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Yves Mersch

Governor of the Banque centrale du Luxembourg

Member of the Governing Council of the European Central Bank

After the EMU rescue – Which way for Europe?

Lecture in Memory of Pierre Werner

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- Check against delivery -

Your Excellencies,
Ladies and Gentlemen,

Neither the European Coal and Steel Community Treaty of 1950, nor the 1957 Treaty of Rome dealt extensively with currency. This might have been because convertibility after World War II was not very wide-spread and capital controls were the norm.

Belgium was one of the first countries to establish free movement of capital but only within a dual exchange rate regime. This particularity had been one of the reasons for Luxembourg to emerge as a financial activities center for Europe.

The principle of fixed exchange rates had been a feature of the international framework for currency stability after World War II for the economies of Europe, North America and Japan. The Bretton Woods System was based on gold and the US dollar as the predominant monetary standard and worked for several years with almost no frictions. By 1968 a new era of currency instability threatened when market turbulence forced the revaluation of the German Mark and the devaluation of the French Franc. These developments clearly revealed the weaknesses of the Bretton Woods System as well as the threats to the common market and specifically the common agricultural policy.

Ideas of a new European currency framework gained momentum and Luxembourg's Prime Minister Werner, also Minister of Finance, was asked to steer a Committee mandated to design the path to an increased economic and monetary integration of the six then members of the European Economic Community. That report, finished on the 8 October 1970 and sent to the Ministers of Finance in the first instance, laid down the achievement of Economic and Monetary Union by 1980.

The youngest member of the Committee and the only one still alive is Prof. Dr. Hans Tietmeyer. It was he who at the first meeting of the Governing Council of the ECB insisted on the seating arrangements to be changed from countries in alphabetical order to members' family name in alphabetical order. In doing so, he was truly loyal to the spirit of the Werner plan.

In deed, if it took another 20 years after the Werner plan deadline before a single currency was established -, for reasons that would take another conference to explain - it is worth revisiting the Werner report finalized 40 years ago. We can call it truly visionary. Although many of the proposals of the original Werner plan have been realized, some of the original thoughts were ignored or diluted and we might with the benefit of hindsight, ask ourselves whether this has not been a mistake. Of course, the Werner report originated in a different environment when the Union with its original six members still was aiming at a final goal of something like a federal Europe. When, after several run-ups, turbulences and tensions, the goal of a single currency was eventually achieved with the introduction of the Euro in 1999, not only had the number of member states increased, but it had become clear that despite the single currency, there would not be a political union to accompany that currency. National sovereignty in the economic policy-making area would be preserved. Nonetheless, recent turbulences highlight the inherent tensions of European integration, especially those between a monetary policy in which sovereignty is pooled while economic policy remains under national sovereignty. Tensions translate into dynamics either for progress or for regression.

True enough, even during the intergovernmental conference that was to lead to the Maastricht Treaty, there were parallel negotiations for the development of a political union. The political union made only limited progress, while the detailed draft for EMU was hailed as a breakthrough for European integration. In truth, it was once again a compromise between the pooling of sovereign competences at the European level in the monetary area - with opt-in and opt-out clauses for some countries - and the economic union where ultimate responsibilities remained at the national level. Many features were similar to the Werner report like a three stage approach with a warming up period (ten years in the Werner plan, eight years in the Maastricht Treaty) or the abolition of all capital controls.

Inside the Werner Committee, the discussions had centered on the sequence of transfer of powers to the European level. Foremost Germany argued that monetary union should follow political union. This so-called crowning theory was inspired by historic developments in other countries. The others on the contrary considered monetary policy union as a powerful catalyst for deeper integration in other policy fields that must follow.

Today, I want to focus on another feature. The Werner report supported the idea of an independent institution for fiscal monitoring and coordination. This thought clearly reflected the concept that a single monetary policy would be supported by sound public finances. More concretely, the report called for ever closer economic policy coordination with an agreed framework for national budgetary policies. At the institutional level, it suggested a “centre of decision for economic policy”. This coordination body for economic policies should have been established alongside the European system of central banks, i.e. the monetary authority. Both institutions were to be independent from the national governments, being politically accountable only to a European Parliament. This independent economic authority should have influenced the national budgets with a focus on the level and the direction of the balances as well as the financing of deficits and the use of surpluses, respectively. The Werner report also advocated a certain degree of tax approximation especially for cross border activities.

When the Intergovernmental Conference on EMU started, Europe had endowed itself with a Parliament, but with limited powers and no capacity to levy taxes and to control centralized policy making at European level. Most European resources were transfers from national budgets. Tax sovereignty was left untouched after a timid attempt to change tack in the so-called Guigou group set up by President Mitterand to prepare the Conference. During the Conference an attempt by Belgium and Italy to move into the tax area ran into massive resistance.

Political union was off the agenda and loose coordination of economic policies was deemed sufficient. It was believed that market discipline would install responsible behavior in the fiscal and competitive position of countries. The land grabbing attitude of the European Commission pretending to be the economic and fiscal authority in the event of more integration indirectly strengthened the case for the intergovernmental approach and the so-called own responsibility of each individual country in this respect.

It can seem surprising that governments were so confident about market discipline and reactive national policies when one major factor of self-correction within a currency union was by design rather weak in Europe, namely labour mobility.

True, progress has been made in language knowledge, university students exchange, diploma recognition and access to professions. Mobility is good at the lower and higher skill ends, but the high share of closed public service in Europe, non-portability of pension rights, rigid labour laws and cultural differences make labour mobility a slow process.

Therefore in 1997 the Treaty was complemented by the Stability and Growth Pact which has mostly focused on fiscal deficits. The result proved insufficiently coercive and was even further weakened when Germany and France failed to abide by the rules in 2003. The absence of a meaningful macro-economic surveillance led to heterogeneity which was further accommodated by the absence of expected market reactions. Today we have to acknowledge that market reactions often come with delays and then tend to overreact.

But let me be clear: Forty years after the Werner report and eleven and a half years after the introduction of the single currency, for me, the verdict is unambiguous: Monetary policy within the Euro area has been a success. It is widely accepted that the best a central bank can do in supporting economic growth is delivering price stability. The ECB has delivered price stability. Even though real GDP in the Euro zone has grown by only 1.5 % per year in the first decade since its establishment, while the US economy expanded by 2.2 %, this difference can to a large extent be explained by the greater population growth on the other side of the Atlantic. On a per capita basis annual real GDP growth rates are very similar, 1.2 % in the US versus 1.0 % in the Euro area. The Euro area's economic growth rebounded strongly in the second quarter of 2010, driven by higher investment and replenishment of inventories.

Last week the IMF revised its figures for growth in the Euro area upwards in line with earlier ECB projections. Incoming hard and soft data for the second half of the year do not warrant increased pessimism.

In the course of the crisis of the past three years the ECB and the Eurosystem were forced to act very fast, boldly and innovatively in order to ensure their long term goal of price stability and the functioning of the transmission mechanism. Their monetary policy interventions were successful. The recovery of the European economy is ongoing and the tensions in the financial systems have eased somewhat, although it is still too early to claim victory.

But we have to draw the lessons from the recent experience. With the eruption of the crisis in September 2008 the accumulation of private debt was suddenly stopped. The problem of excessive indebtedness was not solved, however. Fiscal rescue packages, the impact of automatic stabilizers, and the support of the financial system including guarantees to the banking sector led to a significant increase in public leverage to levels unprecedented in peacetime. In other words, parts of the excessive private debt load were shifted to the public sector.

The crisis exposed institutional weaknesses. Some had their source inside the financial system. Despite some initial temptations for re-segmentation of prudential competences, the response will be at the European and at the EU27 level. It will consist of the implementation of new concepts and institutions aiming at de-risking the financial industry. Liquidity monitoring through a monthly liquidity coverage ratio and a yearly net stable funding ratio will be complemented by macro prudential surveillance in a European System Risk Board closely associated with the General Council of the European Central Bank. The US equivalent to this Systemic risk Board held its inaugural meeting at the beginning of this month.

Three European Agencies for banking, securities markets and insurance start with a mostly coordination function, but have certain evolutionist competence clauses in their statutes. They have to walk the narrow line between cross border activities of banks and integration of markets on the one hand and competences remaining at national levels like deposit guarantee schemes, resolution procedures, insolvency legislation, i.e. everything that pertains to the tax payer who remains fiercely protected by national governments despite the spill-over effects of cross border activities, on the other hand.

To tackle these effects through a potential 351 bilateral Treaties in so many areas among 27 member states, can hardly be seen as a stable equilibrium in decision making nor a level playing field for economic activities in a single area.

The new institutional set-ups at EU level therefore face some of the same problems we experience within the Euro-area. The ultimate goal will however be the same: foster economic welfare through integration of markets and market players.

This obviously will also be beneficial for the optimal functioning of a single monetary policy at Euro area level. The transfer of private debt into public debt as such was similar to what was observed in the whole industrialized world. But the weak institutional framework for fiscal discipline at national and at Euro area level as well as the absence of control by financial markets was emphasized in some countries by three developments:

1. an overextended national financial system
2. an insufficiently strong starting position in the cyclical downturn in terms of deficit and debt
3. a rapidly deteriorating competitive position as shown for example in unit labour costs or current account balances

Suddenly markets reacted and overreacted while Governments excelled in denial and cloak and dagger stories.

This slow reaction forced the ECB into action as a back-stop exposing the unfinished work of the institutional set-up of EMU just as the financial crisis had exposed failures in the macro-prudential area throughout the industrial world.

In both cases, the welfare price of overly relying on market reaction only has become clear. Now credible deleveraging has been implemented in many countries. This action should allow those countries to be back on a sustainable trajectory of growth in the medium term.

A crisis management facility, the EFSF, has been set up as a symbol for the existence of a "community of destiny" that is a monetary union. A common destiny engulfs solidarity. But solidarity presupposes responsibility. This means that crisis prevention mechanisms are even more important than crisis management facilities. And we have to recognize that before a fiscal deterioration occurs and needs corrective actions, we ought to detect early signals in the macro economic imbalances of economies that share a single currency.

To overcome the macro-economic heterogeneity within the Euro area, an explicit and clear framework for the surveillance of competitiveness is needed with the aim of correcting large imbalances. Despite having a single currency and central bank, national economic policies remain insufficiently aligned. Forty years ago (!) the Werner plan was very outspoken on this issue: "Having regard to the marked differences between the member countries in the realization of the objectives of growth and stability, there is a grave danger of disequilibria arising if economic policy cannot be harmonized effectively".

The needed framework is not aimed at increasing the power of the Commission in macro-economic surveillance in the EU but at highlighting the Euro area dimensions of surveillance and policy adjustments. This dimension requires more automaticity with a focus on countries with vulnerabilities, competitiveness deterioration and high debt levels. It should foresee graduated sanctions at a sufficiently early stage to reinforce compliance. It should take aim at national rigidities that are incompatible with a currency union, like automatic indexation mechanisms of wages and pensions.

On the fiscal side, it is also worth remembering the emphasis that the Werner report put on an independent fiscal authority.

The quality and independence of economic analysis is crucial.
Several suggestions could be made in this respect, for instance increasing the role of the Commissioner in charge of Economic and Financial Affairs akin to the role of the Commissioner in charge of competition. External assessment could also be provided by a Committee of "wise persons". Quality and reliability of statistics need to be reinforced,

deadlines in procedures reduced, scope of discretion of exceptional circumstances curtailed and more automaticity introduced. I hope that the Van Rompuy Task Force is bolder on those issues than were the Commission's proposals.

To conclude:

In line with the vision of the Werner Plan, the integration of Europe as an evolutionary process has to continue. The financial crisis of the last three years has uncovered the institutional shortcomings of the current framework and exposed gaps in the existing economic governance regime.

To make sure that the Euro will continue to be a stable and credible currency, monetary policy has to be supported by sound public finances and balanced and sustainable economic growth in the member states of the Euro area. A strengthening of the Stability and Growth Pact, preventing and correcting macroeconomic imbalances at an early stage, and more effective enforcement via gradual sanctions for non-compliant euro-area countries will help to achieve this goal. An independent fiscal authority would help to advance the institutional deepening of the Euro zone and, in this respect, reflect the spirit of Pierre Werner.