Mario Draghi: Stability and prosperity in Monetary Union

Speech by Mr Mario Draghi, President of the European Central Bank, at the University of Helsinki, Helsinki, 27 November 2014.

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Summary

ECB President Mario Draghi outlined the minimum requirements needed to complete monetary union in a way that offers stability and prosperity for all its members in a speech to students of the University of Helsinki.

Acknowledging that, "for all its resilience, our union is still incomplete", Mr Draghi argued that, ultimately, Member States "have to be better off inside than they would be outside."

"If there are parts of the euro area that are worse off inside the Union, doubts may grow about whether they might ultimately have to leave".

"The euro is – and has to be – irrevocable in all its member states, not just because the Treaties say so, but because without this there cannot be a truly single money", he said.

In the absence of permanent fiscal transfers among Member States, there are two minimum requirements to achieve these objectives: the first is that all euro area countries need to be able to thrive independently, the second is that euro area countries need to invest more in other mechanisms to share the cost of shocks.

In a monetary union, the economic performance of any single country cannot be seen as a purely national concern. "There is a strong case for sovereignty over relevant economic policies to be exercised jointly. That means above all structural reforms", the President remarked.

But even so, economic adjustments can have short term costs.

To ensure that countries are better off being in the Union when a shock hits than they would be outside, "we need other ways to help spread those costs…there is a particular onus on private risk-sharing to play this role". In this context Mr Draghi said barriers to capital markets integration needed to be addressed with urgency.

Sovereign debt needs also to act as a safe haven in times of economic stress. It can do so first of all through a strong fiscal governance framework. Secondly, by having some form of backstop for sovereign debt in place. "Over the longer-term", the President concluded, "it would be natural to reflect further on whether we have done enough in the euro area to preserve at all times the ability to use fiscal policy counter-cyclically. But it is also clear that… this could only take place in the context of a decisive step towards closer Fiscal Union".

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Ladies and gentlemen,

A common misconception about the European Union – and the euro area – is that they are economic unions without an underlying political union. This reflects a deep misunderstanding of what economic union means: it is by nature political.

The Single Market is itself a political construct that could not operate without adequate political structures. A strong competition authority requires an executive to enforce competition policy, a legislative to write the law that it enforces, and a judiciary to resolve conflicts under the Law. The Commission, EU Council, European Parliament and European Court of Justice all play these roles.[1]

Likewise, fiat money is a political construct, and monetary union could not operate without adequate political structures. In this case, an independent central bank has to ground its legitimacy in a precisely defined mandate that is embedded in a democratically agreed constitutional framework – which the ECB finds in the EU Treaties.[2]

If our union has proved more resilient over the past years than many thought, it is only because those who doubted it misjudged this political dimension. They underestimated the political underpinnings of our union, the ties between its members, and the amount of political capital that has been invested in it.

Yet it is clear that, for all its resilience, our union is still incomplete. This is the diagnosis that was made two years ago by the Presidents of the European Council, the European Commission, the Eurogroup and myself, in the so-called "Four Presidents Report". And though progress has been achieved in some areas, it remains unfinished in others.

So until we have completed EMU, which means achieving the minimum requirements in *all areas* for our union to be truly sustainable, doubts about its future will never entirely fade away. And this is true no matter how much political commitment is voiced.

What I would like to discuss today is what those minimum requirements are to complete our Union in a way that brings stability and prosperity for all its members.

The minimum requirements for monetary union

When countries join a monetary union, they share monetary policy and no longer have individual exchange rates. This offers significant benefits, but it also creates costs.

On the one hand, especially for smaller countries, sharing sovereignty over monetary policy is a way to regain sovereignty. Rather than having their monetary policy effectively determined by a larger neighbour, they can participate on equal terms in decision-making for the entire euro area. The removal of exchange rate uncertainty also yields immediate benefits in terms of reduced risk premia.

On the other hand, sharing monetary policy and in particular an exchange rate deprives national economies of some adjustment tools in the face of local shocks.

This means that such shocks have to be preempted to the extent possible through sound economic policies. It also means that when shocks do occur – as they inevitably will – adjustment has to take place through other channels. And crucially, those channels have to be *at least as effective* as if countries were not part of monetary union. Members have to be better off inside than they would be outside.

The reason for this is as follows: if there are parts of the euro area that are worse off inside the Union, doubts may grow about whether they might ultimately have to leave. And if one country can potentially leave the monetary union, then this creates a replicable precedent for *all countries*. This in turn would undermine the fungibility of money, as bank deposits and other financial contracts in any country would bear a redenomination risk.

This is not theory: we all have seen first-hand, and at considerable costs in terms of welfare and employment, how fears about euro exit and redenomination have fragmented our economies.

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1 See lecture by Mario Draghi on "Europe's pursuit of 'a more perfect Union'" at Harvard Kennedy School, Cambridge (USA), 9 October 2013.

2 See acceptance speech by Willem Duisenberg on receiving the International Charlemagne Prize, Aachen, 9 May 2002.

So it should be clear that the success of monetary union *anywhere* depends on its success *everywhere*. The euro is – and has to be – irrevocable in all its member states, not just because the Treaties say so, but because without this there cannot be a truly single money.

What I am saying of the euro area could apply to most currency areas. But participation in our monetary union has different characteristics to participation in other political unions. This is particularly because we operate in an environment where there are no permanent fiscal transfers between countries.[3] And this has important consequences.

In all national economies, permanent transfers take place from richer to poorer regions; from more densely populated to more sparsely populated areas; and from those better endowed with natural resources to those less endowed. This is true in the United States, where those transfers occur through the federal budget. It is true within Germany, within Italy, within Finland. Fiscal transfers, so long as they remain fair, often help cement social cohesion and protect against the temptation of secession.

But as such transfers are not foreseen within the euro area, this model does not apply for us. We need a different approach to ensure that each country is permanently better off within the Union than outside – and it entails two minimum requirements.

The first is that all euro area countries need to be able to thrive independently. This means that every economy has to be flexible enough to find and exploit their comparative advantages, so as to benefit from the Single Market. They have to be able to allocate resources efficiently and create a dynamic business environment, so that their economies can attract capital and generate enough jobs.

And they also have to be flexible enough to respond quickly to short-term shocks, including through adjustment of wages or reallocating resources across sectors.

This is particularly important because, due to cultural barriers, labour mobility offers only a limited escape valve from high local unemployment in the euro area – at least compared with more homogenous unions like the US. Certainly, greater cross-country mobility would be welcome, and we should encourage measures that facilitate it. But research suggests that it is unlikely that cross-country migration flows will ever become a key driver of labour market adjustment after large shocks.[4] And no country will thrive anyway if its population deserts it.

The second implication that follows from not having fiscal transfers is that EMU countries need to invest more in other mechanisms to share the cost of shocks.

Many shocks can be preempted by the right policies. But for those that cannot, internal adjustment will generally be slower than if countries were able to adjust relative prices instantly through their own exchange rate. In these circumstances, some form of cross-country risk-sharing is essential to help reduce adjustment costs for those countries and prevent recessions from leaving deep and permanent scars.

In our case this means deepening financial integration in ways that improve private risk-sharing – that is, through having more diversified financial portfolios that can spread risk and reward across regions, and more integrated credit markets that can smooth consumption patterns. And it means ensuring that the conditions are in place so that all countries can retain full use of national fiscal policy as a counter-cyclical buffer.

Let me explain these various points, and their implications, in some more detail.

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3 Cross-country transfers exist as part of the EU cohesion policy. These funds are however of a limited size and are primarily designed to support the "catching-up" process in lower income countries or regions.

4 Beyer, R., and F. Smets (2013), "Has mobility decreased? Reassessing regional labour market adjustments in Europe and the US", mimeo, European Central Bank.

Economies that can adjust quickly to shocks and grow

Building economies that are resilient and flexible entails that wages and prices can adjust to economic conditions, and that resources can reallocate swiftly across firms and sectors.

We know from economic theory that this is crucial in a monetary union to ensure that adjustment happens through prices, not quantities – that is, unemployment. And we have also seen this play out in our direct experience: during the crisis countries with more flexible economies have on the whole adjusted faster and with a lower employment cost. This is evident, for example, if one compares the experience of Ireland and Latvia with that of Spain, Portugal and Greece.[5]

We know as well that economies that are flexible and can allocate resources efficiently benefit most from the Single Market by exploiting their comparative advantages. And where populations are ageing, they also have the best chance of raising potential growth. This is again true in theory, but also visible in practice. To give just one example, the World Economic Forum ranks Finland fourth in the world in terms of global competitiveness, whereas Greece is ranked 81st.[6]

Until now, such differences in the structures and institutions of our economies have largely been seen as a national concern. Countries that reformed their economies and improved their business environments were seen as the chief beneficiaries of their efforts. And if some countries did not reform, it was largely believed that they would be the only ones to suffer as a consequence.

This understanding was reflected in the fact that, while monetary policy became European, important parts of economic policy remained at the national level – and with relatively loose common governance. This seemed natural as many of these policies – such as labour market institutions or social protection schemes – are deeply rooted in a country's social model and national traditions.

But with the benefit of experience, I am sceptical as to whether this view is still valid. That economies can adjust and grow is in fact very much a concern for others.

If some countries in monetary union perpetually adjust more slowly than others, they are likely to have consistently higher unemployment. And if they also have lower growth potential, then that unemployment is more likely to become entrenched and structural. In other words, lack of structural reforms raises the spectre of permanent economic divergence between members. And insofar as this threatens the essential cohesion of the Union, this has potentially damaging consequences for all EMU members.

Seen from this perspective, euro area countries cannot be agnostic about whether and how others address their reform challenges. Their own prosperity ultimately depends on each country putting itself in a position to thrive within the Union. And for this reason, there is a strong case for sovereignty over relevant economic policies to be exercised jointly. That means above all structural reforms.

This was the starting point for the reflection that began with the Four Presidents' Report in 2012 on building a genuine Economic Union for the euro area. And to my mind, deepening Economic Union would mean two things.

First, in the short-term, using more effectively the rules and procedures we already have, such as the European Semester. This means making all parties more accountable for

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5 See speech by B. Cœuré on "Structural reforms: learning the right lessons from the crisis", at the Bank of Latvia Economic Conference 2014, Riga, 17 October 2014.

6 World Economic Forum (2014), The Global Competitiveness Report 2014–15, Geneva, World Economic Forum.

ensuring that recommendations are well-targeted, closely monitored and followed up. And it means actively using the corrective tools that are there to tackle large imbalances, such as the Excessive Imbalances Procedure.

Second, over the longer-term, acknowledging the community of interest and the reality of spillovers in the form of a real sharing of sovereignty in the governance of structural reforms. That is, shifting from coordination to common decision-making, and from rules to institutions.

Private risk-sharing through integrated financial markets

As I said, however, economies will never be so flexible that adjustment happens as quickly as if they had their own exchange rate. There will always be short-term costs. And so to ensure that countries are better off being in the Union when a shock hits than they would be outside, we need other ways to help spread those costs.

In a monetary union like ours, there is a particular onus on private risk-sharing to play this role. Indeed, the less public risk-sharing we want, the more private risk-sharing we need.

Private risk-sharing chiefly comes through a well-integrated financial system. Diversified portfolios make balance sheets more resilient to local shocks and allow the effects of those shocks to be dispersed across countries. And integrated credit markets allow firms and households to smooth any negative effects on income by bringing forward future consumption – which in the euro area essentially means borrowing from countries that are less affected. In other words, financial union is an integral part of monetary union.

The US provides an example of how effective private risk-sharing can be in a monetary union. A well-known study found that around two-thirds of economic shocks are absorbed via integrated financial markets in the US. By contrast, studies on the euro area suggest that credit and capital markets are much less effective in smoothing income.[7]

The explanation for the limited degree of risk-sharing in the euro area can be found in the relatively shallow type of financial integration that evolved before the crisis.

In the banking sector, integration of interbank markets proceeded much faster than integration of retail markets. Thus, most banks' assets remained concentrated in their local markets, while their liabilities were mainly comprised of short-term debt. This meant that when a large local shock hit, they were exposed to heavy and concentrated losses. And rather than sharing those losses, their creditors were able to "cut and run".[8] The resulting financial fragmentation also meant that cross-border credit markets could not do their job.

In this context, Banking Union represents a vital step forward in creating the conditions for a higher quality of financial integration. Single supervision and resolution should be catalytic in lowering the hurdles to cross-border activity and encouraging deeper retail banking integration. In the process, this will create more private risk-sharing within the sector.[9]

Banking Union is now well underway: the Single Supervisory Mechanism (SSM) took over supervision of euro area banks earlier this month. Its founding act, the Comprehensive Assessment of banks' balance sheets, was successfully completed the month previously. And the Single Resolution Mechanism will begin on 1 January next year.

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7 See for example Van Beers, M., M. Bijlsma and G. Zwart (2014), "Cross-country insurance mechanisms in currency unions: an empirical assessment", Bruegel Working Paper 2014/04, March; IMF (2013), "Towards a Fiscal Union for the euro area: technical background notes", September 2013.

8 For an explanation of how the form of cross-border banking integration can influence the stability of financial flows see Schoenmaker, D., and W. Wagner (2011), "The impact of cross-border banking on financial stability", Tinbergen Institute Discussion Paper TI 11–054/DSF 18, Duisenberg School of Finance.

9 For more on this point see speech by Peter Praet on "Repairing the bank lending channel: the next steps", at European Macro Conference, London, 17 November 2014.

But limited risk-sharing within the euro area is not just about banks; it also reflects our relatively incomplete capital markets, and in particular equity markets. Those markets are the most effective for absorbing losses. Yet only 44% of equity issued in the euro area is held by other euro area residents.[10]

So, if we are to deepen private sector risk-sharing in the euro area, we urgently need to address the barriers to capital market integration. This is no doubt a complex issue as it extends into multiple aspects of national law.[11] But if we do not want a transfer union, then we have to be consistent and establish an environment where other mechanisms can work.

This means, first, advancing with the agenda of the new Commission President to establish a genuine Capital Markets Union in Europe. And second, establishing a genuine Economic Union in parallel. If countries are to attract capital and benefit from financial risk-sharing, then it has to be attractive to invest there. And this can only be achieved if, over the medium-term, all countries have sufficient adjustment capacity and growth prospects.

Yet even with full implementation of these Unions, we could still not call EMU complete. We also have to acknowledge the crucial role that accrues to fiscal policies in a monetary union.

National fiscal policies that can act counter-cyclically

A single monetary policy focused on achieving euro area price stability cannot react to shocks that affect only one country or one region. And we do not have a federal budget that can respond instead, as in the US for example. So, for as long as this situation persists, it is absolutely essential that national fiscal policies can perform their macroeconomic stabilisation role alongside monetary policy, and react whenever a local shock occurs.

Fiscal policies are in fact particularly relevant for us, as 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.[12]

For national fiscal stabilisers to be able to play out in full, sovereign debt has to act as a safe haven in times of economic stress. If it instead acts like private debt, and borrowing costs rise under stress, governments' market access becomes constrained at precisely the moment they most need it. Then, fiscal policy risks becoming pro-cyclical.

There are in principle two ways to protect the safe haven status of sovereign debt: the first is a strong fiscal governance framework that is implemented in a credible manner. This means having sufficient buffers over the cycle to absorb exceptional shocks, and having public debt levels that are sufficiently low in good times that they can rise in bad times without disrupting market confidence.

The second way is some form of backstop for sovereign debt.

In the euro area, due to various aspects of our institutional framework, we have very much pursued the first approach, strong fiscal rules. And this provides an essential anchor for confidence, not only for investors but also among firms and households, and crucially, between countries. The importance of each country sticking to its commitments under the Stability and Growth Pact should therefore be beyond debate.

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[10] ECB (2014), Financial Integration in Europe, April 2014.

[11] For details see Special Feature C of Financial Integration in Europe 2014, "Initiatives to promote capital market integration in the European corporate bond and equity markets".

[12] M. Dolls, C. Fuest and A. Peichl (2012), "Automatic stabilizers and economic crisis: US vs. Europe", Journal of Public Economics, Elsevier, vol. 96(3).

Indeed, that a sound fiscal framework is *necessary* in a monetary union goes without saying. Whether it is *sufficient* to safeguard fiscal policy as a stabilisation tool, however, has been challenged by our experience during the crisis.

The EMU framework was grounded on the assumption that keeping one's fiscal house in order would be enough to ensure market access and ward off contagion. And to be sure, countries with more robust fiscal positions have on the whole enjoyed easier financing conditions and have been more protected from spillovers. But we have also seen that this protection is not absolute.

Ireland and Spain, for instance, had low public debts and deficits on entering the crisis yet suffered serious contagion from Greece. And during the phase of the crisis where contagion within the euro area was at its worst, almost all countries saw their credit default swap spreads rise.

In other words, as panics can happen in financial markets, even abiding fully with the fiscal rules cannot provide a cast-iron guarantee of affordable market access.

So what can governments do in these circumstances to safeguard fiscal policy as a stabilisation tool?

First, this is precisely the kind of situation I mentioned earlier where we can and should aim to better preempt economic shocks. The SSM is particularly important in this context, as it should help prevent the kind of large financial imbalances we saw in countries like Ireland and Spain, which subsequently spilled over to the public sector.

Second, markets are less likely to react negatively to temporarily higher deficits if government debt is clearly sustainable over the medium-term. This can in part be achieved through credible fiscal plans, which act on the numerator of the debt-to-GDP ratio. But it also has to involve raising potential growth through structural reforms, which act on the denominator.

And for this reason, governments in fact have a further incentive to enter into closer Economic Union. Insofar as this acts as a commitment device that reforms will indeed by implemented, it will help to raise future government income and improve debt sustainability. And in doing so, it can even help create fiscal space today.

Moreover, using EU funds more effectively to boost both current demand and future potential – which means raising investment – would have a similar effect on growth and debt sustainability. I therefore welcome the Commission's new proposal to stimulate investment spending in Europe. What matters is that its size complements the fiscal stance of national governments, that it is deployed quickly so that it can support demand, and that it is targeted towards those sectors where its impact on potential growth will be largest.

Still, a third conclusion seems unavoidable: that no form of stronger governance can entirely remove the risk of self-fulfilling liquidity crises.

I do not think this is a controversial statement. It has already been acknowledged with the creation of the European Stability Mechanism. And it is also what motivates the ongoing discussion on establishing a backstop for the Single Resolution Fund: the idea is to prevent sovereigns from losing market access based on self-fulfilling expectations of future bailouts.[13]

So over the longer-term, it would be natural to reflect further on whether we have done enough in the euro area to preserve at all times the ability to use fiscal policy counter-cyclically. But it is also clear that such a reflection would have to be part of a larger

[13] For a full explanation of this mechanism see Acharya, V., I. Drechsler, I. and P. Schnabl (2011), "A pyrrhic victory? Bank bailouts and sovereign credit risk", NBER Working Paper No. 17136.

discussion on how to reinforce common decision-making over fiscal policies and strengthen accountability arrangements.

In other words, this could only take place in the context of a decisive step towards closer Fiscal Union. And to make that step we would need to first see a process of convergence in economic and financial policies in the ways I have described.

Conclusion

This brings me to my conclusion.

What I have argued today is that doubts over the viability of EMU will only be fully removed when we have completed it in all relevant areas. This means Banking and Capital Markets Union; it means Economic and Fiscal Union. In a monetary union no policy area can be seen in isolation. Each interacts with and affects the other. And as such, completing EMU in all areas strengthens and underpins the others.

Monetary union is more effective in securing the fundamental interests of citizens when common interests are recognised as such; and when the responsibilities that come with participating in a community are assumed in full. In other words, its ultimate success depends on the acknowledgment that sharing a single currency *is* political union, and following through with the consequences. And that requires commensurate accountability and transparency arrangements.

All countries must benefit permanently from participation in monetary union. And this means that the requirements I have laid out cannot be met only at the time when a country joins the union, or for some of the time. They have to be met all the time. They have to be irrevocable features of participation in monetary union.

And for that reason, the institutional arrangements that ensure those requirements are met must ultimately be binding in nature, and permanent in form.