# Yves Mersch: Deepening EMU - political integration and economic convergence

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the conference on "Economic and Monetary Union - Deepening and Convergence", Linz, 5 July 2018.

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Ladies and gentlemen,

We could have known better.

The discussions on the first meaningful blueprint for a European monetary union already highlighted challenges that we have not yet fully overcome. The plan to establish a single currency by 1980, drawn up in 1970 by a committee of experts chaired by the then Luxembourg Prime Minister Pierre Werner, referred to the need for economic policy coordination amid insufficient economic convergence and the absence of fiscal transfers which would require a political union. Later proposals, including the Maastricht Treaty of 1992, failed to sufficiently tackle the inherent tensions of a currency without a state. Although Europe has recovered from the most severe financial and economic crisis in a century, which threatened the very functioning of our democracies, it is still suffering from these shortcomings.

As the euro is a shared currency, euro area countries with low productivity growth cannot resort to exchange rate depreciation [currency devaluation]; and the more dynamic countries, whose currencies would normally appreciate, end up with stubbornly low inflation rates. The only way out is through internal devaluation, which entails lower wage costs and higher productivity, but this encounters social resistance and fosters populism. Recent political propositions in Italy were kept in check only by market pressures and the sanity of established institutions – national and European alike.

But recognising the design flaws of the currency union cannot mean calling the whole project into question. Too much financial, political and social capital has been invested, and the cost of a break-up would be prohibitively high, with devastating economic, social and political consequences.

The only viable option is to continue the deepening of our Economic and Monetary Union (EMU) through political and economic convergence. Both channels are indispensable for EMU.

Today, I will focus on three areas in which it is vital to make progress. First, we have to more actively pursue fiscal and structural reforms. Second, we need to further reduce risks and fragmentation in the financial sector. And third, we must decisively strengthen the institutional architecture of EMU to weather the challenges of today and tomorrow.

Notwithstanding robust economic expansion, the euro area remains vulnerable to adverse shocks. The risk of an external shock, albeit symmetrical at its origin, has come to the fore lately, as we witness a global environment marked by heightened uncertainty, retrenchment behind national borders, and pressure on the multilateral system.

## Fiscal policies and structural reforms

All euro area countries first and foremost need to increase their resilience. Strengthening macroeconomic resilience is particularly important in the euro area. In the face of asymmetric shocks beyond the control of national authorities, costs are more likely to be transmitted across borders within Monetary Union in view of the strong trade and financial linkages. Even in the face of a common shock, different degrees of resilience among countries will make the transmission of the single monetary policy more challenging. Still, monetary policy cannot act to compensate for national deficiencies.

It is therefore of vital importance to develop the flexible labour and product markets that reduce the chance of crises and allow for quicker recoveries by enabling the factors of production to move more quickly between sectors.[1]

Research from the IMF, the OECD and the ECB demonstrates that well-sequenced and packaged reforms in these areas can increase potential growth and resilience. In parallel, further work to reinforce the soundness and effectiveness of domestic institutions will be critical. [2] [3]

On the fiscal side, it is imperative that Member States use the ongoing expansion to build up fiscal buffers and reduce debt levels, while those with fiscal space ought to address their public investment gaps. Lower debt and higher buffers increase resilience when a shock hits. By complying with the rules, including the requirement for low debt levels, states undergoing a downturn are more likely to retain financial market confidence in their solvency. They also increase their ability to recover from the shock. Sizeable buffers create the fiscal space to mitigate downturns, which minimises output losses and thus strengthens the underlying capacity of a country to pay off the national debt.

It is ultimately up to national governments to pursue sound economic and fiscal policies. But given the spillovers these policies can create, they are also a common concern for the union.

In this light, there is a need for greater ownership of the tools we already have, notably the Stability and Growth Pact (SGP) and the macroeconomic imbalance procedure (MIP). The fact that euro area aggregate debt and deficit levels are now lower in the euro area than in any other major economy demonstrates that our common fiscal rules are having some effect. Yet further structural fiscal adjustment is necessary, particularly in the countries with the highest debt levels. And while the MIP has proven very effective in identifying reform needs, implementation has been sluggish.

In parallel, additional instruments could be developed at the euro area level. Proposals here essentially come in two flavours. Either they focus on supporting convergence by directly strengthening allocative efficiency, thus moving beyond the existing structural and cohesion funds in the EU budget. Or they focus on stabilisation at the euro area level. Although I will not elaborate on this today, there are also proposals that blend the two approaches, for example by supporting investment in downturns.

On the convergence side, the European Commission, for example, suggests supporting structural reforms through the EU budget. In principle, such a tool could contribute to reform implementation by way of positive incentives. However, for that to work effectively, the Commission proposal needs to be significantly strengthened in three ways.

First, reforms should be selected on the basis of their implications for macroeconomic prospects. Second, the funding should be distributed on the basis of a quality assessment rather than in proportion to a country's entitlement to a "slice of the pie". To strengthen such an assessment, the funds themselves should be linked to the packaging of reforms, reforms with short-term fiscal costs or the funding of flanking policies[4]. Pension reforms would be a suitable example, since they can come with short-term fiscal costs[5]. Third, proper and powerful clawback mechanisms should be built in so that the funds could be recuperated if reforms are reversed. While the Commission mentions such a mechanism, the identification of reversals is left overly vague.

Both the Commission and the recent Franco-German paper also foresee additional instruments for macroeconomic stabilisation. Two design elements are essential for the effectiveness of such an instrument. First, a central fiscal capacity should be designed to increase the euro area's ability to counter severe area-wide recessions, thereby supporting monetary policy. Second, any fiscal capacity should come with appropriate incentives for sound fiscal and economic policymaking.

On both counts, the proposals made so far fall short. They fall short in terms of their effectiveness, as they are limited in size and seem to focus on asymmetric rather than symmetric shocks, although existing Treaty provisions already allow for financial assistance to a Member State threatened with severe difficulties caused by exceptional occurrences beyond its control.[6] Moreover, the proposals do not sufficiently counteract moral hazard. The Franco-German proposals did not mention any mechanisms to this effect.

Similarly, reliance on an unemployment trigger – as foreseen by the Commission – would not enable policymakers to distinguish between "bad luck" and "bad policies". Indeed, it might potentially reward policy-induced increases in unemployment.

These examples illustrate that any introduction of a central fiscal capacity should be coupled with an overhaul of the economic and fiscal governance framework. Moreover, agreement would be more likely to be reached if proposals did not repackage tax proposals of questionable value which have been rejected in the past.

## Reducing risks and fragmentation in the financial sector

Let me now turn to the second set of challenges faced by the euro area: risks in the financial sector.

However, I would first like to recall what has been achieved in making the euro area's financial sector more resilient. With the establishment of the banking union, Europe has translated some of the key lessons of the crisis into a more solid framework.

The banking union rests on three pillars, two of which are already fully developed and one on which political agreement is under way. Under the first pillar of the banking union, the euro area's largest banks are supervised by the ECB on the basis of a single rulebook that harmonises banking legislation and regulation. The Single Supervisory Mechanism (SSM) not only seeks to ensure a uniform approach to prudential supervision in the euro area in line with the highest international standards, it also fosters a level playing field that promotes financial integration in Europe.

The second pillar establishes a banking resolution framework for significant institutions aimed at minimising the involvement of public funds in bank failures. The Single Resolution Mechanism (SRM) is a logical complement to the system of single supervision in the euro area: large banks are not only supervised at the Union level, their failure is also addressed centrally. The SRM is a leap forward, as banks can now fail without disrupting the entire financial system. Moreover, the smooth functioning of the SRM is supported through the establishment of a Single Resolution Fund (SRF), which ensures that the financial industry, as a whole, finances the stabilisation of the financial system by pooling contributions. But a solvency and liquidity backstop for the SRF, docked at the European Stability Mechanism (ESM), needs to be established.

The steps that have been taken on the supervisory and resolution side should, in turn, pave the way for political discussions on a European deposit insurance scheme (EDIS). And they should make this discussion easier, as they significantly reduce the likelihood of EDIS ever needing to be used. The key contribution of EDIS is, in fact, that it will instil confidence in the financial system as a whole without probably ever being used[7]. That is the beauty of such backstops.

This, however, only holds if the discussions on EDIS remain fully incentive-compatible. In other words, EDIS should in no way water down the standards on MREL and TLAC or other risk reduction measures, such as moves to reduce the pile of sour loans and prevent the build-up of new ones. But if these conditions are in place, any residual resistance to EDIS is based on a misunderstanding of its nature as an insurance mechanism.

The banking union, and its enhanced regulatory and supervisory framework, has brought about significant progress in reducing overall risk. The Common Equity Tier 1 ratios of significant banks have increased from 9.7% in 2008 to over 14% today. Leverage ratios have risen from 3.7% to 5.8%. And banks have much more stable liquidity and funding. Further risk reduction is under way as we speak[8].

We should not dwell on our achievements, however. The euro area's financial sector remains vulnerable to legacy issues[9]. Moreover, to accelerate further risk-sharing, milestones are necessary to ensure progress in areas of key importance for the optimal functioning of banking union.

For example, focused steps need to be taken towards harmonising and improving certain elements of national insolvency frameworks, including the alignment of the conditions under which a bank is deemed to be failing or likely to fail and the conditions for liquidation under the national laws for credit institutions. Progress is also necessary on the aforementioned sour loans, or non-performing loans – NPLs – as we call them, in particular swift implementation of the ECOFIN action plan. Finally, we need to use the single rulebook to further reduce fragmentation, removing opportunities for regulatory arbitrage, harmonising supervisory powers, and making sure that large cross-border investment firms with risks akin to those of credit institutions are supervised like banks at the European level. All of these policy goals are commensurate with a more efficient operation of the SSM.

In addition, there remains a need for banks to be able to plan ahead and obtain liquidity, even if they are deemed to be failing or likely to fail or if a resolution process has been activated. The provision of central bank liquidity – be it through monetary policy credit operations or emergency liquidity assistance – should however by no means be automatically assumed in resolution planning. Resolution financing is foremost a government task, now complemented by the rules and procedures applied by the Single Resolution Board and the national resolution authorities within the framework of the SRM. Central banks provide liquidity, not solvency support. And funding gaps that cannot be addressed by the industry or through the SRF should be filled, ultimately, by or on behalf of Member States or intergovernmental institutions.

## Strengthening the institutional architecture of Economic and Monetary Union

The elements mentioned so far can be mutually reinforcing. In the fiscal and economic realms, common instruments can bolster convergence, thus providing a shield against bad equilibria and economic scarring in crises. And pursuing the right policies helps to create the policy space to address shocks in the first place. In the financial realm, backstops reduce risk across the system by containing market panics when a crisis hits. And a strong resolution framework ensures that very little public risk-sharing is actually needed when a crisis hits, as the costs are primarily born by the private sector.

Nevertheless, it is a fact of economic life that the risk of significant downside economic shocks can never be fully eliminated. This is why an effective crisis management framework remains indispensable. There is thus merit in strengthening the role of the ESM in managing crises, provided that governance arrangements are duly reviewed with a view to integrating them into the federal set-up of the EU. Should the ESM remain outside the EU legal order as an intergovernmental body, any future discussion of the tasks that could be conferred on the ESM in the field of economic governance must respect the existing competences conferred on the EU and its institutions under EU law.

Market incentives that appropriately support prudent fiscal policies and reduce risks on bank balance sheets may usefully support the implementation of the existing rules-based framework. To reinforce the credibility of the no bailout clause, and better anticipate debt sustainability problems, the ESM needs to be able to distinguish early on between liquidity and solvency problems.[10] More clarity in our policy frameworks would allow us to pick up the can at an early stage rather than kicking it down the road.

Similarly, to definitively break the bank-sovereign nexus, we have to continue to reflect on regulatory instruments to curb the excessive accumulation of sovereign risks on bank balance sheets without triggering market disruptions. In that sense, ensuring the adequate regulatory treatment of sovereign risk and facilitating orderly debt restructurings are two sides of the same coin, reflecting the reality that public debt is no longer risk-free. Still, we have to be mindful that Europe might be walking this path alone.

At the same time, we should be aware that market-imposed discipline often comes suddenly, creates cliff-edge effects and can have negative consequences for financial stability. For this reason, the recent Franco-German proposal to introduce single-limb collective action clauses and moves to align the roles of the ESM and the IMF in debt restructuring negotiations are sensible first steps towards building a more predictable framework for the orderly resolution of debt crises[11].

Let me now turn to my final point, which is that institutional arrangements and democratic control need to evolve in lock-step with progress in the economic, fiscal and financial unions to meet the test of constitutionality.

As European policies assume a stronger role over time, confusion over the assignment of responsibilities and accountability arrangements threatens efficiency and legitimacy. But greater control at EU level is important for two reasons. First, it would be a true reflection of a functioning democracy where sovereignty either has been fully transferred to EU level (in the case of monetary policy, for example) or it involves both national and EU levels (as with prudential policies, for instance). And second, liability and control need to be aligned – he who pays the piper calls the tune. When taxpayers' money is involved at European level, a European control function is called for.

Economic and Monetary Union is unique in this regard. The distinction between the euro area and the EU means that it is more difficult to fully tailor accountability to euro area tasks. In particular, the European Parliament does not sit in euro area composition when discussing euro area matters, even though it would be common sense for it to do so.

Accountability and sovereignty also need to be proportionate in areas that are not exclusively dealt with at EU or euro area level but are areas of shared competence. This holds true for the ESM and for fiscal policies, where the situation is somewhat more complex and blurred.

The ESM, for example, was created on the basis of intergovernmental arrangements and for tasks where the EU only has a coordination role, and where the European Parliament is not yet a counterpart in terms of accountability. So we need to strike a balance. On the one hand, accountability should be assigned to national parliaments for decisions that are fully in the hands of national authorities. On the other hand, the ESM needs to be equipped with swift and credible decision-making procedures. This will never be fully possible in an intergovernmental setting that is hampered by national vetoes and operates outside the constitutional safeguards of the *acquis*. Against this backdrop, the ESM should be turned into a body that is governed by EU law and is accountable to the European Parliament. This would ensure that the ESM is better placed to act in the sole interest of the euro area and thus in line with its functional mandate of ensuring the stability of Economic and Monetary Union as a whole.

A similar logic must be applied in any further discussions regarding a euro area fiscal capacity, the possible centralisation of EU investment schemes or the powers that a European finance minister might have.

Fiscal instruments need to be complemented by institutional arrangements and democratic control at the corresponding level. If a euro area budget is established, it should be part of an ongoing debate on a euro area finance ministry and a euro area composition of the European Parliament, as well as its role on both the revenue and expenditure side.

While the creation of new umbrella funds, such as the InvestEU Programme, may pursue laudable public policy objectives, we should avoid undermining established Union methods. Indeed, we should not succumb to the appeal of relying on secondary legislation in areas where primary law is unambiguous.

## Concluding remarks

As we take further steps to complete EMU, we should keep in mind two principles that are at the heart of effective policy in a democratic society: namely, the effective alignment of liability and control, and the discharge of democratic control or accountability at the level at which policy decisions are taken. Upholding these two principles is a necessary condition in the continuing efforts to foster economic convergence and further integration in the euro area. Given the experience of the past 20 years, there can be no doubt that the progress achieved so far has laid the groundwork for further steps to be taken for a "currency beyond a state" – a fact that the early intellectual architects of Monetary Union were already aware of. In other words, to quote the then Commission President Jacques Delors: "Europe is like a bicycle. It has to move forward. If it stops, it will fall over".

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5 European Central Bank (2015b), "The short-term fiscal implications of structural reforms", Economic Bulletin, Issue 7: 52–70.

6 "Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. […]" Article 122.2, Treaty on the Functioning of the European Union.

7 See Carmassi, J. et al. (2018), "Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?", Occasional Paper Series, No 208, ECB.

8 See Draghi, M. "Risk reducing and risk sharing in the euro area", speech at the European University Institute, Florence, 11 May 2018.

9 Andrews, D. and Petroulakis, F. (2017), "Breaking the shackles: zombie firms, weak banks and depressed restructuring in Europe", *OECD working papers*, No 1433.

10 See Y. Mersch (2016), "Reflections on the feasibility of a sovereign debt restructuring mechanism in the euro area", ESCB Legal Conference 2016.

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