Remarks on the future of economic governance in Europe and the euro

Introductory remarks by Yves Mersch, Member of the Executive Board of the ECB, at panel "The Agenda for Europe", at Ambrosetti's Finance Forum on 'The Outlook for the Economy and Finance', Villa d'Este, Cernobbio, 8 April 2017

In a year of anniversaries – the sixtieth anniversary of the Rome Treaty and the twenty-fifth anniversary of the Maastricht Treaty –, our Union finds itself amidst a debate about its raison d'être and its future.

Earlier this week, the EU commission discussed in Strasbourg "a road map towards a complete Economic and Monetary Union in 2025" as part of a "reflection paper".

In January, the high-level group on own resources (HLGOR) chaired by Mario Monti has been presented in the European Parliament and in the Council. It is reflecting on finding more transparent, simple, fair and democratically accountable ways to finance the EU.

And we are approaching the second stage of the "Five Presidents' report" with the aim of completing the architecture of Economic and Monetary Union.

As a central banker, I will focus on the state of economic governance in Europe. I will first share some considerations on what has been achieved so far. I will then discuss how we could further improve the functioning of our Economic and Monetary Union in the future and invigorate trust and support from European citizens.

The key role of monetary policy in stabilising the euro area economy

As the central bank issuing the euro, we are responsible for the stability of the single currency. Our monetary policy measures played a key role in stabilising the European economy. The European Central Bank acted decisively by deploying a range of conventional and unconventional monetary policy measures, allowing to reduce financial fragmentation, avoid deflation, and support price stability and thereby the economic recovery.

While an effective lower bound for short-term interest rates exists, monetary policy, shifted to steering medium to long-term rates despite of its higher dependency on international capital markets. The ECB employed non-standard measures including forward guidance and asset purchases to deal with the lower bound constraint. These instruments have been effective in narrowing spreads (term and liquidity premia) and lowering the exchange rates, thus supporting the ongoing recovery.

Shortcomings in other policy fields delayed the recovery

The economic outlook has significantly improved since the peak of the crisis. The recovery has strengthened and broadened across sectors and countries and the balance of risks is within a whisker of being called balanced. Growth of GDP per capita was in fact higher in the euro area last year than in any other major advanced economies in the G7. And unemployment has declined to 9.5% in February 2017, the lowest level since May 2009. The output gap should be closing within the policy horizon; NAIRU at the same time has been revised downwards - for those who love unobservables.

But to reap the full benefits of our monetary policy, it needs to be complemented by sound economic and fiscal policies at national and European level. To the extent that fiscal and economic policies did not provide the necessary cyclical support and tackle decisively enough structural drivers of the crisis, the monetary policy reaction is more extended and forceful with the negative consequences as would have been the case in a healthier environment. Therefore, there is a need to improve economic and fiscal policies. This implies both more decisive action by national governments and full implementation of the strengthened institutional framework of Economic and Monetary Union.

The improved financial and economic architecture of EMU

Since the onset of the crisis, many of the shortcomings in the financial and economic architecture of Economic and Monetary Union have indeed been overcome.

Economic governance has been strengthened by enhancing the Stability and Growth Pact whilst introducing a framework for macroeconomic surveillance to identify and address macroeconomic imbalances as well as declining competitiveness through the so-called six-pack and two-pack. Further steps were also taken towards improving budgetary coordination among Member States. However, the preventive arm of the Stability and Growth Pact has proven to be dysfunctional.

The creation of the **European Stability Mechanism** (ESM) provided a tool for crisis resolution at European level.

The establishment of **Banking Union** was a further essential step for safeguarding financial stability in Europe.

> Regarding the regulatory treatment of sovereign exposures, it was agreed to await the outcomes of the Basel Committee. Following the work of the Basel Committee the Council will consider possible next steps in the European context.
>
> In the long run we certainly need to realize that a zero-risk weight for sovereign cannot hold a reality check.
>
> Moreover, the acknowledgement of sovereign debt restructuring as a real possibility requires deeper reflections on sovereign debt restructuring mechanism for the euro area and would underpin the credibility on of the no bailout clause. As experience has shown, “the constructive ambiguity” with respect to the market

interpretation of the no bailout clause embedded in the Treaties has not really been effective. The ESM could play a larger role in this respect.

Capital Markets Union is a natural complement to the Banking Union. It aims at promoting financial integration and enhancing shock absorption via financial markets by facilitating private risk-sharing whilst reducing opportunities for regulatory arbitrage. CMU should also support the smooth and homogenous transmission of monetary policy.

A number of concrete measures are listed in the Commission's Action Plan to strengthen: Securitisation, insolvency regimes, and tax legislation need to be prioritised. Cross-border barriers to clearing and settlement should be removed.

I welcome the commission's communication on accelerating the CMU. Swift implementation is of the essence.

Implementation of promises and adherence to new rules is key

As a result of these measures, our economic and monetary union is considerably more resilient today than it was at the peak of the crisis. The strengthening of the recovery in the past year, in spite of challenges on several fronts, is testimony to that. Yet the strengthened framework can only deliver stability over the longer term if national governments keep their promises and adhere to the rules. For economic and fiscal policies this means:

Structural reforms are necessary to raise productivity and improve the business environment. Fiscal policies should be designed so that they support the economic recovery by focussing on productivity-enhancing measures.

At the same time, fiscal rules need to be respected to build confidence in the sustainability of national finances.

More decisive action by national governments and respect for the rules that we have commonly agreed on is essential for a stronger and safer Economic and Monetary Union. It is also a vital prerequisite for any further move towards shared fiscal sovereignty in the euro area.

The Five Presidents' report has outlined a vision for improving the architecture of EMU and provides a roadmap for completing political and fiscal union. Let me share with you some considerations on frequently floated ideas:

In the long run, sound fiscal policies at national level could be accompanied by the establishment of a euro area fiscal capacity with own resources, central control of spending and democratic control on the European level. This would provide a European automatic stabiliser and could allow financing European public goods. This would lead in the direction of the practice of federations, where spending on functions such as defence or R&D is to a large extent centralised. This however would require Treaty changes and raises the question about a Transfer Union. For both, the appetite of governments and people is currently very low.

Furthermore, a pooling of fiscal resources, whatever their nature and size might be, only works if solidarity goes hand in hand with shared responsibility. Likewise, greater risk sharing in the fiscal realm presupposes sufficient economic convergence among participating countries and the sustainability of public finances.

And where competences are assigned to the European level, they should be part of the Union method, with clear executive powers, full democratic accountability and rigorous judicial arrangements. Conversely, we should avoid creating the wrong impression about what the Union can do: loose coordination at European level may give the impression that a competence has been passed to the European level, when in fact it continues to be dominated by the power play among Member States which is a pattern that has consistently failed to pacify the European continent. This perceived ineffectiveness further contributes to the loss of trust and credibility of EU institutions. Therefore, responsibilities and accountability should be more clearly defined and aligned, similar to the monetary policy framework.

I am aware that the attention of our policy-makers currently lies more on security needs than completing Economic and Monetary Union. Some of these proposals may also require Treaty change for which there may be little appetite at the moment.

But we should also not forget that Europe will be better able to protect itself if it has a strong economy allowing it to address the concerns of Europeans. Ultimately, stability, prosperity and security are interlinked. Not only between these three objectives of the Union but also across European countries. We have common interests – and also common values –, which means there is no reason we should not see our identity and sovereignty as also European.

Thank you for your attention.

European Central Bank
Directorate General Communications
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany
Tel.: +49 69 1344 7455, E-mail: media@ecb.europa.eu
Website: www.ecb.europa.eu