# Economic and Monetary Union

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Before starting, I would like to pay a personal tribute to José Luis Malo de Molina. His contribution to the success of the building up of Monetary Union, and to the proper working of the Eurosystem, has been tremendous. More generally, his contribution to economic research is remarkable. On a more personal note, I was particularly impressed by the remarkable way in which he handled the chairmanship of the budget committee of the ECB, finding the proper balance between the proven need to reinforce the work force, and the risk of letting excessive bureaucracy and centralization develop. His key contribution has been widely recognized by the Governing Council.

Now moving to my remarks on Economic and Monetary union, I would like first to make a few comments on the historical developments since the conception of the simple currency, and then add some reflections on the major issues, challenges and solutions.

## 1 A brief history of EMU

4 steps: conception, childhood, youth, transition to adulthood.

### 1.1 A well thought conception

We should never forget the essence of the European construction concept: it is to enshrine reconciliation between the peoples of Europe, and peace, into a "de facto solidarity", via concrete undertakings, step by step. Since 1957 and the treaty of Rome, this logic uses economic achievements for a very political purpose. The Monetary Union is the most advanced step.

But the EMU is also the result of well thought out reasoning that was already present in the Werner report in 1970. In order to ensure a proper functioning of the common market, one needed to eliminate exchange rate fluctuations; several attempts were made to link currencies together after the collapse of the Bretton Woods system (the monetary snake between 1972 and 1978; the European monetary system after 1979 with the introduction of a single unit of account, the ECU). But the system almost collapsed in the early 1990's, showing that the objective would be better attained by a true EMU. At the same time, the fall of the iron curtain triggered a desire for a new step in European integration: thus the treaty of Maastricht in 1992.

The monetary pillar was well designed, thanks to the Delors Committee which brought together all central bank governors to prepare in concrete for the management of the euro by a truly federal system of central banks, the Eurosystem. Despite the strong recommendations of the Delors Committee, the Economic pillar was unfortunately not prepared with the same ambition, and only the stability and growth pact was providing for some concrete rules and shared management.

## 1.2 A happy childhood

The objectives were broadly met: avoid foreign exchange crises, eliminate a source of costs and risks, simplify corporate management, increase competition, favor free circulation and increase economic performance thanks to a convergence of economic policies. After 12 years, the price stability objective was exactly met, the credibility of the euro was well established, the cost of borrowing considerably decreased. The Euro zone created 14 million jobs in 12 years (versus 8 million in the US). Finally the euro was itself a meaningful instrument, with doors and bridges on the banknotes symbolizing openness and exchanges.

## 1.3 An eventful youth

The Euro area resisted relatively well the global crisis of 2008-2009. But it entered shortly after in a difficult period which we call the "sovereign debt crisis" –not to be analyzed as a crisis of the euro which I think would be a wrong interpretation.

It happened because a number of countries entered the global crisis in 2007 with unhealthy public finances; far away from the objective of structural balance that was the basic pillar of our fiscal framework. Then several countries had difficulties handling the fiscal relaxation needed to fight economic contraction. This was then compounded by the general guarantees widely offered to the banking system and the need to recapitalize banks to avoid the collapse of a

number of them. (To be fair, this was also true in other countries, e.g. US, UK, Japan).

We then realized that two major mistakes had been made:

- The countries themselves (France, Germany, Italy) weakened both the preventive arm of the pact (they were never at a structural balance but always close to a 3% deficit) and the corrective arm (they never observed the foreseen sanctions).
- Something key had been forgotten: the need for an instrument to follow relative competitiveness. The idea is the following: when you join a monetary union whose inflation target is slightly below 2%, you must ensure that unit labor costs (corrected by productivity) are in line with that objective. What worked before entry into the euro did not after. Countries believed they were protected, there was no market pressure, and current account imbalances were simply ignored.
  These two mistakes led to the spread of doubts in the market and to the perception of an ultimate risk of re-denomination. (The risk of being thrown out of EMU for some weaker countries).

### 1.4 A difficult transition to adulthood

The solution was basically to develop the economic pillar, so as to force a convergence of fiscal and structural policies.

That was agreed and done –at least on paper. All the member states have engaged credible plans to clean up their fiscal situation. A new framework has been designed, with two pillars: reinforcement of the fiscal pact with better surveillance and more effective sanctions, and a new procedure to monitor competitiveness and reforms. In addition, a powerful instrument for crisis management, the ESM, was established and CACs were generalized in sovereign bonds to provide for orderly debt restructuring if need be. Finally, a banking union was set up.

## 2 Issue, challenges and solutions

2 pillars: Economic and Monetary

### 2.1 Economic pillar

- On the **fiscal side,** I already mentioned the reforms that were made. There remain in my view two challenges. One is that these new rules

must be adhered to, respected in good faith. The European Commission must withstand the inevitable political pressure, and peer pressure in the Eurogroup has to be exerted with fairness and resoluteness. On all those grounds, we cannot be fully reassured at this stage.

Another aspect is the overall fiscal stance. Although I do not believe that we should only look at the fiscal multipliers and the short-term Keynesian impact of a change in the fiscal balance, but also at the confidence building aspect and the Ricardian effect, it remains that the Eurogroup should look not only at the individual situations and the rules but also at the macro-economic impact of the overall stance and the desirability of some compensation between the stance of the various countries. This clearly has yet to happen.

– On the **competitiveness** aspect, it is even more apparent that the key reform I mentioned earlier has not really been taken seriously so far. The European Commission does not seem perturbed by the enormous current account surplus in Germany for instance, which is clearly a breach of the rules. And furthermore the pressure on countries like France and Belgium to reform the labor market has been very small, although we clearly see the mortal danger of a very high level of youth unemployment.
– Finally, I think we should revisit the **Institutional side.** This issue has been largely taken up by the present debate in the UK. But if we look at it from the Euro-area point of view, we should consider that we are desperately lacking proper institutions. There is no European Commission devoted to the euro zone, no Parliament either, and the Eurogroup is not a very clear legal decision-making body. We should consider correcting that: to take one example, when the President of the ECB (or the Eurogroup President) goes to a hearing in the European Parliament, it is odd that this takes place in front of MPs a large part of whom do not represent the citizens of the euro area.

## 2.2 Monetary pillar

– **Many issues** have been highlighted especially in the Anglo-saxon world about either fundamental issues (like the sustainability of a shared currency by several sovereign states) to the policy of the ECB (always viewed by definition as miserable compared with that of the BOE or the FED).

I believe that there is an enormous bias at all levels. I pick up a few examples: the optimal currency zone is never present in a single country (especially a big one like the US, but also in the UK) and automatic

redistribution does not exist so much in countries with a relatively small federal/central budget as a percentage of GDP.

As far as the policy is concerned, we have seen the ECB criticized for lack of transparency (although it was the first central bank to initiate press conferences just after the monetary policy meetings, and was finally imitated by the FED and the BOE); it was often accused of a lack of reactivity, by people ignorant of the difference induced by the huge gap in economic flexibility on the relationships between output and prices and on the transmission of monetary policy. And in August 2007, the ECB reacted weeks before any other central bank (e.g. the BOE refused to react and provoked the collapse of Northern Rock…)

– This being said, there are true challenges. One of them is, in my view, using in a combined fashion asset purchases (the so-called QE) and negative interest rates. Although in theory it could probably work, in practice, I think it cannot, simply because banks cannot impose negative interest rates on a large part of their customers. Therefore, given that QE creates additional liquidity that the banking system has no power to eliminate and that has to come back in excess reserves, only two solutions remain: either an increase in credit spreads, which would run against the objectives of the central bank; or a weakening of the banking system, which would lead it to give less credit and take less risks, which is also at odds with the objectives of the policy. I am waiting with interest the rewriting of economic textbooks that will explain how to make it work properly!

Thank you.