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The euro area – Prospects and challenges

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1 Introduction

Ladies and gentlemen

Thank you for inviting me to speak here at the Fundacao Getulio Vargas. It is always a worthwhile experience to meet people from around the world to exchange views, share insights and findings as well as learn from each other.

In my speech today, I would like to talk about Europe's experience of a single currency. It was back in 1999 that 11 European countries adopted the euro as their common currency. Today, the euro is shared by 19 countries and more than 300 million people, which, as I see it, makes it a success. Having said that, it has not always been plain sailing. In the wake of the global financial crisis of 2008, the euro area slid into a financial crisis of its own.

This was compounded in 2010 when Greece entered into a sovereign debt crisis, leading to other member states suffering a sudden loss in confidence,

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which eventually brought the euro area to the brink of collapse. Extensive rescue packages by the governments along with non-standard measures taken by the ECB helped to calm the markets and prevented the crisis from escalating.

Five years later, the crisis still has not been entirely resolved as the Greek drama has clearly shown. Are we back at square one? In my view, we are not. Although we have not reached the end of the journey, we have made good progress over the past few years – I will come to that in a moment. Still, the question remains as to which road we have to take from here in order to achieve our objective of a stable monetary union.

In order to recognise the direction in which we have to go, we should first look at where we have come from. Let us therefore look back at the road that led us into the crisis, at its causes.

2 Looking back: the causes of the sovereign debt crisis

There are a very large number of angles from which it is possible to look at such a complex phenomenon as the crisis in the euro area. And depending on the angle, it is possible to tell somewhat a different story. The core elements of those stories are always the same, however. We can find them at both the national and the European levels.

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Let us first take a look at the national level; in other words, the countries themselves. Following the introduction of the euro in 1999, a large amount of capital flowed into the countries which were later at the centre of the crisis such as Greece, Ireland, Portugal, Spain and Cyprus. First of all, that is economically plausible: capital flows from highly developed countries into countries that are catching up economically.

In our case, however, the inflowing capital did not finance a sound catching-up process. Instead, it financed house price bubbles in some countries – such as Ireland and Spain. Elsewhere, it funded excessive government consumption – for example, in Greece.

The inflowing capital did not fund sound growth. Instead, it masked an existing lack of competitiveness and, in fact, made it even worse. The favourable financing conditions stimulated domestic demand, and a procyclical real interest rate effect then ensued. Higher domestic demand led to above-average inflation rates in the countries in question. While nominal interest rates hardly differed across the euro area, real interest rates were below-average in the countries concerned, and public as well as private debt increased strongly.

At the same time, higher demand caused wages to rise as well, which pushed the real exchange rate up and reduced price competitiveness. This, in turn, dampened exports. But the dampening effect on the tradable sector was not sufficient to moderate overall wage increases. In other words, the interest rate effect dominated the exchange rate effect. Consequently, worsening exports did not trigger the necessary adjustment, and current account deficits

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continued. As a result, the deficit countries built up ever-larger external imbalances. These were the structural problems that turned out to be the breeding ground for the crisis.

But this undesirable development was only possible because of shortcomings and blind spots in the framework of monetary union.

In order to understand these shortcomings, it is important to know the particular features of the European monetary union. The European monetary union is special because it combines a single monetary policy with national fiscal policies.

The monetary policy for the 19 countries of the euro area is decided by the Governing Council of the ECB in Frankfurt. However, the fiscal policies of the 19 euro-area member states are a matter for the national policymakers – each country decides itself on its own government revenues and expenditures.

Given such an imbalance of responsibilities, the individual countries have incentives to borrow. This is because the negative consequences of borrowing in a monetary union are less severe for each member state than they would be for countries outside a monetary union. In a monetary union these negative consequences spread across all the member states – for example, by means of a higher interest rate level.

This incentive to borrow, this “deficit bias”, was already recognised by the founders of monetary union. In order to reduce it, they did two things. First,

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they created explicit rules on borrowing in the form of the Stability and Growth Pact. This Pact was intended to keep a tight check on national fiscal policies. Second, the founders of monetary union incorporated the “no bail-out” principle into the Maastricht Treaty: no euro-area country was to be liable for the debts of another member state.

Individual responsibility was therefore to be the guiding principle for fiscal policy in the European monetary union. Each country was itself to bear the consequences of its own fiscal policy.

These rules were intended to keep borrowing by the euro-area countries within reasonable limits. But rules were not the only means of achieving this. The financial market actors, too, were to ensure that that the euro-area countries did not incur excessive debt. If a country were to become excessively indebted, it would only be able to borrow on the financial markets at very high rates of interest. This means that the country in question would have to reduce its debt to a sustainable level.

Yet, neither of these two safeguards worked particularly well. Neither the discipline of the financial markets nor the rules were able to prevent individual countries running up excessive debt. Investors on the financial markets tolerated the problems of individual countries for far too long. At the same time, policymakers stretched and sometimes ignored the rules of the Stability and Growth Pact.

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And then, in 2008, came the global financial crisis. Many countries had to rescue their banking systems and support economic activity. That in turn dramatically drove up their levels of sovereign debt.

And, suddenly, the investors on the financial markets seemed to become aware of the problems which some countries were experiencing. Now they saw the high level of sovereign debt, the lack of competitiveness and the risk of contagion effects between the individual countries. In short: they lost confidence in the crisis-hit countries. But this also meant that capital flows dried up – the capital flows that had previously covered up the problems.

In order to safeguard financial stability in the monetary union as a whole, rescue packages were set up: first for Greece, then for Ireland, Portugal, for the Spanish banking system and, finally, for Cyprus. At the same time, the ECB took various non-standard measures in order to stabilise the situation.

In an exceptional crisis, taking exceptional measures is undoubtedly the right thing to do. However, looking to the future, neither course can provide a permanent solution to the crisis. Neither the rescue packages nor monetary policy can remedy the basic underlying problems that I have just mentioned.

3 Looking forward: ways out of the sovereign debt crisis

Resolving these problems requires structural reforms at both the national and European levels.

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3.1 Reforms at the national level

At the national level, major progress has been made as most of the crisis countries have managed to improve their public finances and to improve their competitiveness.

Price competitiveness in the crisis countries has also improved significantly. Measured in terms of the deflators of total sales, competitiveness has improved by 8 ½ % in Portugal, just over 11 ½ % in Spain and 16 ½ % in Greece. To some extent, these figures can be attributed to the depreciation of the euro. Nevertheless, the figures for the countries I have just mentioned are also positive when measured in terms of the euro area. As a result, current account deficits have been reduced and countries I mentioned are now running a surplus.

At the same time, unemployment seems to have peaked, although it remains exceptionally high in countries such as Greece and Spain. Altogether, it is becoming increasingly clear that the efforts are bearing fruit, particularly in Spain and Ireland.

This makes it all the more important for the achievements not to be compromised. And this is why it is in my view an important success that the Greek government agreed, after a hard struggle with its European partners, to stay on the course of economic reforms.

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Now it is important that the government is really willing to take ownership of the agreement that was reached in August. The agreed measures have to be implemented. This is not only a preposition for further financial assistance but also a precondition for Greek’s economic recovery.

3.2 Reforms at the European level

Suffice to say, it is not enough to correct misalignments solely at the national level, either in Greece or elsewhere in the euro area. We also need structural reforms at the European level. And here, a lot has been done since the crisis broke out.

First, the rules of the Stability and Growth Pact were tightened and a fiscal compact was adopted in order to restore confidence in public finances. Second, a procedure for identifying macroeconomic imbalances at an early stage was established. And third, a crisis mechanism was set up to serve as a “firewall”, safeguarding the stability of the financial system in the euro area.

In addition to these measures, the euro area took a major step toward deeper financial integration. On 4 November 2014, the first pillar of a European banking union was put in place. On that day, the ECB assumed responsibility for supervising the largest banks in the euro area. As of today, this concerns 123 banks which together account for more than 85% of the aggregate balance sheet of the euro area’s banking sector, making the ECB one of the biggest banking supervisors in the world.

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Taking banking supervision from the national level to the European level has three concrete benefits.

First, European banking supervision allows banks in the entire euro area to be supervised according to the same high standards. These harmonised standards will emerge from the cross-border sharing of experience, noting the best aspects of each national approach to banking supervision and adopting these for use at the European level.

Second, European banking supervision makes it possible to effectively identify and manage cross-border problems. This is essential because large banks are usually active in more than one country. During the crisis, there were some instances where a more pronounced cross-border approach would indeed have been desirable.

Third, taking banking supervision from the national to the European level will add a degree of separation between supervisors and the banks they supervise. This will prevent supervisors from handling their banks with “kid gloves” out of national interest.

As you can see, we have come to expect a lot from European banking supervision. And in 2016 a European resolution mechanism for banks will be established as the second pillar of the banking union. This will be another major step forward in designing a better framework for the European monetary union.

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However, to make monetary union more stable, the general framework needs further reform, too. The primary objective should be to increase the incentives to make sound and responsible decisions within the euro area. To this end, it is important to rebalance liability and control – I have mentioned this issue before.

Either we create a fiscal union by establishing centralised rights to intervene in national fiscal policies or we strengthen the principle of individual national liability.

As I do not see enough support for a fiscal union – either in the political sphere or among electorates – I do not expect it to occur in the foreseeable future. Therefore, the principle of individual liability of the member states needs to be underscored. Otherwise, the deficit bias of member states of the euro area will be strengthened, which is harmful to the stability of monetary union.

Relying on fiscal rules alone will not suffice to overcome the euro area's vulnerability to crises once and for all. On the contrary, additional steps are needed to strengthen the disciplining effect of capital markets on fiscal policy. In that sense, the principle of individual national responsibility ultimately means that governments, too, must be allowed to fail financially.

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4 Conclusion

Ladies and gentlemen, despite the intensive political debate over the summer months about the future way of Greece, Europe has covered a lot of ground in a straight line over the past years. There have been reforms nationally, and there have been reforms at the European level. Many of these reforms are bearing fruit.

In any case, to put Europe on a sound footing, we need more integration, not less. After establishing monetary union in 1999 and the banking union in 2014, the next big step will be to establish a capital markets union, which the European Commission plans to have established by 2019. Integration is the way forward for Europe. That is my firm conviction and I am certain that we shall eventually achieve the objective of a stable and prosperous Europe.

Thank you very much.

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