Economic and Monetary Union: past and present

Speech by Mario Draghi, President of the ECB, at the Europa-Konferenz organised by Hertie School of Governance, Jacques Delors Institute and Bertelsmann Foundation, Berlin, 19 September 2018

It is vital today that we move the debate on European integration forward, and conferences such as this are key forums to do so. Fostering open and frank discussion about our common future is critical for knowledge to grow and for consensus to emerge.
It is precisely through vision, rigorous analysis and frank discussion that Jacques Delors was able to overcome the economic challenges of his time, and what he described as the "*fundamental differences of opinion*" and "*mental reservations*" [1]which characterised the political climate back then.

Today, we also face economic challenges and political disputes about the future of European integration. So it is useful to look back at the evolution of European integration in the 1980s and distil the lessons that can be learned from it.

The strategy that Delors, Kohl, Mitterand, Andreotti and other EU leaders developed relied on three elements: first, unlocking the potential of European integration by focusing it on common challenges where the EU could clearly help; second, recognising that integration in one area creates an interdependence with other areas; and third, equipping the EU with the tools and institutions to manage that interdependence and ensure stability and convergence.

These three elements should also guide us today in designing and implementing the necessary reforms to Economic and Monetary Union (EMU).

The single market agenda

The European economy in the mid-1980s was just emerging out of a turbulent decade of recession and weak economic growth.

Unemployment in the European Community had continually risen from 5.8% in 1980 to 11.2% in 1985. Europe's potential growth rate had dropped from about 5% per year in the 1970s, to around 2% per year in the following decade.

The international environment was also becoming less accommodating. America's defence, foreign and economic policy was fastly changing under the leadership of newly-elected President Reagan. Trade disputes had emerged

across the Atlantic and the share of American imports covered by trade restrictions moved from 8% in 1975 to 21% by 1984.
Trust in forging a deeper European project was low. In the early 1980s, just one out of four people expressed an interest in European affairs and only around half of Europeans saw their country's membership of the EU as "a good thing".[2] The integration process was at a standstill and "*Europe seemed to lack faith in itself*", asDelors argued at the time.[3]

European leaders of the day understood, however, that low growth was in fact a common challenge, and the EU had a powerful tool at its disposal to address it: the common market. They also perceived that any further opening of trade should be accompanied by measures that would ensure its fairness.
Intra-EU trade growth had stalled since the early 1970s, in large part because the common market covered mainly intermediate goods where growth potential was already saturated.[4] Converting the common market into a *single* market, however, could open up trade in sectors with high R&D and skill-content and reinvigorate productivity spillovers.

Establishing a single market meant removing both tariff and non-tariff barriers, such as differences in licensing rules and technical standards, which restricted trade and capital flows across countries. And it meant setting common rules to be enforced by a single competition authority, so that all parties in the market were treated fairly.

But for the single market to be sustainable over time, opening markets and enforcing rules was not enough. Interdependence with other policy areas had to be taken into account, and the EU had to be equipped with the necessary tools and institutions to ensure stability and convergence.

First, for safeguarding the integrity of the single market, neither fixed nor flexible exchange rates were seen as a sustainable option in the long term.

Under flexible exchange rates, countries losing market share could engage in competitive devaluations, which would encourage retaliatory actions from others and would undermine trust among Member States. And fixed exchange rate regimes were proven to be vulnerable, as demonstrated by the ERM crisis that transpired a few years later.

So economic and financial integration needed to be accompanied by a commensurate step forward in monetary integration – one market with one money – which culminated in the decision to create the euro and the Eurosystem.

Second, it was well understood that opening markets could sometimes penalise local producers, as well as creating conglomeration effects where industries migrate to the most competitive regions. That could lead to an unequal distribution of the benefits of integration, which needed to be offset by instruments to ensure fairness and convergence.

An integral part of the Single Market was therefore the establishment of mechanisms at the European level to cater for these needs.

Stronger competition enforcement was matched by stronger protections for local producers, such as extending geographical indication protections for specific foods. And there was both an increase in the size of the EU budget and a major rebalancing of expenditure away from agriculture and towards convergence and cohesion.
Specifically, targeted funds were provided to promote adjustment in regions that were less developed or suffering from the effects of trade liberalisation.[5] By 1992, the budgetary allocation for structural funds rose from 17% of EU expenditure to more than 25%.

Taken as a whole, this was a far-reaching and visionary strategy, and one that took tremendous political courage to bring about. And by and large, it worked. By 1988, two years after the Single European Act was launched, growth in intra-EU trade had already regained its level of the early 1970s, and by 1990 the EU's potential GDP growth rate had risen by a percentage point to 3% per year. Thanks to economic integration, estimates suggest that after ten years of EU membership, a country's per capita income is on average 10% higher than if it had stayed outside the union.[6]
As a result, the single market has become increasingly popular: free movement of goods, people and services is routinely seen by the public as one of the most positive results of the EU, next to peace among Member States. This remains the case today.[7]

The lesson is clear: when Europe focuses on common challenges, when it recognises interdependence, and when it responds with appropriate institutions, it does succeed – and when integration is not accompanied by fairness, it does not.
The areas where EMU has underperformed most in recent decades are those that were left unfinished in the 1980s and 90s, such as the frameworks for fiscal policies and for banking supervision. Delors was deeply concerned that the institutions for fiscal policy coordination were too weak for a monetary union.[8] Others saw early on that a single currency would need a system of common banking supervision.[9]
We know that these holes in the framework ultimately contributed to the build-up of imbalances and played a role in the euro area crisis. But it was not the single market and the single currency that produced this situation. It was the failure to follow through in *all* areas with the formula that had worked in those areas.

The role of Europe today

The challenges we face in Europe today are in many ways similar to those of Delors' era. We are also exiting a deep recession that has left lasting scars on the economy and society. The international environment is characterised by rising uncertainty. And some are questioning whether European integration remains the answer to our common problems.

Potential growth has been slowing with respect to other advanced economies and is projected to remain weak for some time.[10]

Just as in the 1980s, many of our challenges have this weak growth performance at their root. Low growth exacerbates pressures on public finances; it aggravates joblessness especially among the young and unskilled; it heightens distributional questions about open markets; and it creates a false perception among the public that protectionism is a solution.

So can Europe again provide the keys to change our growth trajectory? The answer is yes – but only if we transfer in full the strategy that worked in the past. That is, a clear focus on the areas where Europe can add value, and a rigorous attention to consistency across policies.

The most important area where Europe can contribute positively to growth remains the single market.

Most euro area countries have ageing societies, which means that raising living standards will increasingly depend on higher productivity growth. Productivity growth, however, has been stalling in the euro area for some time. The single market represents one of the most powerful tools we have to unlock the mechanisms that will raise productivity.

Productivity growth takes place through two channels, innovation and diffusion of new technologies. We have innovative firms in Europe and they compare well with their international peers. But innovations do not diffuse quickly enough to other firms, which weighs on productivity in the wider economy. The top 10% of firms are on average three times more productive than the firms in the bottom 10%.[11] And the sector where the gap is the widest is services.

In this context, advancing the single market agenda can help in two ways. First, research shows that openness to trade is a key factor in enabling faster technology diffusion.[12] Completing the single market in services can therefore boost productivity by raising trade in services, which should be higher in a fully integrated market. Services make up over 70% of EU GDP, but only 20% of services are traded across borders, representing just 5% of EU GDP.[13]
The second element is building a true single market in capital. Deep financial markets play a critical role in facilitating diffusion, by providing the risk capital for firms to commercialise new technologies.[14] But the opportunities of our large financial market are not being exploited.
In the euro area, only around 30% of debt securities and 20% of equities are held by investors in other countries, and only around 10% of the assets of the banking sector are held by branches and subsidiaries of cross-border banks.[15] Completing banking union and capital markets union are the critical measures to improve this.
Taken together, the gains from this agenda would be sizeable. According to one estimate, removing all barriers to trade could raise the EU’s income by up to 14% over ten years and double intra-EU trade.[16]

This underscores why, especially for countries struggling with low productivity[17], reversing the direction of European integration would not be a profitable path. Moreover, in an international environment where trade openness can no longer be taken for granted, a broad and deep internal market may become even more important to shield us from external shocks.

Completing the single market would also provide a further benefit.

Integrated markets, and especially financial markets, help share risks within and across countries. Such private risk-sharing plays a vital role in adjustment in well-functioning monetary unions, because individual regions cannot adjust to shocks through exchange rate devaluation. This takes place through two main channels.

The first is integrated capital markets. Typically, a recession causes both consumption and asset prices in a region to fall, which then reinforces the downturn. But when people can diversify their asset holdings across different regions, they can smooth their consumption by drawing on the assets they hold in better performing parts of the union.

The second channel is an integrated banking sector. Because local banks are typically heavily exposed to the local economy, a downturn will lead to large losses and prompt them to cut lending to all sectors. But if there are cross-border banks that operate in the region, they can offset losses there with gains in other regions, and can continue providing credit.
In the US, it is estimated that around 70% of local shocks are absorbed through integrated financial markets. In the euro area, however, only 25% of shocks are absorbed in this way because financial integration is low.[18] As I have explained elsewhere[19], this is one reason why our crisis was so protracted and why some countries diverged economically.

Risk-sharing, in other words, fosters both stability and convergence within monetary unions. And without that, it becomes much harder to make high rates of growth sustainable.

So, to boost growth and increase private risk-sharing, our priority should be as follows: to re-establish a clear focus on finishing the single market in all its dimensions; and consistent with the strategy that Delors laid out, to buttress this with appropriate tools and institutions.

Today, this buttressing applies most of all to closing the gaps that remain in the institutional architecture of EMU. There are two key areas where actions are necessary.

Buttressing the Monetary Union

First, we need to address the obstacles that are still standing in the way of deeper financial integration.

We have already taken important strides in this direction with the creation of European banking supervision, a harmonised rulebook and the Single Resolution Mechanism. There has also been considerable risk reduction in the banking sector, with bank capital rising, leverage falling and non-performing loans being progressively reduced.

But there is still work to do. This includes finishing the clean up of bank balance sheets, as legacy assets act as a deterrent to cross-border takeovers, and especially removing the remaining supervisory and regulatory barriers that hamper cross-border activity.
For example, despite the banking union, regulation still limits the free flow of capital and liquidity within cross-border banks. This in turn reduces the efficiency gains for banks of operating on a European scale, and keeps retail banking integration low.[20]

Yet levelling the playing field alone is not sufficient for deep financial integration – and this is the second point. Today's debate is often cast in terms of dichotomies: private risk-sharing versus public risk-sharing, and risk sharing versus risk reduction. But I believe that, to a great extent, these different goals are complements, not substitutes.

Take the example of restrictions on the free flow of liquidity and capital. These barriers exist in part because there is an incomplete framework for bank resolution in the euro area with no public backstop. If there is a residual risk that the costs of bank resolution will end up on one single government's balance sheet, those national authorities will have the incentive to limit capital and liquidity flows, so as to protect their depositors in the event of a bank failing.

With common public risk-sharing through a backstop for the resolution fund, the incentives at the national level to limit capital and liquidity flows would disappear. That would in turn lead to greater banking integration and private risk-sharing at the euro area level.

Risk-sharing, however, would not be a way to avoid risk reduction. When markets have confidence that banks can be resolved efficiently, it stabilises the system and reduces the costs of crises. In other words, risk sharing actually reduces risks.

A good example of this is the Federal Deposit Insurance Corporation in the US, which is also the resolution authority, and is backstopped by a credit line with the US Treasury. During the crisis, it resolved around 500 banks without triggering financial instability. This was possible because of confidence that the resolution framework was effective and that was backed by the resources it needed to do the job.

The same interaction also applies to fiscal policies.

We saw during the crisis how lack of fiscal space, needed to stabilise the economy, can create a vicious circle of low growth, rising bond spreads and loan-losses in the banking sector. That can in turn produce financial fragmentation.

For as long this risk exists, it is obvious that it will deter deep financial integration. And it also means that private risk-sharing tends to collapse at precisely the moment it is most needed.

To address this, the first priority is to make national fiscal policies more effective by encouraging governments to build up buffers. For that, we need to rekindle faith in our fiscal rules by making them both more countercyclical and more binding.

But we know that even sound domestic policies are not always enough. Markets can at times overreact and penalise sovereigns, over and above what may be needed to restore a sustainable fiscal path. And this overshooting can harm growth and ultimately worsen fiscal sustainability. This is why there is also a role for public risk-sharing, although the more we complete banking union and capital markets union, the smaller this needs to be.

The European Stability Mechanism cannot fully fill the gap, as it typically leads to procyclical fiscal tightening. So, we need an additional fiscal instrument to provide stabilisation. There ought to be an instrument that complements monetary policy in delivering macroeconomic stability both at the euro area level and, crucially, in each of its Member States.
As I have discussed elsewhere[21], what shape this fiscal instrument should take is still open for discussion. But any proposal should fulfil the following two conditions.
First, it should be adequate, so that it can restore full fiscal stabilisation capacity.[*]And second, it should be properly designed so as to contain moral hazard. With these conditions in place, such an instrument should be seen as a way of reducing risks rather than increasing them.

Conclusion

Let me conclude.

This is a difficult time. And difficult times provide lessons.

Rather than criticising our opponents’ views, or offering simple solutions to complex questions that are invariably wrong, let’s try to understand what these lessons are. The example of the founding fathers of our monetary union offers invaluable help in this endeavour.

We should not be discouraged that there is still work to do to complete our Union. No union is built perfectly from day one. It is an evolutionary process that is well described by the commitment to build “a more perfect union” enshrined in the US constitution.

History suggests that this evolution tends to follow people's priorities.

In the 1980s, the overriding goal was to shake off the "Eurosclerosis" that stalked Europe at the time and growth became the top priority.

Today's priorities include personal and economic security; addressing youth unemployment; and strengthening social models so as to care better for the sick, old and unemployed.

How could these objectives be achieved? Today, like thirty years ago, the answer lies in the restoration of growth and in the respect of our common European values.

*This text has been updated to reflect its delivery.

[1]Debates of the European Parliament No 2-231, 14 January 1985.

[2]European Commission, "Together since 1957. 35 years of Eurobarometer: European integration as seen by public opinion in the Member States of the European Union", 2009.

[3]Fitoussi, J.P. and Phelps, E.S., "Causes of the 1980s Slump in Europe", Brookings Papers on Economic Activity Vol. 1986, No 2, pp. 487-520.

[4]Study Group appointed by the Commission and presided by Padoa Schioppa, T., "Efficiency, stability, and equity: a strategy for the evolution of the economic system of the European community: a report", 1987.

[5]European Commission, "European Union Public Finance", Fourth edition, European Communities, 2008.

[6]Campos, N., Coricelli, F. and Moretti, L., "Institutional Integration and Economic Growth in Europe", Journal of Monetary Economics, 2018.

[7]European Commission, "Spring 2018 - Standard Eurobarometer" (EB 89), June 2018.

[8]Committee for the Study of Economic and Monetary Union presided over by Delors, Jacques, "Report on economic and monetary union in the European Community". Presented April 17, 1989.

[9]See James, H., "Making the European monetary union", Harvard University Press, 2012.

[10]For the euro area, growth in potential GDP is projected to remain around 1.4% per year over the next decade and reach only 1.6% thereafter. For the US, it is projected to be roughly 1.8% over the next ten years and reach close to 2% thereafter. See OECD, "The Long View: Scenarios for the World Economy to 2060", OECD Economic Policy Papers, June 2018.

[11]See Draghi, M., "Moving to the Frontier: Promoting the Diffusion of Innovation", Welcome address at the joint conference by the ECB and the MIT Lab for Innovation Science and Policy, 13 March 2017.

[12]Saia, A., Andrews, D. and Albrizio, "Productivity Spillovers from the Global Frontier and Public Policy: Industry-Level Evidence", OECD Economics Department Working Papers, No 128, 2015.

[13]European Parliament, "Understanding the Single Market for services", Briefing, September 2016.

[14]Comin, D., Nanda, R., "Financial Development and Technology Diffusion", Harvard Business School, Working Paper 15-036, 31 October 2014.

[15]ECB, Financial Integration in Europe, May 2018.

[16]Centre d'Etudes Prospectives et d'Informations Internationales (CEPII), "What Benefits from Completing the Single Market?", La Lettre Du CEPII, No 316 - 15 December 2011.

[17]Cumulative labour productivity growth since 2000 amounts to 18% in Germany, 15% in Spain, 14% in France, 14% in the Netherlands, and 1% in Italy. For the US the figure is 26% over the same period.

[18]European Commission estimates. See Nikolov, P., "Cross-border risk sharing after asymmetric shocks: evidence from the euro area and the United States", Quarterly Report on the Euro Area, Vol. 15, No 2, 2016.

[19]See Draghi, M., "Risk-reducing and risk-sharing in our Monetary Union", speech at the European University Institute, Florence, 11 May 2018.

[20]See Draghi, M., "The Benefits of European Supervision", speech at the ACPR Conference on Financial Supervision, Paris, 18 September 2018.

[21]See Draghi, M., "Risk-reducing and risk-sharing in our Monetary Union", speech at the European University Institute, Florence, 11 May 2018.