Benoît Cœuré: Investing in Europe – towards a new convergence process

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the Panel "The big rethink for a stronger Europe", The Economist Roundtable with the Government of Greece, Athens, 9 July 2014.

* * *

I would like to thank Lucas Guttenberg, Jean-Francois Jamet and Marion Salines for their contributions. I remain solely responsible for the opinions contained herein.

Summary

Economic and Monetary Union (EMU) is a political triathlon. It requires resilience and resolve to perform well at all times in the three disciplines of a currency union: fiscal policy, economic policy and financial policy. EMU is a team effort. Only if every participant performs well can the euro area team be strong. This is the most important lesson from the crisis.

The European economy is undergoing a moderate recovery, but complacency would be unwarranted. To really overcome the crisis, there are some remaining major challenges still to be faced. The euro area is not in a financial crisis anymore, but it must still contend with high debt, low growth and unacceptably high unemployment. These are reason enough to remain alert and continue acting. In recent years, economic policy-making rightfully focused on re-establishing the most important necessary condition for growth: stability. For companies to invest, for firms to hire, for households to consume, a stable economic environment is tantamount.

There are three relevant dimensions of economic stability: price stability, financial stability and macroeconomic stability, including the health of public finances. In all these areas, we have made substantial progress in recent years. During the crisis, the ECB took all appropriate measures to ensure that price stability provided an anchor in an uncertain and volatile economic environment. As for financial stability, the establishment of the European Stability Mechanism and the launch of banking union, with its Single Supervisory Mechanism and Single Resolution Mechanism, have been milestones in this respect. As a third dimension, the crisis has shown us the kind of existential threat to monetary union that can be brought about by the build-up of excessive imbalances, i.e. by the lack of fiscal and macroeconomic stability. New growth will not be generated by new debt. Sound fiscal policies are essential for growing out of debt. Therefore, the existing rules should be applied in a credible manner.

That said, we cannot claim "mission accomplished". What has been achieved so far is not enough. The answer to the remaining challenges could take the form of a "convergence process 2.0", which should have an agreed timeline and milestones. But convergence can only be sustainable if it is associated with a commensurate deepening of integration, if it is a race towards best practice institutions and policies rather than towards mere nominal outcomes. In this context, structural reforms, if properly designed, lead to greater prosperity in each country and, at the same time, ensure greater resilience of EMU as a whole, thereby contributing to economic and social stability. Growth and stability are therefore mutually reinforcing.

The convergence process should consist of two legs: on the one hand, it should underpin the convergence of economic policies and structures at the national level. On the other hand, it should facilitate joint action.

At the national level, convergence implies that euro area governments need to step up structural reforms, in particular those which have the greatest efficiency gains given the relative distance to best practices. And policy-makers should pay due attention to ensure that the burden of the adjustment effort is shared fairly.

The convergence in national structures could be complemented by joint action at the European level to increase investment and by the transfer of certain budgetary responsibilities to the European level with a view to strengthening risk-sharing within the currency union. But joint action can only occur once trust has been restored across countries and within countries, and the convergence process has advanced successfully. The level and the form of budgetary responsibilities, and how they are matched by appropriate democratic arrangements, should emanate from the political process.

The biggest threat to the Single Market is not euro area integration: it would be euro area stagnation. The challenge of making the EMU work is far from over. Let's get ready for the next stage of the race.

Intro

Ladies and gentlemen,

Let me first of all thank The Economist for inviting me to this distinguished panel.

Almost exactly ten years ago, the Olympic triathlon took place here in Vouliagmeni. On race day, the weather was as hot and as dry as it is today. The athletes needed to have two important attributes in order to be able to compete in a triathlon in these conditions: resilience to withstand the heat and commitment to endure all three disciplines with equal passion.

Economic and Monetary Union (EMU) is a political triathlon. It requires resilience when the heat is on and it requires commitment and resolve for participants to perform well at all times in the three policy disciplines that mark a currency union: fiscal policy, economic policy and financial policy. But there is one important difference with a triathlon: EMU is a team effort. Only if every participant performs well can the euro area team be strong. This is the most important lesson from the crisis.

Today, I want to discuss what this means in terms of the policy efforts that could be part of – as the panel title calls it – "the big rethink for a stronger Europe". I will start with an analysis of the outstanding challenges – or the heat – that the euro area still faces. I will then outline what has already been achieved to bring stability and confidence back to the euro area. And third, I will argue that we need a credible long-term path towards more convergence and stronger resilience in the euro area so as to foster durable growth and ensure that the return of confidence is long-lasting; this is about the commitment to perform right up to the end. I refer to this long-term policy effort – not to qualify for participation in EMU, but to maintain successful participation in EMU – as "convergence process 2.0", as I will explain in a moment.

The state of the euro area

The European economy is undergoing a moderate recovery, but complacency would be unwarranted. To really overcome the crisis, there are some remaining major challenges still to be faced.

First, the euro area's debt has stabilised, but remains at high levels.[1]

Second, euro area unemployment is still high and the youth are suffering disproportionately.[2]

---

1 In 2013 public and private sector debt reached respectively 95.1% and 168.0% of GDP. The debt level is especially high in some Member States: for instance, public debt stood at 175.1% of GDP in Greece and 132.6% in Italy, while private sector debt amounted to 319% of GDP in Ireland and 252% in Portugal.

2 Euro area unemployment rose to 12.0% in 2013. Youth unemployment reached 24.0% in the euro area and increased dramatically in Greece and Spain to 58.3% and 55.5% respectively.

Finally, growth is only resuming at a slow pace.[3] Investment has been too low in Europe over the last 15 years, and the crisis has exacerbated this trend. At the same time, total factor productivity, which forms the basis of long-term growth, has also been disappointing.[4]

If this trend continues over the long term, the euro area will not generate enough wealth to sustain the standard of living of its citizens and to ensure the sustainability of its social model, which is a defining feature of its identity.

We sometimes ask ourselves how to keep the reform momentum going without the pressure of the financial crisis.[5] We would like to believe that what has been achieved since 2010 to strengthen EMU is enough to make it strong and sustainable and we can therefore claim "mission accomplished". But the challenges I have just outlined provide enough of an answer. What has been achieved so far is not enough. The euro area is not in a financial crisis anymore, but it must still contend with high debt, low growth and unacceptably high unemployment. These are reason enough to remain alert and continue acting.

Stability – a precondition for growth

For companies to invest, for firms to hire, for households to consume, a stable economic environment is tantamount. If uncertainty reigns, economic activity suffers. In my view, there are three relevant dimensions of economic stability: price stability, financial stability and macroeconomic stability, including the health of public finances. In all these areas, we have made substantial progress in recent years.

During the crisis, the ECB has taken all appropriate measures to ensure that ***price stability*** provided an anchor in an uncertain and volatile economic environment. Consistent with this principle, our recent decisions have aimed at addressing the risk of too long a period of low inflation and at ensuring that inflation expectations remain firmly anchored.

As for ***financial stability***, the crisis has shown us how the functioning of an economy becomes impaired without a well-functioning, robust financial system. This requires striking the right balance between insuring against crises, curbing risk-taking behaviour and mitigating moral hazard with a strong incentive framework. The establishment of the European Stability Mechanism and the launch of banking union, with its Single Supervisory Mechanism and Single Resolution Mechanism, have been milestones in this respect. The stabilisation and ongoing repair of the Greek banking system is another example.

As a third dimension, the crisis has shown us the kind of existential threat to monetary union that can be brought about by the build-up of excessive imbalances, i.e. by the lack of ***fiscal and macroeconomic stability***. The lesson drawn from this existential threat was that there was a need to reform economic governance. We should be very careful now not to roll back this achievement, in particular in the fiscal domain. New growth will not be generated by new debt. On the contrary: sound fiscal policies are essential for growing out of debt. Therefore, the existing rules should be applied, and they should not be stretched to a point where they would lose their credibility. There is built-in flexibility in the Stability and Growth Pact to account for the cost of major structural reforms – but it cannot be based on empty promises. The sequencing should be clear. First, reforms need to be adopted and implemented. Then,

---

[3] Euro area GDP is expected to recover at a pace of 1% in 2014 and 1.7% in 2015 according to the latest ECB staff projections.

[4] Total investment in the euro area has shrunk by almost 20% since the peak in economic activity in 2008. In addition, total factor productivity has also been disappointing in the euro area since 2000: it grew by 0.45% annually from 2000 to 2007 before receding by 0.47% annually between 2007 and 2012 (source: Ameco database, European Commission).

[5] See Barroso, J.M., "Remarks by President Barroso on the Country Specific Recommendations 2014", speech given in Brussels on 2 June 2014.

the cost of such a reform, independently assessed, could be taken into account under the Stability and Growth Pact, with due attention to the limited fiscal space provided by the high debt levels.

Economic stability is a necessary condition for growth, but is not sufficient alone. For our economies to grow out of high debt and unemployment, and thereby ensure social stability, we need to do more.

Racing to the top: "convergence process 2.0"

The challenges I outlined a minute ago call for an answer that goes beyond the necessary application of the existing rules of EMU. An answer that not only fosters stability and confidence today, but also in the future. An answer that gives EMU the institutional shape it needs to be a successful project in the long run. This answer could in my view take the form of what I call "convergence process 2.0", which should have an agreed timeline and milestones.

To run the political triathlon of EMU and perform well in all three disciplines, there needs to be a *convergence of economic policies and structures*. Moreover, *joint action* is of the essence.

Let me be clear on what I mean by convergence. The crisis has shown the fragility of the convergence of economic outcomes; it can unravel quickly in the face of exogenous shocks. Convergence can only be sustainable if it is associated with a commensurate deepening of integration, if it is a race towards best practice institutions and policies rather than towards mere nominal outcomes. In this context, structural reforms, if properly designed, lead to greater prosperity in each country and, at the same time, ensure greater resilience of EMU as a whole, thereby contributing to economic *and* social stability. Growth and stability are therefore mutually reinforcing.

With regard to ***convergence in economic structures and policies***, the starting point has to be decisive action at national level. Euro area governments need to step up structural reforms, in particular those which have the greatest efficiency gains given the relative distance to best practices.[6] Policy-makers should pay due attention to ensure that the burden of the adjustment effort is shared fairly. The perception of fairness of reforms in the national context is a key ingredient in their success. Fighting tax evasion, rent seeking and corruption as well as increasing transparency are key examples.

These efforts at the national level should be complemented by structural reforms at the European level, aimed at deepening the Single Market, the cement that holds all our economies together. This is particularly true of the Single Market for capital, where a lot can still be done to enhance both risk-sharing and allocative efficiency.[7]

Structural reforms at the national level could also go beyond the country-specific perspective in the areas of direct relevance for the smooth functioning of EMU. In these areas, convergence could be embedded in a binding European effort, based on benchmarks to be met by all euro area Member States. This process would be a race to the top and would close the gap to the frontier in terms of competitiveness and resilience.

For this process to be fully effective and legitimate, it would have to entail the gradual pooling of sovereignty in these policy areas and be based on the Community method with due involvement of the European Parliament.

---

6 Cheptea, C. and Velculescu, D., "A Disaggregated Approach to Prioritizing Structural Reforms for Growth and Employment", in Schindler, M., Berger, H., Bakker, B. and Spilimbergo, A. (eds.), *Jobs and Growth: Supporting the European Recovery*, IMF, 2014.

7 See Cœuré, B., "Ein Binnenmarkt für Kapital", *Frankfurter Allgemeine Zeitung*, 30 June 2014.

The convergence in national structures could be complemented by ***joint action at the European level*** in two respects.

Complementing regulatory initiatives, there could be a joint European effort to increase investment levels by better channelling private savings to investment and by coordinating available public investment programmes. Beyond this, one could envisage joint European investment in public goods such as network industries and R&D, as a way to bolster Europe's growth potential and to even out drops in public investment in economies hit by shocks. Yet, this should be achieved by prioritising spending and should not undermine efforts that remain necessary to bring down debt levels.

In the longer term, the convergence process could culminate in the transfer of certain budgetary responsibilities to the European level with a view to strengthening risk-sharing within the currency union. But let me add an important note of caution. This can only occur once trust has been restored across countries and within countries, i.e. after growth has resumed, unemployment and inequalities have receded, and economies have sufficiently converged. What we are talking about is a new social contract among European countries. This can only be agreed under the veil of ignorance,[8] i.e. under the expectation that participating economies, in their diversity, have comparable strengths and weaknesses. And that is why such a new social contract can only happen at the end of a new convergence process.

As to which level which budgetary responsibilities are allocated, and how they are matched by appropriate democratic arrangements, I believe this is ultimately a political decision. It should emanate from a political process, and I note that other federations with more developed forms of political union such as Switzerland or the United States have found very different answers to this question.

Further integration within the euro area raises the difficult issue of the relationship with the "outs". Adequate safeguards have to ensure full consistency with the Single Market, which is the European Union's most valuable achievement. However, while such safeguards will have a bearing on the design of euro area integration, they cannot change its direction. The biggest threat to the Single Market is not euro area integration: it would be euro area stagnation.[9]

Conclusion

Ladies and gentlemen,

The triathlon competitions here in Vouliagmeni ended a decade ago. The challenge of making EMU work is far from over. In fact, we are now just out of the water. Let's get ready for the bike race and not forget about the running that will come later.

Many thanks for your attention, and I am now looking forward to our debate.

---

8 See Rawls, J., A *Theory of Justice*, Harvard University Press, 1971.

9 See Cœuré, B., "Is Eurozone governance fit for purpose?", speech at a dinner organised by the Centre for European Reform, London, 30 January 2014.