Is eurozone governance fit for purpose?

Keynote speech by Benoît Cœuré, Member of the Executive Board of the ECB, at a dinner organised by the Centre for European Reform, London, 30 January 2014

Ladies and Gentlemen [1],

I would like first to thank the Centre for European Reform for inviting me here to speak today. The Centre is an influential think thank both in the UK and elsewhere in Europe, and its views certainly contribute to shaping the debate on the future of Europe.

Let me start by linking the focus of my speech tonight with a topic which is high on the agenda here in London – as recently underlined by Mr Osborne. It is **the allocation of competences between the national and the European level**. What should Europe be in charge of? In which areas should Member States remain fully competent? Such questions are intensely debated on this side of the Channel.

Tonight I would like to look at this issue from a **euro area perspective, and more precisely, from the perspective of the euro area's central bank, the ECB**. How has the balance of competences between the national and the euro area level evolved during the crisis? Have we now found a more optimal balance which will support the stability of the single currency? I think this will provide a useful lens through which we can examine tonight's question, namely "Is eurozone governance fit for purpose?".

A "fitness test" of the euro area governance

The euro area is a **unique project** – unique because it binds together sovereign and diverse states; unique because it is trying to foster an ambitious process of economic and political convergence; and unique because it is the expression of a wider political project.

These specificities mean that there is **no ready-made governance model** to draw on. Making the governance of the Economic and Monetary Union (EMU) "fit for purpose" is part of an evolving "learning by doing" process.

Clearly, the **Maastricht model – or at least its implementation by Member States – proved inadequate to pass the *economic* "fitness test"** when the crisis erupted. Having monetary policy fully integrated while economic policies, still decentralised, were carried out with an insufficient European perspective, was lopsided. The past years have shown to what extent euro area economies and financial systems are interconnected; how decisions by individual countries can affect the entire currency union; and why national economic policies need to be seen as "a matter of common concern". In other words, the balance of competences between the national and the European level was not commensurate with the requirements of a currency union.

At the same time, I believe that replicating the model of fully-fledged federations in the euro area would not pass the "fitness test" either, mainly for *political* reasons. At this stage, a full integration of economic policies is neither desirable nor feasible. The wide range of preferences among euro area Member States means that progress on economic and fiscal union can only be gradual. There will be no sudden leap towards a fully-fledged political union. And you will never convince the people of Europe that further sovereignty sharing is needed without first showing them in a convincing way that Europe delivers jobs and stability.

How can we steer clear of the minimalist and maximalist scenarios and be pragmatic in making the governance framework "fit for purpose"?

In my view, the European level should be allowed to intervene in national policies – or even be granted new competences – only to the extent that is necessary to account for interdependencies (economists would say: to internalise cross-border spillovers). Equally, national economic policies should take into account the existence of potential spillovers to other members of the currency union.

The approach followed so far implies that the competence for economic policy-making is increasingly being shared between the European and the national level. This brings challenges of its own, both in terms of the effectiveness and legitimacy of decision-making. Despite the inter-linkages, each level should be in a position to deliver on its own mandate. Correspondingly, citizens should be able to identify who is responsible for what. Here I believe that EMU still has some way to go before passing the "fitness test".

Let me now review in turn the economic and political dimensions of the "fitness test" of euro area governance.

Crisis resolution and crisis prevention

During the crisis, the ECB has fully played its role in line with its mandate. The ECB was faced with interrelated key challenges, namely extreme risk aversion and non- linear dynamics, deleveraging, fragmentation and a weak economic environment. Like other central banks around the globe, we have taken decisive measures to support medium-term price stability and improve the transmission of our **monetary policy**. This is not the focus of my talk but I am happy to return to it in the discussion.

In addition, the **governance framework for crisis resolution and prevention** has been significantly improved. To the surprise of some, the crisis has shown the strength of the political commitment to the integrity of the monetary union. If one compares what exists now and what the framework was six years ago, one can notice the quantum leap that has been achieved. Let me elaborate.

Regarding **crisis resolution**, Member States have put in place **mutual insurance mechanisms**, most notably the European Stability Mechanism (ESM); sharing financial risks among sovereign countries is undoubtedly a major political achievement. The ESM was created in order to provide financial assistance to euro area countries in financial difficulty. ESM interventions are conditional on Member States first signing a Memorandum of Understanding containing a programme for the needed reforms or fiscal consolidation to be implemented in order to restore the financial stability.

The reform of EU governance is also about preventing future crises by remedying market and government failures. During the crisis, new safeguards have been established for this purpose:

- The **fiscal and economic governance framework** of the euro area has been reinforced through the adoption of a set of EU legal acts (the "six-pack" and the "two-pack"), as well as the Fiscal Compact. We have thereby achieved a twofold objective, namely a larger role played by Europe in national policies, as well as an internalisation of EMU constraints in the domestic frameworks.
- The reform of EU governance also aims to **prevent future banking crises and break the bank-sovereign nexus**. The establishment of the single supervisory mechanism and the adoption of bail-in rules in the Bank Recovery and Resolution Directive mark significant progress towards preventing excessive risk-taking and making sure that the taxpayer is last in line to recapitalise banks. But we also need to have robust resolution arrangements at the European level. The single resolution mechanism should thus be able to act swiftly and needs ready access to a resolution fund. I'd be pleased to talk more about this in our discussion.

  Overall, significant progress has been achieved:

- We are now starting to **see the results of these actions** to resolve the crisis. Sovereign and corporate bond spreads are declining – it's a clear sign that financial fragmentation has started to recede. This is confirmed by Target2 balances having decreased by nearly 40% from their July 2012 peak. Rebalancing is also on its way. Structural budget balances have significantly improved. Crucially, the public debt-to-GDP ratio has started to decrease at euro area level. Moreover, programme countries have rebalanced their current accounts, not only via demand compression but increasingly through genuine gains in competitiveness. To be sure, we **cannot afford to be complacent**. Debt levels and unemployment are high and unevenly distributed, and the nascent recovery remains weak and uneven. We also need to **restore trust in the banking sector**, which is key to improving lending conditions to the real economy. In this regard, the comprehensive assessment of euro area banks will be crucial.
- Moreover, with the new governance framework the Member States have taken key steps towards internalising economic and financial spillovers within EMU. This has entailed a **shift of the balance of competences upwards**: the central level has been substantially strengthened to make the euro area more stable and resilient.

Fully enforcing the new rules of the game will however be the crucial test. At this stage, the implementation of the new macroeconomic framework has been somewhat disappointing in non-programme countries, notably regarding country-specific recommendations. It is more satisfactory on the fiscal side, but it will be essential that fiscal discipline is also fully enforced in good times, so that countries have enough fiscal space when the next crisis comes. The credibility of the new governance framework crucially hinges on the enforcement of our commitments, today and tomorrow.

To this end, we need to **improve effectiveness and legitimacy** within the euro area. As I mentioned before, while economic policy-making is increasingly shared between the European and the national level, each level should be in a position to deliver on its own mandate. And citizens should be able to identify who is responsible for what. Only with a more efficient and legitimate decision-making will we be able to properly enforce the governance framework; only then will EMU be genuinely “fit for purpose”. This brings me to the **political dimension of the “fitness test”**.

Looking beyond the crisis: a broader political perspective on euro area governance

The **Four Presidents’ Report** identified “political union” as one of the four building blocks of a genuine EMU. It put forward a number of proposals. Some of the momentum behind the discussions on these proposals has been lost. It is not up to the ECB to promote them. But we would welcome policy-makers restarting the discussion and not shying away from ambitious proposals. I see several possible options to enhance effectiveness and legitimacy:

- First, by strengthening **the European dimension of multilateral surveillance.** A full-time Eurogroup President with proper analytical capacity and more autonomous decision-making powers could be a step in the right direction. This could be accompanied by stronger accountability towards the European Parliament, in particular for the implementation of the governance framework. Depending on how far they are developed, both ideas may require a change to the Treaties.
- Second, it would also be important to **strengthen the national ownership of the reforms prescribed by European procedures and recommendations**. European issues and policies could more often be “invited” into the national debate and into national parliaments in order to bring them nearer to, and make them better understood by national citizens . The Commission’s Opinion on Member States’ draft budgetary plans, as mandated by the “two pack”, is an important instrument in this respect.

By fostering a public debate and bringing political preferences closer together within the euro area, the move towards **political union may in fact arouse interest in a further deepening of integration.** Policy-makers and citizens may choose to integrate further in the future, going above and beyond banking union. This shows that the economic and political dimensions of the “fitness test” are closely intertwined and even mutually reinforcing: economic integration calls for political integration, and vice versa. Therefore, there is no such thing as an institutional steady state; **the balance of competences is evolving over time.** However, I believe this further sharing of sovereignty will only happen if Europe is able to deliver tangible progress for its people in terms of stability, growth and job creation. It is the only way to cut the Gordian knot and overcome the current vicious circle whereby a lack of integration leads to a poor economic performance and a lack of political support for Europe. This also applies to the ECB within its price stability mandate: making sure that inflation is below but close to 2% in the medium term should be our contribution to restoring trust in Europe.

As a central banker, it is certainly not for me to prescribe what should be the next steps: they should emerge as the result of a political debate. What I can say is that there would be economic benefits from further integration. We learnt from the crisis that economic risk-sharing mechanisms are needed to making the euro area more resilient. However, there are some preconditions to be fulfilled before progress can be made in this direction. Drawing on John Rawls' thinking [2], I would argue that Member States will agree on a new "social contract" only behind the veil of ignorance, not when the house is still on fire. The euro area thus needs to achieve a higher degree of economic convergence and to address the issue of the legacy arising from past national policy mistakes. In the meantime, a higher degree of risk-sharing can be achieved through market-based mechanisms. The completion of the banking union and a thorough implementation of the Single Market Act II as proposed by Michel Barnier are of utmost importance in this respect. From the ECB's perspective, further risk-sharing should first and foremost focus on what could support a smooth functioning of the single currency.

Further integration within the euro area raises the difficult issue of the **relationship with the 'outs'**, in particular those with a permanent opt-out. The UK has made the sovereign choice to stay out of the single currency. It has to accept the full implications of this choice when euro area Member States need to integrate further. Of course, safeguards have to ensure full consistency with the Single Market, which is the European Union's most valuable achievement. However, while such safeguards will have a bearing on the *design* of euro area integration, they cannot change its *direction*. And let's have our priorities right: the biggest threat to the Single Market is not euro area integration: it would be euro area stagnation.

Ladies and Gentlemen,

In 1946, **Winston Churchill called for the United States of Europe.** This did not pass the political "fitness test" at the time – and would probably not pass it today either. Subsidiarity has been and remains an essential principle of building a common Europe. The debates on the future of EMU governance and the debate on this side of the Channel on a competence review are not dissimilar in this respect. They boil down to the following crucial questions: what do we need and want to tackle together, with common policies and a strong centre? And what can be done nationally, regionally, locally?

However, there is one important element we can still learn from Churchill. No matter how passionately we debate the right allocation of competences, the right governance, the right tools and methods, it must be clear that at the heart of all these choices, there is a **strong commitment to building a strong, stable, open and diverse Europe together.** I have no doubt about this commitment in our debate on the future of EMU. And I hope that the debate in this country in the coming years will confirm that there can be no doubt about this commitment in Britain.

Many thanks for your attention.

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[1]I would like to thank Jean-Francois Jamet and Marion Salines for their contributions. I remain solely responsible for the opinions contained herein.

[2]John Rawls, A Theory of Justice, Harvard, 1971