EUROPEAN CENTRAL BANK
EUROSYSTEM

The single currency: an unfinished agenda

Speech by Benoît Cœuré, Member of the Executive Board of the ECB, at the ECB Representative Office in Brussels, 3 December 2019

It is my pleasure to welcome you here tonight to the ECB's representative office in Brussels. It is overwhelming to see so many long-standing companions and friends.

This office was established in the midst of the euro area sovereign debt crisis in 2011. Today, the Brussels office is part and parcel of the ECB.

It is our eyes and ears on all European matters, thanks to the unwavering commitment and dedication of our staff here on the ground. Their network is essential for us to get first-hand insights and intelligence from Brussels.

Maintaining a high level of cooperation and dialogue with our main European stakeholders is essential, as also exemplified by our successive efforts to further enhance the ECB's transparency and accountability to the European Parliament and to the public at large.[1]

Not everything is in our hands though.

Diversity is a case in point. Taking into account our latest decisions, the proportion of female senior managers at the ECB has increased from 9% to 31% since mid-2012 as a result of our diversity strategy. But *all* 19 national governors are males. This does not reflect Europe's reality. It harms public trust in our institution and in the single currency. Member states are accountable for this situation.

The history of this office coincides closely with the history of my term as member of the ECB's Executive Board, which is now coming to an end. I joined the ECB in January 2012, just a few months after the office opened.

It has been a turbulent eight years, and quite possibly one of the most defining periods in Europe's post-war history. It has been a journey of faith and struggle, of trial and error.

With the benefit of hindsight, part of the cost of the crisis reflects policy mistakes made before and during the crisis as well as the belated recognition of the flaws in the design of our Economic and Monetary Union (EMU). We have a duty to learn and do better.

But we can also be proud of the achievements, which are clearly visible and uncontested. Unemployment in the euro area has practically receded to pre-crisis levels. Wages are growing at their fastest pace in more than ten years. And surveys document that the euro has never been more popular among the public than it is today.[2]

These successes did not come about by chance. Significant efforts were needed to overcome the crisis and its legacy. On the part of people who suffered from it, economically and socially. And on the part of policymakers who invested immense political capital to achieve consensus on the reforms that were needed, at both national and euro area level, to restore economic and social welfare through stability and growth.

Building on these achievements, the ECB has been successful in protecting the integrity of the single currency, overcoming financial fragmentation, and putting the economy on a recovery path.

Some wounds have still not healed, however. As unsettling as it may sound after so many years of economic hardship, the euro area architecture is still not crisis-proof.

Growth remains cyclically too weak to fully restore fiscal space in countries where public debt is unacceptably high. The profitability of banks remains low and, in many cases, below the cost of equity, reflecting risks to business model sustainability.[3]

And productivity growth, the main component that underpins our living standards and social safety nets, remains low in many Member States. As a consequence, unemployment in some countries, in particular among young people, remains unacceptably high, despite the progress made at the euro area level on average.

True, many other advanced economies are facing similar challenges. But the combination of weak potential growth and high debt is toxic in a monetary union with decentralised fiscal policy and insufficiently integrated financial markets.

It implies that country-specific shocks remain a potential source of instability for the euro area as a whole. It weakens political support for further integration. And it means that the single monetary policy has to shoulder the burden of macroeconomic stabilisation in the face of adverse shocks.

The arrival of the new European Parliament and Commission provides an important opportunity to address more decisively the remaining vulnerabilities, refocus priorities and sequence actions accordingly. And it presents us with a time frame for achieving these goals.

In my remarks this evening, I will argue that we need to both strengthen the institutional framework to make our currency union more resilient and implement the right policies to boost the growth potential of our economies.

I will argue that flexible and dynamic markets are the first line of defence in the euro area.[4] They are the key to unlocking sustained productivity growth, and thereby allowing faster normalisation of monetary policy. They also reduce the need for macroeconomic stabilisation and they curb contentious debates about crisis management.

The second line of defence relates to sustainable and growth-enhancing fiscal policies. Countries that have fiscal space should use it to foster investment. Countries where debt is high should calibrate their policies so as to regain fiscal space in the future, limiting the risk they pose to their neighbours. And all countries can improve the quality of their spending.

The third line of defence relates to strengthening our common toolkit – to new policy instruments that are needed to protect the stability of the currency union if shocks are too large to be absorbed by markets or national fiscal policies, and that provide a safety net against poverty and social exclusion.

The first line of defence: integrated and flexible markets

No euro area country features in the top 10 of the World Bank’s ease of doing business index. Many are not even in the top 30.

A consequence of a less business-friendly environment is that business dynamism in Europe is weak. Compared with the United States, European countries have, on average, larger shares of “static” firms and smaller shares of both growing and shrinking firms.[5]

Low business dynamism feeds and reinforces the misallocation of resources across firms in the euro area.[6]

Empirical evidence shows that an increasing proportion of capital is concentrated in firms that are less productive. In Italy and Spain misallocation is currently higher than at any point in time before the crisis.[7]

The absence of a Schumpeterian process of creative destruction weighs on innovation and growth.

There is overwhelming evidence that new firms are more likely to adopt new technologies. There is a significant link between business entry rates, technology creation and diffusion, and productivity growth.[8] New and young firms also contribute disproportionally to job creation relative to their share in employment.[9]

Unclogging the innovation channel requires us to improve the ways in which our markets allocate resources, both within and across countries.

In my view, there are three areas which need particular attention.

Efficient allocation of resources

First, we need to reduce the barriers to entry faced by firms, particularly in the services sector, and we need to improve the quality of insolvency frameworks.

Several euro area countries lack an effective framework for early private debt restructuring. In Portugal, Greece and Slovakia, for example, it takes more than three years to resolve insolvency. It takes less than one year in Japan, Norway and Canada.[10]

The absence of effective insolvency frameworks also makes it harder to deal with non-performing loans. It constrains collateral enforcement and raises the risk of banks granting forbearance to "zombie" firms.[11]

Our economic governance framework, the European Semester, has been effective in informing and exchanging views on our economies.

But member states don't walk the talk. The macroeconomic imbalance procedure always lacked teeth and none of the 2018 recommendations for euro area countries have been fully implemented.

In this context, national productivity boards are useful complements that could strengthen the European Semester discussion.

Completing the Single Market

Second, we must make better use of the economies of scale offered by the Single Market.

20 years after the introduction of the euro, we are faced with a paradox. While the single currency was originally conceived as a complement to the Single Market, lack of progress towards the completion of the Single Market now hampers the deepening of EMU.

The Single Market was initially established with free cross-border trade in *goods* in mind. But the structure of our economies has changed fundamentally since then. The services sector today accounts for more than 75% of European employment, compared with 45% in 1970.[12]

As value added and employment shift from the manufacturing to the services sector, the Single Market is increasingly losing traction as an engine of growth. Despite the Services Package, there are still 5,000 national regulations protecting the delivery of different types of services across Member States.[13]

These barriers stand in the way of European services firms achieving scale and profitability. As a result, there are about three times as many services firms in the EU as in the United States, despite the economies being of broadly similar size.[14]

Fragmentation perpetuates a lack of competition and blocks a healthy consolidation around the most efficient firms. And larger firms generally invest more in human and brand capital as well as in intangible assets, such as intellectual property rights, software and databases.[15]
They are also more likely to export than smaller firms.

Completing the Single Market, in particular for services, is therefore a central pillar in our efforts to boost weak productivity growth.

It will make our monetary union more resilient and support the normalisation of real interest rates towards higher, positive levels.

Launching a capital markets union

Third, if firms are to expand and grow, we need to broaden and deepen the funding mix available for productive investments.[16]

Firms in the euro area primarily rely on bank lending to finance their debt.

This raises two broad concerns.

The first is that over 80% of euro area bank lending remains domestic.[17]
This constrains competition for good credit and amplifies the doom loop between sovereign and bank creditworthiness, which we have failed to eradicate.

And, second, banks often hesitate to finance investments in intangible assets for which collateral values are hard to quantify, or in new sustainable technologies with highly uncertain future payment streams.

New ECB research shows that stock markets are better than banks at reallocating investment toward "greener" sectors, and that innovative sectors with fewer tangible assets grow faster in countries with deeper stock markets.[18]

In the euro area, however, stock market capitalisation – at less than a fifth of that in the United States – is too low to serve as a catalyst in this way. Cross-border integration is similarly low.[19]

Our capital markets must become deeper and, at the same time, more accessible for start-ups and small and medium-sized firms.

Achieving truly integrated capital markets is the only way to find the collective response required in the face of enormous global challenges, such as climate change or digitalisation.

Another reason why a capital markets union is urgently needed is that capital markets help in better sharing economic risks across countries.

In the United States, for example, around 70% of a shock to a state's GDP is cushioned by financial markets, whereas in the euro area the share is closer to 20%. A capital markets union could significantly help to diversify and reduce risk.

Of course, it would be naïve to assume that a capital markets union can be achieved without investing political capital. Improving and harmonising national insolvency laws, for example, goes to the very heart of our legal systems. But it is capital well invested.

Risk sharing by private investors reduces the need for public risk sharing and for the protracted and acrimonious discussions that often ensue.

A capital markets union can't function without European-level supervision of systemic intermediaries and infrastructures.

There are large cross-border spillovers and, if things go wrong, the banks that are directly supervised by the ECB would be left bearing most of the financial risk. Recent reforms of the European supervisory authorities and of the European market and infrastructure regulation (EMIR) were missed opportunities.

The United Kingdom's departure from the EU will have a lasting impact on the architecture of European financial markets. This reinforces the need to react and complete the capital markets union.

The second line of defence: sound national fiscal policies

National fiscal policies fulfil two key roles in a currency union.

The first is to support convergence, growth and the efficient allocation of resources.

In many euro area countries, however, the labour tax wedge, in particular for low and second earners, remains too high, discouraging both labour supply and demand.

Many euro area countries have space to reduce the distortionary impact of their tax systems in a revenue-neutral way, by shifting taxes away from labour and towards environmental externalities or property.[20]

Such national efforts should be complemented by closer tax cooperation. Agreeing and enforcing minimum tax rates for capital income at the EU level would help countries to regain space to reduce labour income taxes, thereby fostering employment growth.

Supporting growth also means spending more wisely.

Public investment in the euro area fell from 3.7% of GDP in 2009 to 2.7% in 2018. At the same time, large parts of the public infrastructure, including schools, hospitals and roads, are in urgent need of repair and modernisation.

The current interest rate environment provides a unique opportunity to close public investment gaps and to strengthen Europe's capacity to innovate by mobilising investment to support digitalisation and to accelerate the transition to a low-carbon economy.

This also entails reviewing and boosting spending in *intangible* assets.

For the past 20 years or so, spending on research and development (R&D) in the EU has stagnated at around 2% of GDP. In the largest euro area countries, public expenditure on R&D, education and transport accounts for around 15% or less of total primary expenditure.[21]

Equally concerning is that environment-related public R&D spending accounts for just 1.6% of total R&D spending across OECD countries. Given that the market does not invest sufficiently in environmental R&D, and that climate change is a deepening emergency, the public sector urgently needs to step in.

The second role of fiscal policy in a currency union relates to stabilisation and resilience.

The Stability and Growth Pact has largely failed on both counts.

It proved toothless in good times when the need to build up sufficient fiscal buffers for bad times was ignored. And it amplified procyclicality in bad times. From 2009 to 2018, the average cyclically adjusted government primary balance was -5.7% for Japan and -3.6% for the United States, but 0.5% for the euro area.

And even when the euro area aggregate fiscal stance was considered broadly appropriate, such as in the most recent years, it was wrongly distributed across countries. Countries with fiscal space were not using it and those without fiscal space were trying to invent some.[22]

As a result, monetary policy had to pick up the slack, quite literally.

Hypotheses are easily made in the absence of true counterfactuals. But I am fairly convinced that some of the measures which the ECB had to take in recent years to stabilise the euro area economy, and which have made it the target of criticism in some Member States, could have been avoided if the recommendations of the European Semester had been more effectively implemented by national governments.

The increasing complexity of the Stability and Growth Pact and the politicisation of its enforcement have not served us well.

We thus need to review both the rules and their enforcement. We need to simplify them, depoliticise them and improve national ownership.[23]
Governments should no longer have the option of using loopholes or blaming technocrats in Brussels to hide their responsibility.

National governments are accountable to their voters. Strong and independent national fiscal councils should clearly explain to the public the potential consequences of imprudent fiscal behaviour for the stability of the country and the euro area as a whole. Unfortunately, we no longer have a lack of examples.

The third line of defence: effective area-wide instruments

The crisis revealed that systemic shocks can go beyond the capacity of national fiscal budgets to provide effective stabilisation.

The European Stability Mechanism (ESM) has been a resounding operational success. It is a crisis management instrument and its role as such will be further strengthened by the welcome decision to make it a backstop to the Single Resolution Fund and the introduction of new precautionary facilities.

But the ESM should be able to act decisively in a crisis by deciding with qualified majority, and it should be accountable to the people of Europe under Community law – two objectives which are not covered under the current reform proposal.

Let me repeat: intergovernmental decision-making may be politically convenient in the short term, but it carries a high economic cost in the longer run. It favours procrastination and turns every decision into a zero-sum game.

Intergovernmental crisis management increased the cost of the crisis for the Greek people – in terms of the burden of adjustment –, for Greece's creditors – in terms of exposure and potential losses –, and for Europe as a whole, in terms of trust and unity. This cannot be the way forward. If we don't learn from past crises, we condemn ourselves to repeat them.

This is why the current proposals can only be a first step. What we are missing, are three complementary instruments.

A common European deposit insurance scheme

The first is a common European deposit insurance scheme, which is a precondition for a truly integrated banking system and single money. I welcome the progress currently being made towards starting political negotiations on such a scheme.

Progress should be made in parallel in two complementary directions. First, to eliminate the bank-sovereign doom loop by incentivising banks to diversify their sovereign exposures in a way that does not disrupt the functioning of government bond markets.

And second, to strengthen our resolution framework. Today, only a handful of banks are deemed of public interest and subject to European resolution, leaving most bank failures to be addressed in nineteen different ways. This is untenable. Creating a single administrative tool for bank liquidation, as proposed by the International Monetary Fund, would be an important first step.

A common fiscal capacity

The second missing instrument is a common fiscal capacity that provides macroeconomic stabilisation with a view to preventing, or mitigating, systemic shocks – that is, before they turn into a full-blown crisis.

The budgetary instrument that is currently being operationalised has a different aim, namely to foster competitiveness and convergence, which is an important aim in itself, albeit already largely addressed by existing instruments. But it is not designed to provide macroeconomic stabilisation. And even if it were, it would not be large enough to do so effectively.

We have also learned the hard way that coordination of national fiscal policies will not lead to an adequate fiscal stance for the euro area as a whole. The current period of weak growth is a case in point.

And even if governments improved their coordination, the cross-border spillovers would likely be too small to be effective. ECB research, for example, suggests that cross-border spillovers could be less than 10% of initial spending.[24]

For all these reasons, the euro area needs a common fiscal instrument. Such an instrument would support monetary policy and prevent a procyclical tightening in bad times. And it would boost confidence in national automatic stabilisers, thereby protecting jobs and minimising output losses.

All successful and stable monetary unions have genuine fiscal instruments, built on strong legal and market-based mechanisms ensuring fiscal discipline at the state level. Such an instrument should not replace national policies, but it will need to be large enough to complement them effectively.

A common safe asset

The third instrument required is a common safe asset.

A joint fiscal capacity and a safe asset can go hand-in-hand. But they do not need to.[25]

A safe asset would fix many of the remaining euro area faultlines. It would help break the doom loop between banks and sovereigns;[26]
support the design and transmission of monetary policy; strengthen the international role of the euro in an environment in which global governance is under threat;[27] and buttress efforts to deepen and integrate our capital markets.

Conclusion

Under the duress of the euro area crisis and its immediate aftermath, much has been achieved towards making our monetary union more fit for purpose. We can be proud of past achievements, but today's steps are more uncertain. The risk is high that Europe will once again fail to fix its roof when the sun is shining.

Jean Monnet's famous prophecy that "Europe will be forged in crises and will be the sum of the solutions adopted for those crises" might once again be proven right, but at what cost? Current discussions now tend to favour Deng Xiaoping's step-by-step approach of "crossing the river by feeling the stones".

But in our uncertain times, the risk of such an incremental approach is obvious: it is that we never make it to the other side of the river, and risk being carried away by the stream.

I trust that the new European leadership will find the resolve to give the euro area new direction and pace, and to provide the ECB with the environment it needs to keep our single currency sound and stable.

Thank you.

[1] See Cœuré, B. (2017), "Independence and accountability in a changing world", introductory remarks at the Transparency International EU Event "Two sides of the same coin? Independence and accountability of the European Central Bank", Brussels, 28 March.

[2] See 2019 Standard Eurobarometer.

[3] See ECB Banking Supervision (2019), "Risk assessment for 2020", 7 October.

[4] For an earlier contribution, see Cœuré, B. (2018), "The euro area's three lines of defence", speech at the conference "Deepening of EMU", Ljubljana, 2 February.

[5] See Bravo-Biosca, A. (2017), "Firm growth dynamics and productivity in Europe", in *Remaking Europe: the new manufacturing as an engine for growth*, Bruegel.

[6] See Cœuré, B. (2017), "Convergence matters for monetary policy", speech at the Competitiveness Research Network (CompNet) conference on "Innovation, firm size, productivity and imbalances in the age of de-globalization" in Brussels, 30 June.

[7] Ibid

[8] See, for example, Anderton, R., Di Lupidio, B. and Jarmulska, B. (2019), "Product Market Regulation, Business Churning and Productivity: Evidence from the European Union Countries", ECB Working Paper No 2332. See also Canton, E. (2016), "Drivers of total factor productivity growth in the EU: the role of firm entry and exit", *Quarterly Report on the Euro Area*, Directorate General Economic and Financial Affairs, European Commission, vol. 15(1), pp. 25-35.

[9] See Calvino, F., Criscuolo, C. and Menon, C. (2016), "No country for young firms? Startup dynamics and national policies", *Technology and Industry Policy Papers*, No 29, OECD Science.

[10] See Consolo, A., Malfa, F. and Perluigi, B. (2018), "Insolvency frameworks and private debt: an empirical investigation", ECB Working Paper No 2189.

[11] See Andrews, D. and Petroulakis, F. (2019), "Breaking the shackles: Zombie firms, weak banks and depressed restructuring in Europe", ECB Working Paper No 2240.

[12] See Cœuré, B. (2019), "The rise of services and the transmission of monetary policy", speech at the 21st Geneva Conference on the World Economy, 16 May.

[13] See Economist (2019), "Briefing: The economic policy at the heart of Europe is creaking", 12 September.

[14] Ibid.

[15] See, for example, Crouzet, N. and Eberly, J. (2018), "Intangibles, Investment, and Efficiency", *AEA Papers and Proceedings*, 108: 426-31. In Italy, for example, approximately three-quarters of the productivity gap to the global frontier can be explained by the fact that national frontier firms – while actually quite productive in global terms – are relatively small compared with those at the global frontier. See Andrews, D. and Cingano, F. (2014), "Public Policy and Resource Allocation: Evidence from Firms in OECD Countries", *Economic Policy*, Vol. 29 (78), pp. 253-96,

[16] See also Cœuré, B. (2019), "European capital markets: priorities and challenges", dinner remarks at the International Swaps and Derivatives Association, Frankfurt am Main, 25 June.

[17] Despite significant progress in recent years to develop a more coherent policy framework for cross-border banking, namely with the single rulebook and the creation of European supervision and resolution.

[18] See De Haas, R. and Popov, A. (2019), "Finance and Carbon Emissions", ECB Working Paper No 2318.

[19] Just 20% of euro area equity holdings are issued in other euro area countries. For bonds, the share is 30%.

[20] See, for example, European Commission Directorate General Economic and Financial Affairs (2017), "Financing labour tax wedge cuts", technical services note to the Eurogroup.

[21] See European Fiscal Board (2019), Assessment of EU fiscal rules, with a focus on the six-pack and two-pack legislation, August.

[22] See the 2019 Annual Report of the European Fiscal Board.

[23] For proposals, see, for example, European Fiscal Board (2019, *op. cit.*); Eyraud, L. and Wu, T. (2015), "Playing by the Rules: Reforming Fiscal Governance in Europe", IMF Working Paper 15/67; and Darvas, Z., Martin, P. and Ragot, X. (2018), "European fiscal rules need a major overhaul", *Bruegel Policy Contribution*, Issue 18, October.

[24] See Alloza, M. et al. (2019), "Fiscal spillovers in a monetary union", *Economic Bulletin*, Issue 1, ECB.

[25] For an overview, see Giudice, G., de Manuel Aramendía, M., Kontolemis, Z. and Monteiro, D. P. (2019), "A European safe asset to complement national government bonds," *MPRA Paper* 95748, University Library of Munich, Germany.

[26] Alternatively, this could be achieved by lifting the zero risk weight that government bonds currently enjoy under the prevailing regulatory framework.

[27] See Cœuré, B. (2019), "The euro's global role in a changing world: a monetary policy perspective", speech at the Council on Foreign Relations, New York City, 15 February.

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