Jörg Asmussen: Agenda 2013 – the next steps in completing EMU

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the "Internationaler Club Frankfurter Wirtschaftsjournalisten", Frankfurt am Main, 19 December 2012.

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1. Introduction

Ladies and gentlemen,

Thank you very much for inviting me to speak to you this evening. It is now almost one year since I started my term in the ECB Executive Board, and it is interesting to reflect on how Europe has changed in that time. When I joined the ECB in January, the situation looked bleak. The first 3 year LTRO had temporarily calmed the markets, but many informed commentators were predicting a very difficult year ahead. Putting probabilities on a euro break-up had become a cottage industry.

Today, we have grounds to be cautiously optimistic. The fear of catastrophic tail risks has lessened. This is in part due to actions taken by the ECB to ensure monetary policy transmission, notably through our OMT programme. But it is also due to very important changes that have taken place in euro area governance. Of these, the most significant is the recognition by the euro area Member States that EMU is an incomplete project – and that it urgently needs completing.

For this reason, the topic of my address will be that process of achieving a genuine EMU, focusing in particular the conclusions of the European Council last week. I will say upfront that this outcome is not the definitive vision for EMU. It necessarily balances the views of European policy makers, reflecting what is realistic in the current political circumstances, while – I hope – remaining sufficiently ambitious to give citizens and investors a sense of direction of where the euro area is heading.

Accordingly, we need to think about the process of completing EMU in two phases: those elements that can be implemented quickly and can make a real difference to the euro area already in 2013; and those elements where more progress needs to be made in the medium-term as the integration process evolves. Let me begin by focusing on the first phase: the key elements for the year ahead.

2. Key elements for 2013

a) Completing financial market union

Perhaps the most important element of agreed by the European Council is the commitment to construct a real financial market union in the euro area. This will be critical in 2013 for three reasons.

First, a stable and healthy banking system is necessary to restore normal monetary policy transmission across the euro area, and hence to ensure that the ECB's low rates are duly passed on to all parts of the euro area.

Second, restoring confidence in the financial sector – of which the banking system is the bedrock – is the only way to re-integrate the single financial market and therefore disentangle banks from their sovereigns.

Third, putting in place a less risky banking system and fixing the credit channel are key contributions to restarting growth across the euro area during 2013.

Towards a Single Resolution Mechanism

The agreement on a Single Supervisory Mechanism (SSM) by the EU Finance Ministers is an important first step towards a real financial market union. But it is only one component. A financial market union has to involve a Single Supervisory Mechanism *and* a Single Resolution Mechanism (SRM). This is the only way to ensure that taxpayers do not end up paying for the mistakes of the private sector. Let me explain why.

Banks that are "too big" or "too interconnected" to fail at the national level – making bailout the preferred strategy – would not benefit from this status at the European level. The SRM would have the legal and financial capacity, as well as independence, to ensure that viable banks survive and non-viable banks are closed down.

Moreover, banks that are "too complex" to resolve via cross-border cooperation – making early action impossible – could be dealt with more effectively at the European level. The SRM would create an authority that could concentrate decisions on resolution and act pre-emptively and quickly, helping to preserve the value of the banks and save money for taxpayers.

Principles for European public support

However, a strong resolution mechanism cannot remove risks for taxpayers entirely. Certainly, any costs incurred from resolution should first and foremost be covered by the private sector, through establishing a European Resolution Fund raised by levies on the banking sector. But a real financial market union must also contain a public sector dimension at the European level. In this context, the European Council called for the operational framework for direct bank recapitalisation by the ESM to be ready by the first semester of 2013.

I am aware that the prospect of ESM direct bank recapitalisation raises serious concerns: that European taxpayers will end up paying for the bad assets accumulated over the past decade; that mutualisation will become standard practice for dealing with banking sector problems. But let me reassure you that these concerns can be contained with what I would see as the three key principles for European support.

First, European support has to be accompanied by European control, meaning public funds can only be used after the SSM has effectively assumed its duties and on the basis of strong conditionality.

Second, European support should only be granted to banks that are systemically relevant, or pose a serious threat to European financial stability, and therefore affect the common good.

Third, European support must come at the end of a sequential process, involving the following steps:

- one, the beneficiary banks must undergo a thorough and independent economic evaluation of their assets to ascertain their real capital needs and reveal any legacy problems;
- two, those banks must be assessed to have a viable business model and so be deserving of additional capital, otherwise they should wound down;
- three, if the banks are to be kept going, private sector sources should be exhausted first – meaning bailing-in of shareholders and bondholders, and if needed, use of the bank-funded resolution financing;
- four, if there are still capital shortfalls, the financial resources of the beneficiary Member States should be drawn on;
- only in the very last step, would European public funds be used.

This pecking order underscores that, the stronger the European resolution framework, the lower the eventual costs for European taxpayers. The more the financial sector can be bailed- *in*, the less it has to be bailed- *out*. We see in the US how this can work: the FDIC closed down more than 400 banks during the crisis, without any cost for taxpayers. This is the standard we should be aiming for in Europe – and a real financial market union is the only way to achieve it.

Let me make a final point regarding the institutional set-up of the SRM and Resolution Fund, which is my own personal view: the ESM would be well-suited to perform the tasks of the SRM and to house the European Resolution Fund raised from the banking sector.

b. Building economic union

The second key outcome of the European Council is the aim to strengthen economic union – particularly by ensuring that national economies can remain competitive and hence prosper within a single currency area. The importance of this issue for 2013 cannot be overstated, as it is critical to ignite growth and lower unemployment. We can see before our eyes a series of cases where quick implementation of targeted reforms could have a strong impact, even in the near-term.

For instance, despite the recession in Italy, unit labour costs have adjusted by only 0.1% relative to the euro area average since 2008. This is because many sectors of the economy are sheltered and wages do not respond to weak productivity. It needs product market reforms to increase competition and reinvigorate its external competitiveness.

In Spain, employment is struggling to rebound, and the burden on unemployment falling disproportionately on the young, because its two-tier labour market protects insiders. It needs labour market reforms to bring in outsiders and improve incentives to hire.

The Conclusions propose to kick-start this much-needed process of reform through three avenues. First, a renewed effort to complete the Single Market, in particular by opening up services and increasing labour mobility. Second, a thorough assessment, carried out in all euro areas countries, of the compatibility of their labour and product markets with membership of EMU. And third, for the issues identified in this assessment to be addressed through the new concept of "Reform Contracts". Let me elaborate some more on this last point.

The idea behind the "Reform Contracts" is that countries would commit to specific structural reforms that have a direct positive impact on competitiveness, with those commitments formalised in a legally binding contract. The contract would be multi-annual and, to foster national ownership, initiated by the national government and approved by the national parliament. If the terms of the contract were met, financial support would be provided, targeted at the transitional costs arising from structural reforms – for instance, re-training programmes for displaced workers.

What are the benefits of this approach compared to the *status quo?* In my view there are three, although they depend very much on how the concept is eventually implemented.

First, the contracts could be entered into as part of a concerted national reform effort, rather than being seen as an imposition from "Brussels" in the context of the EU procedures like the European Semester.

Second, reform commitments could potentially be more precise, measurable and binding in the contracts than under those existing procedures. However, this effect would quickly be lost if it simply becomes another bureaucratic procedure.

Third, and perhaps most importantly, because the contracts are multi-annual they could allow for deeper reforms than are possible under existing procedures. There have been a series of recent studies that suggest that competitiveness is not only about flexibility, but also strongly connected to governance. We see clear correlations between countries' economic

performance and their rankings in governance indices published by, among others, the World Economic Forum and Transparency International. The contracts provide an opportunity, if used properly, to "go deep" and address these more fundamental barriers to competitiveness.

Building a stronger economic union along these lines is necessary to correct what might be called an "original sin" of EMU: the fact that the convergence criteria did not include any structural benchmarks for joining the euro, and hence structural policies remained mainly within the national remit.

3. Areas for further progress in the future

What about those areas that were not outcomes of the European Council and where there is room for further progress in the future?

The most important is greater sharing of sovereignty. The importance of credible governance has been starkly demonstrated during the crisis. Countries without credible policies have been forced by markets to consolidate more rapidly than others in the downturn. This is because markets have not trusted that they can run sufficient surpluses in good times, or achieve sufficient growth, to lower debt levels and ensure long-term sustainability. Paradoxically, the lack of strong external constraints on fiscal and economic policies has led to countries *losing* substantive sovereignty in these areas.

By the same token, countries now need to share more sovereignty in order to *regain* their sovereignty. By sharing decision-making with the European level, they can restore their policy credibility with investors, while at the same time having a voice over where they are heading. This will mean going beyond the Maastricht logic of national responsibility for fiscal and structural policies, and committing to governance arrangements that are actually enforceable – for instance, allowing for intervention rights by the center to prevent unsound national budgets.

Sharing sovereignty implies a number of other changes to euro area governance. First, there have to be strong institutions in order to exercise that sovereignty effectively. This will require a stronger Eurogroup. Second, those European institutions have to be properly democratically legitimated. This requires changes in the way the citizens participate in the European political process, in particular via the European Parliament.

Let me stress: while I would have liked the outcome of the European Council to be more ambitious, these ideas are not intended as criticism of it. They are orientations to advance further which will need to be properly fleshed out in the years ahead as the integration process evolves. This will require a Treaty change in the medium-term in order to complete EMU in a comprehensive way.

4. Conclusion

One year ago, the euro area was facing an uncertain future. But those painted a dark picture at that time have been proven wrong. One year later, Europe has proven its ability to act and we have begun to set the euro area on a more convincing path.

It is now critical that, over the next year, we continue down this path and provide EMU with institutions it needs to advance. Putting in place a genuine financial union and a stronger economic union must be our key priorities for 2013. It is essential that the appearance of calm on financial markets does not distract from the urgent need to address the euro area's fundamental challenges.

Moreover, we should also not row back on what has already been achieved. Implementing the Fiscal Compact and adopting the "Two Pack" of legislation in 2013 are essential to strengthen the fiscal framework. We should not undermine this by re-opening discussions on what constitutes "good" or "bad" deficits by arguing for exemptions for public investment. All

deficits have to be financed on financial markets and increase public debt stocks – and this is the opposite of what we need next year.

However, this focus on 2013 does not mean we should lose sight of the big picture. It is instructive to notice how little markets are reacting to the "fiscal cliff" debate in the US, while they are jolted by the prospect of earlier than planned elections in Italy.

Our long-term goal is a situation where the essential functioning of the euro area is unaffected by events in individual countries, because sovereignty is shared and exercised in strong common institutions – and those institutions have a longer time horizon than politics.

This is what Jean Monnet understood when he said:

> *"Rien n'est possible sans les hommes, rien n'est durable sans les institutions".*
>
> *"Nothing is possible without men, but nothing is lasting without institutions".*

These words have never been more true than today.

Thank you for your attention.