The future of Europe: building on our strengths

Introductory remarks by Benoît Cœuré, Member of the Executive Board of the ECB
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Summary *: The crisis has raised some fundamental questions about Europe and the future of the euro area. We need to go back to first principles and complete our original vision – to fulfil the economic and monetary union based on price stability. We know what has worked in the euro area: an allocation of tasks based on the primacy of price stability. And we know what has not worked: a lack of stability orientation in other policy areas.*

The ability of the central bank to deliver price stability ultimately depends on other policies being oriented towards stability as well. Also, the ECB needs stable banks to be able to implement its monetary policy successfully.

Banking union will not be achieved by mutualising risks. On the contrary, banking union reduces risks for taxpayers.

Our common future cannot be found in the past. The world has changed too much in recent decades to go back. None of our countries are strong enough to survive alone. The euro area needs solidarity mechanisms for extreme events that are out of reach of national policies. But beyond that there is no strong case for further fiscal centralisation.

Fiscal discipline starts at home. Governments have to take responsibility for delivering sound budgetary policies.

Germany also has challenges to confront to maintain its economic performance. One challenge is the effect of an ageing society on the workforce. Another challenge is to raise domestic demand with reforms and investment.

Ladies and gentlemen,

Thank you for inviting me to speak to you today. It is an honour for me to speak in this place that played such an important role in German history. Our intention today, however, is to reflect on the future – and the future of Germany is tied to the future of Europe.

The crisis has raised some fundamental questions about Europe and the future of the euro area. How can we restore stability and sustainable growth? What are the mutual responsibilities between different European countries, especially when they share a common currency? How can we take the people along?

My main message today is that we need to go back to first principles.

We know what has worked in the euro area – namely, an allocation of tasks based on the primacy of price stability. And we know what has not worked – namely, a lack of stability orientation in other policy areas.

Our task today is therefore to build on our strengths, to take what has worked and to reinforce it. This does not require that we map out an entirely new vision for Europe. It requires that we complete our original vision – to fulfil the economic and monetary union (EMU) based on price stability that we set in motion in 1999.

Where Europe works

So what has worked well in Europe?

First and foremost, the single market supported by the single currency.

The benefits of having a single market and a single currency have been proven, especially in this country. Germany's trade with the rest of the euro area increased from around 25% of GDP in 1999 to almost 40% of GDP in 2012. And contrary to a popular perception outside of Germany, its trade with its euro area partners is now broadly balanced. Similarly, almost 65% of foreign direct investment in Germany now comes from the euro area, and half of German foreign direct investment goes to other euro area countries.

Over this period, value chains have also extended across Europe. On average, around 40% of foreign value added in euro area exports comes from other euro area countries. This means that increasingly we can talk about goods being "Made in Europe" – with the German *Mittelstand* standing at the centre of those supply chains.

This economic deepening means that it makes less and less sense to think of competitiveness in terms of countries – or of countries being better off alone. Each EU country, even Germany, is too small to get along in a globalised world. It is connections between firms across Europe that will create our industrial strength and competitiveness in the future. And by the same token, the success of German firms is an asset to the rest of Europe.

Our single currency, the euro, has been vital in reaping the gains of the single market. And it has put an end to competitive devaluations and trade wars between our countries.

A key condition supporting this process of economic integration has been price stability. The ECB has delivered price stability continuously since 1999. And we will do so in the future.

We have been successful in delivering price stability because we have a clear alignment of objectives and instruments – what is called by economists the "Tinbergen principle" after the Dutch economist Jan Tinbergen. We have a primary objective of euro area price stability that is established in the EU Treaty. And we have been given the instruments and independence necessary to fulfil that objective.

This framework is important to understand our recent monetary policy decisions, in two ways.

First, we have lowered interest rates with the sole purpose of ensuring medium-term price stability for the euro area. We understand this decision has implications on different groups. This is however a consequence, not an aim of a monetary policy focused on price stability. And it is not specific to the euro area. If we were now to start basing our decisions on factors that were not related to price stability, we would jeopardise our mandate.

Second, we have a clear and verifiable definition of price stability that we communicated to the public – that is, euro area inflation at below but close to 2% over the medium-term. And average euro area inflation has been almost exactly equal to 2% since 1999.

This has allowed citizens to develop well-anchored expectations of future inflation, and that in turn keeps inflation under control. Indeed, the strong anchoring of inflation expectations has been the needle of the compass for the euro area as it has navigated the storms of the recent crisis.

But for any central bank, the strategy to ensure price stability needs to be symmetric. In other words, inflation should be neither too high nor too low. If we were to react only to high inflation, and ignore low inflation, citizens' expectations would change – and we would risk losing the credibility we have established since 1999.

As a result, doubts would be cast over our commitment to fight upwards risks to price stability – and this could lead to more volatile inflation in the future. This is a risk that we cannot afford to take.

To summarise the current stance of our monetary policy: we are ensuring euro area inflation at below but close to 2% over the medium-term using the instruments conferred on us. This is our responsibility in the Treaty; it is what the people of Europe expect from us; and it is our best contribution to economic policy for the euro area.

Where Europe needs to be reinforced

Yet we know that the central bank does not operate in a vacuum. The ability of the central bank to deliver price stability ultimately depends on other policies being oriented towards stability as well. Without this, the benefits of the single market and the single currency are put at risk – we have seen this clearly demonstrated in last few years.

The task facing Europe today is therefore to secure what we have achieved so far – to ensure that monetary stability is matched by economic and financial stability.

This does not require a quantum leap in integration. Rather, it requires that we finish what we started in 1999 and put the right framework in place to support EMU.

Let me explain what I mean in more detail.

Financial stability

The ECB needs stable banks to be able to implement its monetary policy successfully. European companies are mostly funded by banks, and banks are therefore our main counterparties and the primary channel through which our interest rate decisions are transmitted to firms and households.

However, we saw during the crisis the drawbacks of a system of national banking supervision with integrated financial markets. Our monetary policy had to operate in very difficult conditions – at one point it was even losing effectiveness in some countries. The lesson from this was that a single monetary policy could ultimately not work with multiple approaches to banking supervision.

The ongoing process of building a banking union in the euro area is a response to this. It puts us in a stronger position to defend European financial stability, which in turn will support the proper transmission of our monetary policy and price stability.

And let me be clear: this will not be achieved by mutualising risks. On the contrary, banking union reduces risks for taxpayers.

Having a European supervisor ensures that all banks in the euro area will be kept in check by the same rules and under reciprocal oversight. It therefore limits the likelihood of financial crises and contagion, which is ultimately what leads to countries needing financial assistance.

Moreover, having a European resolution mechanism will ensure that bank shareholders and bondholders will be first in line to absorb losses when a bank fails. The guiding rule should be “bail-in” of creditors, not “bail-out” by European taxpayers.

And both stronger supervision and resolution will reduce potential risks for the ECB by confirming the soundness of our counterparties.

As you know, the European governments and Parliament have decided that the single supervisor should be the ECB. We take this task very seriously, but in line with the Tinbergen principle I mentioned earlier, we are adamant that additional objectives should not be added to monetary policy.

We will therefore ensure strict separation between this new function and our monetary policy. This will help ensure that the European supervisor focuses on its objective to keep our banking system sound and stable, and has the instruments it needs to succeed.

Economic stability

Beyond financial stability, the euro area also needs economic stability. The ECB’s monetary policy is a necessary condition for economic stability, but it is not sufficient. Governments also need to practice the right economic policies.

An ongoing question is how much responsibility for economic policies should be elevated to the European level.

For banking supervision and resolution there is a strong case for centralisation. Clearly, the euro area also needs solidarity mechanisms for extreme events that are out of reach of national policies – that is the role of the European Stability Mechanism. And I see scope for common projects with a common funding if they enhance the resilience of the single currency area and come with appropriate democratic control.

But beyond that, I do not see a strong case today for further fiscal centralisation. There are three reasons for this.

First, fiscal discipline starts at home. Most citizens do not want decisions on taxing and spending to be made at the European level, at least for the time being. This means that governments have to take responsibility for delivering sound budgetary policies.

Europe has a role to play in guiding governments in the right direction. But we know the Stability and Growth Pact was not properly enforced. That is why I am encouraged by the approach taken in the fiscal compact. This enshrines balanced budget rules in national constitutions or equivalent, under the vigilance of independent fiscal councils.

The second reason why I do not see a strong case for fiscal centralisation is that economic adjustment can and should take place via flexible markets.

If countries introduce structural reforms that allow their economies to adjust more quickly to economic downturns, there is less pressure on their national budgets, and hence less need for external budgetary support.

And flexibility does not mean social unfairness. Too often, what delays adjustment is resistance by insiders who have managed to capture an unfair share of national wealth and oppose economic change.

The third reason is that you do not buy an insurance policy when your house is already on fire. Fiscal centralisation can be properly discussed only when euro area countries, large and small, have put their houses in order fiscally, financially and economically.

The good news is that it seems governments have understood the message. Budgets are being consolidated. Structural reforms are being introduced. Competitiveness is being regained.

For example, the countries under full EU-IMF programmes have seen their unit labour costs fall by more than 15 percentage points since 2009 relative to the euro area average. Exports in Portugal and Spain are up by more than 20% since the start of the crisis.

But reform is not a medicine only for countries under strain. Germany also has challenges to confront to maintain its economic performance.

One such challenge is the effect of an ageing society on the workforce. As the labour force shrinks, potential growth will fall and this economy risks losing its leading status. Another challenge is to raise domestic demand with reforms and investment. This would rebalance the economy without hurting the competitiveness and the exports of German companies. As I said, German competitiveness benefits the euro area as a whole and it would be foolish to try to curb it.

To sum up, achieving lasting economic stability must involve finding a new balance of discipline and flexibility in our economies. This would go a long way towards securing a strong EMU based on price stability – and to do so without exceeding the democratic mandate given by the citizens of Europe.

Conclusion

Let me conclude.

Our common future cannot be found in the past. The world has changed too much in recent decades to go back. None of our countries are strong enough to survive alone.

Europe faces considerable challenges, yes, but the answers are not so complicated. The Europe we aspire to is the one that has worked well so far; that is based on economic integration and price stability; and that is embedded in the EU Treaty.

The future of Europe is to continue on the course we set ourselves in 1999 – but follow through with it fully and to complete the original vision where it proves necessary. We at the ECB will continue to deliver price stability. Governments, companies and social partners need to do their part.