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Stability and Growth in the Euro Area – Who Plays the Leading Role?

Sabine Lautenschläger

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Abstract

The IEP Lunch Debate on the topic „Stability and growth in the Eurozone – who plays the main role?“ was conducted with Sabine Lautenschläger, Member of Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the ECB, at the Representation of the European Commission in Berlin on 30 June 2017. Richard Kühnel, Head of the European Commission Representation in Germany, gave a welcoming speech. The event was moderated by Prof. Dr. Mathias Jopp, Director of the Institut für Europäische Politik (IEP). In her speech, Sabine Lautenschläger traced the history of the Eurozone, and went into the role that the European Central Bank (ECB) has played since the financial and sovereign debt crisis.

About the author

Sabine Lautenschläger is a German jurist and central banker. She currently serves as a member of the Executive Board of the European Central Bank, holds the Vice-Chair of the Supervisory Board of the ECB and was formerly vice-president of the Deutsche Bundesbank.

About the series

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Stability and growth in the euro area – who plays the leading role?

Sabine Lautenschläger

Most of us probably go to the theatre from time to time. And we are all aware that theatre is more than just entertainment; often it deals with the fundamental questions of life, with major conflicts and their resolution. Theatre holds a mirror up to life. In classical drama, this always follows the same structure. The story evolves over the course of four acts and is then resolved in the fifth act.

And when we look at the story of the euro area, we see this very same structure – it is just the fifth act that remains to be written. But let us begin by taking a look at the first four acts.

The first act of a drama is the exposition. The audience is introduced to the characters and the circumstances in which they live. In the case of the euro area, this act is quite long – it lasted from 1999 to 2008.

In the second act, the tension rises. In the autumn of 2008, the global financial crisis hits the euro area; barely one and a half years later, Greece gets into difficulties – the beginning of the sovereign debt crisis. The pace of the story picks up as it heads towards its climax.

The climax comes in the third act. We are in the year 2012, and it is no longer just about the banking system. The sovereign debt crisis has spread to several euro area countries, and even some of the larger ones are under pressure. Some market participants and politicians are no longer ruling out the possibility that the euro area might break up.

In the fourth act, the pace of the action begins to slow. The crisis has passed and the economy begins to recover. But in this act there is always a final moment of suspense. The action falters and tension rises again – think of the elections in France.bond

And what now? What is going to happen in the fifth act? How will the story of the euro area continue? Let us spend some time thinking about that question.

1. Who plays the leading role – the ECB or policymakers?

The first thing we need to have, of course, is a main character. Everyone would probably agree that the ECB is currently playing the leading role. However, there would no doubt be differences of opinion regarding the nature of that role.

> *“The ECB is allowed to play one role only, and that role is clearly defined. The ECB has to safeguard price stability.”*

Some would say that the ECB is a villain who picks savers' pockets, who redistributes risk and wealth. Others would say that the ECB is a reluctant hero: when others fail, it reluctantly steps in and saves the world – or at least the euro area.

In my view, the ECB plays neither of these two roles. In fact, the ECB is allowed to play one role only, and that role is clearly defined. The ECB has to safeguard price stability. To be more precise: in the medium term, inflation should be below, but close to, 2%.

I admit that it has been a challenge to live up to that role in recent years. The weak economy and low inflation have obliged the ECB to pursue a very loose monetary policy. This includes the use of some unconventional instruments – bond purchases, for instance.

Even though I am critical of some of these instruments, an expansionary monetary policy stance was generally appropriate in order to fulfil our role.

Nonetheless, I consider it imperative that monetary policy should return to normal as soon as can be justified. This is because unusually loose monetary policy does not just have the intended effect, it always has undesired side-effects too. Among other things, it increases the risk of asset price bubbles. And with time, these undesired risks become larger, while the desired effects wear off.

Against this backdrop, monetary policy has to adjust at the right time, which is as soon as inflation is on a stable path towards our objective. We therefore look at how inflation is evolving over the medium term, not at temporary blips in one direction or the other.

Even if no stable trend is visible as yet, it is important to prepare for different times, for there is reason to be optimistic.

The euro area economy is recovering. For the past four years, it has been growing slowly but steadily. And the recovery has become more broad-based, while risks to growth are now balanced. Funding is becoming easier and easier for companies, more loans are being granted and more investments are being made. The mood among businesses and consumers is correspondingly good – relevant indicators are at their highest levels since the crisis started in 2008.

Thus, although inflation is not yet on a stable path towards our objective, all the conditions are in place. It is just a question of time and patience. That is why monetary policy should already be making preparations for a return to a normal stance. And it should adapt its communication accordingly.

To sum up, the role of the ECB is to safeguard price stability. That is important, but it is not enough for a leading role. That part is for others to play.

And those others are to be found in the field of politics. I am referring to the national parliaments and governments in the euro area and to the European Union's institutions – the Commission, the Council and the European Parliament. They are the main characters, particularly in the fifth act. Only they can take the story of the euro area forward in a way that is beneficial for all.

It is only they who can bring about the much-needed reforms, and it is only they who have the democratic mandate to do so. For that reason alone, it is politicians who have to play the leading role. And it is you, the voters in the euro area, who stand behind them. You elect the people who will decide how this story continues.

2. The fifth act – how will the story continue?

Regarding elections, for some time we have had to watch as the mood of voters going to the ballot box has become increasingly critical towards Europe. But, looking at the recent elections in France, it seems that this has now changed – and rightly so.

After all, a united Europe and a single currency have more to offer than some people may believe. And here, I am not only thinking of the economic benefits, but also of the political benefits.

In particular, I am thinking of global politics. The global stage is dominated by large countries, such as the United States, China and Russia. If we Europeans want to continue playing a role on that stage, and if we want to be heard, then we have to speak as one. From climate change to security policy, we have to speak with one voice – ideally with the voice of reason.

From this perspective, a united Europe does not look like an unnecessary luxury; instead, it looks like a fundamental necessity in order to ensure that the people of Europe have the ability to act.

> *"It is no coincidence that the motto of the EU is "united in diversity."*

And then there's the economic side of a united Europe. The single market gives companies access to around 500 million consumers. This allows them to reap economies of scale and to lower costs. At the same time, greater competition ensures lower prices, which in turn benefits consumers. That is the basic idea of the single European market.

The euro takes this idea one step further: a single currency for a single market. Companies can do business across the entire euro area without having to worry about exchange rate risk. And I am sure that each of us appreciates being able to travel through Europe without having to change money.

And it's not just about travelling. In a united Europe, anyone can live where he or she wants.

As you may already sense, if I were able to write the fifth act of the euro area's story, it would be very European. The citizens of Europe would seize the opportunity provided by the crisis and the new global situation. They would reflect on their similarities and move closer together.

True, that is easier said than done. After all, Europe is very diverse: different languages, different cultures, different perspectives. But should that keep us from coming closer together and becoming a bit more European?

Diversity enriches life – bringing together different perspectives and experiences broadens our horizons. It also helps us to solve problems – both our own problems and those we share with others. It is no coincidence that the motto of the EU is "united in diversity".

When we look at the economy, however, diversity becomes more tricky, particularly in a monetary union. And the countries of the euro area are indeed very diverse. They are diverse in terms of the specialisation and orientation of their economies – and this is certainly an advantage. But they are also diverse in the sense that their economies differ in terms of efficiency and resilience.

That can cause problems. The crisis is a case in point: while some countries weathered it relatively well, others were hit quite hard. And if one member of a monetary union gets into trouble, it affects all the others as well. In that regard, we are all in the same boat. The question is how to deal with it?

Naturally, the first step is to try to prevent crises from happening in the first place. Euro area countries have to become more efficient, and they have to become more resilient. Even then, no one can rule out the possibility that a country might be hit by a crisis.

And that leads us to the question of how we deal with this risk, of who should bear what risks. In essence, there are two options. First, such risks could be shared via the public sector. That is what happened during the crisis: European taxpayers stepped in to help those countries that had been hit the hardest. Second, such risks could be shared via the market – this would certainly be the better option for taxpayers.

Let us take a closer look at all these things.

3. The architecture of the euro area – the ingredients for a successful fifth act

The first step is clear: the countries of the euro area have to become more resilient.

But there's a twist: members of a monetary union lack a crucial tool with which to offset economic shocks. They lack an exchange rate of their own. While countries outside a monetary union can devalue or revalue their currency to rebalance their economy, those inside a monetary union need to make adjustments through other channels.

However, many countries first have to open up those channels. They have to make their economies sustainable and more competitive with the aid of structural reforms. Take labour markets, for example. In many countries, labour markets are rigid Flexible labour markets could help to mitigate shocks. They ensure that crises do not lead to persistently high unemployment.

At the same time, flexible labour markets help the economy to grow. They facilitate the change that is needed to reap the benefits of a united Europe and a globalised world.

But if the benefits of flexible labour markets are truly to reach the people, there is something else that we need. We need a good system of education and training – one that starts in kindergarten and accompanies people for the rest of their lives. The better this system is, the more flexible labour markets can be.

"All in all, banks in the euro area now hold much more capital and liquidity than they did prior to the crisis – they have become much more stable."

As well as labour markets, the banking system also plays an important role. Only sound banks can cope when loans go bad in a downturn. And in a downturn, only sound banks can provide funds to promising companies and thus prepare for the next upturn.

And here, a lot has been done since the crisis – even though some banks still need to do more homework. All in all, banks in the euro area now hold much more capital and liquidity than they did prior to the crisis – they have become much more stable. At the same time, European banking supervision ensures that banks across the euro area are supervised according to the same high standards.

But of course all this cannot stop banks from failing. And nor is it supposed to. In a well-functioning market, companies with a business model that no longer works must exit the market – this is just as true for banks as it is for other companies. And banks can fail, as we have seen in recent weeks. So we have at least come one step closer to a true market.

Alongside labour markets and the banking system, public finances also have an important role to play. They too can help to mitigate economic shocks. One example is automatic stabilisers. In a downturn, the tax burden goes down – thanks to progression. At the same time, social spending goes up. The former relieves the burden on the people, the latter supports them. Together, these effects help the economy. They help the economy just as growth-enhancing measures by the government do.

All this requires sound public finances. That's why we always call upon the euro area countries to consolidate their public finances. And that's why we always emphasise how important the rules of the Stability and Growth Pact are. Their purpose is to keep countries from taking on too much debt. Since the crisis, these rules have been strengthened – now it is important to apply them.

To sum up, countries with flexible labour and product markets, stable banks and sound public finances are in a good position; they are resilient, and they are efficient.

But, as I have already said, even such countries can get into difficulties. Not all risks can be eliminated, and not all shocks can be fully absorbed. And when 19 countries share one currency, all are affected if one gets into difficulties.

And this brings us to the question of how we should deal with those risks. As I have already mentioned, one option is to share risks via the public sector – using taxpayers' money. This was done during the crisis, and led to heated debates on the architecture of the euro area.

While we're on the subject of the architecture of the euro area, there is indeed scope for improvement here. For example, a European finance minister with strong powers could help to bring about national fiscal policies that are also in the interest of all European citizens. Such a finance minister should then not just have a coordinating role. He or she should be able to take action if Member States deviate from the agreed path. The minister could thus serve as an anchor for deeper economic union.

But irrespective of the things that could be improved in the public sector, we should not forget the private sector when it comes to the question of how we deal with risks.

Risks can also be shared via the private sector, through the market. Then, if a country got into difficulties, it would not be European taxpayers who would bear the risks; it would be those who invested in the country – whether they invested in the state itself or in private companies.

To make this work, investors would have to be able to absorb the potential losses. And here, there are still a few things we need to do. Take banks and public finances, for example.

Governments often rely on domestic banks for funding. If the government cannot service its debt, many credit institutions may also end up in crisis. The market is thus not in a position to bear the losses without getting into difficulties. During the crisis, this led to a situation in which taxpayers had to step in.

To resolve this problem, we have to take a look at the rulebook for banks. Currently, government bonds are treated as risk-free. Thus, banks do not have to hold capital against them. This might tempt banks to hold too many of their own government's bonds – given the associated risks.

But we all know now that government bonds are not risk-free. So it is high time that the rules were adjusted. We have to ensure that government bond holdings are backed up with capital. The higher the risk and the more bonds of an individual government a bank buys, the more capital it would need to hold against them. Banks would then hold fewer government bonds in total and fewer bonds of any individual government, and they would have bigger buffers to absorb losses.

If a country were to get into difficulties, the market would then be able to bear the losses without putting the burden on taxpayers.

At the same time, banks would develop an interest in sound public finances. Public finances that were not sound would be punished by the market – it would demand higher interest rates, for example. This would then force governments to keep their finances in order.

And we can pursue the logic of this further. A capital markets union would offer the possibility to share risks – and to do so across borders. In a truly European capital market, risks could be borne by many shoulders. In this context, I am not only thinking of governments, banks and bonds. I am also thinking of private companies, savers and shares. A truly European capital market would make the monetary union more stable.

But the main aim of the capital markets union is of course a different one. First and foremost, the capital markets union would help the economy to grow. Companies would no longer be restricted to domestic banks for funding. They could access sources of equity and loans throughout Europe. At the same time, savers would have more options to invest their money. All in all, it would be possible to fund the economy more efficiently and allow it to grow faster.

For all these reasons, a European capital markets union is currently being built. This is not something that can be done in a day. Capital markets are complex and diverse. Exchanges, central counterparties, tax law, insolvency law – these and much more play a role. Creating a European capital market thus requires many different measures to be taken. And, more than anything, it requires time. Still, that is no reason not to do it. The capital markets union has been an important project from the beginning, and, since Brexit, it has become even more important.

4. Conclusion

The first four acts of the euro area's story have been written. Now it's all about the fifth act. It's about putting the crisis behind us for good, resolving the conflicts and arriving at a happy ending.

This paper discusses how we can deal with risks in the euro area, but it's not just about risks and stability, of course. It's also about opportunities; it's about growth and prosperity. Here too, Europe offers the best possible conditions.

And more and more citizens are beginning to realise that. According to a recent poll, support for the European Union is on the rise.[1] That is a good sign but no reason to relax, because another poll shows that there are still differences.[2] According to that poll, the average citizen does not feel that he or she benefits from Europe. Our goal should therefore be to ensure stability and prosperity for all citizens of the euro area.

We have to achieve that goal. It may not be easy, but it is possible, and it will be worthwhile. I listed a few of the things we can do to get closer to our goal. The important thing now is to make a start and to begin writing the fifth act of the euro area's story.

As the German playwright Friedrich Hebbel said, "Drama should not present new stories, but new situations".

Editorial Team

Publisher: Prof. Dr. Mathias Jopp, Director, IEP

Editor:
Dr. Katrin Böttger, Deputy Director, IEP
Carolin Marx, Research Advisor, IEP
Layout: Dagmar Kolatschny, Fabian Weber

Institut für Europäische Politik e.V.
Bundesallee 23
10717 Berlin

info@iep-berlin.de
www.iep-berlin.de

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