DEUTSCHE BUNDESBANK
EUROSYSTEM

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Designing a stable monetary union – Progress and open issues

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1 Introduction

Ladies and gentlemen

thank you for the invitation to speak at the CEVRO Institute today. It is a pleasure to be here.

Since the Treaties of Rome were concluded in 1957, the history of Europe has been marked by an ever-deepening integration. To some degree this process has certainly been driven by the idea that in a globalised world only a united and strong Europe can succeed.

In 1954, Jean Monnet, one of the founding fathers of the European Union, said: “Our countries have become too small for today’s world, when compared to the potential of modern technical means and in relation to the dimension of America and Russia today, China and India tomorrow.” In that sense, European integration and also the introduction of the euro could be

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interpreted as a response to globalisation – as an attempt to create a strong regional pole in an increasingly multi-polar world.

From an economic point of view, this process of integration culminated in the introduction of the euro in 1999. In that year, Europe took a historical step towards deeper financial integration. However, it was a controversial step. Many critics argued that Europe was not yet an optimal currency area and thus not ready for a single currency. In their “coronation theory”, the creation of a single currency should be the coronation of a long-term process of political and economic convergence, not the precondition for it.

In contrast to that view, proponents of the euro propagated the “locomotive theory” whereby a single currency would be introduced early on and would act as a locomotive for further economic and political integration. Eventually, the proponents of the “locomotive theory” prevailed, the euro was introduced in 1999 and, for the first 10 years of its existence, proved to be a stable currency.

Then, in the wake of the global financial crisis of 2008, the euro area slid into a financial crisis of its own. This was compounded in 2010 when Greece entered into a sovereign debt crisis, leading to other member states suffering a sudden loss in confidence, which eventually brought the euro area to the brink of collapse. Extensive rescue packages by the governments along with non-standard measures taken by the European Central Bank helped to calm the markets and prevented the crisis from escalating.

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To some commentators, the current situation might look similar. Greece’s newly elected government objected to complying with the financial assistance agreements and intended to withdraw some of the reforms that had already been adopted. There were even brief calls for further debt relief. And over the last few weeks, the situation has not improved. Rather, it is obvious that the financing problems are increasing further. How much longer exactly the country’s financial resources will last is hard to gauge, but it seems fair to say that time is running out.

Further financial aid would certainly buy time, as it has done before. However, it cannot remedy Greece's lack of competitiveness or establish a functioning administrative structure. Only the Greek government can undertake the necessary reforms. Therefore, further assistance can only be granted if Greece continues with its efforts to restore sound public finances and competitive economic structures. To regain investors’ trust, sustainability and competitiveness are necessary requirements.

Some observers see these developments as an indication that financial integration in Europe has failed. I see these developments as an indication that financial integration in Europe has to go further. Let us therefore take a look at three areas where further integration could be the way forward for Europe.

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2 Fiscal union – beyond the horizon

The first area is public finances. And in order to understand the core of my argument, it is important to be familiar with the particular features of the European monetary union. The European monetary union is special in that it combines a single monetary policy with national fiscal policies.

The monetary policy for the 19 countries of the euro area is decided by the Governing Council of the ECB in Frankfurt. However, the fiscal policies of the 19 euro-area member states are a matter for the national policymakers – each country decides on its own government revenues and expenditures.

This imbalance of responsibilities gives individual countries an incentive to borrow – a "deficit bias" is built into the system. This is because the negative consequences of borrowing are spread across all the member states of monetary union – for example, by means of a higher interest rate level for all of them. Our objective should be to counter that "deficit bias" to ensure a stable monetary union. This can only be achieved by realigning responsibilities – liability and control have to be in balance.

And one way to rebalance liability and control is deeper fiscal integration. If we were to take this path, the European level would gain certain control rights over national budgets. This would amount to what is known as a fiscal union. However, such a step would depend on the countries of the euro area transferring national sovereignty to the European level.

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Giving up sovereignty in this way would be a radical change and require wide-ranging changes to national and European legislation. More than anything, such changes would need the support not only of policymakers but also of the general public. And on this point we need to be realistic. I cannot identify any willingness to do that at present – not in Germany or in any other country of the euro area.

This means that, for the foreseeable future, control of fiscal policy in Europe will remain at the national level. In this area, deeper integration still lies beyond the horizon.

3 Banking union – the reality of today

At this point in time, a fiscal union remains more of a vision than of a concrete step to be taken anytime soon. However, in another area, Europe has just taken a significant step towards deeper integration.

On 4 November 2014, the European Central Bank assumed direct supervision of the largest banks in the euro area – thereby erecting the first pillar of a European banking union. As of today, this concerns 123 banks which together account for more than 80% of the aggregated balance sheet for the euro-area banking sector. The European Central Bank has therefore become one of the world's largest supervisors.

The banking union is certainly the biggest step towards financial integration in Europe since the launch of the euro in 1999. And to me, it is the most

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logical step to take. Single monetary policy requires integrated financial markets – which includes, without doubt, European-level banking supervision.

European banking supervision allows banks throughout the euro area to be supervised according to the same high standards. In addition, cross-border effects can be covered better through joint supervision than by national supervisors. And adding a European perspective to the national view puts more distance between the supervisory authority and the entities it supervises. This minimises the danger of supervisors getting all too close to their banks and treating them with “kid gloves” out of national interest.

Meanwhile, a comprehensive banking union has to comprise more than just an effective European banking supervision. The second pillar of the banking union is a European resolution mechanism to deal with future bank failures. This mechanism will be in place from 2016 onwards. If push comes to shove and a bank is no longer viable, shareholders and creditors will be first in line to bear banks’ losses, and taxpayers’ money will only be the very last resort. This will realign incentives and make the entire banking system more stable.

4 Capital markets union – a vision for the future?

The European banking union is definitely a major step forward in designing a better framework for the European monetary union. However, Europe should broaden its view beyond the banking sector. Consequently, the EU-Commission has proposed to establish a European capital markets union.

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Following monetary union and the banking union, this will be the third major step of financial integration in Europe.

In essence, the European capital markets union has two objectives. The first objective is to increase the share of capital markets in the funding mix of the real economy. The second objective is to integrate capital markets more closely across borders.

Some people relate the first objective to the question of whether a capital markets-based financial system is superior to a bank-based financial system. Well, to sum up the empirical evidence: it depends. It depends on a number of factors and country-specific characteristics, which makes it hard to provide a general answer.

Nevertheless, the recent crisis shed light on these issues from another angle. A system in which the real economy relies on a single source of funding will most certainly run into trouble when that source dries up – regardless of whether it is bank funding or capital market funding.

Therefore, it is not a question of “either/or”. The objective of the European capital markets union is not to abandon bank-based funding but to supplement it with capital markets-based funding. And in Europe above all places there is ample room to do so. The European stock market is only 60% the size of the US stock market when measured in relation to GDP. Likewise, the European market for venture capital is 20% the size of the US market, and for securitisations the percentage is even lower.

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In the end, it comes down to the uncontested argument of diversification. Increasing the share of capital markets will improve and broaden access to funding particularly for small and medium-sized enterprises which form the backbone of many European economies. At the same time, it will improve the matching of investors to financial risk, thereby increasing the efficiency of the financial system. As a result, the financial system will be able to better support sustainable economic growth.

The second objective of the European capital markets union is to improve the integration of capital markets in the entire European Union. One of the main arguments is that integrated capital markets can improve private risk sharing. The technical question is: to what degree does a shock to the economy affect consumption?

Empirical studies for the United States show that integrated capital markets cushion around 40% of the cyclical fluctuations among the US federal states. A share of around 25% is smoothed via the credit markets, while fiscal policy cushions 10-20% of shocks. Altogether, around 80% of a given economic shock is absorbed before it can affect consumption. Studies for Canada yield similar results.

In Europe, the picture looks different. Here, it is mainly credit markets that cushion economic shocks – and they are not very effective in doing so. Altogether, only around 40% of a given shock is absorbed before it can affect consumption. Increasing the share of capital markets and integrating them across borders would therefore help improve risk sharing in Europe and reduce the volatility of consumption.

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To be sure, the argument for a capital markets union is straightforward, but implementation will be much less so. The capital markets union is a complex undertaking affecting many different areas. Consequently, the European Commission has presented a wide range of suggestions and steps to be taken. Nevertheless, I firmly believe that Europe should embark on the path towards a capital markets union in order to enhance the stability and prosperity of its economy.

5 Conclusion

Ladies and gentlemen

George Washington is credited with having written, more than two centuries ago in a letter to a friend, that a United States of Europe would come into being. This is certainly a bold vision aiming at an encompassing political integration. In my speech today, I have taken a more modest approach and argued from an economic point of view. I have highlighted three areas where deeper integration might help to enhance the stability of monetary union.

The first area is public finances, although a European fiscal union is currently a rather unrealistic vision. The second area is the banking system, and here we have taken a major step towards integration – in November 2014, the banking union became a reality. The third area is capital markets. Looking to the future, I consider a capital markets union another project that would contribute to enhancing the stability of the European economy.

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To be sure, these are all big steps, but in my view they are worth taking. A stable monetary union will eventually benefit all member states and also the rest of the world.

Thank you.

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