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Keynote Lecture: Deepening EMU – Political Integration and Economic Convergence

Dear colleagues,

First thank you very much, this is a great privilege to be here. I would like to thank the organizers for giving me the opportunity to discuss with you the challenges ahead to reignite economic convergence and political integration. In that respect, I would like to depart from a purely institutional view and provide you with my personal views of where we stand and what remains to be achieved to ensure that the EU is best prepared to withstand a potential next crisis. As a disclaimer, and to paraphrase Alan Greenspan famous dictum, I have to warn you that if I turn out to be particularly controversial or innovative, you have probably misunderstood what I said.

As you all know, it has been eleven years since the first tremors in financial markets that gave rise to the crisis where felt. Lehmann Brothers fell ten years ago. During that period, many institutional reforms have been pursued in the EU. Still, much remains to be done and I would thus like to focus on three key messages:

- First one, in light of the progress made, are we ready to withstand the next crisis, whenever it will come? Here, the answer at this stage is "no".
- Second, we have so far, at the national and European level, operated under the "ultima ratio" principle, making reforms only when we had our shoulders against the wall. Counting on the ultima ratio for the next crisis would be extremely risky.
- Third, a narrow approach to risk reduction is bound to fail. More specifically, without the right pre-conditions, measures that seek to reduce the risk of bailout would actually increase the risk. More generally, the dichotomy, which has prevailed since 2016 between "risk sharing" and "risk reduction" will have to be overcome if we are to make decisive progress towards a better functioning EMU.

I will now elaborate on these three key messages.

Progress on EMU architecture made, but not enough

As I mentioned, the institutional reforms that we have made throughout the crisis clearly reinforce the EU. I think that we have put in place a number of mechanisms that allow responding to extreme circumstances. Most prominently, the European Stability Mechanism (ESM) goes a long way in strengthening the institutional architecture of EMU. Also, compared to the pre-crisis period, banks are definitely better capitalized and have stronger balance sheets. In that respect, we have achieved substantial progresses in the establishment of a banking union, a project which was initiated in June 2012, at a time when market pressure was heavy on heads of state and governments. Still, I would say that we are only halfway through. A number of bricks are still missing to complete the architecture and dwindling "political capital" at the EU and at the national level could put further progress at risk.

The banking union rests on three pillars. The first pillar is the Single Supervisory Mechanism, which is now fully operational. The second pillar, the Single Resolution Mechanism, will be completed once the backstop to the Single Resolution Fund (SRF) is established. On the other hand, the third pillar, the European Deposit Insurance Scheme (EDIS), is still ahead of us.

On the backstop of the SRF, we have now a clear commitment at the political level. It is the clearest achievement of the Euro Summit of 29th June

2018. While Leaders have decided that the backstop would be operated by the ESM, the actual implementation now has to address two challenges:

First, the activation of the backstop has to be operational. By its very nature, the related funds need to be made available very quickly, usually over a weekend. This is particularly critical as resolution authorities have to be able to factor the backstop in their decision-making. Putting intricate conditions to its use would risk making the whole instrument unhelpful in case of crisis. The need to ensure parliaments' involvement, which is considered in a number of countries, has to be addressed without compromising effectiveness.

The second point is that having the ESM providing the backstop for the SRF will likely require a change in the ESM Treaty. As this is an intergovernmental agreement, such change will need to be ratified according to national practices in all signatory countries. While there is an agreement, codified in the Euro Summit, that the backstop should be with the ESM, some countries may be tempted to introduce additional elements that are more controversial through their national ratification procedure. Overall, we need to avoid the risk that this derails the adoption process of the SRF backstop. Delivering what the Euro Summit decided in June will thus require political will and tactical prowess.

Regarding EDIS, I see the fact that is was mentioned by Leaders as a positive step. I think it is one of the concrete results of the Meseberg declaration by France and Germany. However, we need to be realistic. Given the divergences of views, concrete steps in that respect are not for tomorrow, probably not even for the day after tomorrow. Still, the fact that there is an agreement means that with the right preconditions, the political discussion can start in earnest.

Overall, proceeding on the backstop and on EDIS is important because otherwise we risk having here the reverse of the "no taxation without representation" motto. Unless we make progress, we would have "representation", in the sense that there is mutual control over the instruments, but we would not have "taxation" meaning that the right resources to have a complete banking union would be lacking.

In the financial area, we have also to proceed speedily and effectively on capital markets union (CMU). There are at least two important reasons why this is crucial at the current juncture and also in the medium term. The first one is that, in order to boost productivity, we need the type of long-term investments that banks, especially in the current circumstances, are unlikely to finance. The European Fund for Strategic Investments (EFSI) contributes to bridge that gap. Going further, we need to make much stronger use of capital markets and CMU is a key enabling factor in that respect. The second reason for the importance of the CMU is actually more euro area specific and is related to the remaining imbalances in the EMU. Internal imbalances, which have played a critical role in the unfolding of the crisis, have not been fully resolved. They imply excess savings in some parts of the Union that have to be reallocated to other parts. Having a CMU would allow to do so via equity rather than via debt which would reduce the risk of sudden stop and of adjustment. In my view, it would also lessen the political tensions linked to imbalances within the euro area.

A third element that we are still missing is a central fiscal capacity. The opportunity of setting up such an instrument is controversial. Although it is mentioned in the letter of the Eurogroup's President to Leaders, there is no agreement on this. Personally, I believe that a central fiscal capacity is needed, not for ordinary shocks that stem from cyclical fluctuations but in the case of large shocks. In the event of a large asymmetric shock, whether it is asymmetric per se or has a common origin for Member States but asymmetric implications across countries, even if countries have created the necessary room for maneuver at the country level, a pure national response is not enough to withstand the shock. In such circumstances, having a central fiscal capacity is critical to deal with the consequences of the shock in an effective manner.

In parallel, it is important that countries use the current favorable economic circumstances to improve their resilience. This implies creating budgetary room for maneuver at the national level to ensure that automatic stabilizers can play freely in case of a crisis. It also means proceeding with economic reforms. Since the crisis abated, we have seen a slowdown of reform in the EU. To support countries in their effort, the EU has put forward a reform support programme. This tool, which goes hand-in-hand with the surveillance as part of the European Semester, and notably the implementation of the Macroeconomic Imbalances Procedure, provides positive incentives for reforms. In its proposal for the next Multiannual Financial Framework, the Commission proposes to allocate EUR 25 billion to such incentives, including EUR 2 billion specifically earmarked to support the convergence of non-euro area Member States and EUR 1 billion for technical assistance.

Overcoming the curse of the "ultima ratio"

The second point that I would like to make is that Europe has been operating for too long under the "ultima ratio principle". The fact that we could only agree collectively on reforms with our back against the wall shows that Europe is still lacking a common narrative. We still have not developed a common understanding of what we want the EU to achieve. Incidentally, we also lack a common narrative on the origin and the meaning of the crisis, with important implications for the legacy of the crisis itself. Having a common narrative cannot be devolved to technocrats, whatever their quality. This is not possible and it cannot work.

Borrowing the analogy with technology that was used yesterday by another speaker, I would say that the role of bureaucrats is to help a country move to the "policy frontier". We have the institutions and the savoir-faire necessary to achieve that. However, what we cannot do alone is push the frontier. This takes politicians and political leadership and it cannot be delegated to the technocratic level. Waiting for the next crisis and expecting that reform progress could only be made, once again, under hardship would be wrong for both economic and political reasons:

From an economic point of view, what experience has taught us over the past decade is that deferred action is always costlier. The case of Greece, which has finally emerged out of the financial assistance programme, demonstrates this sufficiently clearly.

Besides this economic reasoning, there is also a compelling political argument. Throughout the crisis, one could count on the idea that under pressure, governments in the EU made the right choices. Certain specific decisions could have been taken better, faster, but at the end of the day, there was unequivocal political determination in order to safeguard the euro and the integrity of the euro area. Market observers and investors often neglected or downplayed this common will during the crisis and they were wrong. In each case, the political capital needed was put on the table to save the European project. Today, such political capital is depleted, even in a number of core countries. As a consequence, as the debate on the functioning of the Schengen area shows, one cannot take for granted that the same determination and efforts towards a collective solution would be shown. For this reason, we have to try to build a common narrative now to exploit the economically more comfortable times and not wait for the next crisis.

Risk reduction versus risk sharing: a false dichotomy

My third point is that without proper sequencing and the right preconditions, reforms to reduce risk, especially in the banking sector or for sovereigns, may actually lead to more risks rather than less. Indeed, risk reducers and risk sharers in their pure form are their own worst enemies. More specifically, reviewing the regulatory treatment of sovereign exposures or having some form of sovereign debt restructuring mechanism, although they are aimed at avoiding bailout, could very well backfire.

Those who only put the emphasis on risk sharing neglect the fact that the political capital to implement such measures is limited. This capital can only be extended by taking measures to actually reduce risk. This is indeed what is being done regarding nonperforming loans in the EU. In conjunction with the ongoing economic recovery, recent reforms at the EU and national level are putting nonperforming loans on a downward path in every Member States. Asset quality remains very much deteriorated in a number of countries but progress is recorded in all.

At the same time, I would like to insist that developing risk sharing mechanisms across Member States will actually help reduce risks. As an example, I would like to remind of the Commission proposal for a European Investment Stabilisation Fund (EISF). The proposal is to provide EUR 30 billion in loans, with some concessionary interest rate reduction, for countries affected by a very large shock. Clearly, this instrument belongs to the risk sharing sphere. However, it also has an element of risk reduction in the sense that it reduces the likelihood that the country eventually has to apply for a financial assistance programme. In that respect, the experience from the crisis tells us that being submitted to a programme is difficult but that creditor countries also face politically difficult situations. Having to present a programme for a third country to parliament in a context were pro-European parties are weakened, is never easy. Developing the EISF should thus be considered not only as a risk sharing but also as a risk reducing proposal. The same type of reasoning could be applied to the backstop of the SRF and to EDIS. Both will help develop a pan-European mobility of capital and enhance private risk sharing. This will in turn reduce the pressure for public intervention in case of large losses and the related fiscal risks.

These two examples show that the dichotomy between risk sharing and risk reduction can sometimes be fallacious. Although this dividing line has become well-established in policy discussions at the EU level, one needs to question it in a more profound way. As I just mentioned, from an economic point of view, a strict distinction is analytically doubtful. Politically, this is even more problematic. Indeed, relying on such a simplistic opposition crystallizes the division between creditors and debtors, between those who care about "responsibility" and those who care about "solidarity". Eventually, this puts countries in two separate buckets, which threatens the sense of common purpose, which is critical to reach a true compromise. Introducing such a political divide tears the "veil of ignorance" that is necessary to agree on fair reforms.

Overcoming the discrepancy would allow to make progress on further reforms to avoid financial instability. I already mentioned two of them: the fiscal capacity and the completion of the banking union. I also think that we also need to have the courage to put on the table the question of a safe asset for Europe. I know it is controversial, notably because it is usually associated with risk mutualisation. However, a proper design can avoid most of the risks usually highlighted. In addition, if you think about the functioning of modern financial systems, some form of safe asset is needed. I think the scarcity and asymmetric supply of such asset impacts negatively on the availability and the cost of finance for the economy. A genuine European safe asset would be a new financial instrument for the common issuance of debt which would reinforce integration and financial stability and help with the completion of the banking union. In times of market stress, it would also contribute to prevent flight to safety and the types of sudden stops in capital flows that have contributed to the crisis. While work on this issue is not foreseen for the December summit, this will be a "chantier" that will need to be opened in the medium term.

As a conclusion, I would like to remind of the agenda for reforming the EMU both in the short and in the medium term. The next steps in that respect have been clearly set by the Euro Summit of end-June 2018. They include completing the backstop to the SRF in an operational way and strengthening the ESM. The ESM would then be provided with a new term sheet granting it more involvement in crisis management and design of programmes. In the discussions on the developments of the ESM, we have to find the right articulation of the surveillance competence of the European Commission in order not to create confusion and increase intransparency. Along the way, we have to strive to build a common narrative to reinvigorate the sense of a European purpose. This would pave the way for restoring politically the genuine culture of compromise that we seem to have lost over the last few years. In recent negotiations at the EU level, the various actors have nominally found a form of compromise only to go back to their constituency and preach their own position instead of acknowledging the progress and the need to find a stable equilibrium between the various Member States. Only through genuine compromise did we achieve significant progress in the European construction and only through returning to a culture of compromise can we hope to achieve more.

We then have to start discussing the proposals that need to be delivered after the December deadline. This includes notably the EDIS and the fiscal stabilisation. On the latter, the Meseberg declaration by France and Germany is a useful point for reference. However, the declaration actually contains two proposals for fiscal stabilisation: a French one, which foresees varying contributions to the budget according to the phase of the cycle; and a more German one, which is essentially a reinsurance system for unemployment systems at the national level. I believe that the Commission proposal for a EISF, which is currently on the table for discussion at the Council and at the Parliament, has the potential to actually bridge the gap between the two positions.

Finally, in the medium term, there is scope to explore the potential additional instruments such as a European safe asset. We should also try to assess whether the kind of fiscal rules that we have are indeed the most effective one. I think there is room here to simplify, to make the system overall more transparent, less complex. But at the same time, as I mentioned such reforms should not be thought about in isolation but fully integrated in the broader picture which I tried to outline.