscal implications at the EMU level and involve the possibility of inter-country transfers. Examples are uniform deposit insurance and resolution mechanisms within a banking union, euro-level stabilization funds for times of crisis, support for countries affected by negative shocks, and the euro bond initiative.

For fiscal coordination to be credible it seems necessary to move in the direction of a political union, implying budget rules for individual countries and a substantial surrender of sovereignty. The change has to be profound given the lack of enforcement of previous commitments, such as those expressed in the 1997 Stability and Growth Pact, which were later even relaxed. The sustainability of a fiscal union may eventually require letting a particular national government fail if it becomes insolvent, as was the case in the history of the state governments of the United States.[1]

These and other challenges will have to be faced in order to normalize the operation of the EMU and enhance its growth potential. The necessary transformations are complex as they require the approval of sovereign states and, hence they may take several years to implement, in turn prolonging the pain of the adjustment process. The adjustment could indeed result in a long period of low growth, high unemployment, and financial volatility.

In the end, however, it seems likely that both the EU and EMU will become different and strengthened, with better rules, more solid institutions, and healthier financial systems. The possibility of some exits from the EMU cannot be excluded, but they would not inevitably mean the breakup of the monetary union as a whole, and they could be a test of its endurance.

The future for the EU can hardly be described as one of marginalization. The expected more rapid growth of emerging-market economies will necessarily confirm the long-term decline in the relative importance of Europe and other advanced regions within world GDP and trade and investment flows. In spite of this, the EU will likely continue to be the largest world economic area at least for the next two decades.[2]

Opportunities for Central Eastern European countries

During the last two decades, the Central and Eastern European countries have transformed themselves from centrally planned into market economies, thereby augmenting their rates of growth and living standards. In their opening process, they have experienced increasing trade and investment ties with the EMU, making their business cycles more attuned to those of Western European nations.

Close to half of the CEE countries are already members of the EU, while a few states belong to the monetary union. Before the current crisis, there was a queue of countries waiting for admission to the euro zone. The ongoing problems, however, have reduced the interest of these and other possible candidates in becoming members of the monetary union. In fact, some CEE countries scheduled to enter the EMU have explicitly postponed their incorporation.

It is only rational that these and other countries remain in a “wait-and-see” mode. The needed institutional changes in the euro zone may eventually include a revision of the accession criteria, which could affect the possibilities of the CEE countries of becoming euro members. But even if this is the case, these nations seem to be in a privileged position.

CEE countries will have more time for evaluating the net benefits of joining the euro and can prepare themselves for such a step, should they opt for it, and complete requirements for convergence and other conditions deemed beneficial. Also, in the meantime, CEE nations will be able to rely on exchange-rate flexibility and monetary policy to face any idiosyncratic shocks.

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[1] For an analysis of the U.S. federal government´s refusal to bail out states in the 1840s, see Sargent, T. J. 2012, *Wall Street Journal*, “An American History Lesson for Europe”, February.

[2] See, for example, European Commission 2010, *Europe 2050.*

At the same time, CEE economies will likely deepen their integration with Western Europe because of their geographic proximity. It is well known that further economic gains can be achieved from monetary union membership. But if business integration is reinforced over time, the case for these countries' incorporation into the EMU will be even stronger.[3] And there is always the possibility for these nations to unilaterally adopt the euro as a legal tender, as some small economies have already decided to do.

The impact on the world economy

The prospects for the growth of the global economy remain dependent on the strength of international trade and investment flows. In the next few years, world economic growth will likely be led by developing countries, while the developed nations will continue to exhibit lower rates of expansion.

This dual-velocity path is consistent with the fact that emerging economies should grow faster than mature ones, since they have a wider set of investment opportunities to exploit. More importantly, however, is the fact that many advanced nations will have to implement restrictive fiscal measures in order to ensure debt sustainability. As a consequence, the share of emerging economies within global GDP and trade will likely continue to expand.[4]

Given the importance of the EU, however, developments in Europe will continue to be a determining factor in the economic outlook of many countries. Specifically, there is high business interdependence between the United States and Europe, as they hold the largest trade and investment bilateral relationship in the world. Furthermore, U.S. banks are highly exposed to European assets, and European banks have an important presence in the U.S. financial system. Therefore, deterioration of financial conditions or a significant slowdown in the economic activity of the EU could affect the pace of economic recovery in the United States considerably.

Something qualitatively similar can be said about emerging economies. These nations have different degrees of integration with Europe and, hence, they experience diverse impacts from developments in that region. As stated, the CEE countries, as well as large nations such as China and India, are often the most affected by events in the EU.

Turning to my own country, approximately 8 percent of Mexico's foreign trade is with the EU, making this area Mexico's third-largest trading partner, after the United States and China. Furthermore, during the last decade, the EU has been Mexico's second most important investment partner, contributing with almost one-fifth of total accumulated foreign direct investment.

Further deceleration of EU growth could hurt Mexico's economic prospects, indirectly if the U.S. economy slows as a result, but also directly through less dynamic exports of goods and services to Europe, especially in vehicle shipments which are the most important export item, and lower European investment, likely in manufacturing and financial services, which have been the leading recipient sectors. Regarding the latter sector, the Mexican banks have healthy balance sheets and are well capitalized, but some subsidiaries of European banks could nevertheless be impinged by events affecting their parents.

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[3] See, for example, Frankel, J. 2008, "Should Eastern European Countries Join the Euro? A Review and Update of Trade Estimates and Consideration of Endogenous OCA Criteria", *Faculty Research Working Papers Series*, Harvard, Kennedy School of Government.

[4] For forecasts on different economies, see International Monetary Fund 2012, *World Economic Outlook,* October.

Concluding remarks

The current financial crisis represents the first meaningful test of the EMU. Deep transformations are necessary in order to consolidate the long-term viability of the monetary union and the strengthening of the institutions supporting the EU. The challenges call for decisive actions implemented in a comprehensive way, since a piece-meal approach may weaken the credibility of the initiatives over time. Although a breakup scenario cannot be ruled out for the EMU, long-held integration efforts are a guarantee of the common willingness to find solutions to problems.

CEE countries are in an advantageous position since they have time to continue pondering the net benefits of joining the euro area while, at the same time, they can further integrate their economies with Western Europe. Developments in the EU will continue to affect the growth and financial prospects of many nations, especially those with the closest ties with this large economic bloc.