Jörg Asmussen: Saving the euro

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at The Economist's Bellwether Europe Summit, London, 25 April 2013.

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Ladies and gentlemen,

First of all, let me thank the Economist for inviting me to speak on this panel on "Saving the euro".

This is a catchy title – but, in truth, I think it is out of date. The euro is already "saved". It will survive this crisis, it will emerge from it stronger and more countries will join the euro in the future.

The problems we are facing today are different: how to avoid a "lost decade" of stagnating growth and high unemployment; how to deal with unhealthy bank balance sheets; how to answer to the understandable frustration of many citizens who do not see a "light at the end of the tunnel".

In other words, we are not facing an acute or terminal sickness, but as the IMF recently noted, a chronic one, that could cause us pain for years to come unless we fix it.

And fixing it is complex. We are simultaneously facing a banking crisis, a crisis of public and private debt, a competitiveness crisis and a crisis of trust in institutions and political decision making. There is no magic bullet that can solve it. We are in the middle of a decade of adjustment.

But this of course begs the question: what *can* we do?

And this is what I want to focus on in my remarks today: what it is realistic to expect the euro area to achieve – and what it is not. In particular, I want to answer three questions:

First, should the ECB be doing more?

Second, how can we overcome the political challenges to adjustment?

Third, how will Economic and Monetary Union (EMU) develop from here?

Should the ECB be doing more?

Starting with the first question, "should the ECB be doing more"?

First of all, it is important to understand that the ECB has already done a lot.

We have given funding to banks at fixed rates and in unprecedented volumes. We have lent at up to 3 year maturities. And we have widened the collateral that can be used in our operations, allowing national central banks to differentiate, within limits, according to their domestic conditions.

More recently, with Outright Monetary Transactions, we have taken tail risks out of the market by creating a fully credible backstop against unfounded fears about the euro area.

All this has prevented that bank funding tensions created a general credit crunch, as well as helped normalise financial conditions across the euro area. Target-2 balances have fallen by almost 20%, or 200 billion euro, from their peak last year. Banks' access to funding is slowly improving, including in some of the peripheral counties. This is reflected by the fact that many banks decided to repay early a substantial part of the LTRO funds adding to 274 billion Euro or half of the initial net liquidity injection.

But as you know, there are some key indicators where we are still not seeing an effect. Availability of credit to SMEs in some parts of the euro area remains constrained. More

generally, growth remains weak and unemployment, especially for young people, is unacceptably high.

This has led many people, especially in this country, to ask, "why doesn't the ECB do more? Why doesn't it copy the measures of other central banks like the Fed, the Bank of England or the Bank of Japan?"

This is of course a very complex issue – and there are three dimensions to the answer.

First, we have to respect our mandate, which is price stability. This means that there are certain ideas – like allowing higher inflation, or targeting a rate of employment – that we simply cannot entertain.

Second, we have to work within the financial structure we have in the euro area.

The two key facts about this financial structure are that it is bank-based, rather than capital market-based, and that there are multiple benchmark interest rates, rather than a single rate universally acknowledged as "risk free".

This means that large-scale asset purchase programmes targeted at capital markets would not be very helpful in the euro area. And it means that policies like forward guidance or QE, which aim to push down the risk-free rate, are not easily applicable here.

Moreover, a more recent feature of our financial structure is financial fragmentation. This implies that lower interest rates have asymmetric effects, and not in the direction that we want them.

Due to impaired monetary policy transmission, the pass-through of rate cuts to the periphery would be limited, and this is where they are most needed. At the same time, rate cuts would further relax already unprecedentedly easy financing conditions in the core. This is not *per se* a problem – but interest rates that are too low for too long can eventually lead to distortions. In particular:

- to a misallocation of resources, which ultimately leads to lower potential growth,
- to excessive capital inflows into a number of emerging economies with exchange rate effects and credit risks,
- and to reduced incentives for governments, banks, and corporates to adjust.

These costs of very low interest rates are real, and they rise over time. Of course, these costs have to be weighed against the need for exceptional monetary policy measures in a crisis.

These transmission problems bring me to the third dimension: we have to recognise the limits to what monetary policy can achieve in current conditions.

The ECB can and has addressed bank funding problems. But there are other barriers holding back bank lending, like heightened risk aversion, a lack of loan demand and insufficient capital. And above all, bank lending will only fully come back when the bank balance sheet repair is completed in all member states. The ECB cannot remove these constraints. This is where our responsibility ends and that of governments or other EU institutions begins.

Monetary policy is not an all-purpose weapon for any kind of economic illness.

How can we overcome the political challenges to adjustment?

Some of you might react to this that governments are already being asked to do too much. That the costs of adjustment are too high in some countries, and at some point, people will simply not take anymore.

This links to my second question: how can we overcome the political challenges to adjustment?

Let me be clear: every policy-maker in the euro area understands that the process of rebalancing within the euro area is painful. We are deeply concerned by the levels of unemployment we are seeing, in particular for young people.

In Spain, more than 5 in 10 young people currently cannot find work. In Greece, the figure is almost 6 in 10. This is unacceptable – and it is also dangerous.

But the political challenge, I believe, comes not from the process of adjustment itself. People can accept a period of hardship if it is necessary.

It comes from the belief that there are better alternatives available that are being denied. This is what causes people to reject adjustment, or to blame others at home or abroad for their predicament.

This is fine as far as it goes: we are democracies and we need a robust public debate. But it becomes a problem when the debate does not contain all the facts. If politicians put forward supposed alternatives, then they also need to be honest with citizens about their consequences.

Take for instance the common claim that "austerity has failed" and that, to get back to growth, fiscal policy has to be loosened.

This may sound attractive at first sight, but delaying fiscal consolidation is no free lunch. It means higher debt levels. And this has real costs in the euro area where public debts are already very high.

First, it puts countries back at the mercy of financial markets, which may or may not choose to finance the new debt at affordable rates. We should, after all, not forget that financial markets create our own "debt ceiling" in the euro area and several countries are pressing up against it. This also reduces their room for fiscal stabilisation in the future, which is essential in the euro area where we have no federal budget.

Second, it leads to an ever greater proportion of revenue going on servicing debt, rather than investing in future growth. In Italy, for instance, around 80 billion euros a year goes on debt service – this is more than 10% of the annual budget which is not being spent on education or infrastructure.

Third, it simply passes the burden of consolidation to the next generation. Under the new EU debt rule, all euro area countries are legally bound to start reducing their public debts below 60% of GDP. So the more debt rises today, the more it has to be brought down in the future. And six euro area countries *already* have debt levels in excess of 90% of GDP.

In short, delaying fiscal consolidation is not an easy way out – if it were, we would have taken it. Countries are consolidating because, given their already high debt levels, it is the best way to secure long-term stability and inter-generational fairness.

It would help the politics of adjustment if this message got more attention.

Another claim that we sometimes hear is that countries should put off structural reforms; that combining them with fiscal consolidation in the current economy will only make the downturn worse.

But again I have to ask, what are the consequences?

First, it is, in a sense, only delaying the inevitable. The growth models of a number of euro area countries, based on ever-rising public spending, or a particular booming sector, are over. Change had to come. Several are facing an unavoidable period of "double deleveraging" in both the public and private sectors. If they want economic growth, it has to be through a more competitive, export-led model – and this can only happen through structural reforms.

Second, far from being separated from fiscal consolidation, structural reforms are essential to make fiscal consolidation work. If people see only budget cuts and tax rises, with no

measures to produce higher growth, it is no wonder they reject adjustment. We have seen this for example in Italy. By contrast, the experience of Latvia shows that frontloaded reform and consolidation efforts can lead to a quick bounce-back in growth and employment.

Third, those who reject structural reforms often overlook a key aspect from the debate, which is their wider social effect, in particular on fairness. Ultimately, structural reforms benefit the many at the expense of the few. And this is key during a crisis like this where inequality is on the rise.

By breaking down two-tier labour markets, like in Spain, they create opportunity for excluded young people. By opening up closed professions, like in Italy, they help reduce persistently high inflation that erodes real incomes. By reforming tax administration, like in Greece, they ensure the burden of consolidation is spread more fairly over different social groups.

A recent OECD Report called this the "Double Dividend" of structural reforms: they increase growth, and if implemented properly, decrease inequality.

To sum up, overcoming the political challenges to adjustment is fundamentally about *communication*. It is about pointing out the real costs of alleged alternatives; about resisting the temptation to blame others for problems that begin at home; and about explaining the long-term benefits of the path being taken.

Ultimately, however, this is the job of political authorities.

How will EMU develop from here?

If this is what governments can do to get through the crisis, what can the euro area as a whole do? How will – my third question – EMU develop from here?

I think it goes without saying that anyone who is expecting the creation of the United States of Europe anytime soon will be disappointed or – in this country maybe – relieved. But that said, we have made, and will continue to make, big strides in building a more robust institutional architecture for EMU.

And let me stress: this progress is not all for the future, to prevent the next crisis. It could feed into this one, too. In particular it could help boost the three "Cs" that are key to restart growth: *credit*, *confidence* and *competitiveness*.

First, the initiatives that have been taken, and that are in store, to build a Banking Union could give an important stimulus to *credit*.

Having in place a credible single supervisor, which is now agreed, should encourage the gradual reintegration of financial markets, which will improve the transmission of the ECB's monetary policy. On top of this, an effective single resolution mechanism and a fund filled by levies from the industry should kick start a clean-up of banks' balance sheets, preventing "zombification" and unblocking new lending. That is why this is the key challenge for this year.

Second, the new measures we have in place for Fiscal Union could do a lot to bolster *confidence*.

By limiting the "wiggle room" for future governments, the fiscal compact should help anchor medium-term expectations about fiscal responsibility and debt sustainability. This will be complemented by the new "Two Pack" of legislation, which creates real intervention rights from the centre into national affairs, for instance allowing the Commission to pre-screen budgets before they are adopted by national parliaments.

Third, the plans in place for Economic Union could help ensure *competitiveness*, in particular the new idea of reform contracts.

The enhancement of the governance framework shows that governments in the euro area have *finally* understood, what had been laid down in the Maastricht Treaty already: that in a

monetary union, the economic policies of each country are “a matter of common concern” for all.

If questions about the Slovenian banking sector remain unanswered; if worries about French competitiveness remain unaddressed; if an ageing German society cannot better integrate migrants into the labour market – this has an impact on *all* countries of the single currency zone.

It is therefore right and legitimate, that the euro area countries establish – and accept – much closer oversight of national decisions. Other countries may see this differently. But the euro area has to move ahead with deeper union. Like it or not, the euro area has become the engine of European integration, for its own sake, and that of the EU as a whole.

This process is not a threat to the idea of the European Union. The fiscal compact and the SSM show that countries that are willing and able to fulfil the requirements are invited to join. As David Cameron recently said in his Bloomberg speech on Europe, this kind of flexible integration “far from unravelling the EU, will in fact bind its Members more closely”.

Conclusion

Let me now conclude.

My aim has been to create realistic expectations about what we can and cannot expect the euro area to achieve.

We in the euro area have already done a lot to stem this crisis. Budget deficits have been significantly reduced. Rules have been strengthened. With the EFSF and the ESM, 700 billion euros have been put on the table for financial assistance.

But we also have to work within our laws and institutions. And we have to take the people along. We cannot manage the crisis by diktat or impose leaps in integration for which people are not ready. This means that our progress will be slow, incremental and at times messy.

As the Economist’s own Charlemagne columnist noted when reviewing the outcome of 2012, “the pessimists did not overestimate the euro’s problems, so much as underestimate the political will to do enough to stop a euro break-up.”

And anyone who continues to underestimates this will turn out either very wrong, or if you are an investor, very poor.

Thank you for your attention.