



Keynote Lecture 2: Towards a More Stable Monetary Union – What Is the Right Recipe?

Dear Ewald,
Ladies and gentlemen,
It is always a great pleasure for me to visit Austria.

One year ago, almost to the day, I was in Vienna to talk about the future of the monetary union. Back then, the key issue was how to ensure that the union is permanently preserved as a union of stability. Today, we are still dealing with this issue. In fact, it concerns us now more than ever. The meeting of the EU's heads of state or government last week marked yet another milestone on this journey.

As Austria has just taken over the presidency of the Council of the EU, it plays a key role in moderating the reform process. In that sense, we are in exactly the right place to discuss the way forward for the economic and monetary union.

I am particularly pleased to be here in Linz. Since it is my first visit, I am looking forward to tasting Linzer Torte, the nutty jam-filled cake named after the town.

The first recorded recipes for Linzer Torte date from the 17th century. It is therefore believed to be the oldest known cake recipe in the world. And from the outset, there wasn't just one recipe, but a range of variants with slight differences in ingredients and ways of preparing it.

Thus, there is one problem that every baker has to solve: which is the "right" recipe?

When we talk at this conference about the future of economic and monetary union, we are in a somewhat similar position. There are a large number of proposals on the table concerning the future design of the euro area. All proposals share the ambition to make the monetary union more stable and more

resilient. But it is an open question which of the recommendations are appropriate to this end.

Allow me to approach this question in three stages. I will set out with the basic ingredients for a stable union. As you will see, these are largely not in dispute. Then I will turn to the institutional framework which, one might say, resembles the fundamentals of baking. Finally, I will discuss some recent reform proposals – or specific baking instructions, if you like.

1 Basic ingredients

Turning to the basic ingredients, you won't be surprised that, as a central banker, my considerations start from monetary policy geared to price stability.

The European treaties provide us with an ideal framework for this: the Eurosystem is equipped with wide-ranging independence and has a clear mandate with price stability as its primary objective. And that has paid off. With an inflation rate of 1.7% on an average of the past 20 years, price developments have broadly been in line with our definition of price stability. The promise of a stable currency has thus been kept.

But the success of monetary policy also depends on conditions which it cannot create on its own. In particular, it is dependent on a stable financial system.

After the "Great Inflation" of the 1970s, advanced economies experienced a long period of remarkable economic stability that came to be known as the "Great Moderation". Academics were still debating the specific role of monetary policy in bringing about this period of economic calm when the global financial crisis ended it.

Important lessons have been drawn from the crisis. The regulation of banks,

insurers and financial markets has been strengthened. And, along with the reform of traditional supervision, macroprudential policy has been established as a new policy field. It can be deployed against regional and sectoral pockets of exuberance in case they are suspected of posing a systemic risk.

As the sovereign debt crisis has painfully reminded us, such risks can also arise from unsound public finances.

In a monetary union, the risk of excessive debt is greater than in countries which have their own currency. Saying that, I do not so much mean the lack of the option to service government debt simply by printing money. For a central bank committed to price stability, that is a complete non-starter anyway – whether in a monetary union or not.

Something else is more important: in a monetary union, the incentive to run up debt is greater because the negative consequences are smaller. For instance, interest rates may not rise as much in response to fiscal profligacy. In order to prevent such behaviour, the member states agreed on joint fiscal rules. But rules can only be of help where there is a will to observe them.

In retrospect, ever since the euro was introduced, there has not been a single year in which all countries have kept their new borrowing below the ceiling of 3% of GDP. The Commission projects that this will be achieved this year for the first time. That would be good news indeed, but it is no cause for jubilation, as the Stability and Growth Pact calls for more to be achieved in two respects.

First, the 3% mark is not a benchmark, but a ceiling. Fiscal policy should be focused on the medium-term objective,

which requires that member states have a structurally close-to-balance budget.

Consequently, we have to consider the economic environment when assessing fiscal policy. And the underlying conditions have improved remarkably in recent years: the robust economic upturn means higher revenues from taxes or social security contributions and lower outlays for unemployment benefits.

Moreover, government interest spending has fallen thanks to low interest rates. According to Bundesbank calculations, this has generated savings of approximately one trillion euros in the euro area over nine years.¹

In times such as these, fiscal policy should not be satisfied with merely adhering to the 3% threshold: it should be aiming for the zero mark or surpluses. That would give governments the leeway they need to take fiscal measures in the future, when economies may enter another downturn.

It would also help to reduce the overall debt burden, which – and that is my second point – is much too high in some countries. As things currently stand, just 7 out of 19 euro area member states meet the debt ceiling of 60% of GDP. For the euro area as a whole, debt stood at 87% of GDP last year. And these figures do not account for implicit future burdens in connection with demographic change. When considering such implicit debt, public finances in most countries – and certainly including Germany – face demanding challenges.

Elevated debt levels must not become permanent, also because persistent breaches harm the binding effect of the common fiscal rules. Benjamin Franklin already warned us that it is easier to prevent bad habits than to break them.

Moreover, high levels of government debt limit the fiscal room for manoeuvre. They make it difficult to channel government spending towards investment, weaken resilience and thereby raise uncertainty, which is very likely to dampen economic growth in the long term.

And this brings us to the last basic ingredient for a stable monetary union: competitive economies which are resilient enough to withstand or recover from adverse shocks.

Unlike countries with their own currency, euro area member states cannot resort to the instruments of monetary policy and exchange rate flexibility when they face country-specific shocks. And the single monetary policy looks only at the euro area as a whole. It can respond to the specific situation of individual member states only in so far as they affect euro area aggregates.

In the wake of the crisis we witnessed that some countries bounced back quite quickly from the economic slump, while in others growth remained low and unemployment stayed high for a long time. If the monetary union is to function free of tensions, member countries have to improve the underlying structures so that their economies become – or remain – competitive and resilient.

One element, for instance, is that easier market entry for new enterprises – and easier market exit for failing firms – can unlock the innovative potential of companies. Both would facilitate what the great Austrian economist Joseph Schumpeter called “creative destruction”, which he described as a

process that “incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one.”

OECD research suggests that policy-induced exit barriers matter for productivity growth, because unproductive firms that do not exit the market lock workers into unproductive jobs.² According to OECD estimates, reducing barriers to restructuring could, for instance, add more than 2 percentage points to productivity growth within laggard firms in Italy.³

Beyond pro-competitive regulations for product markets, there is a wide range of possible policies for enhancing resilience, including such diverse areas as the quality of institutions, political stability, infrastructure and labour market reforms.⁴

2 Fundamentals of baking: an act of balancing

We have identified four basic ingredients for a stable union: monetary policy geared towards price stability, a sound financial system, healthy public finances, and resilient economies.

Four basic ingredients are also needed for shortcrust pastry, the base of the Linzer Torte: flour, sugar, eggs, and butter.

One secret of the pastry is the right level of gluten. It provides the dough with stability and elasticity, and it forms when proteins in the flour build a network of chains. This happens by adding liquid to the flour and kneading the mixture. However, the gluten content must be limited in order to produce a

¹ Deutsche Bundesbank. 2017. *The development of government interest expenditure in Germany and other euro-area countries. In: Monthly Report. July 2017. 33–67.*

² McGowan, M. A. and D. Andrews. 2016. *Insolvency Regimes And Productivity Growth: A Framework For Analysis. OECD Economics Department Working Papers 1309.*

³ McGowan, M. A., D. Andrews and V. Millot. 2016. *Insolvency Regimes, Technology Diffusion and Productivity Growth: Evidence from Firms in OECD Countries. OECD Economics Department Working Papers 1425.*

⁴ In particular, a Bundesbank study has argued that greater wage flexibility would probably have helped overcome the crisis and safeguard employment in some euro area countries. See Deutsche Bundesbank. 2016. *Wage dynamics amid high euro-area unemployment. In: Monthly Report. December 2016. 33–55.*

tender short pastry. Too much gluten makes the dough tough. Therefore, it is important to refrain from kneading too much.

A similar act of balancing is required for a stable monetary union, when we frame the basic ingredients within a crisis-proof institutional set-up to provide the right incentives for responsible behaviour. The particular architecture of monetary union doesn't make things any easier. In the euro area one single monetary policy co-exists with 19 autonomous fiscal and economic policies.

The autonomy reflects and enables the diversity of member states in terms of their economic and social structures, which is an expression of our societies' distinct preferences and identities. In my view, such great variety is an asset and contributes to Europe's richness. It is not by chance that the official motto of the European Union is "in varietate concordia" – united in diversity.

But the asymmetric construction also makes the monetary union vulnerable.

The original recipe as enshrined in the Maastricht Treaty focussed on a no-bailout clause that would unleash the disciplining power of financial markets. This framework did not prevent the crisis, nor did it provide any mechanisms or tools to overcome it.

Since the crisis, however, the design of the union has already been adapted in some important aspects. The establishment of the ESM as a permanent rescue facility and the creation of the banking union remedied design weaknesses that were either ignored or overlooked when monetary union was founded.

However, the euro area is not yet permanently crisis-proof. And that's why there is a broad consensus that further institutional reforms are needed.

The proposals that are currently under discussion differ on one point in

particular, namely on the extent to which risks should be shared. Some place their faith in greater joint liability, while others would like to strengthen individual responsibility.

However, the true challenge consists in striking a balance between actions and liability. That means the decision-making power and responsibility for the effects of the decision have to be placed on the same level. Responsible decisions are taken only if the decision-makers also bear the consequences. Why, for example, should a government refrain from risky policies if, at the end of the day, the community has to pay the bill?

In the 2010 sequel to the classic movie "Wall Street" the fictional character Gordon Gekko, played by Michael Douglas, explains the problem more eloquently than I ever could: "Moral hazard is when somebody takes your money and is not responsible for it."

Rebalancing actions and liability by no means rules out a greater sharing of risks. In order to maintain the balance, however, the relevant powers would have to be transferred along with the risks to the European level.

Having said that, I can identify very few member states that display a willingness to forgo national competences. Quite the opposite: over the past few weeks it has again become apparent that those who may call the loudest for greater risk sharing explicitly insist on their national sovereignty in fiscal policy matters.

And that highlights the current dilemma: demanding greater solidarity of the community and, at the same time, rejecting any transfer of competences to the community does not match up. The saying "You can't have your cake and eat it too" also applies to this trade-off between national sovereignty and risk sharing.

3 A closer look at some instructions

At last week's Euro Summit in Brussels, the heads of state or government identified the need for further discussion in many areas with regard to the framework underpinning the EMU. This has prompted a great deal of criticism and calls for faster decisions. But I am in favour of putting thoroughness before speed. Further debate ought to take priority over preconceptions or hasty decisions.

Nevertheless, the governments confirmed that further reductions in risks are necessary before the banking union can be completed by introducing the European Deposit Insurance Scheme (EDIS).

The Bundesbank has long recommended that risks which banks incurred under national responsibility should not be retroactively mutualised through the EDIS. To a casual observer the proper sequencing has always been a matter of common sense. In the end, when you have just crashed your car, it's too late to take out insurance with comprehensive coverage.

Obviously, reducing risks requires addressing the legacy of non-performing loans on banks' balance sheets. But we cannot stop there. Going forward, more needs to be done to rein in future risks by severing the sovereign-bank nexus. It is crucial that we abandon the preferential treatment of sovereign debt in banking regulation. If this matter is not resolved, further steps towards completing the banking union would imply a significant increase in fiscal risk sharing.

In the coming months, discussions will also focus on possible new fiscal tools.

At this point, allow me a general word of caution. We need to be mindful of public debt: higher budget deficits today mean higher taxes tomorrow.

Given the burden of government debt in the euro area, the creation of additional possibilities for borrowing is precisely what we should not be aiming for. Instead, we should start by considering the specific tasks that are to be performed at the European level and the value added that these tasks are supposed to create.

As I set out earlier, the promotion of competitiveness and convergence is an important objective. A euro area budget designed for this purpose could be a welcome advancement and refinement of the existing European structural and investment funds.

That does not necessarily mean an increase of the overall size of fiscal transfers. Instead, it would be desirable for this to be part of a fundamental reform of the EU budget as a whole, with the focus resting squarely on designing and efficiently carrying out projects that can deliver added value for Europe.

As far as new European stabilisation facilities are concerned, we have to keep in mind that a lot of the declared stabilisation objectives can be achieved in a much less complex national form within the existing framework.

In the event of a recession, member states with sound finances can themselves take fiscal countermeasures. There is nothing in the European fiscal rules that stands in the way of such action. And if a crisis threatens to overwhelm a member state financially, the ESM is on hand to grant aid on condition that reforms are carried out.

I believe there is considerable promise in strengthening the ESM. However, it is important to preserve the principle of solidarity in connection with joint agreements, and not to weaken it by granting largely unconditional access to the programmes.

Finally, further progress towards a capital markets union would foster

private risk sharing within Europe and, in this way, facilitate macroeconomic adjustment following asymmetric shocks. After all, we should bear in mind that in federations like the USA and Canada, economic risks are primarily shared through private channels. By comparison, fiscal policy takes a back seat, as only 10% to 25% of risks are shared in this way.⁵

The Bundesbank is therefore explicitly backing the project of the European capital markets union. I am sure that this will be one of the key projects as we move ahead.

Conclusion

A permanently stable economic and monetary union will benefit all of us. It will create the basis for a stable currency and robust economic growth, thus ultimately safeguarding our prosperity in Europe.

It would be wonderful if there were a single and straightforward recipe for eliminating EMU's shortcomings. But, I am afraid, there is no such thing as the "right" recipe. Instead, I have stressed that any viable reform must entail a rebalancing of actions and liability.

In a similar vein, what makes the Linzer Torte so distinguishable is the combination of the typical lattice of dough and the layer of jam beneath. Nevertheless, the recipe can be adapted to different tastes. Our Austrian hosts may forgive those who choose raspberry jam for their cakes. I, for my part, prefer the traditional Linzer Torte with redcurrant jam.

When it comes to preferences, however, it is essential that voices from all over Europe are heard in the debate on the future of EMU. And that is exactly why conferences like this one are so important.

Karl Popper, another great Austrian thinker, went even further when he wrote: "All that is needed is a readiness to learn from one's partner in the discussion, which includes a genuine wish to understand what he intends to say. If this readiness is there, the discussion will be more fruitful the more the partners' backgrounds differ. Thus the value of a discussion depends largely upon the variety of the competing views. Had there been no Tower of Babel, we should invent it."

Thank you for your attention.



⁵ Allard, C., P. K. Brooks, J. C. Bluedorn, F. Bornhorst, K. Christopherson, F. Ohnsorge, T. Poghosyan and an IMF staff team. v2013. *Toward a Fiscal Union for the Euro Area. IMF Staff Discussion Note 13/09.*