Which assessment for the Economic and Monetary Union?

Seminar in honor of Tommasso PADOA-SCHIOPPA

1. The Greek word Europe is composed of the words wide and view. Thus, one can say that Tommasso Padoa-Schioppa was literally a true European. He was extremely visionary and farsighted. At an early stage he identified the "impossible quartet" of the European Monetary System and the need to resolve it by introducing a single currency. Few years later he remarked that the single currency is something that needs to be realized while reality evolves. More than ever Europe needs farsighted economists. Thus Tommasso's death leaves a huge gap that cannot be closed for the time being.

2. The organizers of this seminar asked me to give a review of the performance of the economic and monetary union. Although I will try to be as objective as possible, I cannot avoid to be somewhat biased, because late in the 1990s I was one of the few German economists who was actively supporting the introduction of the Euro. In fact, in 1997 I organized a manifesto in favor of the Euro with the support of more than fifty notable German economists.

3. Looking back to the debates of the 1990s one cannot avoid to ask whether the euro-skepticism from Germany but also from Anglo-Saxon countries was right by arguing:
   - the time for a monetary union was not ripe,
   - Europe was not an optimum currency area, and
   - The institutional design of the Maastricht Treaty was insufficient to guarantee stability of the Euro.

4. Analyzing the last 12 years of EMU one might receive a picture that reminds to some of the works of the Dutch artist Maurits Escher. Depending on the direction one looks at them, one can see completely different objects. From one perspective one can see angles, from another one sees devils.

5. One perspective is to regard the euro area as an entity. Then the monetary union has been successful. Especially to the main goal of the ECB, price stability. In 1992 the German euro critics were convinced that a common central bank would never be able to establish price stability. In contrast with an average inflation rate of below 2 % the ECB has been even more successful than the Bundesbank. During the lifetime of the D-Mark the German central bank was only able to achieve an average inflation rate of 2.7 %. While today many observers feel real uncomfortable with an inflation rate of 2.6 % in the euro area, it only demonstrates the ECB's ability to raise the benchmark for price stability.

6. There is also a second field where the euro area, seen as a whole, has been relatively successful. Astonishingly, at least to some of my fellow countrymen that is the area of public finance. According to the IMF, the public sector deficit of the euro area will be 4.6 % of GDP in 2011. Of course, this exceeds the 3 % limit of the Maastricht Treaty, but still goes below much of the values of other major currency areas in the world. It is less than half of the 10.8 % which are expected for the United States and the 9.1 % that were projected in January for Japan. If one looks at the debt level, the euro area's debt to GDP ratio will be 87 % in 2011, and by that 10 percentage points lower than the US ratio and far away from the 227 % that were expected for Japan. Therefore, it is simply not true what many observers argue in Germany that a monetary union will necessarily become a "debt union". The tremendous increase in public sector debt levels and deficits all over the globe reflect the fact that in the last few years the world economy has been hit by a perfect storm of financial and economic crises. In order to stabilize the financial system and to compensate its repercussions on the real economy governments in all countries had no alternative but to increase deficits and debt levels.

7. But in the same way as on can switch the angle to look at an Escher print, one can assess the euro area much more skeptically by seeing it from the perspective of its member countries. . There is no doubt that after a relatively stable period until the end of 2009, four members are now in a very critical situation. And at the same time at least in Germany the population is becoming more and more opposed towards the Euro.

8. So what went wrong? There is no doubt that the framework of the Stability and Growth Pact has not been sufficiently stringent. Greece which was able to avoid sanctions of the pact although even though its deficit had always been higher than the 3 % limit of the Maastricht Treaty for a whole decade. But this is only one part of the story and in my opinion it is not the most relevant one.

   On a quantity basis, Ireland and Spain are the greatest threats for the stability of the euro area, who account for 76 % of the bank exposures to the four problem countries, even though they had a very positive fiscal performance in 2007. In other words, even with the most stringent regime for fiscal policy it would have been impossible to avoid the financial and fiscal disaster of these two countries. This implies that one main flaw of EMU's design is the lack of an integrated banking supervision. With the introduction of a common currency banks were able to expand the scope of their operations beyond their national borders without incurring a currency risk. In fact, this made it possible to transfer savings from surplus countries, especially in Germany, to finance real estate booms in peripheral countries. But while borders for financial markets were removed, banking supervision firmly remained under national competencies with an obviously much too narrow focus. In retrospect one can see that for a functioning monetary union the principle of independence from national influences is not only important for monetary policy but also for banking supervision. Astonishingly, this lesson has not been learned by European policy makers so far. In the last few months they have devoted a lot of effort to improve the functioning of the Stability and Growth Pact, to avoid excessive imbalances and to make their economies more competitive. But there is no willingness to transfer substantial national competences to an integrated euro area banking supervision.

9. Let me say some words about Germany's role in the monetary union. If one listens to German policy-makers one might get the impression that our country's performance has been absolutely flawless. Thus, it would be optimal for the Euro area if all countries would become similar to Germany. I doubt whether this is true. In the last decade Germany's domestic demand has been almost stagnant in real terms, while our exports have increased by more than 70 %. Is this something which should become a universal law for the euro area? It is somewhat surprising that in the mother country of the categorical imperative politicians are unable to realize that the success of the German model was only possible because other countries were behaving exactly in the opposite way. The German wage moderation could only be successful as an isolated strategy. Had it been followed by all member countries the euro area would have ended up in a deflationary process. Thus it is very useful that the Euro Plus Pact envisages a monitoring of unit labor costs. For a more balanced development of the euro area it is essential that it is applied in a fully symmetric way, so that it can also identify countries where nominal wage increases are *below* productivity growth and a compensation for inflation.

10. There is no doubt that in the last few months member countries have made great efforts to protect the euro and to make the monetary union more stable in the future. However, all these initiatives have not been able to stabilize the situation. The risk premia for Greece, Ireland and Portugal are currently at historically high levels, only for Spain the situation has somewhat improved. Target 2 balances of more than 400 billion euro show that banks above all in Ireland, but also in Greece, Portugal and Spain are unable to refinance themselves without a significant support by the ECB.

    The fears of the financial markets are not unfounded. While the heads of state have now designed a comprehensive crisis mechanism for the time after June 2013, there are no strong safeguards to cope with major shocks in the meantime. And given the dire medium-term perspectives for Greece and Ireland even under the assumption of a successful outcome of their adjustment programs, there is a not negligible risk that a majority of the population might come to the conclusion that their country will be better off by leaving the Euro Area.

11. Tommasso Padoa Schioppa is rightly regarded as one of the fathers of the euro. While working with him last year, I could see his anxiety about the growing instability that could jeopardize the very existence of EMU. Therefore in a joint op-ed with Tommasso,

Henrik Enderlein and Andre Sapir which was published in September 2010 we warned that a “wait-and-see” approach for the EMU would be a dangerous course.
This is as valid today as our recommendations are

- an orderly procedure for sovereign debt restructuring is needed and
- The EFSF should use its low refinancing rates for reducing the interest rate burden of the highly indebted euro countries.

In other words, a grand solution is needed which tackles simultaneously the problems of sovereign debtors and the national banking systems and which prevents dangerous contagion effects. This is not an easy task, but the catastrophic events in Japan showed that it is better to cope with risks now then to hope that the great disaster will not happen.