Addressing the Challenges in the Euro Area

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Professor Bordo held a conference on Bretton Woods 20 years ago, and in the introduction to this conference, he described the Economic and Monetary Union (EMU) as a project of stabilization, one could say very much in the spirit of Bretton Woods. But the purpose of a conference like this is to reflect not only on what was achieved – and I think a lot was achieved, and it has been described already – but also on what still needs to be done. The euro area faced two crises: the loss of confidence in the banking system in 2008, which was a global event, and the loss of confidence in European sovereign debt and the euro as a regional stabilization policy in 2010 until 2012. And when Professor Bordo held his conference, controlling the exchange rate was seen as a promising way to achieve macrostability. And this was achieved. Inflation rates were low, interest rates were low. But why did the system not get to macrostability in a much broader sense? One of the explanations could be that in the thinking of the early 1990s, when EMU was conceived, several developments were not yet fully visible. First, the impact of global capital account liberalization, the deregulation of the financial sector, the globalization of trade, and the fact that fixing the exchange rate does not lead automatically to optimal policies; it even takes away pressure and incentives.

So, why did the alarm bells not ring much earlier or not much more broadly? I think two wrong beliefs existed. The first one was that the financial sector can control its risks, and the second one, that integration will stabilize the system. Integration did not go far enough, and therefore it even was a problem that we still had too much home bias, and therefore integration created additional risk because it was not far-reaching enough. This was one of the problems in the banking system that we had a lot of investment in domestic government debt.

What has changed since 2008? It was described already. I think the framework of cooperation in the euro area has been fundamentally reformed. Balance the structural budget, reduce the debt, address macroeconomic imbalances, focus more on competitiveness and structural reforms, and try to get earlier corrective action. Will it work? I think it's too early to say. It certainly needs a lot of commitment and sufficient commitment. And the second point is that, I think, the concept of convergence has to be rethought, because when the euro area was established, the surveillance framework was anchored on monetary and fiscal convergence. Competitiveness and current accounts were not so much in the forefront of the debate.

Why was this framework not sufficient? Because the idea of convergence ignores the behavioral effects, the reform efforts were mandatory before joining EMU, and there was a clear incentive: The benefits were rewarded even before the monetary union started. FDI and cross-border capital flows fostered growth, which made fiscal positions look more favorable than they were in structural terms.

Globalization lowered inflation. The Great Moderation was the result. It was not a European phenomenon alone, however, it was reinforced in the euro area due to the convergence process. I think we have to consider more of living this diversity of regional economies and face the challenge of achieving better growth, attracting investment, creating job opportunities in all regions, and this cannot be achieved by the public sector alone.

The third point of change that has been achieved is the stabilization of the financial system. Resilience was increased by higher capital levels; coherent supervision, restructuring and resolution regimes are in the making; the creation of a common backstop at euro area level is an important element; and compared to the U.S.A., the European banking system is still large and much less concentrated. Reintegration in the financial system should ensure the provision of loans and better diversify the risks, if it succeeds.

Having touched on three areas of change – economic cooperation, convergence, and financial sector reform – the question arises: Will the European stabilization efforts stop here or what could be the next steps in the effort of regaining or strengthening control, as the title of our session suggests?

If fiscal policy remains national – and this is the assumption for the foreseeable future – then two avenues of development are possible: The first is creation or enlargement of a central fiscal capacity. At the moment, the EU budget is 1% of GDP, and no central macrostabilization facility exists apart from the European Stability Mechanism (ESM), which is an intergovernmental arrangement, or the Resolution Fund, and the European Investment Bank (EIB). And, of course, one could think that the EIB could play an even larger role in the future, as managing an intervention tool, countercyclical intervention policy with targeted investments, maybe not only in infrastructure or highways, but also more in the field of education, for instance, qualification, etc.

A second possible avenue is the reflection on further mutualization of policy risks and risk sharing. And let's assume the new fiscal rules are applied and confidence emerges in each other's policies, then the way to make the system more stable would be/could be joint issuance of debt or also of debt from the past or debt in the future. This is, of course, a very big step in the evolution of the system and has to be discussed in the context of the broader debate, which Elena Flores has mentioned, which will take place on the future development of the Union, which was also started, I think, a year ago – this debate with the blueprint.

Let me conclude: Until now, the euro area has regained control, has strengthened its control by reforming fiscal rules, broadening macroeconomic surveillance (which were traditional tasks of the IMF and the OECD), by reforming financial sector surveillance and creating new institutions and improving the resilience. But reflections on the future shape of the Union have to be undertaken. The issue of how much common budget you need in such a Union, what is the role of intervention tools like OMT (Outright Monetary Transactions) or prevention tools like the Single Supervisory Mechanism (SSM) – all these tools mean that more decisions are taken at the European level. Coming back to my introduction: A lot has been achieved, unusual measures were taken and institutional changes implemented, but the spirit of Bretton Woods requires thinking in more holistic terms. Thank you.