Mario Draghi: Security through unity - making integration work for Europe

Speech by Mr Mario Draghi, President of the European Central Bank, at the joint ECB and Bank of Slovenia conference on the occasion of the 10th anniversary of the adoption of the euro, Ljubljana, 2 February 2017.

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It is my pleasure to be here with you today to celebrate this milestone in the history of your country and of our Union.

Though recent years have been difficult for Slovenia, as they have for the rest of Europe, you can look back with pride on what your nation has achieved. After only two years of EU membership you were able to join the euro – the first of the "new Member States" to do so. And since then Slovenia has become deeply integrated into our monetary union. Even today 85% of Slovenes are in favour of the euro, reflecting the strength of our common bond.[1]

But as we celebrate the 10th anniversary of the introduction of the euro in Slovenia, we can likewise celebrate other anniversaries in the recent history of Europe: 60 years since the Rome Treaty, which created the common market; more or less a quarter of a century since the Maastricht Treaty, which launched Economic and Monetary Union (EMU); 20 years since the Amsterdam Treaty, which enacted a common foreign and security policy.

There are those who would like to see such events as part of distinct histories, one of the economic integration of Europe, one of its monetary union, and one of its military and political alliance. But those histories are not distinct.

They have all been part of the same impetus, which is the desire of the people of Europe to ensure their security in the face of common threats: the threat of continental war evoked time and again in our history; and the global threats created by evolving technology, geopolitical risks, and upheavals in our natural environment.

The strength of this impetus has meant that, for most of the period since 1945, the course of European integration has been clear. Though the different strands of integration have advanced at different speeds, the direction has always been forwards. It was hardly disputed that, in the long run, coming together as a Union was the best response to the common challenges we faced. Deeper integration was a question of *when*, not *if*.

Yet, today, perceptions of insecurity are on the rise. And to some, it is no longer self-evident that closer union provides the answer. Integration is viewed in some quarters as a source of insecurity rather than a bulwark against it. One country has even decided that it is better to reverse that process than continue it.

This insecurity in part reflects common factors emerging across Western democracies, such as fears about immigration, globalisation and social change. But in Europe there are also unique forces at play. In particular, the severity of the euro crisis has weakened faith in the EU as a foundation of economic security.

So Europe, and even more so the euro area, faces a moment of decision. We need answers to the questions that citizens are asking. But those answers also need to be balanced: there are things that need to change in Europe, but there is much we can be proud of as well.

European integration has produced many achievements and we should not let our current difficulties diminish them. On the contrary, we need to be confident in the progress we have made – and clear that we would be worse off without it.

But where things evidently need to be better, we need to make them so. Most importantly, that means making the changes in our monetary union that all can see are necessary.

The significance of the single market

Since its formation in 1957, the European project has been built, above all, on a commitment to openness, epitomised by the establishment of a single market among its Member States. This commitment was idealistic, but it was also eminently pragmatic. The founders of the EU had witnessed the damage caused by the inwardness and protectionism of the interwar years. They understood that sustaining economic growth was vital to drain support for divisive nationalism, and the best way to achieve this was through open markets.

Though the last decade has been difficult, over the long sweep of post-war history their vision has been proved right. Since 1960 cumulative growth in GDP per capita has been one-third higher in the EU15 than in the United States. Private wealth, which had been twice wiped out by the wars of the twentieth century, has also doubled as a percentage of national income. This was of course partly driven by the natural catching-up process after the Second World War. But there is plenty of evidence that growth has been accelerated by integration.

According to one estimate, the EU's GDP per capita would be as much as one-fifth lower today if no integration had taken place since the war.[2] Another estimate looking at the effects of integration since the 1980s – so after postwar catching-up had run its course –finds a gain in per capita GDP of around 12% relative to the non-membership scenario.[3]

And the countries that joined the EU in 2004 and 2007, such as Slovenia, have also shared in those gains. The increase in GDP produced by EU membership may turn out to be as high as 40% for the 12 new members,[4] which would not be surprising, since the EU is by far the main trading partner for countries in central and eastern Europe and the main source of FDI.

Today, some are questioning whether openness remains the best way to ensure our economic security. But we need to ask where we would be today if we had not had such a long phase of integration on our continent. And the likely answer is: much poorer.

What is more, the single market has not only provided a foundation for growth, but also for *sustaining* open markets. As we are seeing today at the global level, markets cannot stay open for long if not all participants are perceived to be playing by the same rules, or if the benefits are seen to be shared unfairly. The single market has survived, in large part, because Europe has built a unique model for managing those challenges.

Deepening the market in Europe has entailed building common institutions to protect citizens from unfair competition or discrimination from abroad – namely the common regulatory framework enforced by the European Court of Justice. Safeguards central to the European social model have been progressively embedded in European law, notably the Charter of Fundamental Rights, to provide protection for the most vulnerable.

And Europe has forged the first redistribution system across countries to help prevent persistent regional inequalities. As early as the mid-1970s, European funds were being used to support less developed regions or those threatened with industrial decline. From 2007–13, €350 billion was allocated in the EU budget to structural and investment funds. And let me add that Slovenia was a net recipient of those funds, with annual investment financing amounting to, on average, one-fifth of what the Slovenian government spent on public investment.

No one would claim this system of rules, safeguards and redistribution has been perfect. We know that some feel it improves their lives too little, and others that it intrudes into their lives too much. But what we have built in Europe is a model for sustainable openness – one that can reap its gains while mitigating its unwanted effects. So if we see problems, our challenge is to nurture

and improve that model, not to turn it back.

Because that would not only mean less wealth for our continent. It would also mean less *political* security for our citizens. We should not forget that besides being an engine for growth, the single market has brought vital political benefits as well.

The first is that it has provided a motor for binding political integration among the states of Europe.

As I just described, a single market can only be sustained if there is a common system of laws overseen by a common judiciary – the ECJ. And if there is a judiciary, there must be a legislature to write the law, which in Europe is provided by the EU Council and the European Parliament. And there must be an executive to enforce the decisions of the legislature and judiciary, which in our case is the role of the European Commission. The single market, in other words, creates by its very nature a closer political union.

This is a dynamic we have also seen in the US as its own internal market has developed. As is well-known, the short "Commerce Clause" of the US constitution – which grants Congress the power to regulate commerce among the states – has led over time to a substantial expansion of the role of the federal government in economic affairs.

The second political benefit has been to enhance Europe's influence in the world.

Trade policy decided in common gives Europe real sway in global negotiations, both in the deals it can extract bilaterally, and in the setting of multilateral rules in the WTO. A large market has leverage over large multinational firms, allowing Europe to protect what it deems important, such as privacy on the internet. It also permits Europe to use trade sanctions to counter hostility from unfriendly countries, and thereby enhances military security too. And if Europe wants now to integrate further in other areas – such as defence and foreign policy – it will need the economic foundation the single market provides.

Thus for all these reasons, we should be proud of what we have gained from integration. That does not mean we should be blind to its challenges, nor to the disappointing performance of recent years. We need to restart the single market as a growth agent and do better in compensating the losers it creates. But we should also be clear: we would be worse off today, both economically and politically, if we had not followed this path.

From the single market to the euro

But the single market also had a further effect: it led directly to the euro. Once Europe decided to embark towards a fully integrated market, a single currency was desirable, if not essential. Hence the euro was set in motion at the Hanover summit in 1988, immediately in the wake of the decision to achieve a true single market.

Today some people question this link between market and currency, and ask whether retaining national currencies might have been better for Europe. But one has to remember that the single currency did not appear out of thin air. It was rather a consequence of Europe's long and unsatisfactory experience with different exchange rate regimes since the war. It was also, in other words, both an idealistic and a pragmatic decision.

Europeans had always been sceptical of fully floating exchange rates, seeing currency volatility as inimical to trade integration. That is why, as soon as the Bretton Woods system broke down, they sought to restore fixed exchange rates, first through "the snake in the tunnel", and later through various iterations of the European Monetary System. The prevailing thinking was well-captured by Nobel laureate Robert Mundell, who developed his theory on optimum currency areas in the belief that, and I quote,

"I could not see why countries that were in the process of forming a common market should saddle themselves with a new barrier to trade in the form of uncertainty about exchange rates."[5]

Hence, it was inevitable that the single market would be buttressed by some form of fixed exchange rate regime. The question was what form. And Europe had experienced the costs of fixed exchange rate regimes that fell short of a single currency.

Countries were vulnerable to speculative attacks and currency crises, most painfully demonstrated by the ERM crisis in 1992–3, and that was in a world where capital was less mobile than it is today. Most members had little monetary policy autonomy, since they were required to effectively import the monetary policy of the anchor currency. And when countries did devalue, it did not always prove an effective adjustment mechanism for nominal shocks, provoking instead higher inflation and the need for further devaluations.

Moreover, the fear was that, without a single currency, repeated cycles of devaluations would distort the conditions for fair competition and undermine the single market in the long run. An economy that increased productivity and competitiveness could be deprived of the benefits it should enjoy, in terms of increased market share, because of currency depreciation in competing countries. And if some countries were prepared to practice such "beggar thy neighbour" behaviour, why should others permanently open their borders to them?

The point was not that the single market could not tolerate small exchange rate adjustments among a few of its members. It was that major currency volatility, of the type we had seen in the 1980s, would severely test the willingness of all to keep their markets open. And we can only imagine how, without the euro, currency markets would have reacted to shocks we have seen since its launch – the dotcom crash, the Lehman bankruptcy, the sovereign debt crisis.

The conditions for success in EMU

However, the case for the euro was always based on a trade-off. By reinforcing the single market in this way, it would lock-in the gains of economic integration and thereby benefit the whole Union. But it would also deprive individual countries of adjustment tools for short-term shocks, notably their own exchange rate. Thus for the trade-off to be beneficial, it was essential that those short-term costs were reduced as much as possible.

This depended on certain conditions being fulfilled, which were established by Mundell and later authors as part of the theory of optimum currency areas. They included: trade integration, to reduce the incidence of asymmetric shocks; factor mobility and wage and price flexibility, to accelerate adjustment when shocks did hit; and a system of risk-sharing, to reduce the costs of that adjustment process for individual members. But, in the euro area, it was clear that the importance attached to each of those conditions would not be the same.

Large-scale labour mobility was always unlikely, given cultural and linguistic barriers. It was also improbable that fiscal risk-sharing would reach U.S. levels, not least owing to the relatively larger role for national budgets as fiscal stabilisers. Hence it was essential that euro area countries substituted for lower integration in these areas with stronger commitments in others. This meant four things in particular.

The first was avoiding policy mistakes, such as boom-bust cycles emanating from weak prudential supervision. The second was building resilience to shocks through structural reforms and the continued deepening of the single market. The third was sound fiscal policies to provide sufficient fiscal buffers over the cycle. And the fourth was a strong financial union, with diversified asset holdings and hence real private risk-sharing.

In this way, countries would be able to reduce the severity of local slumps, since asymmetric shocks would be tempered by trade linkages and sound financial policies. When shocks did

occur, wages and prices would be able to adjust more quickly, and resources would reallocate faster in response, limiting the employment cost of adjustment. Fiscal policies would be available at the national level to stabilise the economy during the transition. And losses would be shared across the Union through integrated financial markets.

There was no secret about this. It was known to all in 1999 that these were the conditions for success. This was why we agreed the Stability and Growth Pact for fiscal policies. It is why there was an “E” in EMU: it was clear that structural convergence had to occur. And it is why there has always been a strong emphasis on the need for sustainable financial integration.

We know the history that followed: the slowing down of structural reforms, the watering-down of the Pact, the fragility of financial integration, and the underlying *divergence* between countries that ensued. But we need to be very clear that it was not the euro as a currency that was to blame for this. National authorities knew what they had to do. The currency could not protect them from their own policy decisions.

Indeed, it is worth emphasising that, when countries do pursue the right policies, the euro is no hindrance to success. Germany, for example, did not experience a boom-bust financial cycle, ran relatively sound fiscal policies, and passed a series of labour market reforms in the early 2000s. Its unemployment has fallen from close to 11% in 2005 to under 4% today, and that was during the worst recession since the 1930s.

And even in the presence of policy mistakes, countries that meet the necessary conditions in other areas are able to adjust adequately within the single currency. Consider Ireland, which suffered acutely from the financial crisis. Yet it has seen its unemployment fall from more than 15% in 2012 to 7% today, not least because of its flexible labour market and successful industrial strategy aimed at attracting FDI.

There are some today who believe that Europe would be better off if we did not have the single currency and could devalue our exchange rates instead. But as we have seen, countries that have implemented reforms do not depend on a flexible exchange rate to achieve sustainable growth. And for those that have not reformed, one has to ask how beneficial a flexible exchange rate would really be. After all, if a country has low productivity growth because of deep-rooted structural problems, the exchange rate cannot be the answer.

Still, it is important to ask, if some governments did not follow the right policies to succeed in EMU, *why* did they not? The euro area relied heavily on the notion that the integration process would *itself* create the incentives for sound policies. Faced with stronger competition through the single market and an inability to devalue, governments would be forced to address long-term structural problems and ensure fiscal sustainability.

That this did not happen was in part because the single market process stalled. But it was also because we lacked some key institutions at the euro area level. We did not have a common system of banking oversight to monitor financial flows, which in some countries allowed mounting competitiveness losses to be masked by unsustainable finance-driven growth. And we had only weak common decision-making for fiscal and economic policies.

Several important steps have now been taken to address these issues, most notably the establishment of Banking Union. But that project is still unfinished. And as has been laid out in the Five Presidents’ report, we still remain some way short of a complete monetary union – which is to say, one where countries take collective responsibility for the euro area within common institutions.

Conclusion

So it is clear what the way ahead is for our union. Not to turn away from what has worked: our

model of economic openness reinforced by our single currency. But to put right the mistakes that have prevented it from working as well as it should.

For national governments this means fulfilling the conditions that we have always known are necessary to prosper in our monetary union. And for the euro area as a whole, it means constructing an institutional architecture that sets the right incentives for those policies, and that make us more resilient in the face of common shocks.

But it is also clear that, to reach this point, the sequence has to be right. What is preventing us from moving ahead today is, in part, the legacy of those past failures, which creates a lack of trust among countries to enter into such a new stage of integration.

Trust that all countries will comply with the rules that they have set for themselves, so as to reduce their mutual vulnerability. And trust that all will enact the necessary reforms to ensure structural convergence, so that complying with those rules becomes easier, and sharing risks does not create permanent transfers between countries. Compliance and convergence, and through it growth, are the keys today to give to the integration process new impetus.

And that impetus we must find, because we cannot stay where we are. We have to make our Union more stable and prosperous to deliver the security our citizens crave. And by doing so we will put ourselves in a stronger position to confront the new challenges we face today: the rise of political extremism, insecurity on our borders and an ever more uncertain global order.

So we must rediscover the spirit that has carried our Union this far. The spirit that has led generations of Europeans to work together to secure themselves against common threats. That has yielded tangible improvements for our citizens, such as the freedom to work and trade across our continent and transact in a single currency. And the spirit that, if channelled once more into common action, can overcome the new threats we face today.

Unity is the key to security for our continent – today as it always has been.

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[1] Standard Eurobarometer 86, Autumn 2016.

[2] Badinger, H., "Growth Effects of Economic Integration: Evidence from the EU Member States", *Review of World Economics*, Vol. 141, No 1, pp. 50–78, 2005.

[3] Campos, N., Coricelli, F. and Moretti, L., "Economic Growth and Political Integration: Synthetic Counterfactuals Evidence from Europe", *IZA Discussion Paper,* No 8162, April 2014.

[4] Lejour A.M., Solanic V., Tang P.J.G., "EU Accession and Income Growth: An Empirical Approach", *Transition Studies Review*, Vol. 16, Issue 1, pp 127–144, May 2009.

[5] Mundell, R., "Optimum Currency Areas", luncheon speech at Tel Aviv University, 5 December 1997.