Completing the Odyssean journey of the European monetary union

Remarks by Vítor Constâncio, Vice-President of the ECB,
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Ladies and Gentlemen,

I would like to begin by thanking my Executive Board colleagues for organising once more a farewell conference for the departing ECB Vice-President. All great institutions maintain rituals of recognition that are predominantly directed to preserve a sense of community and collective work, as well as being opportunities to reflect on future endeavours. In this context, I am particularly grateful to all speakers in this colloquium: academics and economists that I respect and admire and with whom I have interacted on several occasions over my years as Vice-President of the ECB.

Having spent almost 34 years working in central banks and 18 years as a member of the ECB Governing Council, the imminent departure is a challenging milestone to master. Milan Kundera, the great French-Czech writer, has accurately described the only silver lining of ageing and ending a career, seeing it as an enhancement of personal freedom resulting from having, as he put it: "No more applauses to conquer, audiences to seduce, ambitions to fulfil."[1] While an insider in a deontological demanding institution, one can exert some influence and generate slight nudges of opinion which may have some impact on events. I have my own private list of such little nudges, but I am very much aware of the limited influence of a sole individual on the major forces that shape reality.

However, before the exit from his position, the insider pays a price for this role, in terms of having to restrain his voice and respect his loyalty towards the institution, to use the well-known Hirschman's tropes.[2] No one has expressed better than Galbraith the risks of such a situation: "The curse of the public man is that he first accommodates his tongue and eventually his thoughts to his public position. Presently saying nothing but saying it nicely becomes a habit. On the outside one can at least have the pleasure of inflicting the truth."[3]

I have refrained until today to express my personal views on the reforms needed to deepen and strengthen the EMU. Close to departure I feel that, following other colleagues, the time has come for me to talk about what is missing to complete the Odyssean journey of the European monetary union. In the ancient Greek epic, Odysseus faces a long and arduous journey home, endured storms and mythical monsters along the way. We are not home yet, and just as Odysseus was not satisfied during his seven years spent on Calypso's island, we should not be lulled into a false sense of security by the current economic upswing.

It is true that with all member countries growing and after the great adjustment in the periphery to correct its imbalances, the euro area is much better prepared to resist external shocks in the immediate future. Thinking, however, farther ahead, it is common knowledge that Europe, and particularly the euro area, remains at a cross-roads today. EU Commission Vice-President Frans Timmermans wrote amid the refugee and migration pressures and the euro crisis of 2015: "It is the first time, in my conscious experience of European co-operation that I think the project could really fail".[4] Since then, the winds of populist nationalism have continued to advance. In the narrower perspective of monetary union, a recent IMF discussion paper by Obstfeld et al. states that:

"…without decisive progress to foster fiscal risk sharing, EMU will continue to face existential risks".[5]

Monetary union design

Aside from a single currency and a fiscal brake, the initial EMU's architecture was minimalist: the governance of economic and financial policies firmly remained a national competence and there was no fiscal policy at the European level, no crisis management mechanisms of financial assistance to States and no European financial supervision.[6] This narrow concept was the result of the web of national interests, opposing any centralisation of complementary policies plus the dominant economic thinking of the time. This reflected a practical convergence of traditional central European ordo-liberalism with the anti-Keynesian views of new-classical economics. In spite of the efforts of many economists, the design did not even reflect the theory of optimal currency areas. Rather, it promoted the view of a monetary union as a viable device of "hard money" to create price stability, from which an efficient and smooth functioning of the economy would result.

The dominant economic thinking at the time of its inception, beyond promoting a minimalist design, favoured an optimistic view of how smooth and successful it could function. With fiscal control and price stability assured, potential imbalances stemming from the real interest shock suffered by countries coming from higher inflation regimes would be countered by counter-cyclical fiscal policy, by financial markets' disciplining effect of good credit risk management and by the gradual restrictive impact of real exchange rate appreciation. On the other hand, increased growth and real convergence would result from the so-called "Rose effect"[7] of trade explosion and from the neo-classical mechanism of real capital migration to less developed areas where, without currency risk, returns would be higher. Sufficiently disciplined fiscal policy would permit its "shock-absorption" role by allowing the automatic stabilisers to play out in full, during downturns.

Monetary union was indeed conceived under the aegis of noble goals and some naïve illusions. In core countries, the dominant thinking was that after providing a single currency and a fiscal brake, it would be up to individual member countries to adjust their behaviour without the need for any additional collective concern or burden, something assured by the no-bailout clause and the prohibition of monetary financing. Monetary union could almost be seen as a vast currency board devised to extend the benefit of price stability to the whole euro area. The only necessary thing would be for member countries to adopt well-behaved fiscal policies and to carry out structural reforms in order to foster growth. Financial imbalances, originating from private sector misbehaviour and excessive indebtedness were totally ignored. In turn, in weaker countries the dominant view was that the drop of interest rates and the disappearance of difficulties of finding foreign currency to pay for external deficits as an easy way to ensure growth and convergence without the need for fiscal prudence, responsible wage behaviour, structural reforms and real economy adjustment.

In 2000, in my role as central bank Governor, I alerted that a successful participation in the monetary union implied adjusting behaviours to new rules to permanently maintain a counter-cyclical fiscal policy and sensible wage development. I wrote then: "In the past five years, unit labour costs (ULC) in Portugal have always grown above rates in the remaining euro area countries. This trend cannot continue indefinitely. […] Thus, the 3.71% increases in the wage settlements of government employees, which may turn out to be effective increases of 6%[8] as in recent years, are a bad example, hardly reconcilable with the situation of public finances, and should not be followed by the remaining sectors of the economy."

All the illusions nurtured by governments were shattered by the crisis. Imbalances accumulated in the run-up to the crisis, with the assumed protective mechanisms failing. The Stability Pact was breached by France and Germany in 2003-2004 and the restrictive role of real exchange rates appreciation was far too slow to operate. Financial markets showed yet again how badly they dealt with sovereign debt, almost equalising the yield of all member states bonds. At the same time, huge capital inflows inundated the weaker countries and the exposure of banks of core countries quintupled between 1999 and 2007.[9]

As Governor of a central bank with banking supervision, in the context of free capital movements, I had no instruments to contain these inflows since the banks complied with their prudential ratios. The only change I could introduce was related to liquidity management rules, raising the coverage ratio of interbank foreign funding by highly liquid assets from 86% in 2000 to 132% four years later. Portugal avoided a housing price bubble, but not the incipient overheating expressed by a real exchange rate appreciation and a growing external deficit.

Contrary to the main narrative, popular in core European countries, the driver of these imbalances was not fiscal, with the exception of Greece. In 2007, the public debt to GDP ratios of Portugal, Spain and Ireland were respectively 65%, 36% and 25%, well below the euro area average. In Italy, although still at 103%, public debt had fallen 10 percentage points since 1999. What had exploded since 1999 was the private debt in all these countries, confirming the general finding of Jordá, Schularick and Taylor (2016) on the analysis of financial crises in advanced economies from 1870 to 2008. The authors conclude that "private credit booms, not public borrowing or the level of public debt, tend to be the main precursors of financial instability in industrial countries".[10] To offset or significantly mitigate the effects of the private debt expansion, budget surplus would have to have been unfeasibly high, as I showed in 2004.[11]

The bitter discussion about how to interpret the crisis still lingers among member states and contributes to mistrust. For some, the design of monetary union was perfect and the blame for the crisis lies with peripheral countries and their unsound fiscal policies and excessive sovereign debt. For others, it is mainly a story of insufficient stabilisation mechanisms and a traditional balance of payments crisis in a "fully fixed" exchange rate regime, with uncontrollable external capital inflows and a banking crisis.[12]

The crisis confirmed that the control of money and inflation is not enough to regulate the macroeconomy, and that finance and debt are at the centre of our economies; private sector defaults and debt do not cancel each other out as in pure 'Arrow-Debreu' contracts. In a monetary union with the consequent financial integration, there are features like centralised supervision, deposit insurance and resolution of banks, with a fiscal backstop that are necessary for the whole framework to effectively function.[13]

Additionally, the crisis also identified three crucial shortcomings in the design of monetary union.

First, the absence of any mechanism to respond to acute liquidity squeezes and "sudden stops" in the sovereign bond market, linked with the demotion of national public debts to debt with default risk. Panicking in markets, fragmentation and contagion without change in fundamentals, threatened the collapse of the whole project. No one had thought about the possibility of capital flows "sudden stops" within the European monetary union.

Second, the framework did not include a macro stabilisation function to deal with asymmetric and symmetric significant recessionary shocks that may exacerbate fragmentation and create redenomination risk, as it happened in the double dip of 2012-2013. It is well documented that the second recession of 2012-13 in the euro area was the result of the simultaneous fiscal consolidation by member states. A working paper published by the Commission has shown that fiscal consolidation led to cumulative deviations from the baseline evolution in 2011-2013 between 8% in Germany to 18% in Greece.[14] Another academic paper using different models finds a loss deviation from baseline between 14% to 20% for the euro area GDP during the same period.[15] The absence of a co-ordinated fiscal policy from a euro area wide perspective has been a core problem of monetary union.

Third, economic and financial integration was not accompanied by any sort of European level supervision of the financial system, particularly of banks. The huge capital inflows into the European periphery, without due consideration to concentration and proper credit risk management, were not countered by prudential supervision that was fragmented across countries.

Under pressure of events, some answers to these three types of problems were found with the creation of the European Stability Mechanism (ESM) and the Banking Union, a project still incomplete. These responses illustrate that a monetary union can never be just a matter of demanding and assuming that individual member countries behave appropriately. The diversity of shocks, the level of financial integration and interdependence requires collective mechanisms for discipline and risk sharing. The unavoidable, political economy debate stems from this. Stronger countries are tempted to deny that overall stability demands some risk sharing and instead, underline mechanisms of risk reduction. Vulnerable countries tend to resist acceptance of severe risk reduction measures if risk sharing is not sufficiently present.

No surprise then that the discussion on continuing the repair of monetary union shortcomings has clustered around two approaches: one more minimalist and concentrated on risk reduction in weaker countries and the other more comprehensive, aimed at including also elements of risk sharing with a certain dose of fiscal union. In this last category, one could include the Five Presidents' Report, several documents by the European Commission and the IMF.[16] The attempt by 14 French and German economists[17] to put forward a well-intentioned attempt of a compromise between the two views is much too tilted towards risk reduction to be acceptable as a possible solution.

The minimalist approach has several variants but, in general, it denies the need for a macro stabilisation function, discards a reasonable way of dealing with government debt liquidity crisis and rejects an early creation of a European Deposit Insurance Scheme (EDIS), offering instead a long-term promise of a contingent implementation. On the other hand, it insists on strong instruments to force diversification of banks' holdings of domestic sovereign debt and to facilitate a Sovereign Debt Restructuring Mechanism (SDRM). When combined, these elements would create immediate instability in sovereign bond markets and induce self-fulfilling crisis.

Another specific variant of this approach[18], also including an SDRM, proposes the abolition of the Stability Pact and the renationalisation of fiscal policy. This would be combined with a full implementation of banking union with all its features, from EDIS to a stronger bail-in resolution regime. The underlying idea is that stabilising the banking sector without public support would be enough to create a workable monetary union with a self-equilibrating private sector. It seems unlikely to me that this could constitute a viable solution in view of the inextricable interdependences among sovereigns, the macroeconomy and finance in a monetary union. These would be compounded by the spillovers and contagion stemming from any sovereign debt incident in one member country.

I will address the problems with the minimalist view when describing my own views on what a comprehensive approach to deepening and completing monetary union is. I will not consider questions of political economy feasibility but my remarks reflect my experience of 18 years as member of the ECB's Governing Council.

In unfolding my views, thinking about the three shortcomings I highlighted before, I will focus on the following six points that I consider the more relevant ones to ensure a stable and effective monetary union: the settled solution to liquidity crisis in sovereign bond markets without an SDRM; the completion of the banking union; the creation of a European safe asset; the serious launch of a Capital Markets Union; the creation of a central macro stabilisation function; and finally, the revision of the Stability Pact.

Sovereign debt in a monetary union

In relation to issues with sovereign debt in a monetary union, Charles Goodhart had already warned us back in 1998 in his classic paper on two concepts of money and optimal currency areas[19]: "Whenever states (as in the U.S. or Australia), provinces (as in Canada), cantons, Länder, etc. have joined together in a larger federal unity, both the main political, the main fiscal and the monetary powers and competencies have similarly emigrated to the federal level. The Euro Area will not be like that. In particular, the participating nation states [...]; in the monetary field, their status will have changed to a subsidiary level, in the sense that they can no longer [...] call upon the monetary authority to create money to finance their domestic national debt. There is to be an unprecedented divorce between the main monetary and fiscal authorities".

The far reaching consequences of this were not properly considered at the time. In 2012, talking about the gaps in the European monetary union, Christoffer Sims wrote in the same vein: "The combination of a treasury that issues fiat-currency debt and a central bank that can conduct open market operations provides a uniquely powerful lender of last resort. The euro as originally structured seemed to require the elimination of national-level lender of last resort functions for central banks, without creating as strong a replacement at the European level".[20] He also warned that a narrow interpretation of the framework "would return Europe to something akin to the gold standard, with no lender of last resort, no inflation cushion against extreme shocks, and an implicit euro area bankruptcy court exacting sacrifices from delinquent debtors. It is not clear that the member nations thought this was what they were signing up for".

Already in 2005, the ECB seemed to confirm a strict view on national public debt, when it changed its policy of accepting all such debt as collateral in regular monetary operations, by introducing a minimum rating by rating agencies, below which sovereign bonds would no longer be acceptable. It would have been preferable to exert its own assessment of credit risk and use a system of differentiated haircuts. [21] With the crisis, the threshold had to be lowered and then waived in the case of official adjustment programmes, showing the unavoidable fragility of the initial ruling.

Later, Paul de Grauwe (2011a, 2001b, 2011c) and Willem Buiter (2012)[22] talked about a fragile euro area, also calling for the creation of a lender of last resort that could deal with sudden liquidity crisis in the markets of national sovereign bonds. The issue stems from the fact that the demotion of national public debt to debt with default risk opens the door, as in any other asset market, to episodes of acute liquidity stress with investors panicking or speculating, leading prices and yields to levels not justified by changes in fundamentals. Without a response, such events create contagion in a monetary union and self-fulfilling crisis with redenomination risks that may put into question the whole monetary union. These market reactions emerge also in several models of sovereign debt with default risk[23], in particular those that allow multiple equilibria[24].

In 2011, after the Deauville episode[25] and the early talk about the Greek debt private sector involvement, financial markets attacked Italian and Spanish sovereign bonds without any change in their fundamentals, showing the outcome of a domino effect that threatened to ultimately reach some core countries as a result of widespread contagion. In this perspective, talking about contagion, I highlighted in Constâncio (2011)[26]: "…besides general risk aversion and own credit risk also the Greek credit rating affected other euro area countries' bond spreads in a statistically significant way, in a small magnitude for some countries such as France and in a larger magnitude for other countries such as Ireland, Spain, Italy or Portugal". The European monetary union was clearly facing then an existential crisis.

The ECB is the central bank of all member countries, and used the legal powers foreseen in its Statutes to combat the financial fragmentation that was impairing the transmission of the single monetary policy to all parts of the euro area. This involved conducting open market operations in secondary markets, including of sovereign bonds, to launch the Securities Market Programme (SMP) in 2010 and 2011 as well as announcing the Outright Monetary Transactions (OMT) in 2012. These initiatives put a stop to the sovereign debt liquidity crisis. At the same time, very sizable medium-term liquidity facilities were made available to the banks to stabilise the system.

At the end of 2011 and beginning of 2012, we were lending to the Irish and Greek banking sectors more than 100% of GDP in the former and about 90% in the latter. A significant part of that lending was under the form of Emergency Liquidity Assistance (ELA), which is implemented by national central banks that also incur the respective credit risk but require a non-objection from the ECB Governing Council, from the perspective of monetary policy objectives. In this context, the Governing Council approved an ELA framework and established a set of procedures to harmonise several features and detailed reporting to the ECB, that must be respected. ELA, an essential temporary safety valve during the crisis, has a general financial stability role beyond banking, for which national authorities are responsible[27] and, in my view, the present framework does not require further changes.

All the bold decisions taken during the crisis would not have been possible without the courageous leadership of Presidents Jean-Claude Trichet and Mario Draghi and it was my privilege to work as Vice-President with both throughout these eventful years. Those decisions saved the euro area and illustrate the importance of having leaders with their convictions at the helm of the ECB.

We were acting within our Treaty competences[28] and the programmes we conducted, the SMP, the OMT and the Asset Purchase Programme (APP), are now part of the permanent ECB toolkit, to be used if and when the situation so requires. It is important to underline that OMT has attached conditionality and adjustment programmes and is for exceptional circumstances, so that it does not imply fiscal dominance for any misbehaviour of member countries. From now on, the ECB will have no excuse to not fulfil its mandate in addressing the impairment of the single monetary policy transmission by intervening in the sovereign bond market. The only alternative that could ensure equivalent results would be the general use of Eurobonds to substitute national sovereign debts, a solution that would require a Treaty change and a very advanced stage of political union.

The agreed and settled framework of asset purchase programmes stabilised the euro area and that would be disturbed by the introduction of a SDRM, with thresholds and automatism, or by simply strengthening the presumption of a debt restructuring whenever a country has to ask for an ESM programme. Contagion and self-fulfilling crises would return. In my view, the fact that the ESM legislation already foresees that the ESM must ask the Commission for a debt sustainability analysis before starting a country programme and that euro countries sovereign bonds are mandatorily issued with Collective Action Clauses, should be enough to dispel the concerns of the proponents of a SDRM.

Nevertheless, the discussion has continued and recent proposals have multiplied. In the recent German-French CEPR Policy Insight n. 91 already mentioned, a subtle presumption of debt restructuring is also included. The authors recognise the sensitivity of the issue and write: ”When introducing such a policy, it is essential to ensure that it does not give rise to the expectation that some of the present debts of high-debt countries will inevitably be restructured, triggering financial instability in debt markets.” However, they acknowledge there is no simple solution to this transition problem. Some of the same authors, jointly with a few others in two CEPR publications dated from 2015 and 2016[29], had proposed to precede the introduction of the SDRM by an operation of legacy debt reduction. They were also more concerned with the transition and state that introducing immediately the SDRM: “would be dangerous, as the transition path would be highly destabilising. Imagine, for example, announcing the implementation of the debt restructuring mechanism … in an environment where several countries are already highly indebted. The result could be a run on their debt. The way to deal with the transition path problem is a quid pro quo. We propose a coordinated, one-off solution to decrease the legacy debt in exchange for a permanent change in institutions”. The debt reduction would be funded by capitalised revenues from seigniorage or assigned taxes. Alternatively, in 2011, Daniel Gros and Thomas Mayer[30] proposed that the ESFS (future ESM) could buy at market prices the public debt of countries applying for a programme of financial assistance. In 2010, in a Bruegel Policy Brief, Delpa and Weizsacker proposed a partial mutualisation of sovereign debts. All these proposals would help reduce the debt overhang of several countries which would have a stabilising effect for the euro area. They seem nevertheless, to be too far away from the realm of possibilities. It is doubtful that member countries would be willing to try the Faustian trade-off between debt reduction and a SDRM.

The reality is, however, that both types of proposals have disappeared from the more recent suggestions to strengthen debt restructuring schemes. On the whole, some sort of SDRM is an idea that several member countries could hardly subscribe to and that, in general, would be quite destabilising, contributing to aggravate potential redenomination risks that would be detrimental to banking union and capital markets union. As recently stated in Acharya and Steffen (2016 and 2017): “A functioning Capital Markets Union (CMU) ... needs a level-playing field in the holding and transacting of debt and equity securities by market participants in different countries. That is, a CMU with fully integrated capital markets can only work when the status of sovereign bonds as a risk-free asset is restored and the risk-free rate across euro area countries is equalized”.[31]

I do not think that it is necessary or desirable to equalise national sovereign bond rates. The important aspect to stress is that we cannot have a CMU without the existence of a European risk-free rate and the absence of significant financial fragmentation and redenomination risk. In this way, only the idiosyncratic credit risk should matter for asset valuations in any region of the monetary union without having to consider redenomination risk.

Completion of Banking Union

Completing the Banking Union would seem to be an easier goal to achieve. Launching the EDIS with a firm unconditional timetable and deciding on the fiscal backstop both for EDIS and the Single Resolution Fund (SRF), as proposed by the ECB in its Public Opinions, would be the logical steps in a project that all countries claim to support. The need for a backstop, both for EDIS and the SRF would recommend the merger of EDIS with the Single Resolution Mechanism (SRM) to form a sort of European FDIC, which would economise resources and the gathering of information.

A large amount of risk reduction has occurred over the past few years in the more vulnerable countries and their banking sectors. All countries have economic growth; all countries now have positive budget primary balances (the Spanish one is still slightly negative) and all show positive current accounts, and their banks' capital ratios have significantly increased. Risk was also reduced with the Bank Recovery and Resolution Directive (BRRD), the practical disappearance of the ESM bank's recapitalisation programmes that now require the previous application of the BRRD, the creation of the SRM, the implementation beginning of the Minimum Requirements of Eligible Liabilities (MREL) and the visible reduction of non-performing loans under the pressure of the ECB/Bank Supervision.

The truth is that so far the Banking Union project has been exclusively about risk reduction and no specific element of risk sharing has been introduced.

In an exercise of changing the goalposts whenever the defined ones are on the brink of achievement, several stakeholders consider that more risk reduction has to be delivered before decisions about EDIS can be taken. Perhaps there are concerns that EDIS will imply significant transfers across countries in case of a new banking crisis. In the recently published ECB's Occasional Paper[32], by simulating severe banking crises we precisely demonstrated that with proper risk-based banks' contributions a almost negligible cross-border subsidisation occurs.

Another aspect of risk reduction refers to the holdings of domestic sovereign debt by banks. Indisputably, the credit risk situation of sovereigns affects banks via several channels, including the amount of debt they hold. However, the influence of the sovereign on national firms, both banks and non-banks, seems to be similar through the powerful effect that a sovereign in difficulties spreads to the whole economy.[33] Over time, for European countries, CDS premia of non-financial firms and banks are impacted in a similar way when the country the sovereign credit rating severely deteriorates. During the crisis, CDS premia do not even show that banks with higher ratios of domestic public debt did significantly worse than others with lower ratios. It is difficult to presume that, with some degree of diversification, the situation of banks can be significantly disconnected from the sovereign position. This "macro channel" dominates the impact and also plays an important role when Credit Rating Agencies decide on banks' ratings.

On the other hand, the literature points to some good reasons for a certain dose of home-bias, from information advantages to hedging against redenomination risk and the composition of their liabilities, to simple risk/return advantages. Additionally, in an IMF working paper Gennaioli et al. (2014) highlight that banks' holdings could act as a disciplinary device for sovereigns that would be more inclined to take measures to avoid a default in view of its effects on domestic banks.[34]

Another significant aspect relates to the recent empirical findings of Giuzio, Craig and Paterlini (2018)[35] that; "Using a sample of 106 European banks included in the EBA stress testing dataset over the period June 2013 to December 2015 … find that a diversification requirement such as the ones proposed can actually increase the risk of the resultant portfolios, while having little effect on the tail-risk or contagion risk. Given that the reduction of risk is a major reason for a costly diversification requirement, results suggest caution before their adoption." This result is intuitive if one thinks that diversification spreads lower quality securities over all the banks which is compound by adding network effects that the authors duly consider. Analysing the tail risk of portfolios, the authors conclude that: "the rebalanced and current portfolios show similar levels of tail risk, both for single countries and for the EU banking system, which means that rebalancing portfolios to increase diversification may be inefficient, even when correlation between sovereigns defaults is higher, as during a crisis."

A last aspect to underline is that no country can reduce the accumulated stock of debt in a few years and has to ensure its annual rollover needs, naturally having to heavily rely on the holders of the redeemed debt. Some countries have to rollover several hundred billion euros every year. The issue therefore is not just about new debt flows, where things would be easier to change.

Despite all this, I have supported a change to positive risk weights for holdings of domestic debt in different fora. The weights would start at low levels and increase with the degree of concentration (measured by the ratio between holdings of domestic sovereign debt and Tier 1 capital), particularly above a ratio of 150%. The justification for this threshold is twofold: first, the regulatory imposition related to the Liquidity Coverage Ratio (LCR), requires holdings of sovereign debt that represent an average close to 100% of Tier 1 capital; second, the radical reduction of the unsecured interbank market in favour of the use of secured transactions (repos) that mostly use sovereign paper, further increases the need for banks to keep a sizable portfolio of sovereign debt.

The gradualism of this proposal takes heed of these facts and would not upset the market for national sovereign debt too much, especially for countries with high rollover levels each year. Other proposals being floated around, either with quantitative limits or starting high “capital charges”[36] at low concentration levels could disrupt debt markets in the short-term, without much gain in terms of risk control as I underlined before. Even under the pressure of harsh regulation, diversification is not easily achieved on a voluntary basis. Banks in core countries since the crisis started have significantly reduced their exposures to banks in the periphery and will be reluctant to change their policy even as a consequence of higher costs to keep their portfolios of sovereign debt of their own countries. Finally, imposing high costs just for the euro area banks would be contrary to maintaining an international level playing field as other jurisdictions could not agree to any change in the present regulation. These points illustrate well that the proposals to introduce a stringent regulation to impose a quick change in banks’ holdings of domestic public debt, go beyond concerns with credit risk management. It relates instead to the objective of making a SDRM possible, which would be difficult to activate if it entailed large losses by banks with portfolios concentrated on the restructured debt.

Additional reforms to complete banking union must include harmonisation of insolvency laws, direct implementation powers to the SRM and the creation of a scheme of provision of liquidity in resolution that only the ECB can implement, with appropriate government guarantees as is the case in other jurisdictions.

Creating a European safe asset

The only good solution to achieve a degree of diversification in banks’ holdings of sovereign debt is to introduce a new European safe asset, built on the basis of national sovereign bonds. This asset would have other, more important roles to play by creating a benchmark rate, thereby making a Capital Markets Union with a sizable and deep European bond market possible.

I am not referring to the type of Eurobonds that would substitute national sovereign debts as a joint liability of member States, as this would require a deep political union. Among the various proposals put forward, I will concentrate on just two: a variant of the ESBies or SBBS[37] and the e-bonds as proposed in the Monti Report.[38]

The current proposal of the SBBSs refers to a tranched, synthetic bond backed by national sovereign bonds. The proposal tries to demonstrate that the structure would assure a senior tranche with lower risk than German debt as a result of the diversification gains based on historical correlations. Market players and rating agencies have been sceptical of the instrument.

Their main concern is a perceived lack of diversification to ensure that the senior tranche can be indeed as safe as claimed because correlations among several countries' debt could increase in a stressful situation (as occurred during the financial crisis). Also, it may be difficult to sell the junior tranche at coupon levels that do not compromise fatally the overall economics of the synthetic security issuance. Indeed, if the junior tranche had to be placed at a relatively high coupon, then the senior tranche would need to offer a lower coupon than Bunds, a doubtful selling prospect. This would render the economics of the SBBS inviable, which would be very unfortunate.

These obstacles could be overcome if, for instance, a small first loss tranche were to be covered by a public guarantee, jointly provided by member states. Such contingent liability could be limited to a reasonable level. The success of the synthetic European bonds would have significant benefits for financial integration and for the banking and capital markets union. This would be my preferred solution.

The alternative of e-bonds issued by a European entity as a pure securitisation of sizable amounts of national sovereign bonds but with higher privileged credit status over them would be less efficient and could increase the cost of issuing the non-preferential part of pure national debt. This could even act as a disciplining device and would not necessarily imply an increase in the costs of the total debt issuance. For instance, according to a recent working paper of the Peterson Institute, in order to have an expected five-year loss rate of 0.5% or lower, the European entity could securitise 50% of a country's debt or 25% of its GDP.[39] The benefits of having a European safe asset would be enormous to strengthen the overall resilience of the euro area.

Creating a genuine Capital Markets Union

An integrated European bond market as a central piece of a Capital Markets Union (CMU) cannot ultimately exist without a European safe asset. A single-term structure of risk-free interest rates could serve as a euro area pricing benchmark for the valuation of bonds, equities and other assets. The safe asset could also be used as collateral, for example for repo and derivatives transactions across the euro area.

An advantage of a CMU is of course, the promotion of private income and consumption smoothing across the whole area, thus mitigating the effects of localised, recessionary episodes. The evidence shows that in the U.S., the three channels of income smoothing across states (public transfers, capital markets income and credit) are able to smoothen around 60% of economic income shocks, whereas in the euro area that number decreases to 20%.[40] The studies behind these findings normally use historical data that include periods of normality and, as a 2015 IMF working paper[41] highlights, risk sharing is significantly reduced in periods of severe downturns as a result of the quasi disappearance of the credit channel. This provides one rationale for the creation of a European fiscal risk sharing mechanism.

Perhaps even more important, the CMU project is highly relevant for economic growth. A deep and liquid market, both of debt and equity, would spur innovation and enable the development of an efficient venture capital market. This relates to the importance of boosting the euro area's capacity to engage in activities conducive to innovation and productivity growth on the wake of new investment. In the years since the Great Recession, the pace of productivity growth in Europe has been persistently slow. In fact, European productivity growth had already started to stagnate during the mid-1990s.[42] Evidence increasingly suggests that while both banks and markets are important for the financing of economic growth, non-bank financial intermediation provides a relatively more powerful contribution to innovation and productivity-enhancing activities in modern sophisticated economies[43] also in the euro area.[44]

Developing a well-functioning capital market which supports economic growth across Europe requires a comprehensive approach, with a much more ambitious agenda. To that end, Europe needs to boost the supply of equity finance. Policies which stimulate individual ownership of traded shares, such as reducing the tax advantage of debt over equity or enhancing financial literacy, can have a material effect on public equity markets in Europe. At the same time, because stock markets often penalise companies which undertake radical, but uncertain, innovative activities, the contribution of private equity – particularly in the form of early-stage venture capital finance – is indispensable, as a critical mass of angel investors who can provide financing for medium-size projects is also needed. Only with a deep, liquid market is it possible to launch IPOs of successful projects that can offset the losses with projects that fail. I recently underlined[45] the importance of building a genuine CMU by saying: "With CMU, we should aim to reach a situation where both issuers and investors enjoy the same basic legal rights concerning capital markets activity regardless of the EU country where they are located. The CMU project involves all EU member states but it is particularly important for the euro area member countries. It is a big waste to have taken the huge step to adopt a single currency and continue to forgo the benefits that could be reaped by creating a true banking and capital markets union. I believe that euro area countries should forge ahead in enhanced co-operation in order to achieve CMU more rapidly.

We should however, be well aware that CMU requires a European safe asset, the harmonisation of taxes on financial products, a convergence of company law, including on bankruptcy, the creation of a single rule book of regulation for markets activity and ultimately a European Single Securities Market Supervisor. The other big condition is a rock solid monetary union so that assets' risks and returns are not significantly influenced by redenomination risk but exclusively by their idiosyncratic features. A heavy toll, I know, but I will believe that the CMU project is possible when I see authorities start making inroads in some of those difficult issues."

A macro stabilisation function

A central fiscal capacity for the euro area has been identified as a necessary reform to correct a basic deficiency of EMU — the absence of appropriate macroeconomic management beyond monetary policy. The necessary central fiscal capacity has two elements: an effective institutional mechanism to ensure co-ordination of national fiscal policies in order to discuss and decide an adequate euro area fiscal policy stance; second, a complementary central Stabilisation Fund that can take several different forms. I can be very brief in addressing this issue by referring to the recent IMF proposals[46] which I consider quite appropriate. Alternatives, in the form of a common unemployment reinsurance scheme or an investment protection scheme, are not so convincing.

What is necessary is a stabilisation fund in periods of significant shocks, in the form of a "rainy-day" fund that would provide transfers to be used in public spending with high multipliers for maximum effect, like investment or income support to the unemployed. The European Stabilisation Fund (ESF) transfers should not permanently benefit the same countries and, to avoid moral hazard, the use of the ESF should be conditional on past compliance by countries with the existent fiscal rules. The design of the Fund should also include sufficient features to avoid disincentives in the implementation of structural reforms. Triggering the transfers should be automatically dependent on a threshold indicator based on the unemployment rate.

By collecting net contributions from the countries in good times, the scheme would also create incentives for a true counter-cyclical fiscal policy. The mechanism should be used both for asymmetric and symmetric significant shocks. The double dip in growth experienced in 2012-2013 could have been significantly mitigated or avoided if such a European stabilisation function had been available. To be effective in such situations, the ESF should have borrowing capacity to temporarily overcome a potential lack of accumulated revenues.

The creation of this central fiscal capacity would be recognition that the efficient functioning of the monetary union is a common responsibility, while at the same time, smoothing out significant economic downturns that can originate dangerous economic and financial fragmentation among member states.

Stability Pact review

A crucial contribution towards a stable monetary union must come from the proper behaviour of member states in avoiding domestic imbalances and promoting healthy growth. The Stability and Growth Pact (SGP) and the Macroeconomic Imbalances Procedure (MIP) are two important instruments to nudge countries in that direction.

The SGP has been attacked over the years, from different perspectives, as being inefficient, but I concur the judgement of the independent European Fiscal Board (EFB) in its first Report that: “Despite imperfections and scope for improvement, the EU's fiscal framework has helped make the euro area more stable”.[47] As I mentioned already, after years of pressure, practically all countries with higher imbalances during the crisis have now budget deficits below 3% and positive primary surplus. These primary surpluses be kept going forward, in order to reduce the public debt overhang. The past adjustment was, in certain cases, excessively harsh and contributed to the second recession in the euro area. This implies that the balance between the two main goals of the SGP, long-term debt sustainability and macroeconomic stabilisation, was not always well managed, particularly in 2011-2013.

The flexibility criteria introduced by the Commission since 2015 partly addresses that issue. Beyond that, the SGP grew in complexity over the years and would benefit from some simplification. A complete overhaul seems however, difficult to achieve. Nonetheless, the proposals to move for a simpler expenditure rule, combined with a gradualist debt rule deserve discussion as a possible long-term solution. Let me point out that the debt rule would need to consider a quite gradual path of debt reduction as a too demanding path would annul some benefits of the less procyclical expenditure rule. Besides, models of optimal fiscal policy have shown that a slow reduction of public debt is preferable.[48]

Meanwhile, the EFB’s suggestions of strengthening the enforcement by introducing compliance conditionality in relation to the EU budget transfers, and streamlining the present framework are valuable and deserve implementation in order to enhance countries’ fiscal discipline.

Conclusion

Let me conclude.

The European Monetary Union was a hubristic endeavour from the start, full of unprecedented ambition in historical terms. The initial minimalist design did not do justice to the wide-ranging implications of the project. The framework is not yet complete and is still risking existential threats.

A solid, effective monetary union requires national and European institutions that can ensure a cohesive economic and financial performance thus avoiding excessive imbalances, financial fragmentation and significant persistence of redenomination risk for member states. In turn, these features imply my order of priorities for the reforms I consider necessary: acceptance that the ECB has no excuses not to intervene in the sovereign bond market to deal with acute liquidity stress; creation of a central fiscal stabilisation function for macroeconomic management, including a Stabilisation Fund; introduction of a European safe asset; completion of Banking Union; a quantum leap in creating a genuine Capital Markets Union, using an enhanced co-operation to speed up the process; an improved fiscal rule to discipline countries' fiscal policies.

Ensuring the conditions for a successful monetary union is an individual and collective responsibility of all member states. To date, some have benefited more than others from the project but its collapse would indisputably greatly harm all countries. As Barry Eichengreen once wrote, the collapse of the euro would be "the mother of all financial crises". The vested interest of all countries should be to create the institutional conditions that would avoid existential crises like the ones we have been through since 2010. Letting new crises develop and then implementing last-minute interventions under duress will always be more expensive.

Contrary to the views of sceptics, the euro area has undergone a substantial part of this journey since 2010. The remaining efforts are both necessary and technically not difficult to implement. As I said initially in presenting my views, I did not consider issues of political economy feasibility. However, this does not mean that I adopted a maximalist view of desirable reforms. Note, for instance, that I did not mention in my list the necessity of a full-fledged fiscal union with permanent fiscal transfers and other policies to ensure a closer convergence of real incomes across member countries or institutional governance reforms involving the Eurogroup or the European Parliament.

This implies that my proposals are not just the musings of a deluded technocrat aiming for perfection. I take into account the socio-political consequences of the way Europe addressed the crisis as well as the other causes that have resulted in the growing trends towards authoritarian nationalism, illiberal democracies and populist demagoguery that endanger our European values. I also know that responsible politicians are well aware of these dangers and that they cannot be defeated by adopting pure national interest strategies.

I also understand how difficult it is and why President Macron refers to the need for "political heroism"[49] in calling for "… a re-creation of a sovereign, united and democratic Europe…. Only Europe can, in a word, guarantee genuine sovereignty or our ability to exist in today's world to defend our values and interests."[50]

Indeed, these are not technocratic goals but vital political necessities for a European Union that should protect our citizens in terms of safety and prosperity. Our nations tied themselves to the Odyssean mast of monetary union and endured mighty storms to survive and pursue the journey towards a peaceful and prosperous destination. We must persevere in our aims. We must complete what is missing. We must achieve what is essential. Our Penelope is still waiting.

Thank you for your attention.

[Update:] A preliminary version of the speech was published and replaced with the correct version on 20 May 2018.

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https://www.ecb.europa.eu/pub/pdf/other/ecb.20180409_feedback_on_the_input_provided_by_the_european_parliament.en.pdf?93cc41c170e7ce695812d30e4b0c51ea

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