# Jörg Asmussen: Cooperation and diversity – principles for a stable euro area

Acceptance speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at Bocconi University on the occasion of the award ceremony "Alumnus of the Year", Milan, 25 October 2013.

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Dear Professor Monti, dear Mario,

Dear Professor Sironi,

Dear Mr Guindani,

Ladies and gentlemen,

I was a bit surprised when my assistant told me that Professor Monti would like to have a telephone conversation with me. I thought, when the former Italian Prime Minister wants something from the ECB, why doesn't he call the other "Super Mario", the ECB President. But I returned his call immediately, of course. Surprise and joy were tremendous when he informed me about the decision of Bocconi University to grant me the award "Alumnus of the Year 2013".

I feel very honoured and I am very grateful to receive this award and I see it as an obligation for the future at the same time.

I would like to thank Mario Monti for his very kind introduction. It is generous of Mario to say repeatedly that he knew me during my MBA here in 1991-92, but I suspect there was some asymmetry in the relationship. I was a student and he was the Rector, so I think it was rather that I knew him!

My choice to study an MBA degree at Bocconi may have had something to do with the old German craving for Italy. If there is such thing as an emotional relationship between peoples, then for sure between Germans and Italians, just think of Goethe's Italian Journey and the quest for Arcadia and, on the other hand, the long-standing Italian admiration for German efficiency and our sense of order.

The time I spent at Bocconi I look back on with great fondness. It was a privilege to study in one of the great seats of learning in Italy and Europe. And I see this period as one that helped forge the views that later served me as a European civil servant and policy-maker.

When I studied here aged 25, I was coming from northern Germany with little first-hand experience of other cultures besides the Danish one. But being here at Bocconi changed all that. It was a truly multicultural environment, with students from 26 different nations from around the globe, working side by side. I shared a flat with two Turkish students. All these experiences taught me some key lessons.

The first lesson was the value of cooperation. We learnt at Bocconi that on average teams achieve better results than individuals. Only brilliant individuals are better than groups, but most of us are not brilliant. Our work was always conducted in groups and we got one mark. We had to stand or fall together.

The second lesson was the value of diversity. I brought with me my German traditions, others brought their own cultures. But none was better or worse – in fact, this diversity simply provided an opportunity for more learning.

It is not hard to see how these lessons have helped me in my professional life, in particular in tackling the crisis. In the euro area, ultimately, we also only get one mark. We cannot have a stable monetary union where some succeed and others fail – we have to advance together.

Yet we also need diversity. There is no single economic model that fits all countries. This is why we need to learn from each other about which kind of policies produce jobs, increase our growth potential, secure equality of opportunity as well as participation, and find ways to apply them in our national contexts.

In keeping with these themes, I would like to use my remarks today to lay out a pragmatic vision for combining cooperation and diversity in the euro area – or put differently, for building a more integrated economic and monetary union that respects our differences. In particular, I would like to present what I see as the rationale for a banking union and sketch some first ideas about a fiscal union in the euro area in the medium term. My focus is the euro area, which in my opinion is the core of future integration. But it is an open core – whoever is willing and able to join is welcome.

For reasons of time, I will today not tackle economic union, which is an essential part of a complete economic and monetary union, and neither will I touch upon political union, without downplaying its importance. Progress on fiscal union can only be achieved by progressing on political union in parallel. In general, as Mario Monti and Sylvie Goulard highlight in their recent book[1], greater European integration has to be accompanied by greater "democracy by the people". At the end of my speech, I will use Italy as an example of what should be done at the level of the Member States in the euro area.

## Banking union

Let me start with banking union.

Here I think the key problem in the past was that there was too little cooperation and too much diversity – we lacked a coherent European approach to financial sector policies. But there is clearly scope for more cooperation today as, particularly after the experience of the crisis, preferences are more aligned in Europe. We all want banks that are well supervised and that can be resolved at minimum cost to the taxpayer.

To achieve this, I think we need not reinvent the wheel. There are elements of the US approach that have worked and that we can usefully borrow in Europe. These fall into two basic categories: first, what I call the US's "public banking union" – its federal institutions for dealing with banking crises. Second, what I dub its "private banking union"– its integrated financial market that dissipates the costs of crises.

### *Public banking union*

Clearly, the key difference between Europe and the US is that banking problems in the US have been mainly taken care of at the federal level, whereas in Europe responsibility for troubled banking has thus far remained national.

During the crisis in the US, it was federal institutions that stepped into the breach. The Federal Deposit Insurance Corporation (FDIC) resolved 490 unviable banks, using resources from its deposit insurance fund financed by all the banks. The US Treasury provided recapitalisation support and guarantees through its Troubled Asset Relief Program (TARP). The Federal Reserve undertook a thorough stress-test, determining banks' additional capital needs.

To understand the situation we are in in Europe, it is useful to make a thought-experiment, and imagine that no such federal institutions exist in the US. Imagine that the state of California would have had to come up with the TARP money for Wells Fargo instead of the US Treasury. Imagine that the state of New York would have had to provide the guarantees to Citigroup. Think about how the markets would have treated these states? And how they

[1] M. Monti and S. Goulard, *Democracy in Europe* (2012).

would have treated these banks? The lesson for the euro area is clear: federal institutions can prevent local crises from becoming systemic.

In Europe, we do not yet have these federal institutions that can act as shock absorbers. So far, responsibility for dealing with bank problems lies exclusively with the individual EU countries. The result is that – to quote an FT editorial – "national taxpayers subsidise banks implicitly in good times, explicitly in bad times, and suicidally in a sovereign debt crisis".

Indeed, the crisis in Ireland has shown that problems in domestic banks can overwhelm the fiscal capacity of national sovereigns. The causality can also be the other way around, as the case of Greece has shown, where fiscal problems have dragged down the banking system. These countries got caught in a vicious fiscal-financial feedback loop, which in the end also drags down the economy, breaks up the internal market, and impairs our monetary policy conduct. Removing this vicious feedback loop is what Banking Union is all about.

Creating a banking union will be good for the euro, good for the internal market, and good for the recovery. It will be good for the euro, because it will help to repair our monetary policy transmission mechanism. In other words, it will ensure that the ECB's low interest rates will be effectively passed on to those countries that probably need them most. It will be good for the internal market, because it will be of help to reverse the significant financial fragmentation that we have seen so far. And it will be good for the recovery, as banks will be put on a stronger footing, confidence will be improved, and ultimately credit will start to flow again to enterprises on affordable terms.

But what are the necessary elements of a banking union? To our mind, two elements are indispensable: a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM).

Let me start with the Single Supervisory Mechanism. The ECB has been asked to assume responsibility for this mechanism, and to mould the existing national supervisory authorities into an effective and efficient federal supervisory team. We are making good progress on this front, and the SSM should become fully operational in the last quarter of 2014.

Before we take on this task, we want to get an adequate view of what we will be supervising. In the coming months, the ECB will therefore undertake a balance sheet assessment. The importance of this exercise cannot be overestimated. It is an extraordinary opportunity to rebuild confidence in the banking sector and promote the long overdue repair of bank balance sheets, which in turn is a precondition for a sustainable economic recovery.

One particular point needs to be stressed: credible national backstops must be put in place. If not, the credibility of the whole exercise is put at risk as the outcome will then almost certainly be negatively perceived by market participants. Doing this balance sheet assessment without a backstop in place would be a bit like getting on a boat in rough weather conditions, and not taking a life jacket on board. Any recapitalisation needs uncovered by the exercise should of course first and foremost be covered by the market. National budgets may intervene as a second line. Finally, a European backstop, the ESM with its existing instruments, may be available.

The second key element of a banking union is the Single Resolution Mechanism, a European equivalent to the Federal Deposit Insurance Corporation. The crisis has shown that simple coordination among Member States has been inadequate to organise the resolution of cross-border banks in an efficient, least-cost manner.

The Single Resolution Mechanism contains three essential elements: first, a single regulatory framework. This has been established but has not yet entered into force with the Bank Recovery and Resolution Directive (BRRD). The second element is the single resolution authority and the third, a single resolution fund, funded by contributions from the financial industry. The last two elements are currently in the legislative process and we strongly support the envisaged timeline for their entering into force (1 January 2015), as it ensures

that the establishment of the Single Resolution Mechanism would follow shortly after the effective start of the Single Supervisory Mechanism.

### *Private banking union*

The "private banking union" in the US is created by its integrated financial market, which includes both the banking sector and capital markets.

In the banking sector, the US has genuinely nationwide banks, which allows them to better diversify risk. If such a bank makes losses on loans in one state it can offset them with gains in another – thus at least in part internalising the costs. In the euro area, however, banks tend to have a more domestic focus, meaning losses in one country are more likely to exhaust the capital of the domestic banks.

In the capital markets, the US has integrated equity and debt markets, allowing losses from bank failures and corporate insolvencies to be dispersed across the whole market. In the euro area, by contrast, cross-border capital markets are only partially developed, which means the effect of a negative economic shock is fully concentrated at home. In Germany and France, for example, around 85% of equity is held domestically.

One should not underestimate the importance of this: it has been estimated in a paper that two-thirds of economic shocks in the US are absorbed via the integrated financial market.[2] While the launch of the euro seems to have encouraged more private risk-sharing between EMU countries, it remains at much lower levels than between US states, and markets are vulnerable to fragmentation.[3]

This point underscores that the private and public banking unions are to a significant extent interdependent. Having a strong set of federal institutions can stop market failures such as a fragmentation during a crisis. Similarly, having a single financial market can make the task of federal institutions easier, in particular for resolution, as it allows mergers and takeovers to be used as a primary resolution strategy.

Indeed, 450 out of the Federal Deposit Insurance Corporation's 490 bank resolutions since 2008 have involved what is called "Purchase and Assumption" – selling parts of banks to other banks, often located in different states.

The conclusion from this is simple: completing the banking union and completing the single financial market go hand in hand.

## Fiscal union

Let me now turn to the fiscal union.

For the fiscal union, finding the balance between cooperation and diversity is more difficult. National preferences for taxing and spending are stronger, and the case for elevating certain functions to the European level is more complex.

And there can be no taxation without representation, meaning any shift to a more European fiscal policy must be accompanied by the same shift towards European democratic control.

So to frame the discussion, I think it is helpful to recall the taxonomy of economic policy functions described by Richard Musgrave. He distinguished between stabilisation, allocation and distribution. Broadly speaking, stabilisation helps smooth the business cycle, allocation

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[2] B. Sørensen and O. Yosha (1996), "Channels of interstate risk sharing: United States (1963-1990)", The Quarterly Journal of Economics, November, pp. 1081–1111.

[3] Y. Demyanyk, C. Ostergaard and B. Sørensen (2008), "Risk sharing and portfolio allocation in EMU", DG Ecfin Economic Papers 334.

ensures that resources are used efficiently and distribution ensures an equitable sharing of income.

Which of these functions do we need at the European level for fiscal policy, and in what form?

### *Stabilisation*

Starting with stabilisation, there is a long-standing debate in Europe about whether monetary union needs a federal budget to support counter-cyclical stabilisation. As you may know, the report by the four Presidents on a genuine EMU suggested that a small fiscal capacity could be used for this purpose.

I do not want to comment on the specifics of this proposal, but there are questions about whether national preferences are sufficiently aligned to permit it. For that reason, we have to think carefully about whether it is essential for the euro area. In particular, we have to consider how having a genuine banking union might change the debate.

As you know, stabilisation in Europe takes place through national budgets and, in normal circumstances, they are sufficient to smooth the cycle. A recent study demonstrates that 47% of an unemployment shock is absorbed by the automatic stabilisers in the EU, compared with only 34% in the US.[4] They were insufficient in some countries during the crisis only because they faced an exceptional circumstance: a very large shock from the financial sector.

With a genuine banking union, however, the risk of this happening again should be lower. First, we expect the SSM to increase the quality of supervision and the assessment of systemic risk. Second, if a financial shock were still to appear, national budgets should be better insulated. The costs of banking sector repair would be shared with the private sector through the Single Resolution Mechanism and a more integrated European financial market.

All this suggests that stabilisation at the national level could be more effective in future. Or put differently, the more successful we are in building a genuine banking union, the less we would need a central budget for stabilisation purposes.

However, this does not mean I see no role for fiscal union in the stabilisation area.

First, we would need the public backstop, namely for the resolution fund, which would be fiscally neutral over the medium-term. In my view the ESM could play this role.

Second, we would need an insurance mechanism against tail events that may still arise and endanger euro area financial stability. Here we already have the ESM to act as lender of last resort to sovereigns.

### *Allocation*

Turning from stabilisation to allocation, I see a role for a fiscal union that performs an allocative function – ensuring resources are used efficiently.

In the literature, this typically refers to the provision of public goods, and in this context one possibility is to use common funds to incentivise growth-enhancing reforms. However, I will not discuss this in detail today, even if I think that this is a good idea, especially for the euro area, including an own revenue source.

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[4] A recent study demonstrates that automatic stabilisers absorb 38% of a proportional income shock in the EU, compared with 32% in the US. In the case of an unemployment shock 47% of the shock is absorbed in the EU, compared with 34% in the US. This cushioning of disposable income leads to a demand stabilisation of up to 30% in the EU and up to 20% in the US. See: M. Dolls, C. Fuest and A. Peichl (2012), "Automatic stabilizers and economic crisis: US vs. Europe; Journal of Public Economics", Elsevier, vol. 96(3), pp 279–294.

Instead, I want to focus on a different aspect of allocation: taxation. Differences in tax regimes create hidden barriers and inefficiencies in the single market, and in my view one function of the fiscal union should be to remove them.

These hidden barriers hinder both financial and economic integration. Different rules for taxing dividends, for example, discourage cross-border investments in equity.[5] Different corporate tax regimes mean companies do not necessarily invest where production is most efficient, but where they receive the higher after-tax return.[6] While the Commission has made some progress in addressing these issues, the overall approach to tax policy in Europe remains piecemeal. Yet at this time, when growth is stalling and markets are fragmented, I see clear benefits to greater cooperation that deepens the single market, focusing on the taxes that are most important for the functioning of the single market, e.g. corporate taxation and capital taxation.

In my view, this implies a more coherent strategy based on three prongs.

The first is harmonising *tax codes*. This would mean removing distortions to cross-border activity created by problems such as double taxation or different treatment of residents and non-residents.

The second is harmonising *tax bases*. I see the common consolidated corporate tax base as a good way forward here, as it would make tax levels more comparable and allow firms to file a single consolidated tax return for their EU activity, thus supporting the single market.

The third step would be to focus on harmonising *tax rates*. Some tax competition is healthy, but in a single market it has to be within limits. For example, we could think of agreeing a minimum floor for corporation taxes.

Ideally, such a strategy would involve all EU countries. But if this is not feasible, euro area countries could lead the way by deepening the fiscal union in this area.

### *Distribution*

A harmonised approach to tax policies could also have a distributive function – the third part of Musgrave's taxonomy. I see this as an appropriate role for a euro area fiscal union to play.

We have witnessed several examples in recent years of multinationals arbitraging tax systems to pay less than their fair share to society. We have also witnessed the possibility for cross-border tax evasion from wealthy individuals. A more cooperative approach to tax policy could counteract this and would be in the interest of all countries. It would also be a timely reminder to citizens of how the Union can defend their interests.

It goes without saying, however, that there is too much diversity on the wider questions of distribution for these to be answered at the European level in the medium term.

To sum up: a functioning banking union reduces the need for the stabilisation function of a fiscal union, but not to zero. Greater efforts should be invested in the allocation function.

## Conclusion

Ladies and gentlemen,

I have laid out what I see as a realistic medium-term vision for the euro area, which combines the twin needs: cooperation and diversity.

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[5] European Commission (2012), "Taxation of cross-border dividends within the EU".

[6] S. Bond et al (2000), "Corporate Tax Harmonisation in Europe: A Guide to the Debate", Institute for Fiscal Studies.

But for the euro area to prosper, we also need a third concept: responsibility. As we are all in the same boat, every country has a responsibility to pull its weight. Diversity is welcome but it cannot become a shield against change.

Having lived here for two years, I would not be as pessimistic as Barry Eichengreen, who in a recent commentary wrote: "And the biggest problem is yet to come, namely an Italy that is unable to grow, incapable of reforming, and burdened with what increasingly looks like an unsustainable debt."[7]

Indeed, the euro area cannot prosper if its third largest economy has a potential growth rate of zero. Italy has to grow, and this will not happen by waiting for the cycle to turn. The challenges for Italy are long-term and the solution is structural. We need only look at the trends to see this: its real growth rate was 5% in the 1950s, 4% in the 1960s, 3% in the 1970s, 2% in the 1980s, 1% in the 1990s, and 0% in the 2000s.

Italy is too big to be rescued from the outside, it has to make the turnaround on its own. Its fate will critically determine the fate of the euro area. In this sense, the future of the euro area will not be decided in Paris or Berlin, or in Frankfurt or Brussels. It will be decided in Rome.

But because of my personal experiences in this country, I neither worry about the future of this country nor about the future of the euro area. On the contrary: the vivid entrepreneurship in this country, its world-famous creativity, the power of its civil society and citizens, its educational system with institutions such as Bocconi and now maybe the evolution of a new political system are promising.

I hope that Italian citizens will rally behind such efforts, because reforms will lead to growth, growth leads to maintain debt sustainability, and growth can be shared with the whole of society.

As I said: the turnaround is in your hands, but your friends will be with you.

Let me again thank you for the award given to me. I am touched and honoured and promise to keep on working to further build our European house in the 21st century.

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[7] Finanz und Wirtschaft, 15 October 2013, "Germany's Complacency Problem"; (http://www.fuw.ch/article/germanys-complacency-problem/).