28 February 2014

Progress through crisis?

Conference for the 20th anniversary of the establishment of the European Monetary Institute

***Introduction** by Luc Coene, Governor of the National Bank of Belgium*

It would be wrong to consider the history of European integration as a smooth process. On the contrary, it has gone through several crises right from the start. Jean Monnet had observed long ago that crises can act as a catalyst: "Les hommes n'acceptent le changement que dans la nécessité et ils ne voient la nécessité que dans la crise"[1]. It should not be forgotten that European integration is basically a political process, which has its roots in the crises of the two world wars. The memory of the wars made for a very strong political will to drive European integration forward.

While the start of the European integration process dates back to the 1950s, economic and monetary union came only on the agenda with the December 1969 Hague summit and the Werner Report, but, initially, without much success.[2] In 1988, the monetary union project was relaunched, with the establishment of the Delors Committee, of which Alexandre Lamfalussy was a member. It provided a blueprint for economic and monetary union, which was taken up in the Maastricht Treaty. Despite heavy monetary thunderstorms, the European Monetary Institute was established in January 1994. It played a crucial role in the preparations for the euro, especially the elaboration of the changeover scenario. The EMS crises in 1992 and 1993, with exchange rate turmoil and high interest rates in many countries, could have dealt the EMU project a fatal blow, showing that EMU was not inevitable.

Why then did Europe succeed in establishing EMU, notwithstanding this looming crisis? I would put forward three factors: firstly, stability-oriented policies were pursued, which provided for sound economic fundamentals; secondly, the changeover scenario, in which the EMI played a crucial role, provided a credible and robust framework for the introduction of the euro; and, thirdly, the strong political will of Europe's leaders, who adopted difficult measures in order to establish EMU.

European Economic and Monetary Union, with a single currency but no political union, was, to use a patented expression of Alexandre Lamfalussy's, "navigating in uncharted waters". However, the first decade of the euro went smoothly, even too smoothly. The sovereign debt crisis, which started

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[1] Monnet, 1976
[2] Maes, 2002

in October 2009 after new Greek budget data, revealed the flaws in the structure of the European Economic and Monetary Union. It demonstrated that membership of a single currency in a single economic and financial market creates extremely strong and complex interdependencies. That is why much stronger integration of economic policy is absolutely vital. Furthermore, this poses fundamental questions of democratic legitimacy and accountability. Deepening EMU should go together with significant progress towards a political union. This should also enhance "national ownership" of policies agreed at the European level.

Progress towards economic policy integration is all the more necessary as one cannot trust markets to impose sound economic policies. Indeed, the history of the euro highlights the limits and excesses of market forces. In the first ten years, markets hardly responded to the growing macroeconomic imbalances. Their subsequent reaction was too late and overblown, further disrupting the economy. The contagion sweeping through European financial markets in 2011 and 2012 was unprecedented. It is noteworthy that Alexandre Lamfalussy, as a member of the Delors Committee, had already warned about these issues. He strongly questioned whether "it would be wise to rely principally on the free functioning of financial markets to iron out the differences in fiscal behavior between member countries: (a) the interest premium to be paid by a high-deficit member country would be unlikely to be very large ... and (b) to the extent that there was a premium, I doubt whether it would be large enough to reduce significantly the deficit country's propensity to borrow"[3]. Lamfalussy argued consequently for a "Centre for Economic Policy Coordination", an idea which, however, was not taken up in the Delors Report.

The sovereign debt crisis became a watershed in the process of European integration. European economic policy-makers responded with a range of measures, not just emergency assistance and fiscal consolidation programmes, but also substantial reforms in European economic governance.

In first instance, a substantial strengthening of fiscal sustainability was realised. The "Six Pack", "Two Pack" and the new "Fiscal Compact" were particularly important. A primary aim is to tighten fiscal discipline by reinforcing the Stability and Growth Pact. The Treaty on Stability, Coordination and Governance implies further a significant revision of the fiscal rules and new commitments by the euro area Member States in the fiscal policy sphere. Moreover, with the Macroeconomic Imbalances Procedure, there is now a system of *ex ante* surveillance of macroeconomic risks and competitiveness positions. The European Union also set up new financial stabilisation mechanisms to provide for financial solidarity, especially the European Stability Mechanism. However, further reforms, especially a functioning banking union and greater political integration are necessary. Of fundamental importance is also a resolute and ambitious programme of structural reforms, to enhance the competitiveness and growth potential of the euro area.

In line with its mandate, the Eurosystem kept watch over the anchoring of inflation expectations, in order to avoid both inflation and deflation. For that purpose, the central policy rate was cut several times and forward guidance was introduced. To safeguard the transmission mechanism of

[3] As quoted in James, 2012, 249.

monetary policy, which was threatened by the fragmentation of European financial markets and the risk of a break-up of the euro area, the Eurosystem set up major series of non-conventional measures. These comprised three-year refinancing operations and Outright Monetary Transactions. However, one has to bear in mind that monetary policy can only buy time. It is for governments to make fundamental reforms, both in terms of economic policy and in strengthening the governance framework of Europe's EMU.

The fragmentation of Europe's financial markets, especially the vicious nexus between banks and sovereigns, made clear that further progress in European financial integration, a real banking union, was needed. This was certainly no surprise for Alexandre Lamfalussy. As far back as the discussions on the Delors Report, he had argued in favour of giving the European Central Bank a role in the area of banking supervision[4]. In 2004, Alexandre Lamfalussy focused further on the organisation of prudential supervision in the European Union, which he described as a "mind-boggling patchwork". He stressed that central banks had a crucial role in the management of financial crises, especially in "preventing a potential crisis from turning into a real one"[5]. For him, the crucial issue was to give the ECB responsibility in the supervision of the large, systemically important, banks.

A genuine EMU should then not only include a fiscal union and an economic union, but also a banking and political union. The road map to get there was drawn up by the President of the European Council, Herman van Rompuy, in close collaboration with the Presidents of the European Commission, the Eurogroup and the European Central Bank, in the report "Towards a genuine Economic and Monetary Union".

A crucial task for Europe's policy-makers now is to create a genuine banking union, with two essential pillars, supervision and resolution. Setting up the Single Supervisory Mechanism is a significant step in the European integration process, probably the most important one since the introduction of the euro. The Eurosystem is working to have the Single Supervisory Mechanism fully up and running in November 2014. A major task, in cooperation with the European Banking Authority, is a comprehensive assessment of banks' balance sheets, the so-called Asset Quality Review. However, integrating supervision is not enough in itself. An appropriate resolution framework is essential to deal with banks that are failing or likely to fail. The agreement reached by the European Parliament and the Council on the Bank Recovery and Resolution Directive is an important step in this direction. We now need to have an agreement on an effective Single Resolution Mechanism and Single Resolution Fund. We should be mindful to avoid another, to use Alexandre Lamfalussy's terminology, "mind-boggling patchwork". The Single Resolution Mechanism needs lean decision-making, particularly in emergency situations.

So, toconclude,the experience of the 1990s clearly showed that a crisis can act as a catalyst for progress. To make progress now, like in the 1990s, three elements are crucial: firstly, structural

[4] ECB Archives.
[5] Lamfalussy, 2004, 7.

reforms to strengthen the competitiveness and growth potential of the European economy, while budgetary consolidation should become more growth-friendly; secondly, a robust framework of European economic governance, including a true banking union; and thirdly, a political union, expressing the strong commitment of Europe's political leaders to European integration.

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