Ignazio Visco: European Union – progress or regress?

Dinner speech by Mr Ignazio Visco, Governor of the Bank of Italy, at the 50th Anniversary Conference of the Istituto Affari Internazionali, Rome, 13 November 2015.

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I first wish to thank the Istituto Affari Internazionali for inviting me this evening. And I congratulate the Institute founded by Altiero Spinelli for its activity, research and contributions over the last fifty years. Best wishes for a future as rich and productive.

Assessing the recent and prospective evolution of the European Union is an issue far too vast to be addressed in detail in a short speech. My remarks will therefore focus on what I see as key elements concerning what was neglected before the crisis, the changes introduced over the recent difficult years, what further advancement is needed, and, to be somewhat provocative, some risks of a regress instead.

On the way to the crisis

Today the discussion on reforming the governance of the EU and the euro area centres on the need to complete the EMU and make it stronger, on how to get to "a deep and genuine economic and monetary union".[1] The need to move towards political union is widely and hotly debated. But for a long period this issue was underrated and neglected. I recall the discussions that took place in the late 1990s in OECD Committees, and the analysis put forward in monographs and surveys. The 1999 OECD report on EMU, for instance, noted that "long lasting monetary unions among major sovereign nations have never been observed before, without strong political integration", but then focused on different issues. Its discussion delved into the costs and benefits of a monetary union, the role of the Stability and Growth Pact, institutions and processes for macroeconomic policy co-ordination, exchange rate targets, labour market and wage flexibility, labour mobility, and product market reforms.[2]

Interestingly, the same report underscored the potential advantages of a single monetary policy – not a single fiscal policy – in managing asymmetric shocks. It argued that such shocks "are more easily absorbed in a monetary union where monetary policy should adopt the stance most appropriate for the area as a whole than under the previous arrangements, which were at times shaped by domestic German policy considerations". Also in subsequent analyses, the words "state" or "political" were more often missing than not. The attention was instead on such issues as fiscal consolidation, ageing populations, financial fragmentation, incomplete capital market integration, monetary policy communication, decentralized banking supervision, under-utilisation of human capital, insufficient structural reforms, all of which were diligently analysed with foreseeing discussions.

Yet awareness of the need for what today is termed a common "fiscal capacity" had been present well before the signing of the Maastricht Treaty. A report on fiscal union (the MacDougall Report) was published already in 1977 on behalf of the European Commission, and a mention concerning the economic desirability of a transfer of fiscal sovereignty to the European level is present even in the 1970 Werner Report. Later on, the technical papers

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1 European Commission, *A Blueprint for a Deep and Genuine Economic and Monetary Union – Launching a European Debate*, COM(2012) 777 final/2, Bruxelles, 2012.

2 OECD, *EMU Facts, Challenges and Policies*, Paris, 1999.

accompanying the 1989 Delors Report and subsequent work by the Commission discussed the topic in depth.[3]

The discussion was well alive also in academia. Economists have discussed the costs and benefits of membership of a monetary union since the seminal contribution on optimal currency areas by Robert Mundell in 1961.[4] Peter Kenen was the first to point out in 1969 that a shared fiscal policy could reduce the costs of being a member of a monetary union. He argued that the operation of area-wide automatic fiscal stabilizers would allow re-establishing equilibrium while limiting the necessary reduction (increase) in domestic prices and wages in countries affected by an adverse (positive) asymmetric demand shock.[5]

The introduction of the euro was a fundamental step in European history, a political event that certified the progress made on the road to integration, a profound economic and social change. It was only a step, however, and not the end of the road. Tommaso Padoa-Schioppa, who contributed so much to the achievement of monetary union, was well aware of this. On May 3, 1998, when Europe was completing the last steps before the adoption of the single currency, he wrote in a column for "*Corriere della Sera*": "The Union has full competence for microeconomic policy (…), but its capability for macroeconomic policy is, with the exception of the monetary field, embryonic and unbalanced: it can avoid harm (excessive deficits) but it cannot do good (a proper fiscal policy). (…) It is thus right not only to applaud yesterday's step but also to underline its unfinished nature, the risks and the rashness."[6]

At the beginning of the euro, Tommaso spoke clearly of the perils and weaknesses of a "currency without a State". With the global financial crisis and more specifically with the sovereign debt crisis the importance of the unification process has become crystal clear, but, in the words of Padoa-Schioppa, "there is more bitterness than satisfaction in witnessing a prophecy come true. […] It is clear that we needed more of a European State, not less of a European currency: without the euro, Europe would now be living a catastrophe. One reason for the lack of credibility of national politics is that it keeps on giving people the illusion that national powers are capable of tackling issues (energy, climate, finance, security, migration, primary goods) which are not national, but continental and global."[7]

In the absence of political union, the economic governance of the area was based on a fragile alliance between market forces and rules of conduct. Market forces were to ensure the economic convergence of the member countries and the definition and implementation of the necessary structural reforms at national level. Rules of conduct were expected to guarantee prudent budgetary policies. But economic convergence was slow and difficult; in some cases the gaps actually widened. In many economies the delays and obstacles to adjusting to the large-scale global changes weakened competitiveness and the ability to grow. Mitigated by the improvement in funding conditions after the introduction of the euro, market pressures alone were not sufficient to drive the necessary reform efforts. Moreover, the rules for the public finances defined in the European sphere were seldom respected and sovereign risks were basically not priced by the markets: until the outbreak of the crisis the spreads between government bond yields within the euro area were close to zero.

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3 European Commission, "Stable Money, Sound Finances. Community Public Finances in the perspective of the EMU", European Economy, 53, 1993. European Commission, *The Economics of Community Public Finance,* European Economy – Report and Studies, 5, 1993.

4 R.A. Mundell, "A Theory of Optimum Currency Areas", *American Economic Review*, 51, 1961, pp. 657–65.

5 P.B. Kenen, "The Theory of Optimum Currency Areas: An Eclectic View", in R.A. Mundell and A.K. Swoboda (eds.), *Monetary Problems in the International Economy*, University of Chicago Press, Chicago, 1969.

6 T. Padoa-Schioppa, "Il passo più lungo", *Corriere della Sera*, May 3, 1998.

7 T. Padoa-Schioppa, Interview with *la Repubblica*, August 6, 2008.

Perhaps the convergence process had been displaced, firstly, by the acceleration of the enlargement of the EU and increased participation in the Eurosystem and, secondly, by a clear (though according to some, irrelevant) predominance of intergovernmental agreements over the so-called community method.

The response to the crisis

In this framework, after the global financial crisis and the very severe global recession in 2008–09, the full revelation of the conditions of Greek public finances produced tensions, which then spread to the economically weaker euro-area countries, characterized by excessive public or private debt, a foreign trade deficit, poor competitiveness, and low economic growth. Tensions grew with the bursting of the property bubble and the consequent disruption of banking in Ireland. With the announcement of the involvement of private investors in restructuring Greek debt in the summer of 2011, financial markets suddenly became aware of the implications of the ban on interventions to rescue member states under the Treaty on European Union. There followed a very serious crisis of confidence in the ability of the single currency to survive, with negative consequences for the real economies of individual countries and for the area as a whole.

The list of potential causes of the crisis is rather crowded. Fiscal imbalances, labour market rigidities and competitiveness deficits, insufficient innovation and productivity growth, excessive bank lending from core to periphery countries, all these have been good cause of lags, disturbances and vulnerabilities. But I believe that the sovereign debt crisis should be interpreted first and foremost as a major lack of trust in the future of the EMU, the euro and possibly the EU. The severity of the sovereign debt crisis, which at some point threatened the very existence of the single currency, owes in part to the incompleteness of the EMU project, which dramatically exposed the reversibility of even the major progress towards European financial integration made with the introduction of the euro.

The rise in yield spreads between government bonds in the euro area was determined by two factors, one national and one European, linked respectively to the weaknesses of some countries' economies and public finances (sustainability risk), and to the incompleteness of European construction and the attendant fears of a break-up of the monetary union (redenomination risk). Europe's response to the sovereign debt crisis has consequently been two-pronged: on the one hand, individual countries have pledged to adopt prudent budgetary policies and structural reforms to support competiveness; on the other, a far-reaching reform of EU economic governance has been undertaken.

The definition and implementation of this response was not smooth, let alone optimal. But the constraints were significant – first and foremost, the lack of trust among member states, partly justified by the episodes which ignited the crisis (fiscal misreporting and failures in financial supervision). Moreover, there was a lot of ground to be covered in a very short term. Europe had no tools with which to manage a sovereign crisis and the legal basis for providing financial support to countries in distress had to be defined. International treaties needed to be drafted and ratified, also to strengthen peer oversight on national fiscal policies and structural reforms. Further integration of financial markets was necessary to increase the resilience of the area to asymmetric shocks: the banking union and the on-going project of the capital market union are both far reaching reforms, affecting in depth the institutional fabric of member countries.

The ECB Governing Council, by providing a series of conventional and unconventional monetary policy measures to fulfil its price stability mandate, ensured accommodative financial conditions that mitigated the fall in aggregate demand and helped to "buy" the considerable time needed to implement this strategy, while countering market uncertainties that could undermine its implementation. The European strategy to respond to the crisis has brought overall a stabilization of financial conditions and an easing of tensions in sovereign debt markets, even if we are still in deep and at times unknown waters. But, obviously, monetary policy cannot guarantee strong and lasting growth on its own, it cannot be a substitute for the needed reforms, it can only provide favourable conditions to speed the process up and absorb its short-term costs. A successful effort requires, once again, action at both the national and the European level.

Lacking a common fiscal capacity, demand in the euro area must draw support from a more convinced use of the available fiscal space. In particular, this implies a substantial, and symmetric, respect of the requirements of both the Excessive Deficit Procedure and the Macroeconomic Imbalance Procedure. In the case of national budgets, the existing flexibility should be reasonably used within the limits of European fiscal rules. At the same time the creation of new income, new demand, and new jobs must be supported by measures and reforms designed, as of now, to raise productivity and enhance growth potential. These reforms should take into account the structural challenges that characterise our "new world", including demographic developments, the new wave of technological progress, climate change. A marked expansion in activities that require expertise and new skills is ahead, but at the same time it is possible that the scope for employment in the sectors most susceptible to automation and to the growth of the digital economy will shrink, even considerably.

The way forward

The Five Presidents' Report published in June 2015[8] sets out a roadmap for completing the EMU and, specifically, to increase its resilience to local shocks. It calls for contemporaneous progresses along four dimensions: ensuring that each economy has the structural features to prosper within the Monetary union (economic union), limiting risks to financial stability and increasing risk-sharing within the private sector (financial union), ensuring both fiscal sustainability and fiscal stabilization (fiscal union), and providing democratic foundations for all the above (political union).

The Report makes proposals to be adopted in two stages and a recent Communication by the European Commission takes forward key elements of the first stage. On economic governance, such elements include the introduction of national "Competitiveness Boards" (mirroring the creation of national Fiscal Councils introduced by the six-pack for fiscal surveillance) and of an advisory "European Fiscal Board" (providing an independent evaluation of the implementation of the EU fiscal framework). In addition, steps towards financial union are also considered (notably through a European Deposit Insurance Scheme), as well as a more unified representation of the euro area in international organizations.

For the long term, the Report calls for the creation of a fiscal stabilization function for the euro-area, complementing national instruments to cushion severe negative shocks. Participation in this shock-absorption mechanism would be conditional on compliance with common standards in economic convergence.

Unsurprisingly, the Report is far from being uncontroversial, most notably in the fiscal area. According to some, the weaknesses are such that the Report risks to be another "missed opportunity".[9] One can doubt the benefits of introducing further layers of "technocratic" control in an already complex framework, often criticized for lack of democratic accountability. In the medium term, and at least until the creation of a common fiscal stabilization function, the shock absorption capacity of euro-area countries remains dangerously limited (especially for those countries with limited fiscal space). In the longer term, since access to the common fiscal capacity would be conditional on significant and sustained economic convergence,

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[8] *Completing Europe's Economic and Monetary Union*, prepared by Jean-Claude Juncker, in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Shultz.

[9] F. Saccomanni, "The Report of the Five Presidents: A Missed Opportunity", *Documenti IAI*, 15|14, July 2015.

there is a risk of introducing a new source of tensions among different Member States within the euro area.

Regardless of its individual proposals, in my view the key questions to ask about the Report are two: Are we going in the right direction? And, are these efforts sufficient? I believe that, however arduous it might prove, it is worth proceeding along the roadmap set out in the Report. But it might not be sufficient. I believe that more progress on the side of the political union should not come sequentially, at the very end of the process, but important elements should be considered right away. In other terms, more action at the economic and financial level needs to be accompanied by parallel action also at the institutional and intrinsically political level: for example, on the legal side (from company and bankruptcy laws, to more basic rights and principles); on solidarity and welfare; on defence and security; on the timing of elections, and so on. There is also a case for reversing the *de facto* predominance of the intergovernmental approach on the so-called community method, even if we must be aware of the risks of this being dominated by an excessively administrative and bureaucratic policy-making.

I often joke that, for a sense of shared purposes to be built-up in the euro area and to fully remove uncertainty in the eyes of interested external partners and observers, perhaps it would have been better to have a "single army" before adopting a "single currency"…. Jokes apart, and aware that issues such as this have been very much debated over the last sixty years or so, I believe that those taken in the last few years on monetary policy and banking supervision are critical steps ahead towards a stronger union. Financial fragmentation along national lines, which came to represent a hallmark of the euro area crisis, has been reversed by the European response to the crisis; financial integration is now back to a level comparable to pre-sovereign debt crisis levels, although some fragmentation still remains.

However, the recent opposition to a common European Deposit Insurance Scheme is unwelcome news if not outright regress. Some claim that for European integration to proceed more collective responsibility needs to be necessarily accompanied by a parallel transfer of sovereignty. One may reply that this transfer of sovereignty has already taken place for monetary policy and banking supervision, without the corresponding introduction of common macroeconomic stabilization mechanisms or common deposit insurance.

What is certain, most of the actions needed to strengthen EMU calls for trust. A confrontational approach would be detrimental. Much can be done at the level of the European Institutions – Parliament, Council, Commission – to make them better instruments of a genuine Union, rather than a collection of states. Each country must continue to build on the progress made so far, before or during the crisis, in macroeconomic and structural adjustment. All must show some understanding for their peers and play their part in renewing a shared sense of purpose and trust. We have to realize that Europe's strength lies in the fact that we are united.