Luis M Linde: “The New Hegemon or Last Country Still Standing”

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at the Frankfurt Finance Summit 2014, Panel IV: The New Hegemon or Last Country Still Standing, Frankfurt am Main, 20 May 2014.

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As a result of the crisis, the institutional and intellectual setup of European Monetary Union is being deeply revised. Fresh views on the role of stability across several dimensions – including fiscal and macro-financial – have emerged and taken over the old approach of the Maastricht Treaty. Several players, including, indeed, the ECB, are contributing to this overhaul.

I would like to review the main elements of the old institutional setup, the weaknesses revealed by the crisis and the way a reinforced culture of stability is contributing to their repair.

The monetary union designed in Maastricht included, in addition to the ECB and the single monetary policy, a relatively loose governance framework for the euro area based, first, on a fiscal discipline device – the Stability and Growth Pact – and, second, on coordination for the remaining economic policies – the Broad Economic Policy Guidelines –. The setup also relied on governments, households and firms being able to internalise the stability patterns required within a monetary union and counted on financial markets penalising those who would not do so.

What we observed before the crisis, and what we became painfully aware of when it erupted was, however, that public and private agents in some countries did not change their behaviour, that financial markets did not play any disciplining role and that the loose application of the Stability and Growth Pact and the Broad Economic Policy Guidelines rendered them ineffective as stabilisation devices. The Pact and the Guidelines were not strong enough to prevent the accumulation of a series of imbalances.

We also discovered two other gaps during the crisis: too little attention had been paid to how financial markets work within a monetary union and no crisis management mechanism was available.

To be stable, the European building needed operational repairs. The stability principles, as conceived in Maastricht, were insufficient and a new culture of stability had to take over.

The ECB acted on several occasions to curb the so-called “tail risks” – the risk of the monetary union breaking up – and to gain the time needed for others’ actions to bear fruit. It is worth noting, however, that monetary action can hardly go beyond this as the cracks detected in the building were not of a monetary nature. At the Member State level, fiscal consolidation policies and structural reforms were needed and are being implemented to better accommodate domestic behaviour to the patterns of stability required within a Monetary Union.

As for euro area governance, a deep process of reform has been undertaken. The Stability and Growth Pact has been strengthened to preserve fiscal stability; and a new procedure – the Macroeconomic Imbalance Procedure – has been established to prevent the accumulation of other non-fiscal imbalances. Also, the European Stability Mechanism and the banking union process have filled in two serious gaps.

Now, to conclude, I shall try and respond to the questions to this panel about Germany’s role in the European debt crisis and whether Germany is a reluctant hegemon.

Indeed, Germany has played a key role in the response by the European Monetary Union to its financial and fiscal crisis and to the dangers this crisis has entailed for the Union and the euro. In early 2012, many analysts and politicians considered it very possible that certain countries might exit the Monetary Union, thereby triggering an extremely serious crisis. Many believed the European Monetary Union was running an almost terminal risk, at least in its formulation under the Maastricht Treaty.

To Germany, then. Its economy and its Government have been fundamental in facing and overcoming these risks. Without a German political stance in defence of the Monetary Union and the euro, the single currency would surely not have survived. Obviously, Germany has not acted alone, but as the euro area's leading economy, its role has been crucial.

I do not believe Germany may be said to have exercised this role reluctantly. In Germany, as in other euro are countries, there were and are forces in disagreement with the Monetary Union, analysts and economic agents who considered the break-up of the euro as likely. But what counts is what the German Government's position was and its support, at key moments, to save the Monetary Union and the euro, its support to the programmes for stressed countries and the Banking Union process.

Rather, we can say that the new hegemon is the culture of monetary and fiscal stability that has gained in strength over the course of the crisis.

The strengthening of the institutions and of the rules to ensure fiscal stability is essential for maintaining the stability of the Monetary Union and of the euro. This is because, as we all know, the source of the Monetary Union crisis lay basically in certain countries' fiscal performance, even more so than in the banking crisis which has also affected – to differing degrees of intensity – virtually all the euro area members.