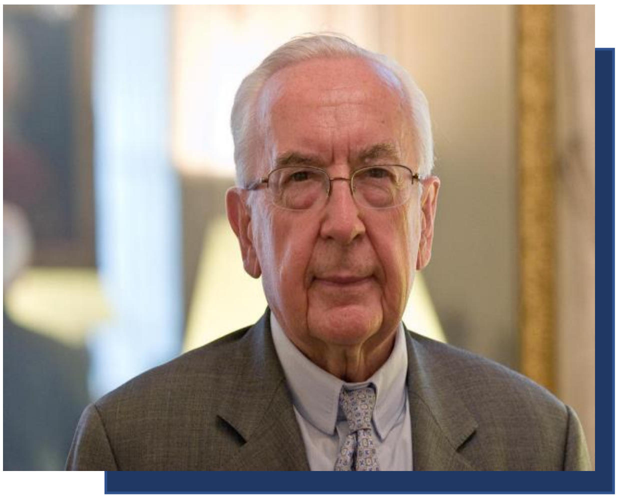
Keynote Address - Mr Jacques de Larosière

Towards EMU 2.0: Hindsight and Prospects – 4 October 2023



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EMU: myth or reality?

The specificity of the euro currency is that it is not an overwhelming symbol of unity but a permanent source of issues to negociate for the Member States of the euro zone.

A national and sovereign currency usually constitutes a synthesis of the economy of a given country. It reflects the relation between the country and the international system and is part of the necessary dialogue between the fiscal and monetary authorities. To put it bluntly, the currency is the catalyst of a country's unity.

For sure, the euro has been a success insofar as it has become the second most important currency globally after the American dollar. Indeed, in 1999, the euro became the single currency of a vast economic entity whose market of 350 million inhabitants is one of the largest in the world. Exchange rates have disappeared by design, and the share of the euro across various indicators of international currency use continued to average close to 20% in 2022[1].

But this success cannot conceal the deep internal divisions within the monetary zone.

[1] ECB, The international role of the euro, June 2023

If one takes a close look at the euro, one can perceive that, unlike other currencies, it is far from being the reflection of a country's unity. The euro has gone through dramatic turmoil during the euro sovereign debt crisis

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and is regularly a source and a manifestation of discord among Member States.

Why is that? There are several reasons:

- The first reason is that there are as many fiscal policies as there are members of the euro zone,
- The second reason is that there are heterogeneous perceptions of the inflation that must be fought (North countries are less prone to inflation than South countries),
- The third one is that the key interest rate of the euro is the same for all members of the monetary zone. It is an average, which, by definition, is more tolerant for counties with higher inflation than for those that have a more stable outcome,
- The fourth one is that the Union has moved since the 60s from structural European policies (industrial, agricultural, energy competition…) toward a single market with no community preferences and strong national trends.

In short, the handling of the single currency is a matter of permanent discussions between the members of the boards of the ECB and the Eurogroup.

I. The euro zone is characterized by growing heterogeneities

All observations point to the same finding: the euro zone is more characterized by these internal economic and fiscal divergences than by its unity. Here are some examples of the mentioned heterogeneities.

- In terms of growth, the euro zone has been lagging behind the US for decades. Indeed, since 1995, the cumulated level of real GDP has risen by 94% in the US, compared to only 51% in the euro zone[2].

One can also observe that the growth gap between the US and the euro zone has been intensifying since the Great Financial Crisis (GFC) of 2008. This is partly due to productivity growth, which is stronger in the United States.

- The euro has strengthened the more industrialized countries, to the detriment of those in deeper industrial decline.

The elimination of foreign exchange risks normally encourages productive specialization within a Monetary Union. This turned out to be true only for certain Member States of the euro zone; the single currency has given an edge to exporting countries that specialized in tradable products for which they exhibit a strong competitiveness such as Germany and Austria over countries that have progressively experienced deindustrialization such as France and Spain.

[2] P. Artus, "The growth gap between the United States and the euro zone and its consequences", Natixis Flash Economics, 20 September 2023

Indeed, the economies of the best performing countries benefit from the fact that the external value of the euro represents an average for the entire economic area and appears undervalued in relation to their economic performance, resulting in an additional competitive advantage. For example, it is estimated that Germany's exchange rate is 20%

undervalued, in terms of real effective exchange rate relative to the euro area.

- <u>The euro zone macroeconomic divergence is especially conspicuous when looking at the TARGET 2 imbalances.</u>
  Indeed, the net TARGET 2 liabilities of the Bank of Italy and the Bank of Spain are quite high, standing at respectively €623 bn and €422 bn as of May 2023 (which represents roughly 32% of GDP for the two countries). Conversely, the Bundesbank had a net TARGET 2 credit of around €1.082 bn in May 2023 (roughly 28% of Germany's GDP).

It has been forgotten that a monetary union does not erase current account imbalances which remain, by definition, national.

So even though we are in a monetary union and have a single currency, the monetary reality is different: the value of the euro minus inflation is highly volatile depending on the Member State.

- <u>The divergence in public debt levels across Member States is a major concern.</u> Indeed, the public debt-to-GDP ratio has continued to grow steadily in significant countries of the euro zone (*e.g.* France, Italy, Belgium, Spain) and is approaching - and even sometimes exceeding – 120% of their GDP. On the contrary, countries such as the Netherlands, Germany or Austria have been able to maintain a ratio of public debt-to-GDP of about 60% or less in the recent years.

- Disparities are also striking in terms of public deficit: in 2022, while Germany and the Netherlands have managed to have a public deficit below the 3% threshold (respectively -2.6% and 0%), France, Spain and Italy have exceeded the 3% threshold with respectively -4.7%, -4.8% and -8%.

  As M. Luis de Guindos recently said: "After four years without EU fiscal rules, governments may have got used to a little bit of a 'whatever it takes' approach with respect to fiscal policy,". "But that has to change. Having a tightening of monetary policy and, simultaneously, an expansionary fiscal policy would be a very bad policy mix."

- Current Account Balances are another indicator of the heterogeneities of the euro area: in 2022, Germany and the Netherlands had Current Account Surpluses of respectively 4.2% and 5.5% of GDP whereas France, Belgium and Greece had important structural deficits of respectively -1.7%, -3.4% and -9.7%.

- Regarding inflation in Europe, there were two discernable zones during the 2000s: one where inflation was rather high (Spain, Italy…) and one where inflation was rather low (Germany, the Netherlands…).

In other words, while the objective of maintaining an inflation rate similar to the one observed before the global financial crisis (ie. close to 2%) was, on average, attained, it remains that the “peripheral” countries who had let their inflation soar, their budgetary deficits derail and their real estate markets explode, had, in a way, “taken advantage” of the low interest rates of the ECB (whose rates were obviously too low for them while they were more in line with the needs of the more stable core-countries of the Eurozone).

Consequently, the current account balance of countries with high inflation have deteriorated during the 2000s. Meanwhile, countries that had contained inflation had positive real interest rates and current account surpluses, encouraging them to be even more virtuous in their fight against inflation. The monetary system has thus pushed countries towards one extreme to the other depending on their economic discipline.

- Finally, the reality of the European Single Market has not favored more economic coherence

The single market is an essential objective, but it does not improve the homogeneity and economic performance of all member states in itself. It would only have positive results if all member states advanced at an almost similar pace in terms of structural reforms.

Cross-border capital flows within the euro zone have been limited since the euro sovereign debt crisis. Additionally, until 2008, European crossborder capital flows mainly fueled unproductive asset bubbles (in Greece, Spain, Ireland…).

- The ECB's interest rates have been structurally lower than the FED's ones for 15 years, which leads to capital flight from the euro zone to finance the rest of the world, especially the United States.
- The accentuated economic divergences between Member States can scare investors away, as they have better remunerated and less risky opportunities elsewhere, especially in the United States.
- The EU banking market remains fragmented notably due to homehost issues and ring-fencing practices from host countries.
- The Capital Market Union (CMU) remains a dream[3].
- The absence of a European safe financial asset due to the absence of a common fiscal policy

It is therefore important to promote integrated banking and financial markets where excess savings from North countries could finance necessary investments in South countries which would foster not only growth in Europe and the international role of the euro but also the European strategic autonomy in the financial area. But unfortunately, this does not work due to the increasing economic divergences between Member States.

[3] To achieve a genuine CMU, the EU needs to have adequate financial products - especially pension funds (essential to fund retirement pensions at the national level), sufficient interest rate remuneration, rules that foster equity financing and securitization, and European actors as well as consolidated infrastructures, which requires a harmonized legal framework regarding bankruptcy and securities.

To overcome the inherent contradiction of the heterogeneity of the monetary zone, there should have been at least an element of macro prudential surveillance:

In the 2000s, simple, non-monetary regulatory measures such as loan to value, higher down-payments by borrowers for loans would have been effective in preventing asset bubbles. We missed out on this macroprudential phase.

It's already difficult to manage a single monetary policy with strong economic divergences, and it's even more difficult if we don't use the simple measures known as macroprudential, which would have made it possible, in particular, to attenuate the problems of financial instability in the 2000s.

II. The ultra-loose monetary policy in the euro area has disincentivized Member States to undertake structural reforms and has led to "fiscal dominance"

The delicate arrangement of the European construction, largely illusory, depended very much on the maintenance of a zero-interest rate policy from the ECB to make public deficits easily financeable. Which is what we did for almost 20 years! (apart from the crisis of 2009-2011).

Keeping interest rates at 0 for so long reduced the financial difficulties caused by the emergence of spreads and the public deficits but encouraged general indebtedness as well as the vulnerability of the financial system, and have disincentivized Member States to undertake necessary structural reforms (especially in France and Italy).

The fact that the ECB has gone so far on the fiscal issue (the Eurosystem holds more than 30% of the outstanding public debt) sheds a rather dark light on the concept of independence of the central banks.

Monetary policy can erase spread differentials in the Euro area but can neither solve domestic structural problems nor relaunch capital flows from the North to the South. Indeed, since the EU sovereign debt crisis, Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita GDP countries (Spain, Italy, Portugal, Greece). This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between the Eurozone countries, the insufficient number of investment projects and the absence of a European industrial policy.

By setting medium and long-term interest rates in an administrative manner, central banks have crossed a crucial boundary: that of intervening in the allocation of resources and the distribution of wealth without letting the market define interest rate equilibria based on the supply and demand of capital. In fact, central banks have systematically favored debtors over creditors. Are we still in the realm of monetary policy?

Now, the debt servicing costs are rising along with the interest rates and are becoming heavy on highly indebted countries' budgets, leaving them with little room for maneuver. Without efforts to comply with the fiscal discipline required by a monetary union, the sustainability of the debts of certain EU Member States could be questioned.

When the ECB buys financial securities, it is, by definition, running a risk, which is that of the intrinsic value (default risk) and duration (interest-rate risk) of these securities.

If the Central Bank has miscalculated its risk (by underestimating inflation or forcing rates to 0 while financial bubbles are inflating), it is preparing for a crisis.

In the ascending phase of QE, governments were happy with the fall in rates and the rise in the value of Treasury securities. But as soon as inflation reappeared and rates had to be raised, governments began to worry: borrowing would cost them more, and they would have to make up the central banks' deficits (through recapitalization) and suffer the consequences of rising interest rates.

- <u>What goes around comes around. A political agenda that leads to fundamental economic divergence is one that turns its back on reality. And when one turns one's back on reality, the spreads of interest rates on the markets tend to increase and the spreads for the least competitive countries to jump</u>.

As long as it is not sufficiently understood, especially in highly indebted countries, that over-indebtedness is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate and it will be all the more difficult to make progress in the construction of an economic and financial Europe.

Indeed, the intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a policy of "every man for himself", creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharing and weakens the euro zone.

III. Necessary improvements are required to face challenges ahead of the EMU

Monetary policy should be normalized to fight inflation

ECB should pursue the normalization of monetary policy to fight inflation which remains persistent and elevated. As long as real interest rates are negative, it is still a reward for debt.
However, should monetary policy take into account the possible financial fragmentation that exists in the euro zone?

The fear of the reappearance of spreads in Europe should not dominate the decision-making process of monetary policy. Indeed, sooner or later, structural spreads – based on the past accumulation of fiscal and structural deficiencies – in Europe will appear on the markets.
The ECB is certainly concerned with moderating "excessive" market rate differentials between European countries. But central banks do not have an obligation to systematically erase all traces of interest rate differences in the appreciation of the markets. The elimination of all spreads would be difficult to reconcile with the Maastricht Treaty, as some member states – known for their fiscal discipline – place greater emphasis on the objective of monetary stability (believing that the ECB should not monetize public debt).

Monetary policy cannot solve structural issues. Member States are the ones who must adjust their economic and fiscal policies accordingly to address their domestic economic weaknesses.

It would make sense to start decisively a quantitative tightening monetary process in order to undo the excessive liquidity that has accumulated during the years of monetary accommodation.

<u>The review of the Stability and Growth Pact (SGP) needs to be ambitious and immediately effective to avoid a looming euro crisis</u>

The goal of this EU fiscal framework was to unify the economic environment in which monetary policy operates. Thus, there is a need to replace fiscal dominance with a gradual convergence of the various fiscal policies of Euro area Member States. If the fragmentation that currently characterizes European fiscal policies persists, then the EMU is in a deadlock, and the situation will be going from bad to worse.

- The case-by-case framework proposed by the EU legislative proposal seems the right approach. In particular, the speed of the return to a public debt below 60% of GDP should be specifically adjusted to each country.

  A set of rules adapted to each problem (expenditure, primary balances, debt) is necessary in order to acknowledge national economic specificities. The methodology used must be unique and indisputable.
- The countries with large deficits and over indebtedness should achieve and maintain a primary surplus to be defined and monitored by the EU Commission or an independent EU fiscal authority. In this perspective,

primary fiscal balance should become a quantitative benchmark to support the EU reformed fiscal framework as well as the comparison of the ratio of public expenditure to GDP with the average for the euro zone.

- Keeping the 3% of GDP deficit rule is a reasonable option.
- The quality of public spending and composition on public finances must be given more importance than its quantity. But public investments should not be excluded from a country's deficit and debt calculations[4].

The Macroeconomic Imbalance Procedure (MIP) needs to be rigorously respected thanks to equal treatment and multilateral surveillance assured by an independent dedicated Commission

The Macroeconomic Imbalance Procedure (2011) must be applied effectively, and evenly among all Member States. This means that the adjustments of the current account balances should not only concern countries running structural deficits, but also countries running structural surpluses.

It is not possible nor honest to expect South countries to be the only ones to indefinitely scale down their revenues to compensate for the growing surpluses of North countries.

It is therefore high time to design and implement a **symmetric** adjustment mechanism where surpluses are addressed the same way deficits are.

[4] It would be a grave mistake to push the extreme fiscal limits in the present situation. Investment-friendly rules – such as the golden rule to protect public investment implying a separate capital account – can lead to excessive borrowing and weaken the link between fiscal targets and debt dynamics, fostering potential risks to debt sustainability.

The present complex situation where a monetary union is run without a credible mechanism dedicated to economic stability is not sustainable in the long term. Member States must use their fiscal and structural policies to strengthen the cooperation that the Union needs. In the present circumstances, the European Union with 27 members is not willing to force economic convergence on Member States in the name of a discipline that ultra-loose monetary policy has discouraged.

To break this contradiction, it is essential that the European executive power, and more precisely the Commission, assume their responsibility regarding the respect of economic discipline.
This requires independence, skills, vision and courage from the leaders in charge of these economic topics within the Commission.

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As ECB vice-President Luis de Guindos has recently stated on inflation:
“We are on our way towards 2 per cent,”. “That’s clear. But we must monitor that very closely, as the last mile will not be easy . . . the elements that might torpedo the disinflation process are powerful.
This is, at the end of the day a very delicate balance”.

If the fiscal, inflationary and economic drift were to continue in the euro area, we would end up making the “virtuous” countries pay for the slippage. This would be the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them.

So, we have to take the Union’s destiny in our own hands and not let it drift.

If the drift were to prevail, the logical result would be an inevitable, new crisis of the euro zone.