Yves Mersch: Law, money and market – the legal dimension of monetary policy

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Information Club Meeting, Luxembourg, 31 May 2014.

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Ladies and gentlemen,

Thank you very much for inviting me to speak at this event.

What I would like to address in my remarks is what went wrong with the governance of the euro area and how to fix it. But as this has been much discussed in the past, I want to come at the question today from a slightly different perspective: that is, to go back to the first principles of what makes a market economy function, and then to look at the situation in the euro area from there.

1. Law, money and the market

A well-functioning free market is a socio-economic construct. It is created by a consistent accord of rules, instruments and institutions.

As economies develop, what this accord entails changes. But at the most fundamental level there must be a harmony of law, money and freedom. This is because the rule of law guarantees the freedom of the individual by defining the scope and boundaries of his or her action. And in turn, it is the freedom of the individual that creates the agency and choice which is essential to produce a free market to the benefit of the whole society.

The way money fits into this framework was well illustrated by Nicolas Oresme, who was bishop of Lisieux and adviser to Charles V, the king of France. In 1360 Oresme initiated a sweeping monetary reform after a period in which the currency was debased many times. A comment that is attributed to him at this time is that *"Money must be as solid as a law, as stable as a law of nature".*[1]

In essence, what Oresme was saying was that solid law and stable money are two sides of the same coin (if you will forgive the expression). They both support the ends of the individual. The law exists to create an environment in which individuals can make free and safe decisions. Money is the same. And both are pre-conditions for a market economy to function.

Even one of our most famous Luxembourgeois, John the Blind, implicitly appreciated these interactions. By experimenting with various currency reforms he sought to ensure that each coin in his realm would have the same value in trade and commerce, regardless of its geographic origin or disparities in physical appearance. At the time of course the debate was about the law of God taking precedence over the law of kings. But fittingly, his motto was "Ich dien" – German for "I serve". And indeed, this notion of money as "public service" was exported and lived on: the same phrase appeared on British two pence coins until 2008.

Thus, there is a long intellectual tradition linking rule of law and sound money to functioning of free markets. But this connection found perhaps its clearest expression in the ordoliberal school that developed in Germany in the 1930s. Conceived at the University of Freiburg by Walter Eucken and Franz Boehm, the central understanding of ordoliberalism was that a stable and well-functioning market economy required a strong legal and institutional

[1] "Moneta debt esse quasi quaedam lex et quaedam ordinacio firma". Nicolas Oresme, Traité de la première invention des monnaies (ca. 1355).

framework. Pure *laissez-faire* capitalism was unstable and liable to capture by monopolies. Collectivist central planning, on the other hand, led towards waste and totalitarianism.

Thus, as the ordoliberals saw it, the role of government was to frame markets in such a way that actual outcomes would approximate the theoretical outcome in a perfectly competitive market. Achieving such outcomes could imply de-regulation, if government was interfering too much in market processes, or re-regulation, if market failures were apparent – a feature that distinguished it from a *laissez-faire* approach. In other words, the role of government was both to untie the "invisible hand", and to keep it firmly cuffed to the rule of law.

At the same time, ordoliberalism recognised the crucial importance of monetary and economic stability to a well-functioning market. This implied an economic framework built around price stability, competition regulation and budgetary discipline – in Eucken's words, the perfect "economic constitution".[2] This thinking had a strong influence on the design of the post-war social market economy in Germany, and is seen by some as the foundation for German economic success in that period.

Interestingly, as many developing countries transitioned from planned to market economies in the 1980s and 1990s, there was something of a large-scale social experiment of the ordoliberals' views outside of Germany. Several transition economies followed the macroeconomic policy recommendations of the so-called Washington Consensus, which emphasised the *laissez-faire* side of liberalism – decentralization, deregulation and privatization – while downplaying the legal and institutional underpinnings of a well-functioning market economy.

The "poster boy" for this approach was Chile in the 1980s under the influence Augusto Pinochet and German immigrants connected to his regime, together with the so-called "Chicago Boys."[3] While quite striking results were achieved initially, leading Milton Friedman to refer to "the miracle of Chile", financial speculation and foreign debt quickly built up behind the scenes. Moreover, privatisation allowed formerly public monopolies to become private monopolies – precisely what market-oriented reforms were supposed to avoid. The speculation bubble then burst in 1982, after which economic policy changed track.

A similar pattern was observable in other transition economies. Russia, for example, privatised and liberalised extensively following the collapse of the U.S.S.R. Without a solid legal and institutional framework to organise market interactions, however, the country experienced a series of crises, while resources ended up being concentrated in the hands of a few powerful individuals.

These experiences led the assumptions of the Washington Consensus to be progressively revised. Even the IMF acknowledged the flaws in the original list of suggestions, in particular regarding the importance of institutions.[4] Reviewing the available evidence, the economist Dani Rodrik wrote that the strength of institutions is the most important element of development economics. The mantra of the so-called "revised" Washington Consensus, he wrote, should be to "get the institutions right."[5]

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[2] Vanberg, Viktor J. "The Freiburg School: Walter Eucken and Ordoliberalism." Walter Eucken Institut, April 2004.

[3] The Chicago Boys were a group of young, liberal economists from Chile educated at the University of Chicago.

[4] "Report on the Evaluation of the Role of the IMF in Argentina, 1991–2001." Independent Evaluation Office of the IMF, July 2004.

[5] Rodrik, Dani, et al. "Institutions Rule: The Primacy of Institutions over Integration and Geography in Economic Development." IMF Working Paper Series, November 2002.

2. The principles of effective economic policy

The aim of this brief review is to underscore that all well-functioning market economies are based on a consistent accord of rules, instruments and institutions. And what I would like to turn to now is the state of that accord in the euro area.

The designers of the euro area clearly intended to build a consistent rules-based framework.[6] The euro area fitted within a single market centred on a strong competition authority that could break-up monopolies and remove competitive distortions. The ECB was established with a mandate to focus solely on price stability. National fiscal policies were expected to be stability-oriented and conducted within a strict framework, known as the Stability and Growth Pact (SGP). This would be supplemented, it was believed, by the disciplinary force of financial markets.

This begs the question: why did the euro area then have a major crisis? The answer, in short, is that the designers got it wrong. The accord of rules, instruments and institutions in the euro area was in fact inconsistent.

There were two dimensions to this:

- The first was inconsistency *within* policy areas, which produced a fragmented and unstable governance framework.
- The second was inconsistency *between* policy areas, which caused negative interactions between them to appear.

Let me address each in turn.

Inconsistency within policy areas

In a highly integrated currency area like the euro area, there are several types of economic policies that are "of common concern". This may be because they have consequences on euro area aggregates – for example, excess domestic demand in one large country pushing up overall euro area inflation – or because they create spillovers for other Member States. These policies therefore warrant some form of coordination at the euro area level, notably via common rules. The implementation of these rules, however, can broadly speaking take two forms.

One form is where rules are agreed centrally but applied decentrally by national authorities. For this to work, however, there has to be very little room for discretion in how those rules are applied. Otherwise, political and economic preferences at the national level or industry lobbies can lead to substantial divergence between member countries. This in turn risks externalities for others in the currency area.

Another form is where rules are agreed centrally and applied centrally by a European institution. In this case there can be discretionary decision-making, as the European institution, provided it has sufficient independence, is not influenced by preferences at the national level. Moreover, through appropriate accountability arrangements it will be *de facto* forced to take a euro area-wide view and apply that discretion evenly.

When EMU was launched, only really monetary policy conformed to one of these forms. Monetary policy decision-making was fully centralised in a European institution, the ECB, which had substantial discretion in how it implemented its tasks. This was made possible by the ECB's clear mandate referenced in terms of the euro area as a whole, for which it was

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6 For a more in depth exposition of this argument see: Nedergaard, Peter. "The Influence of Ordoliberalism in European Integration Processes: A Framework for Ideational Influence with Competition Policy and the Economic and Monetary Policy as Examples." MPRA Paper No. 52331, December 2013.

accountable *ex post*. This internal consistency explains why monetary policy is the only part of the EMU framework that has clearly functioned as designed.

Fiscal policies were supposed to conform to the other form of governance, where countries would decide on and execute their own budgets, but within the strict constraints of the deficit and debt limits set in the Treaty. Those limits were supposed to be policed by markets, the Commission and other Member States, but in practice the incentives of the latter to enforce the rules were weak. This meant that *de facto* rules could be applied with discretion, while Member States themselves decided on how to exercise that discretion – in other words, the worst combination of the two forms.

The result was that fiscal positions diverged significantly, which then created substantial spillovers for other euro area members. But perhaps more fundamentally, internal inconsistency meant that fiscal policy *itself* became ineffective in several jurisdictions. A number of governments either did not have the fiscal space to absorb the shock they faced in the early stage of the crisis, or they were unable to maintain the trust of the market when investors finally reacted – and over-reacted. Fiscal policy therefore had to effectively give up its stabilisation function – which is vital with a single monetary policy – and switch to convincing investors of debt sustainability.

Prudential policies were also supposed to fit the decentralised model, although here the framework was even looser. While a general set of rules for European banks was progressively established in successive capital requirements directives, substantial flexibility remained in how those rules was interpreted at the national level. The Lamfalussy process was launched in an effort to iron out these differences, but the process rested entirely on cooperation between national supervisors, with no possibilities for binding mediation or enforcement at the European level – and it was fiercely resisted by countries with financial centres.

The divergence this permitted in the application of regulatory and supervisory standards allowed serious financial imbalances to build-up in some jurisdictions, which then of course created serious blowback for the euro area. But similar to fiscal policies, an inconsistent framework also undermined the value of prudential policy itself. As, for example, definitions of forbearance and non-performing exposures differed widely across countries, investors simply did not trust in banks' stated asset values and provisions. In other words, the confidence effects that prudential policy is supposed to provide disappeared when they were most needed.

For structural policies there were no binding European rules at all, as they were seen as having a primarily national significance.

Inconsistency between policy areas

These governance arrangements were not only internally inconsistent, however; they were inconsistent with each other. Governance of the euro area can be imagined like a set of interlocking cogs wheels: they do not all need to be of similar size – that is, we do not necessarily need the same degree of centralisation in each area – but they need to all move in the same direction. If one cog moves in the other direction, the whole machine grinds to a halt.

There were several inconsistencies between policy areas in the euro area that had such a countervailing effect.

To begin with, the frameworks for economic and financial policies pulled in different directions. Increasing financial integration encouraged capital to flow from core to periphery, but this was not accompanied by increasing integration of product and services markets to ensure that this capital was allocated efficiently. In fact, as competitive pressures remained weak, in particular in the non-tradable/services sector, certain industries were able to maintain excessive rents and distort price signals. This meant that the low marginal product

of capital in these industries was offset by rising profit margins, leading capital to become misallocated.

The fiscal and financial frameworks also interacted negatively with one another. In particular, policy-makers underestimated the extent to which financial integration depended on the false perception of relatively homogenous sovereign credit risk. As euro area banks were heavily exposed to own governments' debt, when perceptions of sovereign creditworthiness diverged, so did confidence in their respective banking systems. The resulting market fragmentation further increased sovereign risk, entrenched domestic banks as the marginal buyer of their sovereigns' debt, and thus deepened this bank-sovereign nexus.

Finally, the interaction between bank and sovereign risk jarred with the single monetary policy. A fragmented banking system not only impaired monetary policy transmission. But more fundamentally, it called into question the singleness of money. Money, it has to be remembered, is a liability of the banking system. Banknotes represent only a fraction of the money we use daily; the bulk of money is deposits. Thus, for there to be a truly single money, there has to be full fungibility of deposits across borders. If confidence in national banking systems diverges, such that a deposit in one jurisdiction is seen to worth less than a deposit in another, then money within the euro area is no longer unquestionably single.

3. Bringing consistency back

To sum up, the problems the euro area has faced derive from the fact that it did not learn its own lesson. The stability of European countries in the second half of the 20th century was based on providing their national economies with the right accord of rules, institutions and instruments to produce desirable market outcomes. Yet when it came to the euro area economy, these tried and tested principles were somehow overlooked. Several policy areas were governed inconsistently, with little reflection given to how the different cogs wheels would fit together.

The main aim of the euro area today is therefore to bring consistency back: that is, to make governance of different policy areas mutually consistent and internally consistent. Let me briefly review how this is being addressed in the banking, fiscal and economic domains.

Banking union

Since 2012, the priority has been to restore consistency between the single monetary policy and other policies – that is, to guarantee the singleness of money irrespective of the fiscal health of sovereigns. Essentially, this had to involve removing the fault lines between national banking systems that called into question the fungibility of deposits, and that meant bringing those national systems together into a single system. This is where the banking union comes in.

Banking union means three things: it means a single supervisory framework that minimises equally the risk that a euro area bank takes excessive risk and runs into failure. It means a single resolution framework, so that if a bank does still fail, it can be resolved in the same way, with limited use of taxpayer money, irrespective of where the bank is located or the fiscal strength of its government. And it means a system of deposit protection that provides depositors with equal confidence that their deposits are safe, regardless of jurisdiction.

In terms of implementing these three elements, the euro area has made considerable progress. And importantly, the governance reforms that have been agreed are much more internally consistent. They come close to the two ideal forms that I mentioned earlier: in some areas there will be centralisation and discretion; in others decentralisation and no discretion.

From November this year banking supervision will be centralised in the Single Supervisory Mechanism (SSM). Bank resolution will also be centralised in the Single Resolution Mechanism (SRM). The latter is particularly important as the legal framework it will

implement – the Bank Recovery and Resolution Directive (BRRD) – contains quite some discretionary exemptions, in particular from the new bail-in provisions.

For deposit guarantee, there is no centralisation yet. But under the recently adopted directive national schemes will have to meet the same minimum standards for levels and funding, meaning that there is also little discretion. Implementation, therefore, will be key.

Fiscal union

Banking Union will certainly help reduce the impact of sovereign risk on the banking system. But still, there is little that can be done if sovereigns pursue manifestly unsound fiscal policies. Domestic banks remain heavily exposed to their sovereigns. And any regulatory initiatives to address this issue – e.g. large exposure limits or doing away with the risk-free treatment of sovereign debt – can only be introduced very gradually in order to avoid market turmoil, and most likely only in the context of other governance reforms. Thus, to be consistent, a single banking system and a single currency require a fiscal framework that guarantees budgetary solidity.

The euro area has done a lot since the start of the crisis to strengthen fiscal rules. In particular, Member States have sought to move away from the unstable middle ground of the first SGP by anchoring fiscal rules more firmly in national law. The Fiscal Compact – which requires countries to run balanced budgets over the cycle and reduce their debt levels progressively towards 60% of GDP – has to be written into national constitutions or equivalent, and is overseen by national fiscal councils. This comes closer to the model of having decentralised implementation of rules, but with very little discretion.

But will this be enough? I see two possible outcomes.

The first is a stable equilibrium between centralised banking governance and decentralised fiscal governance. That is, banking union better insulates national budgets from financial shocks, meaning budget deficits are generally milder. And in this context, the Fiscal Compact provides sufficient medium-term credibility to allow fiscal policy to operate counter-cyclically without threatening market access.

The second possibility is some form of deeper fiscal union at the euro area level.

Economic union

Clearly, the political economy of deeper fiscal integration is difficult, especially given the preferences expressed at the recent European Parliament elections in some reform-resistant countries. Thus, we should focus our efforts for now on making the new equilibrium work. But here again we need consistency. If the current fiscal rules are to be credible, we need higher growth, and that means looking deeply at how we coordinate structural policies across Europe.

On our current reform-resistant course, I see a distant but distinct probability that growth in the euro area begins a secular downward drift. With inflexible markets, downswings are likely to deeper, as adjustment has to happen slowly through quantities – i.e. unemployment – rather than quickly prices. And with low productivity and investment, upswings might be shallower as growth is driven only by cyclical rather than structural factors. Indeed, most estimates find that potential growth in the euro area has diminished during the crisis.

This is why moving ahead with structural reform is essential. The best way to raise real growth in the euro area is to open up product and services markets and to reallocate resources to the most productive industries. When I see that most countries in the euro area

periphery have a revealed comparative advantage in services,[7] and yet these markets are the least integrated in Europe, it strikes me as a missed opportunity.

Implementing structural reforms is of course mainly a national responsibility. But so far we have not done enough at the European level to help gather momentum behind them. Some might argue that the European elections will make this harder still, but I would tend to disagree. First, the reasons for extremism in some countries have more to do with national governments than with Europe. Second, what is causing some people to turn against the EU, in my view, is not a dislike of European governance *per se*; it is a lack of delivery on jobs and growth. If European policy-makers can find better ways to get the most out the European project, I strongly doubt the voters as a whole would be against that.

4. Conclusion

Let me conclude.

What I have tried to underline today is that a well-functioning market depends on getting the rules, institutions and instruments that govern it right. And the source of the euro area's difficulties, in my view, is that policy-makers failed to do so.

For this reason, it would be wrong to conclude that Europe, or the euro, has failed. It was policy that failed. But importantly, policy can also be fixed. What we need now, therefore, is to finish what we started in 1999 and make the euro area work.

We have done much to stabilise the euro area with Banking Union and other reforms; but now we need to find ways to make the euro area sustainably grow. Voters in Europe have overall given policy-makers a mandate to do this; we have a pro-European majority in Parliament. If we do not seize this mandate, however, they may not provide another one.

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[7] For more details see Rahman, Jesmin and Tianli Zhao. "The Role of Vertical Supply Chains in Boosting Growth", in *Jobs and Growth: Supporting the European Recovery*, IMF, April 2014.