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Peter Praet: EMU - how much federalism?

Keynote address by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 5th Frankfurt Conference on Financial Market Policy, organised by the SAFE Policy Center of Goethe University, Frankfurt am Main, 27 October 2017

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Ladies and gentlemen,

I would like to thank the organisers Jan-Peter Krahnen and Hans-Helmut Kotz for inviting me to speak at the fifth edition of the Frankfurt Conference on Financial Market Policy.

The theme of the conference is well-chosen. Despite significant improvements to its architecture over recent years, there is a clear sense that Economic and Monetary Union, or EMU, remains incomplete. There is much less clarity and precious little agreement on what a complete EMU would look like, however. This is why the question posed by the organisers – "how much federalism" – is so relevant.

In my remarks, I would like to first review how federalism has evolved in the EU, highlighting that it is as much a process as it is an end-state. I will then – drawing on the economic concept of fiscal federalism – look more at the question of "how much federalism", focusing on issue of risk- sharing and the role of different levels of governance within EMU.

Federalism in the EU

The nature of the discussion on federalism in Europe has changed quite dramatically over time. Shortly after the Second World War, the ambition for some was to create a "United States of Europe", mainly as a way to avoid renewed, devastating war.

This vision was shared by those who laid the foundations of the European Union in the 1950s, most notably Jean Monnet, the first President of the European Coal and Steel Community. From today's perspective, it may seem surprising that the start of such a grand project was confined to an area as specific as coal and steel. But Monnet and the other early architects of European integration clearly understood that political federalism was the end-point of long process, which had to be achieved incrementally and through focused actions in limited policy areas where the benefits of European cooperation could be clearly seen.

To quote one of Monnet's contemporaries, Alcide de Gasperi, "we must begin by pooling only what is strictly essential to the achievement of our immediate aims, and do this by means of flexible formulae which can be gradually and progressively applied". For these "fathers of Europe", however, it was self-evident that such incremental measures would gradually move Europe deeper into federalism. Indeed, this clear sense of direction was, in their way, a key motor to keep the integration process moving forward.

Since then, the European integration process has tended to move in waves. There have been times when it has stalled, such as the during the "empty chair crisis" in the 1960s. And there have been times when it has unexpectedly sped ahead, such as with the launch of the

Single Market Act in the 1980s, and the commitment to Economic and Monetary Union (EMU) in the 1990s. But today, there is some confusion as to where we stand.

In some ways, the degree of ambition to achieve a full political federation seems to have become more limited, which has led some to wonder whether the integration process will lose its forward momentum. This reflects in part the failure of the Constitution for Europe in 2005. The unsuccessful referendums in France and the Netherlands can be interpreted in different ways, but they clearly suggested that the people of the European Union were not ready to embark on the road towards full political federalism – or at least not at that point in time. It is also fair to say that the appetite for such federalism today is not much different from in 2005. In recent years there have been growing doubts about the European project.

At the same time, polls consistently show that European citizens support federal decision-making in a wide range of areas, ranging from energy to migration to the fight against terrorism. This reflects the fact that the benefits of federalism are much broader than its economic, fiscal and monetary dimensions. Indeed, since the EU was originally devised as a peace-keeping device, it is not surprising that one of the early initiatives for European integration was a motion to establish a European Defence Community, although this failed in 1954. While a full defence union is probably still unrealistic, there are increasing signs that further integration in this area could happen in the near future.

The Commission reflection paper published on 7 June of this year lays out proposals for establishing a European Defence Fund, which could form the nucleus of a future defence union. Last week, the European Council welcomed the significant progress made by Member States in preparing a Permanent Structured Cooperation (PESCO) in the field of defence, and the work done on the Commission’s proposal for a European Defence Industrial Development Programme (EDIDP). All this clearly chimes with the preferences of European citizens, three- quarters of whom support “a common defence and security policy among EU Member States”. [1]

The conclusion that follows is that we have to distinguish federalism as a state from federalism as a process. It may be the case that a full political federation is not currently desired by European citizens. But that does not mean that they reject the process of federalism – which is to say, the dynamic allocation and reallocation of responsibilities to different levels of government according to the preferences and needs of the time. While this process may benefit from the gravitational pull of a pre-defined end point, it can also advance without it, so long as actions are taken in areas where the benefits of cooperation are clear and the steps taken are legitimate in the eyes of citizens. Indeed, what gave the EU both momentum and popular legitimacy in the years after the war was its achievements – effective actions in specific areas – not necessarily the visions of a unified Europe.

So how much federalism would satisfy these requirements today? One way to assess this is through looking at the economic aspects of federalism. Certainly, as Richard and Peggy Musgrave wrote, “economic analysis does not tell us what degree of closeness the member units of a federation should feel toward each other”. Political aspects transcend economic ones. But economic analysis can help us better understand the consequences of various institutional arrangements and choose the instruments we should use to pursue our common objectives. In the rest of my remarks I will zoom in on some of these aspects of federalism.

Economic aspects of federalism

An important theme – one aspect of which will be addressed in the first session today – is risk- sharing. The crisis has reminded us that both private and public risk-sharing are underdeveloped in Europe, and that this underdevelopment comes at huge cost.

So, there is general agreement that risk-sharing channels need to be improved. There is less agreement on where the emphasis should lie. Some argue that the priority should be to strengthen private risk-sharing, by completing the banking union and establishing a truly integrated capital markets union. Others argue that EMU needs to focus on public risk-sharing, be it through introducing a central euro area fiscal capacity or creating safe assets.

In reality, separating these two channels of risk-sharing is far from the obvious solution. Is private risk-sharing a substitute for public risk-sharing? Or do they complement each other? There are several arguments in support of the view that the two channels complement each other – but only if the right powers are matched at the federal level.

For example, it is clear that the banking union would not fully achieve its goal of severing the toxic link between banks and national governments without a central fiscal backstop for the already- existing Single Resolution Fund, as well as for the European Deposit Insurance Scheme that is still under discussion. At the same time, fiscal backstops generally raise legitimate questions about incentive structures to protect taxpayers, which need to be addressed in parallel by appropriate fiscal governance at the federal level.

The process of building the banking union also illustrates how important it is to reach an appropriate degree of federalism to achieve the objective of a stable and integrated financial system that supports the European economy. Ideally, in a genuine banking union banks would operate in the Single Market just as they operate in their domestic market. This is essential to reap the full benefits of financial integration. The country in which a bank is headquartered should be irrelevant. But, in practice, it remains relevant for as long as the consequences of potential bank failures are still predominantly national. The irrelevance of a bank's headquarters, therefore, depends on the institutional structure of the banking union.

Let me take one very specific example to illustrate my point. The banking union is not yet considered a single geographical area in the supervisory methodology applied to globally systematically important banks. These G-SIBs are subject to additional capital requirements, which are calibrated on the basis of a cross-jurisdictional indicator. This indicator reflects the fact that failures of global banks are more difficult to handle owing to coordination difficulties and cross-border spillover effects.

When the responsibility for banks is shared, additional capital buffers for cross-border activities lose their raison d'être. A single set of harmonised prudential rules for all banks in the European Union would not, in and of itself, be sufficient for the EU to be considered as a single geographical area. But the Single Rulebook, the existence of a single supervisor, the Single Supervisory Mechanism (SSM), of a single resolution authority, the Single Resolution Mechanism (SRM), and of a common backstop, the Single Resolution Fund (SRF), when taken together, have equipped the banking union with all the features of a single geographical area. This should mean that the banking union is treated as a single geographical area in the supervisory methodology in future.

Finally, there is the question of how to design fiscal risk-sharing mechanisms for EMU, while taking into account EMU's unique nature. In existing federations the stabilisation function of the central budget is usually a by-product of redistribution via large tax transfer systems. At this stage of European integration, it is clear that any politically acceptable euro area fiscal capacity will be modest in size. So, the key question for the economics profession is whether it is possible to remove the link between the stabilisation function and the redistributive function, allowing for a central budget of moderate size to have a meaningful macroeconomic stabilisation effect. If this were possible, such a central budget could help monetary policy, especially in times of deep recessions when nominal interest rates may reach their effective lower bound. The European Commission set out some proposals in its reflection paper published on 31 May – these require further study.

Conclusion

Let me conclude.

The answer to the question of today's conference – "How much federalism?" – is not easy. Yet, speaking as an economist, I think it is likely that the right answer lies on the side of "more than today" rather than "less than today".

Monnet famously said that "Europe will be forged in crises, and will be the sum of the solutions adopted for those crises." He was certainly right that further integration will proceed incrementally rather than in a big bang. What I hope, though, is that Europe will not be forged in crises only.

Significant progress towards a genuine Economic and Monetary Union has been achieved in times of acute crisis. Today's improved economic environment offers a window of opportunity to demonstrate that progress is possible in quieter times, too.

I thank you for your attention and hope you have productive discussions at today's conference.

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[1] Standard Eurobarometer 87, Spring 2017 (fieldwork: May 2017).

Fonte: Bank For International Settlements (BIS)

https://www.bis.org/review/r171027h.pdf

François Villeroy de Galhau: Insurance in a world of disruption

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the 9th International Insurance Conference, Paris, 27 October 2017

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Ladies and Gentlemen,

I am very happy to be here today as supervisor in my capacity as President of the ACPR, and also as guarantor of the smooth financing of our economy in my capacity as Governor. In these two respects, the insurance sector is both close to me and important to me. Thank you for inviting me to speak on this theme of disruption. To put it more clearly, and as you have pointed out, Mr. President [Bernard Spitz], the world is in turmoil in many ways. This undeniably represents a challenge for insurers, but also a motivation: the raison d'être of insurance has always been to be a vector of protection and stability in the midst of uncertainty. This morning, I would like to stress the essential role that insurance must play in our economy, by emphasising two areas: its financing and its digitalisation. But before that, I would like to mention the very recent developments in monetary policy.

I. Our monetary policy is in itself a source of stability

Yesterday, at the Governing Council presided by Mario Draghi, we took the important decision to reduce our net monthly asset purchases by half – to EUR 30 billion – until September 2018. This is an essential step towards their possible end later; a step that is justified by our confidence in the gradual convergence of inflation towards our target of 2% over the medium term: we consider the economic recovery in Europe to be "increasingly robust and broad-based". In parallel, we said that we will continue to ensure "ample" monetary support, rather than "very substantial" support as mentioned in our previous statements – thanks to the whole range of our instruments, including the sizeable stock of assets that we will continue to hold in line with our policy of reinvestment, and our forward guidance on interest rates. In this new paragraph, the Governing Council stresses an essential point that I have often referred to over these past few weeks: our non-standard monetary policy is not a solo – it is not simply about net monthly purchases, and we shouldn't focus too much on them –; it is a group of instruments that we can play, by following a predictable sequence, as part of our gradual normalisation strategy.

It is therefore important that insurers continue to adapt their business models to the low interest rate environment. In particular, I welcome the gradual moderation of interest rates paid out on life insurance contracts, which should be pursued in order to maintain, in the long run, insurers' solvency and their ability to meet all their commitments vis-à-vis policyholders.

I would like to add a few words on the bad controversy that had surrounded the Sapin II law, and which now luckily seems to be behind us. Much has been said about the measure which gave the possibility to the Haut Conseil de stabilité financière (HCSF) to limit life insurance withdrawals in the event of a crisis, and which was, according to some, an impingement on French citizens' freedom to dispose of their savings. These allegations were, perhaps, temporarily detrimental to life insurance; it would therefore be in your interest as professionals to point out, against certain populist excesses, the truth, which you know: these powers are only intended to be used in serious and exceptional circumstances, to better protect the rights of policyholders. Here again, our concern is to preserve stability.

II. The essential role of insurers in the financing of our economy

The insurance sector is the largest institutional investor in the euro area, with total assets of close to EUR 7,800 billion in the second quarter of 2017, of which more than EUR 2,600 billion for the French market alone. Better steering these flows to sectors that need long-term financing is essential for our economy. What comes to mind are infrastructures, of course, but also companies, which need more equity financing to be able to innovate more: as innovation is more risky, it is financed through capital rather than debt. Start ups are well aware of this, but our scale-ups, midcaps and SMEs also need greater access to equity leverage. In this field, our economy, like that of our neighbours in the euro area, is seriously lagging behind: in France, equity only accounted for 64% of GDP at end-2016, which is half as much as in the United States (128%).

It is true that French and European savers are very attached to safe investments. The bulk (69%) of the EUR 4,765 billion in financial wealth held by French households is invested in interest rate products, compared to only 31% in equity products, i.e. invested in corporate capital in the form of listed or unlisted shares. [1] However, it is important to distinguish, with respect to savers' expectations concerning security, two components: they are attached to the protection of capital, even more so than to liquidity. With the increase in life expectancy, and with a greater need to prepare their retirement, savers are increasingly being steered towards long-term products; the liquidity component is becoming less decisive.

Here, insurers have an essential role to play, by taking the lead on new forms of life insurance that aim for a three-fold compatibility: with low interest rates, our economy's need for equity financing and the expectations of the French people. This requires new long-term savings products that are less liquid but feature a form of capital protection and offer over time the higher equity-type returns. Let me make myself absolutely clear: the development of unit-linked policies is not a sufficient response. I take note of the vitality of these policies' net premium inflows (up 27% in 2016, with inflows for the first 10 months of 2017 at more than twice their levels for the same period in 2016), but they offer no capital protection, and let me remind you of the duty to advise on the real risks incurred by policyholders. Instead, we must encourage the Euro-Growth (Eurocroissance) product, which should be revamped and expanded. The product's initial calibration has prompted debate; its commercial take-up, though tangible (assets under management of around EUR 1.8 billion), is still slow. I know that certain professionals have their own ideas to address that. And it's my sincere hope that progress is made on those ideas, and quickly. It is not the responsibility of the public authorities to develop good products – that is down to you –; but it will be our responsibility to encourage them, at the proper time, through the appropriate prudential and even tax-related measures. This struggle, targeted towards life insurance that is more equity-linked and long term, seems more promising to me than the struggle against the flat tax (prélèvement forfaitaire unique); I would like to mention in passing that the flat tax contributes to a neutral stance on the different forms of savings, which is long overdue.

The diversification, properly understood, of the investments of French savers towards more equity-based, long-term savings is in everyone's interest. And today there are additional incentives for life insurers to offer new products that break away from the dual cash-liquidity guarantee, due to the lesser Solvency II capital requirements.

And this brings me to the issue of regulation. Here too, insurers have an essential role to play, i n preparing the review of the Solvency II Directive's new regulatory framework. The directive came into force almost two years ago now and you have implemented it with a great deal of professionalism. In many respects, Solvency II represents a very significant step forward for the insurance sector. But this does not mean that it's perfect: we must analyse its impacts closely, particularly its effects on investment behaviour and the financing of the economy, in order to propose the adjustments that prove necessary. Progress has already been made on the financing of infrastructure projects and businesses, thanks to two amendments that came into effect in April 2016 and September 2017, respectively, which adapted the calibration of capital requirements. More generally though, the reviews of the standard formula and long-term guarantee package measures planned for 2018 and 2020, respectively, are important opportunities to make essential improvements. The work is already underway, and the more you actively participate, alongside your European colleagues, the more our chances of success will be enhanced.

III. The role of insurers in the digitalisation of our economy

It is essential for our economy to adapt to the digital revolution: it creates incredible opportunities, but with them, new risks against which the insurance sector, once again, can bring stability and protection. I would like to discuss two subjects in particular:

Firstly, cyber-insurance. The cyber-insurance market is still underdeveloped. Insurers can and should take inspiration from their own experiences in tackling cyber-risk, and use it to develop a more mature French and European cyber-insurance offering. The coverage against cyber-risk is a very real concern that affects all companies – both small and large – as cyber-attacks are becoming increasingly frequent and costly: according to figures from Euler-Hermès, 57% of French companies were victims of these attacks in 2016, compared with 32% in 2015. We at the Banque de France, alongside the Eurosystem and our G7 colleagues, have made cybersecurity one of our strategic priorities.

And secondly, personal data and big data. Naturally, the spread of connected objects that is triggering an exponential rise in the amount of data available on insurance policyholders represents an opportunity for the business of insurance, which consists precisely in collecting and exploiting data in order to quantify and put a price on risk. Nonetheless, I would urge insurers to take a responsible approach: we need to strike the right balance between segmentation and the sharing of risk between policyholders. The basic principles of solidarity and risk-pooling that are intrinsic to insurance are at stake. And we must not lose sight of our collective values regarding individuals' right to privacy.

Before concluding, I would like to add a few words about Brexit. The French authorities are mobilised and committed to making Paris a leading destination for insurance undertakings. The ACPR has taken the lead with an English-language fast-track authorisation. We are holding serious and discrete discussions with various business prospects. The recent announcement by the American group Chubb, the United States' leading property and casualty insurer, of its intention to transfer its operations to Paris demonstrates that our expertise in supervision in particular is a recognised asset. But mobilising must not mean abandoning our high standards and requirements, and Brexit cannot be an opportunity for British entities to simply set up empty shell corporations in Europe, mere company name plates, while keeping their resources in the United Kingdom. In this respect, I fully agree with the vigilance called for by EIOPA. And lastly, Brexit also brings with it certain risks, and consequently the need for contingency plans: I am thinking particularly of the French policyholders who took out insurance directly with British undertakings, and by way of symmetry, the French undertakings with commitments in the United Kingdom.

Beyond what the insurance sector can do for our economy, I would like to conclude by telling you what we can do for you. At the Banque de France and the ACPR, we are ready and committed to supporting you through all the current upheavals that are forcing you to rethink your business models and professional reflexes. That could be digital technology – for which we have created a FinTech unit and put in place the FinTech Forum – and could also be regulatory developments or even climate change, which we will discuss again on 11 and 12 December in Paris. I know that you are resilient, and we are there to help you. Thank you for your attention.

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[1] Annual report of the Observatoire de l'épargne réglementée, July 2017.

Fonte: Bank For International Settlements (BIS)

https://www.bis.org/review/r171031d.pdf

Andreas Dombret: Between integration and reform - current developments in the euro area and Germany

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bombay Stock Exchange (BSE), Mumbai, 31 October 2017

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1. Introduction: Quo vadis Europe?

Mr Chauhan

Mr Steinrücke

Ladies and gentlemen

It gives me great pleasure to be back in Mumbai, and it is an honour to be speaking at the Bombay Stock Exchange.

The Bombay Stock Exchange is prospering, with its BSE Sensex reaching all-time highs, beyond 33.000 points. I am hopeful that this is a sign of India's economy growing in a strong and broad fashion in the future, after some recent setbacks.

Talking about economic setbacks and recoveries: I have been asked to talk about the economic situation in the euro area and in Germany. I am happy to do so, and will also take the opportunity to discuss their economic future in light of the current political situation.

Wherever I go these days, people ask me: Where is Europe heading? Will the EU recover? Or will it eventually break up? Brexit and the rise of populism have raised doubts about the Union's future.

In this debate, one side is calling for the EU to disintegrate substantially, or at least to go not any further with integration. In the other corner are EU proponents. They think that the answer to the political and economic problems is more integration, not less.

I think both views are not balanced enough. Neither more, nor less integration are per se solutions to the problems that Europe is facing. We must instead take a closer look at the problems at hand and solve them with problem-oriented reforms.

In my talk, I will explain to you that the economies of both Germany and the euro area are currently doing quite well. Yet I will highlight the fact that important fundamental problems have not been dealt with either at all or at least not sufficiently. I will argue that this is an important explanation for the current political troubles in the EU. To counter these political tensions, we need problem-oriented reforms in the euro area as well as in the individual member states. I will outline important directions for such reforms.

2. The German and euro area economy: Better...

Let's start with the current economic situation in the euro area. Until recently, despite extensive monetary easing, the pace of recovery since the financial crisis has been disappointing. Lately, however, there have been clear signs of a broad economic recovery.

Recent figures show a sound GDP growth of 0.6% for the second quarter of 2017. Unemployment stood at 9.1% in July, well down from its peak of 12.1% in 2013.

Moreover, both the IMF and the ECB staff have recently upped their growth expectations for the euro area. [1] At the same time, the healthy upswing of the German economy is continuing: 2017 will be the fourth consecutive year of GDPgrowth outpacing potential output.

Growth has gained further momentum and the upswing has become more broadly based. Thus far, the major drivers have been consumption and housing investment. Recently, industrial activity, exports and business investment have also made significant contributions to growth.

Looking ahead, the very high level of confidence among firms and households suggests that the upswing will continue not only into the second quarter of 2017, but also beyond.

A very positive effect of the economic upswing has been the substantial reduction in unemployment.

3. ...but not yet good

With regard to the Euro area as a whole, however, a recent study has shown that the labour market is in worse shape than the official job figures suggest, with workers unlikely to see real increases in pay because of the level of underemployment. [2] A measure of "slack" in the labour market indicates that about 15% to 18% of the euro area workforce are without jobs or would like to work more – which is nearly double the official unemployment rate. Underemployment is even growing further in weaker labour markets, such as those in France and Italy.

The still weak labour market in many regions of the euro area is one of the most severe ongoing repercussions of the recent financial crisis and an indication that the recovery is not yet strong enough. This is particularly true with respect to the high level of underemployment among young people and in peripheral regions.

Thus, while the euro area economy looks increasingly healthy on average, it becomes clear on closer inspection that a lot still remains to be done to move onto a sustainable, integrative path of prosperity.

This is also one of the reasons why populist extremists are still making electoral gains.

4. The political landscape: More populism in sight?

When we look at the German general election five weeks ago, however, although a populist party came in third, things need a more differentiated explanation – only half of the populist supporters were economically disaffected. I will come to that in a moment.

In my eyes, though, the positive outcome is one of government stability: Chancellor Merkel's conservative Union has remained the largest force in parliament.

But she faces the difficult task of forming what has been dubbed the Jamaica coalition with the business-friendly Free Democratic Party and the Green party. The negotiations have just begun and are challenging. But I am confident that an agreement can be reached and that German political stability will stay intact. And that the German economy's strong growth momentum will also remain intact, which, in turn, will be a strong basis for continued growth of the euro area economy.

Yet this election reveals a deeper, inconvenient truth – that people are not convinced that politicians have found sustainable solutions for longer-term social cohesion. This is mirrored in the first far-right party entering the Bundestag since 1949: Alternative for Germany, or AfD for short. It is now the third-biggest party in the Bundestag, having received almost 13% of the popular vote.

About half of the party's voters are economically disaffected – people without jobs, people with declining real income and people fearing future losses.

This is the economic side of why protectionism and populism have enjoyed support in Germany. The AfD, like many other populist parties, blames the economic malaise on globalisation and European integration – and are demanding that they be reversed.

These simple explanations offer intuitively appealing solutions to Europe's problems. But they overshadow the mid-term economic challenges, which need to be tackled urgently, however.

If we do not solve these mid-term challenges, populist influence might well grow – and that would put global and European cooperation at risk. These unresolved problems could become the roots of serious political conflict.

Can this really become such a problem? I have one word for that: Brexit.

In June 2016, UK voters decided to leave the EU – they had been told that they would be able to save their money and put it to better use, and that they could once again control their destiny in the global economy, all without any negative consequences. Unfortunately, the campaign was built on false anti-EUinformation. These intuitively appealing anti-European sentiments did find support – to a substantial degree – among economically disaffected citizens.

Where are we now? Brexit is definitely happening, and it is more and more likely to be a hard one – by which I mean that there will be a complete exit rather than a partial one. The UK and the EUwill go their separate ways in March 2019. After we agree on how to separate, we will start to negotiate the terms of our future partnership. At the moment, it is possible that we could start this second phase in December of this year – this is the guidance of the EU Council, but for it to happen substantial progress has yet to be made on several fundamental issues such as the rights of EUcitizens in the UK after Brexit.

Since negotiations have been going rather slowly, there may be a transition period of two years from 2019 to 2021 – during which the old rules would still apply and the terms of the new partnership could be implemented. What kind of economic partnership this will be has yet to be determined. If we do not find a solution, the EU and the UK will trade under rules set by the World Trade Organization – which is in nobody's interest, but could be particularly harmful to the UK economy. I hope that all parties involved will be able to negotiate an economic partnership that underscores the close political amity between the UK and the EU.

5. Neither less, nor more – but better: Reforms are needed

Brexit shows that less integration is not the solution to the root causes of our economic problems.

But a simple case of more integration is not a solution either.

One thing should be put first: The EU appears stronger today than it did a year ago. This was reflected by Commission President Jean-Claude Juncker's State of the Union address on the 13th of September, and in French President Emmanuel Macron's plan to reform the EU, as set out in his speech on the 26th of September. I agree with them that a strong EU is in the best interest of all Europeans and that it can play an important role in international relations. More integration may thus be warranted.

But I think that we should get the order right: first reform, then the next steps towards more integration.

This is especially true with regard to the European monetary union. The euro area will remain vulnerable, as long as its fundamental stumbling block remains unchanged: its asymmetric institutional design. Member states surrendered sovereignty in monetary policy matters to the ECB, but retained ownership of their fiscal and economic policies.

This creates two big challenges: first, a common monetary policy for economies that are at different developmental stages – like France and Greece – and at different stages of the business cycle. Second, the moral hazard that arises when governments borrow too much in order to take advantage of lowered interest rates as a result of averaging in the currency union.

We need solutions to both problems. For the first, no simple, realistic solution is available. The economic convergence of the euro area will take time. Far-reaching structural reforms need to be undertaken in countries in order to narrow the gap to the best-performers with respect to competitiveness.

The second problem – excessive borrowing by governments – could, in theory be much more easily solved. However, the necessary political reforms have made little progress so far.

Formally, the EU has a set of fiscal rules that restrict public lending – the Stability and Growth Pact. Yet these were regularly violated before the financial crisis, without any meaningful consequences. In response, the EU reformed it, but the discretionary scope was actually expanded even further.

The European Commission, albeit foreseen as the guardian of the Stability and Growth Pact, has already exploited scope on several occasions and invariably interpreted the rules very generously in doing so. Some euro-area countries have been breaching the rules for nine years now.

What is needed to strengthen the fiscal rules is a simple and transparent design and implementation of the rules. [3] An independent institution taking over responsibility for fiscal surveillance from the Commission would be a key step towards a less political approach. One promising way would be to strengthen the role of the European Stability Mechanism (ESM) in fiscal surveillance.

However, if member states retain their fiscal autonomy, the sustainability of public finances needs further safeguards than rules alone.

It is therefore essential that the binding force of the rules be additionally shored up by the disciplining effect of the market. In other words, interest rate levels and thus financing costs have to be realigned more closely with the risks in government budgets.

For this essential function of a modern market economy, we need investors and stock exchanges such as the Bombay Stock Exchange, as they are the economic equivalent of political checks and balances.

The only way to achieve that, however, is to give the no bail-out clause in the Maastricht Treaty more credibility again. Investors have to perceive a more credible threat of losing money if they buy bonds from governments that have unsound public finances. One proposal put forward by the Bundesbank thus envisages changing the contractual terms for sovereign bonds in the euro area by introducing an automatic maturity extension for them as soon as the issuing government applies for an ESM programme.

Up to now, a large part of the assistance loans have ended up being used to pay off the original creditors. This means that the original creditors, such as banks, are then let off the hook – at the expense of taxpayers.

In contrast, extending maturities would leave them on the hook, and they could still be held liable if a later debt restructuring were necessary.

To sum up: Neither less nor more integration at any price is a panacea for the problems in our economies.

And that is why, not only the euro area, but also the member states have to tackle reforms sooner rather than later.

Let me focus on the German case, and point to two challenges: first, we need to face our demographic challenges ahead; second, we need to ensure that those who lose out from globalisation and digitisation are compensated.

One major challenge for the German economy is the foreseeable ageing and shrinking of the domestic population and its impact on potential output growth in the medium term.

In view of the shrinking domestic labour force, it can be assumed that Germany’s potential growth will drop below one percent in the next decade.

We need to mitigate this effect by encouraging more women and older people to participate in the labour force. What’s more, we will probably be forced to think about raising the statutory retirement age.

A second important task is that we need a fairer market economy – to encounter the fears of people moving down to a lower layer of societal strand.

We need to strike the right balance between two types of policies: those that foster the competitive dynamics of market economies, and those that ensure the social cohesion that is necessary for market economies and indispensable to democratic societies.

The most obvious tools are fiscal policy instruments that serve to strengthen the social security system, which provides financial compensation to individuals such as those who are unemployed.

At least as important as the provision of financial compensation is making sure that people are capable of helping themselves. To that end, we need better education and higher qualifications: countries need to promote equal access to high-quality primary, secondary and tertiary education. What is crucial to educational success in 5 to 50 years is that we increase public spending on qualified personnel. Moreover, active labour market policies shall support the jobless in their efforts to qualify for other professions.

6. Conclusion

Ladies and gentlemen

The euro area’s economy has made it through the rain and is now under relative sunny skies. Yet clouds still hover over the less-than-complete recovery – a lot remains to be done.

The Germany economy, on the other hand, has been in the sun for quite some time now, and even the short term outlook is quite promising. Yet, serious medium-term risks loom.

A vital euro area requires more reform: The monetary union must be reformed – but it is not a matter of simply more – or less – European integration. Instead we need problem-oriented reforms of its institutional design.

Moreover, member states must embrace reform. For example, Germany has to face the demographic challenges, and its economic policy has to strike the right balance between fostering the competitive dynamics of market economies and ensuring the social cohesion that is necessary for democracies.

I am confident that this is possible – but policymakers have to take their responsibility to reform very serious.

Thank you for your attention.

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[1] GDP projection by IMF: 2017: 2.1% (+0.2 pp); 2018: 1.9% (+0.2 pp); GDP projection by ECB staff; 2017: 2.2% (+0.3 pp); 2018: 1.8% (+0.0 pp); 2019: 1.7% (+0.0 pp).

[2] European Central Bank (2017), Assessing labour market slack. ECB Economic Bulletin 2017 (3): 31–35.

[3] Deutsche Bundesbank (2017), Design and implementation of the European fiscal rules, Monthly Report, June 2017

Fonte: Bank For International Settlements (BIS)

https://www.bis.org/review/r171031e.pdf