The journey to the euro and a resilient euro area

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Royal Highnesses,
Excellencies,

Ladies and gentlemen,

Introduction

As a convinced European, it is a pleasure to be here today to discuss our Economic and Monetary Union. It also is a privilege to be a keynote speaker alongside Jacques de Larosière. His policy experience at the national, European, and international level is unparalleled. I also admire his enthusiasm for the euro area journey.

The single European market: a resounding success

This year, we are celebrating the 30th anniversary of the single market. It became effective on 1 January 1993 in 12 member countries. It was the first major amendment to the Treaty of Rome, which had given birth to the European Economic Community 35 years earlier.

The single market's objective was – and still is – to guarantee the free movement of goods, capital, people, and services. It was a logical milestone after the Treaty of Rome, whose aim was to introduce common customs tariffs and eliminate customs barriers.

It has been a resounding success. Today, 27 European Union (EU) countries participate in the single market, which covers about 450 million people, more than 20 million businesses, and represents about 20% of world GDP.

Norway, Iceland, Liechtenstein, and partially Switzerland have access to it, which shows its attractiveness. Also, the UK, which had to leave the single market after Brexit, wants to keep as much access to it as possible.

Early on, it became clear that the benefits of the single market could only be maximised with the introduction of a common currency.

A single currency as a natural complement to the single market

The idea of a currency union was not new either.

The Latin Monetary Union, set up by Belgium, France, Italy, and Switzerland – and later joined by Greece – was created in 1865. The Scandinavian currency union between Denmark, Sweden, and later Norway, was established in 1873. Eventually, both failed in the 1920s. The Belgian-Luxembourg Economic Union, which came into force in 1922, provided for a monetary association. It came to an end with the introduction of the euro, as both countries joined the euro area.

However, the real impetus for the introduction of the euro came from a series of reports, notably the Pierre Werner report of 1970, which advocated to establish an economic and monetary union over a period of ten years.

But the collapse of the Bretton Woods system in 1973, i.e. the end of the system of fixed exchange rates, and the different economic responses by member countries to the first oil shock of 1973 made it impossible to implement the plan as it was envisioned.

It is only nearly 20 years later that the Delors Report of 1989 ultimately laid out the roadmap to our monetary union. The final gameplan was set by the Treaty on the European Union (Maastricht Treaty), which came into force in 1993. I participated in this process as a diplomat, during the Luxembourg presidency in 1991.

It set 1 January 1999 as the date at which the single currency would be introduced in its scriptural form. Banknotes and coins were introduced three years later.

The euro met with scepticism

Next year, we will celebrate the euro’s 25th anniversary. For younger generations, the euro is taken for granted, as they were born with the single currency in use. But, as I just highlighted, it was a very long and tortuous journey to get there.

The project was challenged by many politicians and experts, who typically pointed out that macroeconomic policies had to be aligned more before introducing a single currency. In other words, it was like putting the cart before the horse.

Some experts pointed to the optimum currency area (OCA) theory, which originated with the Canadian Nobel Prize economist Robert Mundell.

The theory offers a framework for determining whether a group of nations adopting a single currency is appropriate. It emphasises the significance of institutional and economic issues that can determine if a currency union can be successful.

The elements that were seen as misaligned with the OCA theory in the euro area were, notably, the imperfect mobility of labour (e.g. different languages, cultures, and social benefits), and the insufficient mechanisms for fiscal transfers and risk-sharing in case countries were hit by asymmetric shocks.

The fact that the determination of monetary policy became centralised at the level of the European Central Bank (ECB), while fiscal policies remained decentralised, was seen as another major challenge. Although the introduction of the Stability and Growth Pact in 1997 and its subsequent reforms aimed to avoid excessive divergences across fiscal policies, its implementation has proven difficult.

Fundamentally, scepticism was justified. Indeed, the global financial crisis that emerged in the United States in 2007, and the self-inflicted euro sovereign debt crisis that started in 2010, uncovered the gaps that existed in the EU and euro area architecture.

Gaps and policy responses

A lender of last resort for sovereigns

The first gap was the absence of a lender of last resort for sovereigns. When the single currency was introduced, it was inconceivable that a euro area member country would risk losing access to the financial markets. At the same time, the treaty forbids a country from taking up the debt of another country and it prohibits monetary financing. In other words, the ECB and national central banks, together known as Eurosystem, are not allowed to finance public deficits.

When euro area member countries were on the brink of losing market access, they requested a programme from the International Monetary Fund (IMF).

However, even the IMF’s resources were too small to face the large financing needs and member states provided bilateral loans to help Greece.

At the same time, the European Financial Stability Facility (EFSF) was created in 2010 as a temporary mechanism to help euro area sovereigns. In 2012, the European Stability Mechanism (ESM) was established as a permanent mechanism to prevent and manage crises in the euro area. Together, both institutions provided close to €300 billion of financial assistance to five beneficiary countries: Ireland, Greece, Spain, Cyprus, and Portugal.

The ESM is owned by the 20 countries of the euro area. It is endowed with very high paid-in capital, slightly over €80 billion. This allows it to benefit from the highest credit rating, i.e. AAA, from all major rating agencies and to tap the markets at favourable rates. These rates are then passed on to beneficiary countries. Today, its available lending capacity is about €417 billion.

When lending to countries, the ESM does not use taxpayers' money. It sells bonds to investors worldwide and uses the proceeds to lend. In return, beneficiary countries need to implement reforms to fix their economies.

Looking back, the five beneficiary countries have experienced economic growth above the euro area average until the pandemic hit. While conditionality imposed difficult sacrifices at times, the adjustment programmes ended up being successful. Greece's recent upgrade to investment grade by one major credit agency is a testimony to that.

Undoubtedly, the ESM contributed to safeguarding the integrity of the euro area. Other essential factors were the commitment of the beneficiary countries to ultimately implement crucial reforms, and the accommodative monetary policy of the ECB. Regarding the latter, the innovation that came with quantitative easing was necessary to support the transmission mechanism of monetary policy and ward off deflationary pressures.

What no theory had foreseen was the strong political will that existed to prevent the euro area from imploding.

The creation of the ESM and the monetary policy of the ECB were signalling that the euro was there to stay, whatever it would take, as Mario Draghi famously put it.

The doom-loop: a blind spot

The euro crisis also revealed the insufficient attention that was given to the interactions between the real economy and financial systems.

The introduction of the euro led to a decrease in long-term interest rates. In the case of Ireland, cheap money was channelled to the real estate sector. When the real estate market went down, the government had to face a difficult choice: save the banks or risk their bankruptcies bringing down the economy. The decision to save the banks led to massive fiscal deficits and ballooning public debt.

In the case of Greece, a balance of payments crisis was mainly brought about by a severe increase in unit labour costs. Combined with the deterioration of the fiscal balance and a high level of public debt, this led to a loss in confidence by the financial markets. This also affected the banking sector, which was fundamentally sound, but which was holding government debt.

This scenario is what economists have dubbed the “doom-loop”, where a banking-sector crisis can affect a sovereign, and a sovereign can affect a banking sector, creating a self-reinforcing loop.

Better supervision, stronger banks, and more effective resolution of banks

This second gap in supervision and macroprudential oversight had been identified in a report by Jacques de Larosière in 2009. Its observation was that the EU’s framework remained fragmented in terms of regulation, supervision, and crisis management.

The de Larosière report led in 2011 to the creation of the European System of Financial Supervision. It encompasses three sectoral supervisory authorities: the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority.

It also includes a macroprudential authority, the European Systemic Risk Board, whose purpose is to monitor risks to the financial systems across the EU. In this context, every euro area member country had to set up a national macroprudential supervisory body, which I had the task to chair as a Minister of Finance.

In 2014 came banking union. It was part of the roadmap for the achievement of a genuine Economic and Monetary Union drawn at the end of 2012 by the President of the European Council, in close collaboration with the Presidents of the European Commission, the ECB, and the Eurogroup. Its aim is to establish a more integrated financial framework and is based on three pillars.

The first pillar is the Single Supervisory Mechanism, which moved the supervision of systemically important banks to the ECB. While domestic competent authorities continue to supervise smaller banks, the ultimate responsibility lies with the ECB.

The second pillar, the Single Resolution Board, was established as a central authority for bank resolution together with its financial arm, the Single Resolution Fund (SRF).

The third pillar, the European Deposit Insurance Scheme, was meant to strengthen the protection of depositors but remains to be agreed by Member States. It remains a weak spot of banking union.

Thanks to the implementation of new banking regulation standards and common supervision, European banks significantly strengthened their capital and liquidity levels.

Consequently, the euro area was in a better position to withstand the double shock of the pandemic and the economic consequences of the war in Ukraine.

While banks had been part of the problem during the financial crises, they became part of the solution during the Covid-19 crisis. Stronger balance sheets and public guarantees allowed them to continue providing loans and keep economies afloat.

The pandemic and the EU's strong response

The pandemic, which brought about terrible human distress, also showed the EU's capacity to react quickly and effectively in times of hardship.

In April 2020, European leaders agreed on a rescue package worth €540 billion. It was put in place by the European Commission, the European Investment Bank, and the ESM. Its objective was to support, respectively, workers, businesses, and sovereigns.

A few months later, the €800 billion the European Commission's Next Generation EU programme was adopted. This temporary instrument, at the core of which is the €724 billion Recovery and Resilience Facility (RRF), has constituted an unprecedented act of solidarity. Created to help EU economies recover from the pandemic, it also provides financial resources to help our economies become more digital and greener. Nearly half of the funds emanating from the RRF are provided in the form of grants.

At the domestic level, fiscal stimulus was boosted to help households and businesses. These European and domestic measures, which were swift and well-coordinated, helped the euro area economy rebound from a sharp economic contraction.

The war in Ukraine: the latest crisis

The ongoing horrific war in Ukraine due to the unacceptable aggression of Russia put the EU once more to the test. It is the fourth crisis in the last 15 years the EU is facing. There are no words to qualify the human devastation a war brings about, in Ukraine and elsewhere in the world.

In Europe, by pushing up energy prices, the war exacerbated inflationary pressures that had already emerged during the pandemic because of severe disruptions in supply chains. It also dented economic growth. The EU acted by introducing REPowerEU, a plan to quickly wean Europe off Russian gas. However, uncertainty remains.

The good news is that the ECB is fighting inflation and EU economy is expected to continue growing, even if very slowly. Economic activity has become weaker, both in manufacturing and in services. It is unavoidable to see slower economic growth if we want to tame inflation.

An unfinished agenda

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Jean Monnet was prescient when he said that Europe would be forged in crisis and be the sum of the solutions adopted for those crises. The EU and the euro area have come a long way and undoubtedly have become more resilient.

Does that mean that we have reached the end of our journey? Clearly, no.

Despite the resilience the euro area has shown so far, risks remain. History has taught us that crises are recurrent. We do not know when and under what form they occur. But eventually, they do. What policy makers can do is to build up fiscal buffers in good times and make our economies as resilient as possible to mitigate their impact.

Important policy measures are yet to be completed.

Complete banking union

The collapse of three regional banks in the US and Credit Suisse earlier this year were a reminder of how vulnerable the financial system can be to unexpected shocks. It also showed how in today's world, investors and depositors instantly withdraw their trust and money when they sense things are going awry.

Further protecting Europe against such risks points to the need to finish the third pillar of banking union. Ultimately, we should have a European deposit insurance system. This would increase confidence in the EU banking system as a whole and enhance financial integration.

Another important addition that should be brought to fruition in the short-term is the ESM backstop for the SRF. In 2021, all ESM member countries signed the amended ESM Treaty, which gives the ESM new tasks. Upon its ratification, the ESM will notably be able to act as a backstop for the SRF. At the end of the year, this fund will have close to €80 billion available to restructure failing banks in an orderly manner, without relying on taxpayer funds. Once the green light is given, the ESM will add a layer of protection of €68 billion in case the resources in the SRF are insufficient. If these funds were used, they would be reimbursed by the banking sector not the taxpayers.

We are currently waiting for the ratification process to be completed.

Establish a genuine capital markets union

Resilience could also be strengthened by creating a genuine capital markets union, which would remove barriers, harmonise regulations, and deepen integration within Europe's capital markets. Currently, capital markets remain segmented and, compared to the US, they are significantly smaller. While capital markets predominantly contribute to the financing of the economy in the US, bank lending is by far the main source of financing in the EU, about 75%. The goal is to increase the overall financing of the economy and the role of capital markets in financing the economy.

Banks would have an important role to play within capital markets union, and bank lending would complement market lending.

Strengthen economic governance

Updating our economic governance is also imperative to put us on a safer track.

During the pandemic, it was legitimate to ramp up debt to protect people and businesses. This is why the fiscal rules at the European level were suspended, via the so-called general escape clause within the Stability and Growth Pact. This suspension has been providing the necessary flexibility for governments to act. During the energy crisis, it also was sensible to support citizens in the face of higher energy prices.

However, a sharp increase in inflation has required a tightening of monetary policy. The ECB’s mandate is to bring inflation back to its target, namely 2% over the medium term. The normalisation of monetary policy has been inevitable.

Therefore, fiscal policy and monetary policy need to become better aligned, as fiscal stimulus has been contributing to inflationary pressures. Last July, the Eurogroup agreed to revoke energy support measures.

Fiscal consolidation is required to build up buffers for future challenges, like future shocks, population ageing, and the digitisation and greening of our economies. Fiscal consolidation also is needed to guarantee debt sustainability. Of course, this will need to happen without putting additional pressure on more vulnerable households.

The general escape clause will phase out at the end of this year. This is why the current negotiations on the reform of the Stability and Growth Pact are so important. The new framework will need to contribute to sustainable growth and stability. Time is of the essence to foster the trust of people and markets.

In the coming weeks, I hope that the EU can agree on a revised Stability and Growth Pact that is transparent, with observable benchmarks, with a credible debt reduction path and, last but not least, that ensures equal treatment of countries.

Conclusion

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Let me conclude.

Over the past 15 years, Europe has experienced several crises: the global financial crisis, the euro sovereign debt crisis, the pandemic, and now the war in Ukraine. While the European construction initially followed the method of small steps, it accelerated throughout crises. The lessons of the crises were not wasted; we have learned along the way. The EU and the euro area have become more integrated and more resilient.

The euro is here to stay. Far from being a factor of division in the European integration process, as has been suggested by Jacques de Larosière, our single currency has acted like a glue, keeping euro area members together, fostering a high degree of solidarity. Nonetheless, some gaps remain in the architecture – but they are known. We should not risk waiting for another crisis to fix them.

Thank you for your attention.

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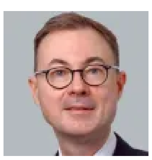

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