Building, preserving and developing the euro

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Speeches

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The organisers asked me to talk about “Building and preserving the euro” and I’m happy to talk about historical developments, how monetary integration started in Europe and how we built the euro. I will explain what went wrong during the first decade of EMU (short for: economic and monetary union), how we got into the euro crisis and what we did to get out of it. And I will finish by showing what else Europe should do to make the euro area more resilient, less crisis-prone and how to strengthen the international role of the euro.

1. How it all began

European economic and monetary union (EMU) began on 1 January 1999, more than a quarter of a century ago. But to understand how EMU became possible, how it was built, one has to go back half a century, to 1971, when the initial Bretton-Woods-System ended. After the US de-linked the USD from gold, a global system of floating exchange rates emerged.

Europe developed almost immediately ideas to limit the extent of exchange rate fluctuations between European currencies. Excessive exchange rate fluctuations were seen as negative for intra-European trade and, later, the functioning of the single market.

- Already in 1970, the Werner Plan proposed a three-stage process that would have resulted in a single currency. However, the time was not ripe for such a fundamental shift; the oil crisis in the early 70s, the subsequent high inflation rates and the lack of convergence of European economies made it impossible to fix exchange rates in that decade.

- A less ambitious approach was the so-called “Snake-in the Tunnel” which created a single currency band for the member states of the European Economic Community (EEC). But countries left and re-entered the system frequently and by 1977 only 5 countries still participated.
- The more ambitious European Monetary System (EMS) began in 1979, with an Exchange Rate Mechanism (ERM) which allowed limited fluctuations between participating currencies. The system lasted 20 years, till 1999. Although it had quite a number of crises - several realignments, the permanent departure of the pound Sterling and the temporary departure of the Italian lira in 1992, a widening of the fluctuation margin in 1993 - the system ultimately led to more convergence of economic policies and more convergence of economic developments among participating countries. Without that convergence, enforced by the European Monetary System, the begin of EMU would not have been possible in 1999.

- A European Summit in June 1988 gave the mandate to develop a timetable for creating a monetary union. The Maastricht Treaty was signed 1992. As a result, remaining exchange controls in Europe were already abolished in 1990 and national central banks that had not been independent became independent by 1993.

All these were essential steps to make EMU possible.

However, creating a monetary union with one centralised monetary policy and one exchange rate, but with fiscal and other economic policies decided at the national level, was a huge experiment under all circumstances.

Many academics, particularly in the Anglo-Saxon world, argued that EMU could not work without creating some sort of political union and fiscal union. But if the member states of EMU had created all that – a full political union and fiscal union together with the monetary union – we would have had the United States of Europe which is, perhaps, a long-term goal but not doable in the short run. Academic criticism, particularly from outside Europe, often overlooked the convergence process of the previous quarter of a century. Although far from being perfect, that convergence had created the basis for the start of EMU.

Of course, successfully operating a monetary union with centralised monetary policy and de-centralised fiscal and structural policies requires that economic policies in all member states are well coordinated and are permanently consistent with being a member of a monetary union. Otherwise, convergence will be reversed and competitiveness problems will appear. That’s what happened in a number of member states during the first decade of EMU; I will talk about that in a moment.

In addition, when EMU began in 1999, its architecture was incomplete and weak. There were four institutional gaps:

First, the coordination of macro-economic policies was too narrow and could not be enforced strictly. The Stability and Growth Pact covered only public deficits and debt. And Eurostat did not even have the authority to verify the fiscal data provided by member states.

Second, banking union did not exist. The term banking union had not even been invented. There were long discussions in the 90s about creating a European supervisor, but no consensus was possible at the time. Banking supervision and resolution remained purely national, there was no macroprudential supervision at the European level, no common resolution framework and no common deposit insurance.

Third, EMU had no lender of last resort for sovereigns. Although all important central banks around the world had moved away from financing fiscal deficits of their governments, in a crisis they do just that. In EMU, “monetary financing” of the public sector by the ECB is not allowed. And as it was not anticipated that a country, after joining the monetary union after a long convergence process, could lose market access, there were no procedures in place to help a member state in such a situation.

Fourth, there was no agreed procedure for PSI, private sector involvement, in case a restructuring of public sector debt became unavoidable, like in Greece in 2012. Such a situation was – again - not anticipated. Therefore, the public budgets had to accept a huge burden when the real estate bubble burst in Ireland and Spain. And the debt restructuring in Greece happened rather late after a lot of private capital had left the country.

2. What went wrong during the first decade of EMU?

Looking back in more detail, what went wrong during the first decade of EMU?

To put it simply: Not all members of EMU conducted their economic policies in a way that was consistent with being a member of a monetary union. Consequently, convergence, which had happened before joining EMU, was reversed in several member states. And the four institutional gaps, which I just mentioned, made it more difficult than necessary to discover problems early and to help countries after they got into a crisis.

Of course, what happened during the first decade of EMU must also be seen against the background of what happened at the same time in the world economy, outside Europe.

The first decade of this century, until 2008, was called “the great moderation”. With hindsight, this sounds like a bad joke because the Global Financial Crisis (GFC) followed immediately – partly because of wrong policies during the “great moderation”. The GFC was triggered in the US but strongly affected the financial sector and all economies in Europe.

One reason for the seriousness of the euro crisis from 2010 was that it followed immediately the GFC, which had weakened banks and financial markets in general. But the main underlying reason for the euro crisis was home-made: cost and price developments, fiscal policies and current account deficits in several euro area member states were incompatible with macro-economic developments in the other parts of EMU.

Each of the five countries that needed emergency financing from their European partners and the IMF had different problems. But they all had lost competitiveness and therefore ran huge current account deficits. In Greece, for example, unit labour costs had increased 40% faster during the first decade of EMU than in Northern Europe, as public sector pay almost doubled within a decade. Ireland, Portugal, Spain and Cyprus all experienced unit labour costs 20-30% higher than in the North. Not surprisingly, the current account deficits of these countries amounted to 5-15% of GDP in 2009. That implied, of course, that these countries needed net capital imports from the rest of the world equivalent to 5-15% of their respective GDP. Every year.

Greece, Portugal and Cyprus also had significant fiscal deficits, up to 15% in Greece in 2009, and therefore rapidly rising public debt. Ireland and Spain, on the other hand, had several years with fiscal surpluses, as a result of strong revenue growth related to the real estate bubble. Ireland and Spain therefore had relatively low debt levels when the euro crisis hit. For these countries, the frequently used term, “sovereign debt crisis” is not right. That’s why I use the term “euro crisis”.

3. The response to the crisis

Given these major macro-economic imbalances within EMU, countries that lost market access had to adjust. They all needed to improve their competitiveness, not easy inside a monetary union where nominal exchange rate depreciations are not possible. Only a cut in nominal incomes - wages, salaries and pensions – can improve competitiveness quickly, like a nominal devaluation in a country with its own currency. Cuts in nominal income were unprecedented – they happened in Latvia in 2008 for the first time – and according to standard economic textbooks they are not supposed to happen at all. They are painful, of course, and therefore difficult to do politically. But nominal income reductions of 10-30% happened in Greece, Portugal and Ireland. We call this now “internal devaluation”.

At the same time, the five countries implemented significant structural reforms as part of their adjustment programs and that also improved competitiveness. According to OECD and World Bank studies, these five countries were for several years among the top reformers in the world.

Fiscal consolidation was the other key component of the adjustment programs. Fiscal deficits in these countries fell by 5-10% of GDP during the first few years early last decade. Subsequently, with less domestic absorption and improved competitiveness, current account deficits of the five countries almost disappeared.

These difficult, painful adjustments were facilitated by very large financial support packages. The European Financial Stability Facility (EFSF) was created for that purpose in 2010 and the European Stability Mechanism (ESM) in 2012. EFSF and ESM lending copied IMF lending: Financing was provided against conditionality. However, the refinancing of these new institutions is completely different from the IMF, which uses central bank reserves. The EFSF and ESM have to issue bonds in financial markets before lending to a member state. Given the substantial amount of capital that euro area countries have given to the ESM – €700 bn, of which €80 bn is paid-in – the ESM has a AAA-rating from all major rating agencies. The relatively low interest rates at which bonds are issued are passed on to the borrowing countries.

The IMF supported the different adjustment programmes but alone would not have been able to provide the required financing. IMF programs typically do not exceed 10% of a country's GDP. But Greece needed more than 100% of its GDP in official lending. Lending from the European partners came mainly from the EFSF and ESM but also from a smaller EU facility and on a bilateral basis. Importantly, EFSF/ESM lending carries much better conditions than IMF lending, with lower interest rates and longer maturities. Greece saved €80 bn in interest payments last decade because of the AAA-interest cost of EFSF and ESM; that's 40% of Greek GDP. And the EFSF/ESM loans to Greece have average maturities of 40 years. Low interest rates and long maturities on more than half its public debt are the main reasons why Greece can reach debt sustainability over time (with the appropriate policies, of course).

Overall, the EFSF disbursed €186 bn to Ireland, Portugal and Greece. The ESM disbursed almost €110 bn to Spain, Cyprus and Greece. The EFSF will be closed when the last repayment is made by Greece, while the ESM was created as a permanent institution; it has currently an unused lending capacity of around €430 bn.

Greece needed three adjustment programmes between 2010 and 2015. The third programme ended in 2018. Greece was the most difficult case because its macroeconomic imbalances were the biggest and its implementation capacity the weakest among the five countries. In addition, the process was interrupted by a change in government in early 2015, when policies were reversed for half a year.

In contrast, Ireland and Portugal were able to end their 3-year programmes early. Spain implemented a successful reform programme centred on the reform of its banking system. And Cyprus undertook a massive restructuring of its excessively large financial sector.

All these five countries became success cases after the end of their reform programmes. Their economic performance has been better than the average of the euro area, with higher growth and strong labour markets. This is not surprising because this is exactly what we know from most IMF adjustment programmes: After a period of painful adjustment and reforms, countries normally have a decade where economic performance is particularly strong.

Looking back, three elements came together to end the euro crisis:

First, the efforts of the countries that had lost market access. Their reforms and adjustments were initially painful but ultimately successful in tackling the underlying problems that had led to the loss in market access. If the countries had not done this, the euro crisis would still be with us and some of the countries would probably have left EMU.

Second, European partners were willing to provide substantial amounts of emergency financing to five countries, mainly through the EFSF and ESM. The IMF added relatively small amounts but its expertise in designing adjustment programmes was very welcome, particularly at the outset of the crisis. Without this emergency financing, the immediate adjustment needs in some of the countries would have overburdened the population and very likely led to an exit from EMU.Third, unconventional monetary policy of the ECB. You all remember Mario Draghi’s statement in the summer of 2012: “Whatever it takes…”. The subsequent creation of OMT (outright monetary transactions) linked potentially unlimited ECB interventions to ESM programmes.

All this was essential to calm financial markets at the time. However, looking at the data, it is clear that the adjustment in the five countries had started in 2011 already. Fiscal and current account deficits were falling as competitiveness was gradually restored. This was visible in available quarterly data since late 2011 and sophisticated investors around the world followed those developments closely as I know from my roadshows at the time.

Therefore, reforms and adjustments in the countries concerned, emergency financing and unconventional monetary policy all had to happen more or less simultaneously to end the crisis; they reinforced each other. If we had seen only one or two of these elements, it would not have worked.

The euro crisis also triggered the creation of new processes and a number of new institutions – apart from the already mentioned EFSF/ESM - to strengthen crisis prevention.

Macroeconomic surveillance was broadened and deepened through

- the new “Macroeconomic Imbalance Procedure”
- the “European Semester” which created a yearly cycle of economic policy coordination
- the Fiscal Compact
- a strengthened Stability and Growth Pact (SGP)

One can argue that all these processes and procedures are far from perfect. To some extent it is a “learning by doing” process. But looking at all these efforts together, surveillance in EMU today definitely is stronger than it was before the euro crisis.

In addition, several new institutions were created during the last decade, the second decade of EMU, particularly in the context of banking union. And these new institutions will also help to deal with any new crisis:

- The Single Supervisory Mechanism (SSM) became operational in October 2014 and was a real breakthrough for the European banking sector.
- The Single Resolution Board (SRB) and the Single Resolution Fund (SRF) are important parts of banking union together with the BRRD (Bank Recovery and Resolution Directive).
- Hopefully, the ESM Treaty revision will be ratified by Italy one day so that the

ESM can become the backstop for the SRF.

- Other new supervisory authorities are EBA (European Banking Authority), EIOPA (European Insurance and Occupational Pensions Authority) and ESMA (European Securities and Markets Authority).
- And the ESRB (European Systemic Risk Board) was created to monitor macro-prudential risks.

Finally, an important institutional improvement outside banking union was the decision to grant Eurostat the right to verify fiscal data.

So, a lot happened during the last decade to strengthen the architecture of EMU, to improve surveillance and crisis prevention. Although nothing is perfect, we could see early last year that the European financial sector has indeed become much stronger, compared to mid-sized US banks and one big Swiss bank.

4. Unfinished business

Nevertheless, there are several measures that should be taken to make EMU work better, to enhance its resilience and to strengthen the international role of the euro.

“Risk sharing” is the key concept in this context. We need measures to strengthen “risk sharing” within EMU. Risk sharing is often misunderstood as additional transfers. Instead, risk sharing describes adjustment mechanisms that kick in automatically when certain regions of a country or a particular country in EMU are hit by an asymmetric shock.

Risk sharing is underdeveloped in EMU - compared to the US – because we do not have a common tax and social security system that automatically provides risk sharing within the US when certain regions or states develop differently. In Europe, we may never have such a common tax and social security system.

The other important risk sharing mechanism in the US is the integrated bank and capital market. Unfortunately, we don’t have that risk sharing mechanism either although that should be possible if EU member states were willing to adjust national interests in favour of European solutions.

Banking union, capital market union (CMU) – or Savings and Investments Union - and a single market for financial services would be a big step towards more risk sharing. And it would have many advantages:

- A more efficient use of capital would raise Europe’s growth potential.
- Fragmentation within EMU and the single market would be avoided or reduced.
- Cyclical differences between member states would be dampened automatically through more risk sharing.
- And the international role of the euro would be strengthened.

Finally, risk sharing can take place via fiscal channels, even if we don’t have a common tax and social security system. Limited fiscal risk sharing has been happening for a long time through the EU budget and EIB loans, since 2011 through EFSF and ESM loans, and since Covid through the Commission’s Next Generation EU Programme (NGEU).

Academics and all international and European institutions have suggested the creation of an additional central fiscal capacity in EMU which would provide financing in case of asymmetric shocks. Several proposals exist but the topic remains highly controversial among governments. One technically simple solution would be to use the ESM not only in a big crisis (like during 2011-15) but also to help member states to respond to smaller cyclical divergences.

I see also a trade-off between risk haring via market mechanisms and risk sharing via fiscal mechanisms. The more we have of one, the less we need the other.

In any case, if risk sharing inside EMU is not developed further and strengthened over time, then we will likely experience more crises in the future than necessary.

5. Concluding remarks: Europe and the euro in a new world order

Let me end by saying a few words about the international role of the Euro.

I have argued for a long time that the role of the euro in the international monetary and financial system could and should be strengthened. To be clear, strengthening the international role of the euro does not mean replacing the US dollar. But the international monetary system could move from a situation dominated by one currency to a multipolar system with three or four important currencies. That would support European sovereignty but also be advantageous for the world economy.

The weight of a currency in the international monetary system is a relative concept, of course. And I see big shifts in the relative importance of the dollar and the renminbi.

In the US, President Trump seems to be very successful in reducing the prominence of the dollar in the international monetary system as confidence in US policy making and the credibility of the US legal system suffers. But, to be fair, it’s not only Trump. As Asia is so successful economically, the share of the US in the global economy necessarily shrinks.

China has been pursuing an explicit and aggressive policy for some years to strengthen the role of the renminbi. China’s trade with Asian and Arab countries and with other BRICs is increasingly done in renminbi. China is developing its own international payments system, CIPS (Cross-Border Interbank Payment System), competing with SWIFT. The Chinese central bank has established swap lines with many Asian countries and started working on a digital renminbi long before other central banks. The share of the renminbi in the international financial system is still fairly small but has increased dramatically the last few years.

What should Europe do to position itself in this emerging new world order with two superpowers?

I see 8 points:

i) improve Europe’s potential growth and competitiveness by implementing many of the proposals in the Letta and Draghi reports.

ii) strengthen the euro area’s internal risk sharing, which I talked about. This would make the euro area more resilient.

iii) create an integrated financial market so that international investors do not need 20 legal experts, 20 tax experts and 20 supervisory experts if they want to invest in all 20 euro area countries.

iv) create more safe assets. European public goods should be financed jointly. I know how controversial that is among member states. But international financial markets are screaming for more safe assets denominated in euro.

v) develop the financial plumbing which underpins the functioning of the euro payments systems; this would include a digital euro but also more ECB swap and repo lines with major central banks around the world.

vi) promote the use of the euro in international trade, e.g. in trade agreements, and as invoicing currency.

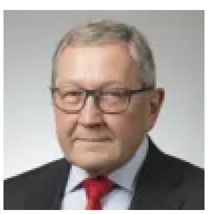
vii) strengthen the euro area’s international monetary cooperation. That could be done fairly simply by creating one single chair for euro area countries at the IMF. The euro area could become the most important member of the IMF and at the same time, release voting shares for the Global South. In addition, Europe should give up its traditional right to name the head of the IMF. If the US leaves the Bretton Woods institutions, all this would become even more important.

viii) create a European Defence Union. When some American friends told me 20 years ago that a truly international currency needs an army, I thought this was nonsense. But in today’s world it becomes clearer that there is some truth in this. Christine Lagarde, in a speech on the history of international currencies a week ago in Berlin, emphasised that “Trade and military power are important for establishing demand for an international currency.”

It's a long list. But most of the items on the list are not new. Work is ongoing in the European Commission, the Eurogroup, the Council and member states.

After building and preserving the euro, now is the moment to develop it into a truly global currency!

Author



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Laudatio for Klaus Regling

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