Yves Mersch: Europe: a work in progress - political integration and economic convergence in Monetary Union

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Banking and Corporate evening, organised by the Hauptverwaltung in Bayern der Deutschen Bundesbank, Munich, 22 November 2018.

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Ladies and gentlemen,

Europe has no problem with identifying the issues it faces; it has a problem with implementing solutions.

Many of the weaknesses and shortcomings of the European framework have long been known. And the measures required to address these issues have repeatedly been discussed for some time now. Unfortunately, national interests and complacency have consistently dampened the momentum that Europe needs to become a true Economic and Monetary Union. Electoral machinations extending to the regional level and rising populism have recently added to the problem.

The latest proposal was in June. At a meeting in Meseburg Palace, the leaders of France and Germany issued a joint declaration in which they stated their objective “to strengthen and deepen the euro area further, and make it a genuine economic union”.

Their statement that sharing the same currency entails specific needs in terms of economic coordination and integration[1] is correct – and it is something that has long been known.

As far back as 1970, the committee of experts chaired by the then Luxembourg Prime Minister Pierre Werner, which drew up the first meaningful plan for a European monetary union, stressed that insufficient economic convergence and the absence of a common fiscal policy would give rise to the need for greater economic policy coordination.

Later proposals, including the Maastricht Treaty of 1992, unfortunately failed to sufficiently tackle the inherent tensions of a currency without a state.

The spirit of Meseberg stems from the original European idea and the pledge of prosperity that brought the single currency into being: the euro benefits Member States. They profit from having a credible and stable currency and a larger, competitive market.

But the crisis demonstrated that the euro area is susceptible to negative shocks and that greater economic and political convergence is needed.

Today, I would like to 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 Economic and Monetary Union (EMU).

Structural reforms and fiscal policy

Unlike countries that have their own currency, euro area members cannot use the exchange rate to tackle asymmetric shocks.

Instead, they must undertake structural adjustments to ensure that their economies are competitive and resilient.

If some Member States adjust more slowly than others, economic differences may become permanent. And to the extent that this endangers the effectiveness of monetary policy and the cohesion of the Union, it has potentially damaging consequences for all Member States.

It is thus vital that Member States push ahead with structural reforms to make labour and product markets more flexible, thereby enabling the factors of production to move more quickly between sectors.

To this end, national reform requirements are determined in the context of the European semester with a view to strengthening the coordination of economic policies at the EU level. Country-specific recommendations need to be implemented in the interests of all parties to avoid persistent imbalances.

But progress in implementing the reforms has been slow. The European Commission concluded that the overwhelming majority – meaning more than 90% – of country-specific recommendations had only been implemented to "some" or a "limited" extent in 2017, similar to the previous year.[2]

The European Commission suggests supporting countries' reform efforts through the EU budget. In principle, this could create positive incentives to implement reforms. However, for that to work in practice, the Commission proposal would need 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". Third, powerful clawback mechanisms should be built in so that funds could be recuperated if reforms are reversed.[3]

The implementation of structural reforms is only one of the factors that helps strengthen the resilience of Member States. Another factor is sound fiscal policy.

Here common fiscal rules are important to ensure that Member States do not take on excessive levels of debt, because low levels of debt and larger buffers give countries greater fiscal space to mitigate economic downturns.

Aggregate debt and deficit ratios in the euro area are currently lower than those in any other major economy, which demonstrates that our common fiscal rules are having a certain effect.

But the rules have repeatedly been called into question in recent months, in particular by countries with high levels of debt.

To this one can only say that consistently breaching the rules will not only make them less effective in the long run, it could also worsen financing conditions for some or all Member States.

It is thus imperative that countries, especially those with the highest debt levels, use the ongoing expansion to build up fiscal buffers and reduce debt.

This is not only crucial to strengthen resilience, it is also a precondition for strengthening the solidarity between Member States in times of crisis.

As such, the Meseburg declaration represents a turning point, as the German government is now recognising the need, in principle, for a stabilisation facility at the European level.

The recent proposal for an EU unemployment insurance scheme put forward by the German finance minister, Olaf Scholz, is also to be welcomed. The fund, which the Member States would pay into, would grant loans to particularly crisis-stricken social security systems, without any transfer payments taking place.

In addition, the European Commission is proposing a European investment stabilisation function to mitigate large asymmetric shocks in the euro area.

And a few days ago, France and Germany agreed on a proposal for a limited euro area budget by 2021.

Two elements are essential for the effectiveness of such instruments. 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, it should set appropriate incentives for sound fiscal and economic policymaking.

On both counts, the proposals made so far fall short. They are limited in size and designed to counter asymmetric shocks. However, asymmetric shocks are extremely rare, and there is a lack of analytical concepts and normative answers to help distinguish between difficulties affecting a country through no fault of its own (bad luck) and those that are the result of the wrong economic policy choices (bad policies). What's more, existing EU Treaty provisions already allow for financial assistance to a Member State threatened with severe difficulties.[4]

"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.

In addition, the proposals do not sufficiently counteract moral hazard.

The recent Franco-German proposal takes some of these issues into account, for example by suggesting that the euro area budget only be made available to countries that fully respect the European framework, including the fiscal rules. It also explicitly states the aim of fostering competitiveness and economic convergence. At the same time, any attempt to set up an intergovernmental decision-making structure to manage a federal sub-budget is likely to be difficult to implement in practice, and the effectiveness of a financial transaction tax as the central source of funding is overrated.

However, I don't want to pick too many holes in the idea – indeed, I warmly welcome the fact that the European debate is picking up speed again.

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.

The financial crisis demonstrated that an unstable and highly fragmented financial sector represents an existential threat to Monetary Union.

Europe has translated key lessons of the crisis into a more solid framework by establishing the banking union. The euro area's largest banks are now supervised at the EU level and their failure is addressed centrally.

The improved regulatory and supervisory framework has allowed considerable progress to be made in terms of reducing risks. The Common Equity Tier 1 ratio of large banks has 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.

At the same time, insufficient progress has been made in creating a European banking market. Euro area banks largely operate in their home markets, leading to overcapacity and making the Union more susceptible to fragmentation.

Fragmentation along national lines and overcapacity are also visible at the aggregate European level if we compare some key figures for the sector with those of other currency areas. From 2013 to 2017, the average return on equity for the euro area banking sector was 4.5%, while it was 9% in the United States. Over the same period, European banks had a cost/income ratio of 69%, while that of US banks was just 60%. The euro area had 44 bank branches for every 100,000 inhabitants, almost twice as many as in the United States, which had 26. In the euro area, only 52% of banks' total assets are publicly traded, while the figure is close to 80% in the United States.[5]

An integrated financial market offers risk-sharing mechanisms that can be used to mitigate country-specific shocks. Banks that have more geographically diversified loan and deposit portfolios are more resilient to local shocks and can keep their lending activity more stable.

We must hence continue enhancing the conditions for cross-border banking in the euro area.

The first step is to reduce the legacy non-performing loans on banks' balance sheets which have hampered cross-border lending and M&A transactions over the past few years.[6]

That would then pave the way for the completion of the banking union, which we need to reinforce in order to boost confidence in the resilience of the whole financial sector.

Financial market fragmentation may be exacerbated by perceived or actual differences between the national safety nets for banks which undermine the banks' capability and willingness to expand their cross-border activities.

The introduction of a common and credible fund for the Single Resolution Mechanism (SRM) would inspire confidence that banks can be resolved more efficiently, regardless of their location.

Likewise, the creation of a European deposit insurance scheme (EDIS) would enhance depositor confidence throughout the euro area and create a level playing field for banks. The main benefit of EDIS is that it will generate confidence in the financial system as a whole. Provided that the standards on minimum requirements for own funds and eligible liabilities (MREL), total loss-absorbing capacity (TLAC) or other risk reduction measures are not eroded, EDIS will probably never be deployed at all. At the same time, we should not fail to mention that especially smaller institutions have next to no experience in accessing capital market funding. This makes it more difficult to rigorously apply the MREL requirements.

Moreover, the introduction of such security mechanisms at European level could give national governments less incentive to restrict the free flow of capital and liquidity; this would in turn promote cross-border activity.

But EDIS must be incentive-compatible. Its introduction must not result in any retrospective sharing of the burden of legacy non-performing loans.

And in order to avoid systematic transfers between banking sectors, the banks' contributions to the fund should be structured to reflect banks' risk appetites.

Strengthening the institutional architecture of Economic and Monetary Union

These economic and fiscal reforms are essential in order to make the euro area more resilient. However, they cannot fully prevent the risk of severe economic shocks.

In the future too, effective crisis management will be indispensable to protect the Member States from serious imbalances.

In this respect, I am very much in favour of strengthening the European Stability Mechanism (ESM). However, the reorientation of the ESM should be coupled with its integration into EU law.

If the ESM were to remain an intergovernmental institution, any transfer of tasks must be consistent with the allocation of responsibilities between the EU and its Member States as laid down in EU law, as a transfer of powers from the European level (European Commission) to the intergovernmental level (ESM) would amount to a throwback to national models and self-interests. By analogy, this also applies to a Euro area budget.

We also need more clarity with regard to the political framework for Monetary Union.

We must identify problems with countries' debt sustainability at an earlier stage. The ESM needs to be able to distinguish between liquidity and solvency problems early on.[7] That would allow us to pick up the can early rather than kicking it down the road.

Similarly, we need to do more to break the bank-sovereign nexus. We need 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 restructuring are two sides of the same coin.

We should be aware that market-imposed discipline often comes suddenly, creates cliff-edge effects and can have negative consequences for financial stability. The recent Franco-German proposal to introduce single-limb collective action clauses and moves to align the roles of the ESM and the International Monetary Fund in debt restructuring negotiations are sensible first steps towards creating a more reliable framework for orderly debt restructuring.[8]

This brings me to my final point: democratic control.

Progress in completing Economic and Monetary Union needs to evolve in lock-step with appropriate democratic control to meet the test of constitutionality.

What matters is that liability and control are aligned. When taxpayers' money is involved at European level, a European control function is called for.

Any confusion over the assignment of responsibilities and accountability arrangements threatens the efficiency and legitimacy of European measures.

The task is complicated by the particular architecture of Economic and Monetary Union. 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. And of course it leaves a sour taste when representatives of countries that neither belong to the euro area, nor will remain in the EU in the long term, actively fill central positions in the European Parliament or its committees.

At the same time, responsibilities and accountability also need to be proportionate in areas of shared competence between the EU and Member States. This holds true for the ESM and for fiscal policies, where the situation is 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.

We need to strike a balance here. 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.

A similar logic, necessitating Treaty change, must be applied in any further discussions regarding a euro area fiscal capacity and the possible introduction of an EU investment facility or a European finance minister.

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.

We should avoid undermining established Union methods. This also holds true for parallel financial structures aiming to bring separate funds under the same umbrella, in case they would hamper the efficiency of established federal institutions.

We should neither succumb to the appeal of relying on secondary legislation in areas where primary law is unambiguous, nor use semantic tricks to subjugate the letter and spirit of the Treaty to secondary legislation. The central bank must keep its distance from politics rather than constantly pushing its way into new fields of action under cover of financial stability.

Conclusions

The euro area is a special construct. 19 countries share a common currency, but responsibility for their economic and fiscal policies still lies in national hands.

Convergence in these areas is, however, crucial for the success of Monetary Union. So it is imperative for all Member States to adhere to the common rules.

The resilience of the euro hinges on the implementation of the necessary economic and fiscal reforms. And further steps must be taken to boost private and public risk-sharing.

At the same time, as we progress towards completing Economic and Monetary Union, we should keep in mind two principles that are at the heart of effective policy in a democratic society.

First, liability and control must be aligned, with important decisions taken only by those who will bear their consequences.

Second, the discharge of democratic control must lie at the level at which policy decisions are taken.

Given the current state of our Economic and Monetary Union, further efforts to deepen it through political and economic convergence are clearly indispensable.

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[1] archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806

[2] www.ecb.europa.eu/pub/economic-bulletin/focus/2018/html/ecb.ebbox201805_06.en.html

[3] While the Commission mentions such a mechanism, the identification of reversals is left overly vague.

[4] "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.

[5] Restoy, Fernando (2018), "The European banking union: what are the missing pieces?"; Public lecture at the International Center for Monetary and Banking Studies, Geneva, Switzerland, 16 October 2018.

[6] www.ecb.europa.eu/pub/fsr/shared/pdf/ecb.sfbfinancialstabilityreview201711.en.pdf?

bc1a2e57de30c0b2cee99fbd4ae141a5;

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

8 See Benassy-Quere et al., “Reconciling Risk Sharing with Market Discipline”,CEPR Policy Insight, No 91, Centre for Economic Policy Research.