Benoît Cœuré: Towards a consistent, coherent and complete Economic and Monetary Union

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the conference "Financial stability and the Single Market – the keys to growth in Europe" on the occasion of the 20th anniversary of the Single Market, organised by the European Commission, Brussels, 19 November 2012.

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I wish to thank Wouter Coussens for his contribution to this speech. I remain solely responsible for the opinions contained herein.

Introduction

Commissioner Barnier, Ladies and Gentlemen,

I would like to thank the European Commission for inviting me to speak at this conference on "Financial Stability and the Single Market".

The crisis has demonstrated the incomplete character of Economic and Monetary Union. Much thought has already been given to diagnosing the issues, identifying the shortcomings of our current institutional set-up and outlining possible solutions. Further food for thought will no doubt be offered throughout the day in this room. But the time that lies ahead is the time to take decisions.

Since the publication in June of the first draft of the "Four Presidents' Report" on the future of EMU, the commitment by the European Council to the banking union, the ECB's decision on Outright Monetary Transactions, and also thanks to visible adjustment efforts in euro area countries, there has been a return of confidence in the outlook for the euro area. Both the status quo and a piecemeal approach to EMU reform would weaken the assumptions underlying this return of confidence.

Today, therefore, I wish to make a plea for consistency, coherence and completeness in the institutional reforms we are seeking. And I will do so by elaborating on each of the building blocks identified by the four Presidents in June.

What I will do for each of these building blocks is to highlight in what respect EMU is incomplete, why it matters, and how the situation can, in my view, at least be remedied. In doing so, I hope it will become clear to you how these four building blocks form a consistent whole.

Why the euro needs a banking union

Let me begin with the so-called financial or banking union. The heart of the problem here is the fragmentation of the euro area banking system. I will not dwell on the symptoms of fragmentation. They are well known and have been documented, e.g. in the ECB's reports on Financial Integration in Europe and Financial Stability Reviews, and have covered, among other matters, the renationalisation of interbank markets, dispersion of bank funding costs and bank lending rates along national lines.

Equally well documented is the high correlation between the creditworthiness of banks, as well as their funding conditions, and the creditworthiness of their respective government. The ultimate protection of senior bank creditors, depositors in particular, comes from the fiscal backstop provided – or not – by the sovereign. It is therefore not surprising that the fragmentation of the banking system along national lines only became visible and damaging after the start of the sovereign debt crisis, even though the fault lines had existed beneath the surface.

The fundamental reason why this matters is that the single currency is really single only if the banking system is also single. Money, remember, is the liability of the banking system. Base money, issued by the Eurosystem, is undoubtedly single, but it represents only a fraction of broad money. The remainder is issued by commercial banks. If the credit of the banking system – including deposits – is fragmented along national lines, then so is money.

More prosaically, if there is a national bias in the funding cost of banks, then monetary policy impulses cannot be transmitted uniformly across the euro area.

So how can the singleness of the banking system be ensured?

The first option would be to strengthen the creditworthiness of individual sovereigns so that differences between them became negligible. It would mean moving to the situation, not as it was, but as it *should have been*, and was *perceived to be* before the crisis. Under this approach, national governments would remain responsible for backstopping their banking system, but this backstop would be robust across the euro area.

This is appealing, but it has two shortcomings.

First, current conditions are not favourable. Most governments have excessive levels of public debt and will need several years to restore their creditworthiness to the point where all could be deemed equally robust. In the meantime, bank access to funding would remain fragmented along national lines. This would perpetuate divergences in the conditions of access to credit for firms and households, and jeopardise national adjustment efforts. The potential for negative feedback loops or "multiple equilibriums", to use the economic jargon, is obvious. National economies would continue to diverge.

The second shortcoming is that this approach assumes that market discipline is totally effective. The "keeping the house in order" approach functions if markets are correctly differentiating. I am a firm believer in the usefulness of market signals. Note, for instance, that the Outright Monetary Transactions will leave ample room for market forces to play: at the short end of government yield curves in normal times, and at the long end at all times. But we know from what happened before and during the crisis that we cannot always rely on market signals.

The alternative is that the banking system is backstopped at the European level. In other terms, the link between national banking systems and their sovereign is severed and replaced by a relationship between the euro area banking system as a whole and European institutions. In that case, we would truly have a single banking system.

Here again, several options can be envisaged, but the key is completeness and consistency. What it means, in my view, is the following.

A genuine banking union is one where the location of deposits does not play a role in the confidence they inspire. This will require three interconnected elements: first, a strong, single supervisory mechanism to prevent crises; second, a common resolution scheme which allows effective and early decisions to be taken if a crisis nonetheless occurs; and third, eventually, a common European backstop which can be called upon in the event that there is still a need for public resources despite the involvement of the private sector. These three elements are complementary and mutually reinforcing.

Since work on the SSM has advanced the most, and since it involves the ECB as host, let me make a few observations in this regard.

First, it is crucial that all banks are covered by the SSM. A two-tier system would result in an uneven playing field, effectively segmenting the banking sector, which is precisely what we are trying to repair. Putting all banks under the umbrella of the SSM does not mean that supervision would be conducted entirely from Frankfurt. That would be neither effective nor desirable. We should – and would – rely on the resources and knowledge of the national supervisors.

A second point is that arrangements need to be made to separate financial supervision from the ECB's monetary policy function. We are examining procedures that would separate clearly the relevant workstreams supporting the two functions, and strictly limit Governing Council involvement in supervisory matters.

Yet separation should not mean isolation. There are important synergies to be achieved between the two functions, an argument that is gaining international recognition and that the Eurosystem made publicly as early as 2001.[1] Most euro area governors are already banking supervisors. Supervision could allow for better-informed monetary policy-making. In parallel, monetary policy operations could provide useful signals to the supervisory function, for instance, when a bank relies disproportionately on central bank funding. The creation of the SSM is an opportunity for Europe to rethink the links between banking supervision and monetary policy in a way that can strengthen both functions and learn the lessons of past banking crises, such as avoiding "zombie banks" infused with central bank money or the evergreening of non-performing loans.

The SSM does not need to be limited to the euro area. As the cornerstone of a financial market union, it is *necessary* for the euro area, but it is *desirable* for the EU as a whole. The participation of additional Member States is welcome and would strengthen the Single Market. These countries have raised legitimate concerns about a fair involvement in the decision-making of the SSM. We are working hard on arrangements that would address those concerns consistent with article 127.6 TFEU.

Two versions of the fiscal union

There exists a link between the notion of a banking union and the second topic highlighted by the four Presidents in June, that is the fiscal union. A fully-fledged banking union, including resolution and deposit insurance, assumes a partial fiscal union. Let me note that this does *not* imply that the structure and powers of the SSM can only be decided upon when we know the full details of the fiscal union. The SSM as such does not have fiscal consequences, and should be implemented promptly.

What I am referring to here is a *first interpretation of the fiscal union*: a limited risk-sharing capacity allowing the absorption of idiosyncratic shocks. These shocks cannot entirely be absorbed by national policies alone, given the constraints imposed by the single monetary policy and the lack of an exchange rate. Therefore, there has to be a euro area fiscal capacity, as a form of limited rainy day insurance. Whether other tasks could be assigned to this common fiscal capacity, such as supporting allocative efficiency, is a matter of choice, not necessity.

Let me voice two words of caution. First, such risk-sharing capacity should serve as a *complement*, not a *substitute* to fiscal responsibility at national level. It should not undermine the implementation of the strong national fiscal governance rules enshrined in the Fiscal Compact. Second, the fiscal union should be precisely delineated so that is does not mutate into a transfer union. Transferring resources permanently from core to peripheral countries would be tantamount to accepting that economies will not adjust and that countries will not find their way back in the global economy.

This brings me to a *second possible interpretation* of fiscal union, which refers to a transfer of fiscal governance from the national to the European level, in the form of enforceable control of national budgets.

I would argue that such a transfer of governance would not amount to a loss of sovereignty but to *recovering* sovereignty. Let me explain. To be able to borrow in a recession – and

[1] See www.ecb.europa.eu/pub/pdf/other/prudentialsupcbrole_en.pdf.

crucially to be able to do so at affordable rates – governments rely on confidence among investors that their fiscal position is sustainable. When this confidence is eroded, government debt no longer acts as a safe haven. The cost of raising finance goes up and this can set adverse debt dynamics in motion. In extreme circumstances, governments can lose access to markets, which has happened in several euro area countries. From this perspective, the sovereign debt crisis in the euro area is tantamount to a loss of fiscal sovereignty.

With respect to the establishment of a fiscal union that fully supports the return of the euro area to full viability, we ought therefore to distinguish between fiscal rules which underpin sustainability, and rules of enforcement which underpin credibility.

Fiscal rules, as they have now been designed, agreed, and enshrined, in particular in the six-pack and two-pack legislation as well as the Fiscal Compact, are an important step forward. These rules are designed by reference to structural deficits, thereby assigning clear and realistic medium-term objectives, while allowing for the absorption of cyclical shocks.

Where credibility can still be improved, however, is at the level of enforcement. A number of ideas have been put forward in this context, including that of endowing a European Commissioner with the power to intervene in national budgets.[2] Each of these options raises its own set of issues, not least the clear-cut need for strong political legitimacy of any form of control.

Which of these two interpretations of the fiscal union should eventually prevail? I would say both. Europe is a unique construct that needs to find its own balance between the roles of the euro area and national fiscal responsibilities.

Economic union

The genuine completion of banking and fiscal unions would ensure that the union and its members are better able than they are now to withstand a wide variety of shocks: cyclical shocks, exogenous asymmetric shocks, as well as, if need be, shocks arising from the banking system.

There exists, however, a final category of shocks to which monetary union must be impervious. They derive from inadequate policies – labour market policies, for instance – or the absence of corrective policies, which amounts to the same. If left unaddressed, this either results in prolonged economic divergence – which is inconsistent with the objectives of the Union, or in permanent fiscal transfers – which is politically unacceptable.

What is necessary here, at the very least, to complete monetary union?

First and foremost, in my view, is the completion of the single market in all its aspects. The European Union is a market economy in which each country can benefit by exploiting its comparative advantages. The euro was introduced to serve the single market and ensure its viability. The argument is symmetric: the completion of the single market is necessary to allow each country to effectively exploit its comparative advantages and to prevent the imbalances that would otherwise undermine the viability of the euro. That is why the ECB fully supports the Single Market Acts I and II.

Second, where macroeconomic imbalances occur as a consequence of inadequate policies, those imbalances need to be identified early and corrective action taken. I believe that the surveillance tools are now in place, in particular through the Macroeconomic Imbalance Procedure, and that the emphasis should now be on implementation and enforcement by the European Commission.

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[2] Other ideas include the notion of making the validity of national budgets conditional on prior approval at European level. Along the same lines is the notion, included in the first report of the four Presidents, that debt issuance would be subject to prior approval.

The interim report on the future of EMU in October suggested that euro area Member States could enter into contracts with EU institutions, under which they would commit to undertake specific structural reforms, on the basis of measurable and verifiable targets. Correctly designed, those contracts could both enhance national ownership and reinforce – rather than weaken – existing economic coordination procedures. There could be a role here for the euro area fiscal capacity, which could provide financial incentives to countries partaking in those contracts.

Political union

The last building block identified by the four Presidents in June is political union. In fact this is not a separate building block – it cuts across the entire discussion on other points. Decisions that have fiscal consequences require democratic backing. Any form of European control over national policies must be based on political legitimacy and strict accountability, in particular vis-à-vis the European Parliament. We at the ECB are very well aware of the need for democratic accountability wherever power is delegated. The ECB's new supervisory task must be matched by additional reporting and accountability channels.

Yet, I think the general issue here is one of clarification, rather than one of institution-building. The notion that the euro is a currency without a state is in my view misguided. The euro is a currency with a state, only with a state whose branches of government are not yet clearly defined. Here again, let me explain:

As I underlined earlier, the euro was created to serve the single market. That market itself is a political construct. It not only presupposes the freedom to play a part in the market – that would be anarchy. It also presupposes the means to protect that freedom, such as the protection of property rights and the enforcement of contracts. For there to be a single market, there must be a legislative body that establishes the rules and a judiciary that can enforce them. If there is a legislative and a judiciary, there has to be an executive arm to implement their decisions. For a market to function, the three branches of government have to exist. This makes the single market a political union.

What is not yet entirely clear in the case of the euro area, and apart from the ECB which has a clear but limited mandate, is who exactly will execute these powers, and to whom it will be accountable. As we move towards a genuine EMU, this clarification will become ever more necessary.

Conclusion

Mr Commissioner, Ladies and gentlemen,

There has always existed a debate as to whether the euro area is an optimum currency area. I think this is a flawed debate, if by optimum we mean perfect, because no currency area is ever perfect. The question we are facing is what the *minimum* conditions are to ensure the full viability of the euro area over time.

As I said in my introduction, there has been increasing confidence in recent months that these conditions will be met. Financial market participants have understood that there exists a political commitment to the euro. Practical decisions are needed now to anchor this confidence and commitment.

I will end my remarks by quoting – as is appropriate within these walls – from none other than Jean Monnet: "*Ce qui est important, ce n'est, ni d'être optimiste, ni pessimiste, mais d'être déterminé.*"

Thank you for your attention.