Sabine Lautenschläger: The euro – idea and reality

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the Single Supervisory Mechanism, at the Europa Forum Luzern, Luzern, 2 May 2016.

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President of the Confederation Schneider-Amman,

President of the Government Wyss,

Mayor Studer,

Excellencies and parliamentary representatives,

Ladies and gentlemen,

800 years ago, here in the Swiss Alps, a structure was built that was vital in bringing people together in Europe: the Devil's Bridge over the river Reuss. It was because of this bridge that the Gotthard pass become one of Europe's main routes, "the people's road". Lucerne is located on this road and is thus an early witness of European integration.

Today, in the 21st century, Europe is interconnected by much more than a pass. Europe has become a political and economic community. A tangible symbol of this community is our single currency, the euro.

The euro – do the idea and the reality clash?

The idea of the euro was, and is, to support Europe's internal market, and thus provide for economic growth and prosperity. But the name of the currency says it all: the euro should be more. The euro aims to be a single currency for a united Europe. It should deepen Europe's cultural and political unity, dismantle borders and strengthen our feeling of togetherness.

So much for the idea. Some people – perhaps even some of you – may be sensing a different reality: financial crisis, economic crisis, unemployment – these are the keywords currently dominating the discussions on monetary union.

How much does the reality have to do with the actual idea of the euro? Is the euro still a symbol of what holds Europe together? Or has it become a symbol of what divides Europe? The growing appeal of anti-euro and anti-Europe parties is a sign that we need to make the incalculable benefits of a single currency easier to understand for the people of the euro area.

And we should encourage people to look at the full reality and not just one facet. The euro is a fundamental part of the single market. More than 300 million people in 19 countries make payments using the euro. It's the world's second most important currency. Over 20% of global currency reserves are held in euro. And despite all the euroscepticism, recent surveys[1] show that 70% of people in the euro area want the single currency.

Obviously, in my view too, a united Europe with a single currency is the right idea; as Theo Waigel, former German Minister of Finance, once said, the euro is "ingenious". And, for me, it's about more than the economic advantages brought by a united Europe and a single currency.

It's also about a political reality. Not all the countries of Europe can live in "splendid isolation" – Europe's voice in world affairs would fall silent. More than 60 years ago, Jean Monnet, one

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1 Standard Eurobarometer 84, November 2015.

of the founding fathers of the European Union, said: “Our countries have become too small for today’s world, at the level of modern techniques, at the measure of America and Russia today, China and India tomorrow”.

The idea is therefore ingenious and the will of the people is clear. Together, this represents an appeal to policymakers to straighten out what is crooked, to reinforce the foundations of monetary union and once again reconcile the reality of the euro with the idea of the euro.

The consequences of the recent financial and economic crisis show what is needed to achieve this from an economic perspective. What we certainly need is a European crisis tool – a mechanism that works quickly, effectively and efficiently in an acute crisis. A first step was taken with the creation of the European Stability Mechanism.

But what’s necessary above all are structural reforms at national level, including reforms of social security schemes, labour and goods markets and insolvency laws. Reforms which ensure that the community of 19 countries grow together economically and move closer to the highest international standards. Such a convergence is important, not only to keep monetary union stable in the medium and long term, but also to safeguard economic growth and prosperity.

Yet even after successful structural reforms, in a monetary union with 19 Member States there can always be economic shocks which affect some countries more than others. Flexible labour markets and a responsible fiscal policy help to cushion such shocks – not only in a monetary union. In such a union however they play an even greater role, because the countries concerned can no longer react by way of the exchange rate or national monetary policy.

But if the shock is excessive or the economic structures too rigid and the national budget under pressure, the Member State in question may be quickly overwhelmed. This is exactly what we have seen during the recent crisis. The costs of the crisis were borne in large part by the citizens in the crisis countries, but also shifted in part to the European level through mutual guarantees. Basically, the countries concerned resorted to a sort of implicit insurance that was not originally foreseen.

This experience gives rise to two key questions:

- First, how can Member States better absorb external shocks – even without an independent exchange rate and without a national monetary policy?
- Second, how can risks be shared at European level without a transfer of risk occurring which distorts the incentives for the individual Member States?

A monetary union needs strong members...

As for the first question, the euro area countries need economic structures which meet the requirements of a single currency. The crisis has made this abundantly clear. Many countries are now on the right track. Ireland, Spain and Portugal, for example, have implemented a series of reforms; they have become more competitive and their economies are recovering.

And yet, in some euro area countries, unemployment remains very high, especially among young people. In addition, many countries still have large public deficits and high levels of debt. So further reforms are necessary here. The same applies to goods markets and the general business environment.

In many Member States bureaucratic hurdles have to be overcome in order to start a business, and not only in the crisis countries. Removing such administrative barriers is much less expensive than national recovery plans, and can contribute significantly to sustained growth and increasing prosperity.[2]

It is all the more worrying that the OECD in its recent “Economic Policy Reforms” report notes that particularly in the euro area countries the pace of reform is slowing. It would be disastrous if necessary reforms cannot be implemented or, if implemented, reforms were even to be withdrawn. That would slow down, or even totally impede, the necessary economic upswing. Central banks would then come under pressure to counteract this by pursuing an exceptionally loose monetary policy.

A stable monetary union rests on the shoulders of individual Member States. Sound economic and responsible fiscal policies at national level are an essential basis for a stable monetary union.

Against this background, the founders of the monetary union put in place a rulebook that seeks to ensure sound fiscal policy: the Stability and Growth Pact. We all know that these rules were not particularly effective. They have therefore been strengthened since the crisis and complemented by a better control of macroeconomic imbalances. But even the best rules only work if they are respected. And even the best rules may not prevent a country from experiencing economic shocks.

... but union also means community

For cases where these shocks are too big to be absorbed at national level, a monetary union needs mechanisms to spread the ensuing costs over more than one pair of shoulders.

And this brings me to the second question: how can risks be shared at European level without a transfer of risk occurring which distorts the incentives for the individual Member States?

I mentioned this earlier: during the crisis, risks were shared especially by way of mutual guarantees and thus via national budgets. However, such a sharing of fiscal risks can reduce the incentives to pursue sound fiscal policies.

In order to counter this disincentive, both the risks and the monitoring would therefore have to be shared at European level. So the Presidents of the European institutions[3] – including the ECB – are calling for stronger fiscal integration leading to a fiscal union.

For the moment, I see little political will to create a European fiscal union. Fiscal risk-sharing, for the time being, therefore remains a problematic issue.

As long as the basic willingness to share fiscal sovereignty is lacking, we could and should then agree that sovereignty will be relinquished if a Member State does not comply with the jointly agreed objectives, such as the deficit and debt limits.

At the same time, it’s necessary to strengthen national ownership and private risk-sharing. From an economic perspective, it would seem obvious: if a state gets into financial difficulty, why shouldn’t the state’s creditors bear the losses? In reality however, this is not so easy to implement. Bear in mind how long it took to arrange that for the resolution of banks their creditors will also be liable in the future.

Where does the problem lie? It lies in the possible contagion effects and in concerns about financial stability. The creditors of countries are in many cases the domestic banks. A state bankruptcy with a bail-in could therefore trigger a financial crisis.

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[2] Masuch, K.; Moshammer, E.; Pierluigi, Beatrice (2016), Institutions and Growth in Europe. Centre for European Policy Studies (CEPS Working Document No. 421).

[3] “Completing Europe’s Economic and Monetary Union”, presented by J.-C. Juncker, in close cooperation with D. Tusk, J. Dijsselbloem, M. Draghi and M. Schulz, 22 June 2015.

This problem is intensified by the fact that the regulation creates incentives for banks to hold government bonds. A bank neither has to put aside capital for government bonds nor is bound by an upper limit on how much it can be indebted vis-à-vis an individual sovereign debtor. On the one hand, government bonds are treated as if they were risk-free. On the other hand, banks may easily hold very many government bonds of a single issuer – and this is usually the home country.

First, banks in this way increase their exposure to the financial problems of states. Because government bonds are not as risk-free as the regulation assumes. The crisis has shown this.

Second, it becomes easier for an individual state to run a loose fiscal policy. It's becoming more likely that systemic problems are emerging or intensifying: a state infects the national banking system, or vice versa, and the problems spread across borders. Such systemic risks can then only be kept in check by way of a fiscal risk-sharing.

In order to promote ownership and private risk-sharing, we must revise the preferential regulatory treatment of sovereign debt. One option is to introduce a risk weighting for government bonds which rises along with the concentration risk. The more government bonds held by a bank, the more capital the bank would have to hold against each of these bonds. In this way, the capital requirement and upper limit would be combined in a single rule. This would be an important step towards breaking the vicious circle between banks and sovereigns; and it would be a further step towards reinforcing the foundations of monetary union.

Private risk-sharing does not have to be exclusively via the credit markets and not solely in relation to the public sector. Investors can also help to share risks via the equity markets.

Take a German company as an example. If the German economy is hit by a shock, this company will probably be affected too. If its owners, the shareholders, are spread across many countries, the company's losses will be spread likewise.

The more cross-border financing companies have, the less the national economy is affected by any shock and the faster it can recover.

In the United States, for instance, this kind of risk-sharing works: studies show that integrated capital markets in the United States absorb 40% of the cyclical variations between the states.[4]

This speaks in favour of the European capital markets union project. And also for, as part of this project, a greater harmonisation of equity markets in particular. I admit that this is an ambitious goal as insolvency law and company law, for example, would need to be further harmonised. This step would remove a few barriers to a single European capital market.

Closing remarks

Ladies and gentlemen,

At the beginning of my speech I mentioned the Eurobarometer survey which indicated that 70% of people in the euro area want the euro as the single currency. The problem is not the idea of the euro. It is much more about repeatedly reviving citizens' awareness of the benefits of a united Europe and a single currency. And about creating a solid and sustainable economic basis.

I have shared with you some proposals on how monetary union could be designed so that it responds to people's wishes and durably fulfils its objectives. Are these proposals new? No, these and other proposals for the further development of monetary union have been around

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[4] Asdrubali, P., Sørensen, B.E. Yosha, O (1996), "Channels of Interstate Risk Sharing: US 1963–1990", Quarterly Journal of Economics, 111(4), 1081–1110.

for quite some time. This shows that we have no problem understanding, but we do have a problem implementing.

It's up to politicians to create a framework that is appropriate for the idea of a single currency – at national as well as at European level. The longer politicians stand still, the more people will lose faith in Europe. One sign of this is that political parties which want to move backwards have recently been gaining support.

At the same time, the European Central Bank is being pushed into a role for which it was not created. Monetary policy can neither solve structural problems at national level nor institutional problems at European level. On the contrary, the more that is expected from monetary policy, the more likely it is to be overburdened.

The ECB alone cannot create growth and prosperity for all. For that, structural reforms are necessary – at national and European level. At the same time, structural problems are making monetary policy less effective in the euro area.

In this context, it seems very odd to me that politicians are now criticising the European Central Bank. This endangers our independence and undermines trust.

I would like to see a political class that has the courage to lead public opinion. Politicians who have the confidence to explain to voters that a fully fledged European monetary union is not without an alternative, but that it is worthwhile – even if it's proving difficult to get there. But once the idea and the reality of the euro are back in harmony, then Eurosceptic voices will not find many listeners. I am convinced of this.