EUROPEAN CENTRAL BANK
EUROSYSTEM

The euro area’s three lines of defence

Speech by Benoît Cœuré, Member of the Executive Board of the ECB, at the conference “Deepening of EMU”, Ljubljana, 2 February 2018

For a long time, the European Central Bank has been at the forefront of macroeconomic stabilisation in the euro area. There’s broad agreement that without our unprecedented actions, the euro area would have fared far worse. Even more people would have lost their jobs, and wages and prices would have stagnated for much longer, or would even have fallen. Although our actions were bold and unparalleled, we acted within our mandate, as confirmed by the European Court of Justice.

The establishment of the European Stability Mechanism, and the progress made in setting up a banking union, have fixed some of the shortcomings in euro area governance and instruments. These steps were important in easing the pressure the crisis has put on the ECB. But many of the institutional failings that caused and perpetuated the crisis remain unresolved. Incentives to pursue sound policies remain too weak and stabilisation of shocks too difficult. These are deep-rooted issues that cannot be resolved by a few years of above-trend growth. To assume that the current economic expansion will heal all wounds is naive. The euro area needs reform.

As the central bank of the euro area, the ECB should not interfere in the details of what is mostly a political debate. But we have a stake in the success of the current discussion. Without further reforms, the next crisis may well force the ECB to test the limits of its mandate. Depending on the nature of the next crisis, policy action might require taking short-term rates much deeper into negative territory. Or it might require purchases of assets that are riskier than public or corporate debt. Or it may draw us dangerously close to monetary financing of governments.

As things stand today, and given member states’ still limited fiscal policy space, even a small downturn could create large economic and social costs. It could, once again, test the cohesiveness of the currency union. Unless the euro area finds a way to change direction, to reform itself and to regain space for active macroeconomic policy, the same fractures we saw in 2012 could reappear and widen when the next downturn comes.

Many ideas for reforms are being floated, of course. Some are bolder than others. The recent proposals by German and French economists are a worthwhile attempt to bridge differences and surmount trade-offs. Today I will not offer another blueprint. What I will offer instead are requirements than any euro area reform will have to pass. I will call them the three “lines of defence” that any well-functioning monetary union depends on. They are needed to deliver a stable currency. They are needed to protect the ECB and its mandate. And they are needed to keep belief in the future of the euro strong.

Flexible markets form the first line of defence.

They are indispensable for a currency union. They reduce the need for macroeconomic stabilisation and curb contentious debates about crisis management. Markets that can absorb shocks efficiently do not waste costly political capital. And they create more policy space in downturns, for both fiscal and monetary policy.

To bolster the first line, the way we implement economic policies needs to change. The current system has clearly not delivered its intended benefits. Take the European Commission’s country-specific recommendations as an example. In 2016, less than 5% of the recommendations were implemented by Member States. Limited enforcement of the recommendations, rather than the incorrect identification of the main issues, has made the existing framework fail.

Why? Because recommendations from outside a country, even if correct on substance, are typically dismissed. Sovereign governments don’t accept what they see as diktats from Brussels. Economists should have known better. Incentives are the drivers of our actions. So, if outside recommendations are perceived as being politically too costly, then we need to find solutions that promote national “ownership” of reform efforts. Money is not the answer. It is political incentives that need resolve.

The other key domain to spur the catalyst function of our market economies is the Single Market. It is incomplete as we all know. Take services as an example. They account for over 70% of the EU’s GDP and an equal share of its employment. But we still face significant barriers when it comes to cross-border service provision in the EU. The Services Package that was adopted about a year ago was a step in the right direction but more needs to be done.

Efficient and integrated financial markets are part of the first line of defence. In the United States, around 60% of a shock to a state’s GDP is cushioned by financial markets. In the euro area, the share is currently closer to 20%. Country-specific shocks remain unsmoothed to a large extent, mainly because cross-border equity risk-sharing is hugely underdeveloped in Europe.

A true capital markets union could significantly help to diversify and reduce risk. It would thereby limit the financial burden to be levied by governments in the case of adverse shocks. And it would broaden the scope of monetary policy transmission beyond the banking sector, making policy less vulnerable.

Finally, to avert banking collapses, governments in the past were forced to disburse large sums of public money in the pursuit of economic and financial stability. Completing banking union will reduce risks for taxpayers and break the remaining link between banks and national governments. A European deposit insurance scheme is a precondition for a truly integrated banking system and single money. Let us not forget that 86% of our money is created by commercial banks. The transmission of the ECB’s monetary policy will always be incomplete as long as differences in depositor confidence prevail across the euro area.

The second line of defence relates to the role of governments.

Even the most flexible and efficient markets cannot fully absorb very large shocks without imposing economic hardship on a considerable number of people. In other words, flexible markets come at a price. They increase uncertainty for employees and often require relinquishment.

Uncertainty, for example, is born of the fear of a loss of employment or of not being able to respond to today’s fast pace of change. But it is also born of the fear that governments themselves have been pushed to the sidelines as globalisation has proceeded. Recent election outcomes around the world bear witness to this fear. The more exposed individuals are, the more likely a political backlash.

Governments can mitigate these effects. Unlike the United States, however, the European Union is not a federation. This means that, as a rule, stabilisation and the provision of security in the form of social services takes place first at national level. Keeping governments solvent is a precondition for achieving that. As we saw during the crisis, if perceptions of sustainability among markets decline, then counter-cyclical spending can quickly become constrained. So we need to regain fiscal space, which means building adequate national fiscal buffers.

The current broad-based economic expansion is contributing a lot to this end. But many countries are emerging from the crisis still bearing legacy burdens that could take decades to resolve. This leaves us vulnerable to divergence and fragmentation when a crisis strikes – and in some ways, even more so than before.

Fiscal consolidation therefore needs to go hand in hand with efforts strengthening our area-wide defences. Of course, the ESM is already an important safeguard. But we need to enhance its competences in the field of crisis management and make it more agile. This includes making full use of its existing instruments, such as the direct bank recapitalisation tool and precautionary financial assistance, and moving away from the unanimity requirement. And in the long run, it means bringing the ESM into the community framework. The stability of the euro area cannot be in the hands of one, or a few, Member States and their parliaments. Ultimately, the ESM needs to be accountable to the people of Europe.

But union stabilisation cannot stop with the ESM. The euro area needs a fiscal instrument that can help it cope with large shocks without having to rely excessively on the ECB.

Such an instrument would be the third line of defence of our monetary union.

It would support aggregate demand in countries experiencing a crisis, drawing on common funds. It would thereby provide an additional layer of stabilisation that safeguards trust in national policies. EU solidarity would then take on a whole new meaning.

Whether such an instrument would directly support national safety nets, or would instead undertake investment projects that create jobs and income, will be subject to much debate. Whether it should be balanced by stronger market discipline will be even more heatedly debated.

These discussions will take time. However important, they should not obscure what should be governments' urgent priority: strengthening the first two lines of defence of our monetary union. Achieving lasting economic stability must involve finding a balance of discipline and flexibility in our economies. This will both strengthen support for the euro and help alleviate the pressure and burden on the ECB in crisis times.

Realpolitik will dictate the speed of reforms. What we do need is broad agreement that they will be built on these three lines of defence, and visible progress on the first two.

Thank you.

European Central Bank
Directorate General Communications
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany
Tel.: +49 69 1344 7455, E-mail: media@ecb.europa.eu
Website: www.ecb.europa.eu

› **Media contacts**