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The Outlook for the Euro and the Eurozone

Who is right? [SLIDE 2]

In intermediate seasons you see people in the streets very differently dressed: some still with just a T-shirt, some already heavily dressed. The different appreciations of Munchau [click] and Soros [click] somehow follow the same pattern as they see the same situation from very different perspectives. [click] I hope the audience today is not so dominated by € sceptics, which would prejudicially agree with Munchau, and I trust it is not made either only of €-philes, that would side with Soros no matter what. I therefore hope you are willing to listen to a presentation that is less definitive in its conclusions than either Munchau or Soros. But let me tell you something more precise on how I will reach my conclusion.

PLAN OF THE PRESENTATION [SLIDE 3]

I. Monnet and Padoa-Schioppa: on the brink theory.
II. A complex crisis
   a. Economic
   b. Financial/monetary
   c. Institutional, limitations in
      i. banking union,
      ii. fiscal and economic union,
      iii. mutualisation of shocks,
III. The progress so far
   a. In the economic field,
   b. In the financial/monetary field,
   c. In the institutional field as regards
      i. banking union,
      ii. fiscal and economic union,
      iii. mutualisation of shocks,
IV. An overall assessment.
V. The next challenge

I. Progressing through crises [SLIDE 4]

Progressing through crises sounds awkward, yet this is what the European Union has successfully done for over 60 years, as foreseen by two of its fathers.

Jean Monnet famously wrote in his memoirs that «J'ai toujours pensé que l'Europe se ferait dans les crises, et qu'elle serait la somme des solutions qu'on apporterait à ces crises.» [SLIDE 5] I found a similar statement while sifting through the huge archive Tommaso Padoa-Schioppa has left, while collecting material for his biography, about

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a **tightening of contradictions** leading to a positive outcome like the single currency. This in the same vein as the idea of Jean Monnet that crises generate the discontinuities within which progress towards the Union of Europe is achieved.

In a positive, as opposed to normative, approach one may accept that indeed Europe is being built crisis after crisis, but one may still think that this is undesirable: why do we need a crisis to progress towards the union? Could we not take a pro-active instead of a re-active approach?

Without making brinkmanship a virtue, I think there are two reasons why it is difficult to move from a re-active to a pro-active approach: the first is quite general, the second is specific to Europe.

The general reason is well summarised in the dictum: If it is not broken do not fix it. The rationale of the proverb is that we only have an imprecise understanding of what works and what does not work. Empirical tests are needed to reach a precise conclusion. And a crisis is the ultimate test that something does not work.

The specific European reason is that the construction of European Union is an endeavour without precedents, and this constitutes its beauty and its difficulty. In the most perceptive paper I have read on the European crisis, Fred Bergsten and Funk Kirkegaard (does it mean something that neither author is from the €-area?) put forward a *"...theory to describe the current process of European integration: the "only on the brink" theory"*. Of course saying that the *"only on the brink"*, reactive approach is unavoidable does not close but rather opens the really interesting analytical and policy question: is the speed of reaction in Europe sufficient to avoid falling from the brink? Are we wasting or exploiting the crisis to move forward?

Answering this question is indeed the purpose of my presentation. Let me start with a description of the crisis.

II. A multifaceted crisis

While the main dimension of the European crisis, as argued by Bergsten and Kirkegaard, is institutional and requires a cession of national sovereignty to be surpassed, there are also economic and financial/monetary components to it. So let me deal with these first.

a. Economic [SLIDE 6]

The economic vulnerabilities of some of the countries of the euro area developed in three areas: growth, budget, competitiveness and current accounts.

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As regards growth [SLIDE 7] while in some countries (like Spain, Ireland and Greece) the growth rate was pumped up before the crisis by the lowering of nominal interest rates towards the low levels prevailing in Germany and by even lower real rates determined by inflation higher than in the core, in some other countries, like Italy and Portugal, growth was anaemic for a number of years, one would say notwithstanding the very low nominal and real rates. This is a clear sign that the structure of the economy was not performing. [Click] Then came the sharp recession which followed the demise of Lehman Brothers that was only partially surpassed in the following years so much that by 2012 GDP in the euro area was still not back to its pre-crisis level.

As regards the **budgetary vulnerability**, overall some improvements in the deficits and debt had been realized at the beginning of the 2000s in some countries. Ireland and Spain even had a budget surplus [SLIDE 8]**.** But this was not quite enough. In Ireland and Spain the private sector accumulated a huge amount of debt due to excesses in funding of the housing sector. As a consequence, the crisis basically started in the banking sector in these two countries. In Italy and Greece, instead, the modest correction of the fiscal situation was insufficient given the existing heavy debt. Then the effects of the banking and macroeconomic crisis which followed the Lehman default aggravated dramatically the situation and both deficits [SLIDE 8 again] and debts worsened sharply, as both automatic stabilizers and discretionary policies reacted to the fall in demand, raising expenses and lowering revenue, while the cost of bailing out the banking system heavily impacted the public budget. Of course, similar developments, with the much larger inertia that is implicit in stock variables, took place in the debt to GDP ratio.

A regards **competitiveness**, practically all countries in the euro area recorded heavy losses since the introduction of the euro with respect to Germany, but the losses were particularly dramatic in the cases of Ireland, Greece, Portugal, Italy and Spain and this inevitably had a strong effect on their current accounts. [SLIDE 9]. During the crisis both ULC and Current Accounts [SLIDE 9 Click] started to adjust quite sharply.

b. **Financial/monetary** [SLIDE 10]

The lessening of inflation and growth variability in the period between the middle eighties and the beginning of the crisis led to christening that period “The Great Moderation”. The relative macroeconomic stability was one of the reasons to argue that “This time is different” and justify the low levels of risk premia, the stability of financial variables, the increasing leverage of financial firms, both banks and non-banks. Two financial innovations, derivatives and Asset Backed Securities, were identified as additional reasons for a more stable financial system.

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This reassuring picture changed abruptly when the crisis revealed that derivatives and ABS were misused, sometimes to the point of fraud, that integration was shallower than thought and reversible, that financial institutions had taken risks they could not bear, that credit risk and liquidity risks had been artificially compressed and under remunerated. The crisis in the financial sphere was followed by severe damage in the real economy, in terms of a sharp contraction of activity and risk of deflation. Something looking very close to a repeat of the Great Depression started to develop. Overall, the forgotten message of Kindleberger, that crises are an intrinsic characteristic of that wonderfully efficient but vulnerable system which is a market economy, was sort of rediscovered, also thanks to the encyclopaedic work of Reinhart and Rogoff, which measured in all their possible aspects centuries of crisis all over the world.

The crisis affected monetary policy in three different guises:

1. interest rates had to be reduced to react to the risk of deflation and recession;
2. the control of the money market rate, the hinge of the yield curve, became much more difficult;
3. the relationship between the money market rate and the rates more relevant for the real economy, such as those on longer term assets and bank loans, became much noisier.

The reduction of interest rates was (relatively) easy until it bumped into the zero bound, but the other two problems were unprecedented: before the crisis the central bank had a nearly perfect control of money market rates while the spreads, even if too low, followed an understandable logic and were quite stable.

Two charts help make the point. **SLIDE 11** clearly shows that the control of the overnight interest rate was nearly perfect until the beginning of the crisis but has become much more difficult since **[Click]** until the huge amount of excess liquidity since the beginning of 2012 compressed the overnight rate very close to the level of the deposit facility rate). **SLIDE 12** illustrates the dramatic increase in the size and variability of different spreads, taken as example of the generalized loss of order in the relationship between the money market rate and the rates relevant for the real economy.

Thus the comfortable situation of a tight control of money market rates and smoothly adjusting spreads vanished with the crisis.

c. Institutional [SLIDE 13]

One useful way to think about the institutional component of the crisis is to recall the controversy between so called “monetarists” and “economists” that preceded the launch of Monetary Union **[SLIDE 14]**. The so called monetarists (nothing to do with Friedman and his successors) thought that one could come to a single currency

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even if not all the criteria of the so called Optimal Currency Area theory were satisfied, since the very fact of creating a single currency would lead to strong integration. In a way, monetarists anticipated, in the policy area, what would later be known, in the analytical area, as the Endogenous Optimal Currency Area theory. So called economists, instead, to be found in large number at the Bundesbank (where, to confuse matters, many were monetarists in the Friedmanian definition) thought that the economic criteria of the traditional Optimal Currency Area approach had to be satisfied before creating a monetary union.

The choice to proceed with Monetary Union taken with the Maastricht Treaty and implemented in 1998 followed a mild version of the "Monetarist" approach, as there was no pretence to have satisfied all the criteria that qualify an Optimal Currency Area, even if it was thought that some progress had been made in that direction with the Growth and Stability Pact.

Whatever the view on the assessment of the Monetarists and Economists positions, the crisis clearly showed that mainly three components were missing in the institutional design of the €-area:

1. Economic and Fiscal union,
2. Banking union,
3. A tool to mutualize idiosyncratic shocks within the euro area, compensating the disappearance of the exchange rate.

Let me now come to the three issues in turn.

On Economic and Fiscal union, as you very well know, the Maastricht Treaty had written some rules which should have avoided fiscal policy mistakes. These were complemented by the Growth and Stability Pact, which however failed when it should have restrained the fiscal policies of Germany and France. From this to a general discredit of the pact there was a short distance. The Growth and Stability Pact basically failed in its task of constraining fiscal policies into some "reasonable" boundaries, but it also revealed a flaw in its design, as it did not take into account that excessive private debt could all too easily transform itself into public debt and could of course not protect against fraud, like in Greece. Beyond fiscal issues, it also appeared that excessive divergences had cumulated in economic performance because of structural deficiencies in some countries. The lack of growth for well over a decade in Italy and Portugal witnesses to this effect.

Banking union

As I showed above, Spain and Ireland were, before the crisis, fully respectful of the growth and stability pact as their budget was in surplus and the debt to GDP ratio was well below the Maastricht threshold of 60%. Where problems were brewing, however, was in the banking sector. This showed, together with the too narrow scope

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of the Growth and Stability Pact, the other limitation of the Maastricht design: the maintenance of a prevailing national approach to bank supervision. A single currency, a single payment system and a national approach to banking supervision were clearly inconsistent. The maintenance of national supervision also had the, deplorable but inevitable, consequence that national supervisors tended to act as defenders of national champions rather than as genuine supervisors.

Indeed as the crisis developed, the awareness grew that it would not be sufficient to move supervision to a euro-area level, but that one would have to make big strides towards a more encompassing banking union, which comprises a single rule book, a single resolution mechanism and a common deposit guarantee scheme in addition to single supervision.

Mutualisation of shocks

One of the conditions for an optimal currency area that so called "Economists", in the sense I used the term above, argued was missing in Europe was a mechanism to mutualize idiosyncratic shocks that could hit one or another part of the euro area. The reasoning, in many ways correct, is that when a single currency is created and the exchange rate can no longer fulfil its role as shock absorber, another tool must be found to offset shocks not hitting the area as a whole. In the United States this mechanism is identified in financial integration, labour mobility and transfers from the federal budget, which are much weaker mechanisms in the euro area.

III. The progress so far [SLIDE 15]

Checking whether we are wasting the crisis means measuring which progress we have achieved so far in surpassing the different criticalities that appeared during the crisis. This is the purpose of this section.

a. In the economic field

Clear progress has been achieved in correcting flow imbalances: as can be seen in **SLIDE 16**, the current account of all peripheral countries has reached or is forecast to soon reach balance or a surplus. Contributing to this improvement is a substantial progress in competitiveness developments, with unit labour costs of Germany going up and those of other countries (except Italy) going down. What is missing is a more significant correction of the surplus of Germany. The budget deficit in all peripheral countries is moving towards more sustainable levels **[SLIDE 17],** while debt is still not recording an improvement.

What is worrying, however, is the situation and prospects regarding activity developments **[SLIDE 18]**. There are two aspects, both worrying, to be considered in

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this respect: the aggregate growth situation in the euro area and the North-South macro divide. As regards the euro area, growth is anaemic as it is hovering around zero. Also prospectively the situation is not satisfactory: GDP in the euro area is not even supposed to reach by 2017 the level it had before the crisis. The North-South divide is captured, overlooking the more extreme case of Portugal and Greece, by the recession in Italy this year (-1.8 %) and stagnation next year (+0.7%) against a somewhat better performance in Germany (+0.3 and +1.3 %respectively).

b. In the financial/monetary field [SLIDE 19]

In the financial and monetary field two important progresses have been achieved. First, thanks to the action of the ECB, and in particular to the very long term refinancing operations conducted at the end of 2011, the risk that a solvent bank would become insolvent because of illiquidity has been substantially reduced, probably close to normal level and the overnight money market rate has been stabilized **[SLIDE 20]**. Second, the spreads between yields on peripheral government securities and those of Germany have been substantially reduced (by some 200-250 basis points for the most important cases of Italy and Spain, much more for the three other, smaller, peripheral countries) **[SLIDE 21].**

The fact remains, however, that monetary policy still exerts a perverse effect on the different part of the euro area, being more restrictive in the periphery, which is in recession, than in the core, which finds itself in a less precarious situation.

c. In the institutional field [SLIDE 22]

i. Fiscal and Economic [SLIDE 23]

The demonstration of the limitations of the Growth and Stability Pact and the evidence of differentiated growth performance of euro-area economies led to a set of innovations in the Fiscal and Economic domain, which go under a host of nick names: Six pack, Two pack, MIP (Macro Imbalances Procedure), Fiscal Compact, European Semester, Euro Plus Pact. The specific content of these innovations is contained in the following table **[SLIDE 24]**. But the gist of the innovations can be summarized in 5 points:

1. The role of the Commission in assessing budgetary developments is substantially increased,
2. The commitment to fiscal prudence is now enshrined into national legislation, often of constitutional nature,
3. The community procedures kick in before a country fixes its budget plans not only after they have been implemented and the actual developments are recorded by statistical offices,
4. Countries commit to implement structural reforms and the delivery of such reforms is subject to a check by Community instances.

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5. The obligations to correct imbalances are operationalized in much greater detail and regularly checked.

TSCG: Treaty on Stability, Coordination and Governance

ii. Banking union [SLIDE 25]

As mentioned above, banking union comprises four components [SLIDE 26]:

1. A single Rule Book
2. A single supervision
3. A single resolution mechanism
4. A common deposit guarantee scheme.

The progress on the four components decreases as we go down the list.

Relatively little further progress is required to get to **a single Rule Book**: the different interpretations that created a somewhat uneven playing field among different jurisdictions are being gradually eliminated.

The progress towards a **single supervisor** has been extraordinary since the Heads of State and Government decided in 18 October 2012 that this new responsibility should be given to the ECB. Now the legal set-up is clear and the ECB is preparing itself to take this new, difficult task. Two difficulties have to be surpassed here: one is of technical nature, the other more political.

The technical difficulty is to harness the large and specialized resources that the ECB will need to supervise directly some 130 largest banking groups, representing some 85% of the total banking system, and indirectly, through national supervisors, the remaining thousands of smaller banks. This is by no means a trivial task, also considering that the ECB should be ready to take up its new responsibility very quickly, by autumn of next year, after having conducted a thorough so called Comprehensive Balance Sheet Assessment.

The political difficulty is even more challenging. The ECB will have to stand firm against the request, which one can forecast will be strong and possibly aggressive, of national institutions for a forbearing approach toward its banks. The first, and decisive, occasion in this area will be the Asset Quality Review and then the Stress Test that will have to be conducted before the ECB takes up its supervisory responsibility. This will be essential to “clean the slate” before supervision is moved from the national to the European level and to clearly distinguish the responsibilities relating to the past from those relating to the future.

The **single resolution mechanism** is being discussed just currently and the big issue is which institution will have the final say in deciding that a bank is no longer viable and has to be resolved. The difficulty here is that, even if everything will be made to try and avoid financial repercussions on national budgets one cannot exclude these

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repercussions and it is of course awkward to have a Community Institution imposing obligations on a national budget.

The European Commission has proposed a model whereby the last word will be for itself but it would act upon preparatory work done by a Single Resolution Board, composed of national authorities. This model is opposed by some Member States, particularly Germany, that is loath to give the final word to the Commission and would like to keep it closer to national authorities. A compromise will not be easy to achieve, but does not look impossible either.

The **common deposit guarantee scheme** is the area where less progress has been made. And this is not surprising because here, even more than in the case of the single resolution mechanism, there can be here significant repercussions for national budgets, notwithstanding the idea that funds collected from banks should provide the first recourse in case of need.

iii. Mutualisation of shocks [SLIDE 26 again]

The down to earth expression "Mutualisation of shocks" is not part of Community jargon, which prefers the nobler expression of "Solidarity", but it is a much more precise description of what the euro area needs. And, without putting them in a pre-established architecture, devices providing this function have been at work during the crisis. Some, the more explicit ones, have come from governments and go under the name of European Financial Stability Facility (a temporary facility which can no longer engage in new operations as from July of this year) and of European Stability Mechanism, which is a permanent institution that can extend help to member states needing it for up to 500 billion euro and has a total subscribed capital of 700 billion. The ESM has in fact supported Spain and lately Cyprus, while the EFSF has supported Greece, Ireland and Portugal.

A form of mutualisation mechanism has been provided during the crisis also by the Eurosystem. Of course, it is somewhat more difficult to see the provision of liquidity by the ECB to banks as a tool to mutualize shocks, but this is what it also was. Just consider that the banking systems in the peripheral countries found it difficult, admittedly with different intensity, to fund their activities in the market and thus had recourse to the funding provided by the ECB for very large amounts. At the end of 2012, the Target 2 balances, which are a reflection of the liquidity support provided by the ECB, exceeded one trillion euro in value terms and amounted to around -50 per cent of GDP for Ireland and Greece, around -40 per cent of GDP for Portugal and Cyprus and -32 per cent of GDP for Spain. Correspondingly, creditor countries had very large surplus balances.

Both the support provided by the EFSF and the ESM as well as that provided by the ECB are not only very large in amount, they are also very cheap. Just consider that

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the ECB currently lends money to banks in stressed jurisdictions at rates of 50 basis points, which is arguable just a fraction of what these banks would have to pay to get funding in the market, if they could indeed get this funding at any cost.

IV. An overall assessment [SLIDE 27]

An overall assessment of whether Europe is exploiting the crisis to provide the economic, monetary/financial and institutional innovations necessary to surpass it and put the entire construction on a more solid basis is difficult and necessarily relies on a good amount of judgment.

My own sense is that the direction has been right and the speed sufficient. **[SLIDE 28]** The goal is still far and the going tough, but one should not confuse the difficulty of the process with a doubt about the direction. **If** the progress achieved so far will be sustained Monnet´s prediction will turn out to be, once more, right and the "stringersi of contraddizioni" will have worked again.

But **if** is a small word with a big weight. I qualified the speed as sufficient, which is much less than good, we are therefore still in a vulnerable situation. Any stop in the progress in any of the aspects of the crisis (economic, financial/monetary and institutional), let alone a reversal, could prejudge the entire process of surpassing the crisis and completing the union, putting it on a sounder basis.

I see, in particular, three risks:

1. **Adjustment fatigue in peripheral countries** – the political difficulties, particularly in Greece, Portugal and Italy, in continuing with fiscal correction and, even more importantly, with structural reform witness of the dimension of the risk that one or the other country may stop pursuing the necessary policies,
2. **Institutional innovation fatigue** – the difficulties in progressing on banking union are the clearest symptom that there are, inevitably, big hurdles to surpass to achieve the needed institutional innovations. The cautious attitude of Germany in this domain is understandable, but the border between doing things with the necessary care and delaying them to the point of losing effectiveness is a blurred one,
3. The **lack of adequate growth** in Europe and the North-South divide create a strong headwind, making everything more difficult.

At the end, my judgment is that, notwithstanding the risks, the current favourable trends will be sustained and that indeed the crisis will not be wasted. So, in the Munchau-Soros range I am closer to the latter than to the former, but I do not have the guts to say that the crisis is over as yet.

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V. The next Challenge (Slide 29)

As the crisis hopefully ebbs away, a new challenge confronts the €-area. Indeed this is a challenge establishing both a **continuity** and a **break** with the crisis **(slide 30).** Let me start explaining this apparent conundrum by, first, presenting the new challenge and, then, clarifying in which sense this is at the same time a continuation and a break.

The new challenge is to avoid that the crisis is substituted by a chronic stagnation, similar to what Japan had for more than a decade.

This represents **continuity** [click] with the crisis because, as I said, lack of adequate growth is a headwind making everything more difficult. It is also a continuity because the first step to avoid a prolonged period of low growth is to make the European financial system, and in particular its largest component, banking, again capable of financing adequate growth, and here the completion of banking union is crucial. The next steps in this endeavour, the Risk Analysis, the Asset Quality Review and the Stress Test, to be conducted by the ECB in conjunction with the European Banking Authority, are critical in this respect.

This represents a **break** [click] because the experiment of the €, a single currency for 18 countries, is no longer the crux of the matter. In a way, the challenge to revitalise the €-area economy presents itself in no different way than in a national setting. It is not by accident that I referred to the experience of Japan. A second element of discontinuity is that the emphasis of policy must move away from demand to supply management. Since the issue is to achieve higher long term growth, fiscal and monetary policies become less relevant while issues like demographics, participation rates, investment in physical and human capital, productivity become much more important.

The omens here are mixed and the “on the brink” approach does not work for these long term issues. So we may still have interesting developments to discuss in the future.

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