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The Economic Future of the European Union

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In this lecture I hope to deal with the process of European economic integration, with particular reference to the establishment of the euro. The views I express are my own and are not representative of any body of which I am a member.

I hope to show that this project has deep roots in post war European history. It is part of a process to build a structure of peace and stability in Europe based on deep integration of European economies with one another.

The euro has helped keep inflation low. Inflation in Germany has been, for example, lower in the 12 years since it joined the euro, than it was in the 12 preceding years. It has created a zone of exchange rate stability, very helpful for exporting nations. The usage of the euro in a large number of countries has saved travellers cost and inconvenience, and brought seignorage revenues to the euro area's central banks. It has increased the availability of credit and households and businesses and it has facilitated trade within the euro zone.

It was at all times a pragmatic project, where one learned by trial and error how best to achieve the ultimate goal. Some problems were not foreseen, others were not addressed as soon as they might have been, but European Union leaders have, sometimes late in the day, been able to find solutions.

I will deal with some of these problems as I go along, such as

1.) The narrow focus, and ineffectiveness, of the Stability and Growth Pact
2.) The strange failure of the European Central Bank to use its very explicit article 14 powers to rein in member state Central Banks in countries where credit fuelled bubbles were developing, and
3.) The failure, so far at least, to come up with a credible overall plan to recapitalize Europe's banks

But, overall, the process toward Economic and Monetary Union has brought great benefits to Europe. To understand that, one has only to contemplate what Europe would have been like in the last thirty years, if we had had a series of competitive devaluations of national currencies. If that had happened, the common market itself might not have survived.

The goal of Economic and Monetary Union has been part of the European agenda from the immediate post war period. When the European Federalists met in Montreux in 1947, they spoke of the need to regulate currencies and capital movements at European level. They recognised that devaluations and protectionism in the inter war period had aggravated the Depression and contributed to the tensions that led to World War Two.

When the OEEC, the forerunner of the OECD, was founded in 1948 to help ensure that Marshall Aid was spent effectively, its mandate spoke of the need to avoid financial disequilibria in Europe and of studying the possibility of setting up a European Customs Union.

Nine years later, the Treaty of Rome was agreed between six countries, and established the European Common Market. It set the goals of

"ever closer union among the peoples of Europe",
of **"*strengthening the unity of the economies* "**of member countries, and of
"***progressively approximating"*** their economic policies.

The goal of the Treaty of Rome was never a simple free trade area. It was always more than that. It was an economic union.

The first serious outline of a plan for a single currency for Europe was considered at a Summit of the leaders of the six Common Market countries in the Hague in 1969.They commissioned a study on Economic and Monetary Union and a single European currency, from a group chaired by the then Luxembourg Prime Minister, Pierre Werner.

Pierre Werner's report was presented in 1971 before either Britain or Ireland joined the Common Market, but both intending members were put on notice , by this report , of the direction in which the body they were joining was heading, and were free not to join at all, if they did not accept what it entailed. Neither Britain nor Ireland made that choice.

The Werner report envisaged proceeding towards the issuance of a European currency in three stages. The first step would involve free movement of capital between intending members. The second would involve a system of coordination between the Central banks of the intending members, and the final stage involved fixing exchange rates and issuing a single currency.

The Werner Report was quite specific on the point that that being part of Economic and Monetary Union would mean EU involvement in domestic economic policy making. Here is an extract from the Report, issued in 1971

"To facilitate the harmonization of budget policies, searching comparisons will be made of the budgets of the Member States from both quantitative and qualitative points of view. From the quantitative point of view the comparison will embrace the total of the public budgets, including local authorities and social security. "

It was thus clear that EU scrutiny would extend beyond narrow public finance, to include impacts on the broader economy.

It also said

"It will be necessary to evaluate the whole of the fiscal pressure and the weight of public expenditure in the different countries of the Community and the effects that public receipts and expenditure have on global internal demand and on monetary stability. It will also be necessary to devise a method of calculation enabling an assessment to be made of the impulses that the whole of the public budgets impart to the economy"

The next big step was the Single European Act of 1986. It sought to introduce majority voting on a range of matters so as remove barriers to intra EU trade in goods and services. It also made Economic and Monetary Union an explicit goal in the EU Treaties. To help countries prepare for the extra competition they would face in an economic union, regional funds were introduced. Both Ireland and Britain accepted these funds.

In 1989, a second report was prepared with the goal of reviving the project for Economic and Monetary Union.. This time the report was prepared by a group chaired by Commission President, Jacques Delors, and on which Ireland was represented by Maurice Doyle , Governor of the Irish Central Bank, and the United Kingdom by Robin Leigh Pemberton of the Bank of England.

This Delors report was even more specific than the Werner report was, in envisaging the dangers that inconsistent economic policies within the single currency area could give rise to.

It warned

"Monetary union without a sufficient degree of convergence of economic policies is unlikely to be durable and could be damaging to the Community. Parallel advancement in economic and monetary integration would be indispensable in order to avoid imbalances."

It went on to predict exactly what went wrong in Ireland's case. Recalling that financial markets are very bad at predicting crises, and go on lending long after they should have stopped, it said

"Experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Market forces might either be too slow and weak or too sudden and disruptive. Hence countries would have to accept that sharing a common market and a single currency area imposed policy constraints. "

Unfortunately the Delors report was all too prescient. Markets, and their handmaidens the rating agencies, were initially "too weak and slow" in penalising the build up of excessive borrowing and lending in parts of the eurozone in the period from 2000 on, and when they did eventually recognise the problem, they were, exactly as Delors predicted, *"sudden and disruptive"* in their response.

The next important step in the process of economic integration was the negotiation of the Maastricht Treaty in 1992, which set a precise timetable for the actual achievement of Economic and Monetary Union. It followed the three stage model recommended by Werner.

Free Capital movements came first, in 1990, and restrictions on capital movements were explicitly forbidden in the Maastricht Treaty. The full implications of this seem not to have been envisaged at the time.

It created the conditions in which banks in EU countries could borrow freely from one another.

At retail level, Europe still had national banking systems, supervised by national regulators.

But, at wholesale level, free movement of capital meant that the European Union gradually developed a single European banking reality, with banks all over the EU, seeking the highest returns wherever they could find it, increasingly lending to one another, dependent on one another, and vulnerable to one another.

The logic of that development should have been a common European Banking policy, with tight supervision from the centre, especially in those parts of the Union where the common interest rate was inappropriately low for local conditions.

The Maastricht Treaty gave the independent European Central Bank a responsibility to *"keep under review*" the monetary policies of member states, a right to *"deliver opinions"* and to keep capital movements under review.
Furthermore, Article 14 of the statute of the European System of Central Banks says clearly that *"the national central banks are an integral part of the European System of Central Banks and shall act in accordance with the guidelines and instructions of the ECB"*
One must ask then what use the ECB made of Article 14 when it saw the disproportionate increase in the size of the banking sector in countries like Ireland and Spain from 2000 on.
For example, The European Commission has recently claimed that it "repeatedly signalled downside fiscal and macroeconomic risks related to the property boom in Ireland" from "as early as 2000." If that is so, and given that the ECB had the power under article 14 of its statute to issue instructions the Irish Central Bank , one has to ask whether and how it used those powers and if not why.
If the Central Bank of a country was allowing its banking sector to grow to 300% of its GDP, surely the ECB would have seen the dangers in that and used its powers?
As a member of the Executive Board of the ECG, Lorenzo Bini Smagi himself said in Paris last week

" It is no surprise that most of the countries with the largest deficits and the largest increases in debt after the crisis, have been those in which the financial sector played an increasing role"

" No surprise" he said. The financial sector in Ireland and Spain grew disproportionately. Given its overall responsibility for financial stability, should then the ECB have been surprised by what followed, as they clearly were?
So it is fair to ask if the ECB considered using Article 14 when it saw the domestic financial sectors in Ireland and Spain grow disproportionately, and if not, why it did not do so.
From 2000 on, British, German, Belgian, French banks, and banks of other EU countries lent irresponsibly to the Irish banks in the hope that they too could profit from the then obtaining Irish construction bubble. They did this notwithstanding the fact that they had lots of information available to them about spiralling house prices in Ireland. They were supervised by their home Central banks, and by the ECB, who had the same information available to them too, and who seemingly raised no objection to this lending.
Of course, primary responsibility for this does rest with the Irish authorities who did not supervise the Irish banks properly. There were, I suggest, major failures of prudential supervision, at wider European level too, in other central banks, and in the ECB.
Irish taxpayers, in taking on in 2008 the private liabilities of the Irish banks to other European banks, are now helping to stabilize the situation of European banks , and of the European banking system. There is a tendency in some quarters to glide over that fact, and to present it as a purely Irish problem with purely Irish responsibility. While that story may be comforting to some audiences, it is not the whole story, and blinds us to lessons that need to be learned at a wider European level too.

Moving back to the narrative, one has to admit that when we came, at the Dublin EU Summit in 1996, to set up the Stability and Growth Pact to give effect to Maastricht, we again made the mistake of focussing exclusively on Government finances, and neglecting the possibility that trouble would be caused by private sector excesses, and that to avoid that, we needed tougher transnational European banking supervision.

As I have said, this omission subsequently facilitated pro cyclical monetary expansion in some countries, like Ireland and Spain. Interest rates, that were suitable to Germany, as it went through the difficult post reunification phase, were too low for Ireland and Spain. When local inflation was taken into account, they were actually negative. When interest rates are negative, you create an incentive to the creation of pro cyclical bubbles in the economy.

In putting that right now, we must not over react in the opposite direction.

Insisting, at the bottom of a market, in marking all bank assets to the price they could realise if sold immediately into a market in which nobody can raise the money to buy them, would aggravate an already difficult situation. It would destroy value and make no economic sense. I hope European and national regulators do not compound the problem by doing that. Fire sales do not clear the road towards prosperity.

On the 25^{th} March, EU leaders will come together to agree a new Treaty based fund to help countries that get into difficulty.

This will be underpinned by a competitiveness pact. The latest draft of this has been prepared by President Van Rompuy of the European Council and President Barroso of the European Commission. It focuses on measures to be taken by member states in their own field of competence. In this respect it is an elaboration of the so called Lisbon Strategy, but it contains somewhat more rigorous invigilation of what states do, and do not do, in respect of the commitments they make under the pact.

The focus is, I believe, on

- Reducing labour costs in countries with competitiveness problems
- Decentralizing wage bargaining
- Opening up professions and energy networks to competition
- Less expensive legal systems
- Raising the retirement age
- Introducing a constitutional or other legal limit on government borrowing and
- having a single consolidated base for corporation tax

Most of these proposals are good and sensible. I believe strongly that it is right that the European Commission will have an important role in monitoring all this, and in proposing changes in policy when member states depart from the pact.

On the suggestion of a common consolidated tax base, Ernst and Young have , however, estimated that a common consolidated tax base would add a net 13% to the tax compliance costs of Irish firms. Another study suggests that big countries with big markets would collect more tax under it, while smaller peripheral countries would collect less, thereby worsening their relative debt repayment position

I am also not sure that it is sufficient to rely on heads of Government policing one another to ensure that commitments are delivered. While small countries may submit to peer pressure from big countries, I am not sure the process will work in reverse, when bigger countries are the ones needing to respond. The experience of trying to apply the Stability and Growth pact to Germany

and France in 2004 is a case in point. That part of the Van Rompuy/Barroso proposal must be strengthened ,if it is to be credible.
The idea of a constitutional debt brake will bring lawyers into the centre of fiscal policy making. I am not convinced that this will improve matters. It would be useful to study the history of a similar effort in the United States, the Gramm-Rudman law. The debt brake could become a political football . It needs to be very carefully designed, and leave room to deal with genuine emergencies.
That said, it is absolutely right that we the focus be placed on getting public debt under control. The US Congressional Budget Office predicts that, on present trends, US Federal debt service will rise from 10% of US revenues today, to 58% by 2040. Our present difficulties and the prospective cost of ageing societies puts most European Governments on a similar trajectory.
The real problem, in making sure these proposals are implemented, is that of designing penalties for errant behaviour, that go beyond mere peer pressure.
Under the present rules, we say we will impose fines on countries that exceed the deficit limits (but interestingly not the debt limits). These rules have not worked.

I have two concerns here.

First, in some countries like Ireland, government deficits were not the primary problem, the primary problem was the expansion of private sector credit, and there were and are no penalties for that. Nor are any proposed.
Second, imposing fines on countries, that already cannot pay their way because they have too big a deficit, is hard to enforce, because it involves trying to extract blood from a stone.
I believe we must design a new system which will ensure that the markets do their job properly and in good time, and are not allowed to be “too slow and too weak” in reacting to problems in particular countries, as the Delors report feared they would be. I believe the best way may be for the supervisory authorities to rub the markets noses in problems they might otherwise ignore until it is too late.
I suggest that this could be achieved if March 25th meeting of the European Council decided that Commission and ECB should adopt a policy of formally and regularly briefing

1.) the rating agencies, and
2.) all the political parties in all member states,

with their candid assessment of emerging problems in competitiveness, credit growth, and public finance imbalances in each member state, on a systematic basis.
Thus, rather than rely on cumbersome bureaucratic procedures in the European institutions to eventually bring peer pressure on countries to put problems right, more reliance would be placed on competitive markets, on competitive financial markets, AND on competitive political markets, to deliver the necessary policy changes. I believe this would be much more effective than peer pressure at closed door meetings in Brussels!
Finally the Van Rompuy/Barroso proposals do not deal with the banking crisis. They contain no proposals on that subject. They seem to assume that the problem is solved ,and that a push on competitiveness is all that is needed. I disagree.

The Summit on 25 March must tackle the problem of recapitalizing Europe's banking system and show how that can be done over a reasonable time frame.

I accept that there will be no transfer union within the eurozone. The political conditions for it do not exist.

But a proposal to re launch Europe's banking system would have much more support that a transfer union. George Soros recently wrote the EUs emergency funds should all be used to recapitalize Europe's banks. If that is not to be done, there must be an alternative. The March 25th Summit should come up with one.

There has been much criticism of the stress tests carried out on Europe's banks.

Europe's banking system is three and a half times Europe's GDP, whereas the US banking system is only 80% of the US GDP. Loan to deposit ratios are considerably higher in Europe too. Europe relies very heavily on banks because it has not developed alternative means of raising finance. The Van Rompuy/Barroso proposals should address that issue.

It is arguable that Europe's banks are now so interdependent on one another that the problem of recapitalising banks should be a European rather than a member state responsibility. It is also arguable that central banking policy has added to problems, rather that mitigated them. The Basel 2 system that central banks were using until recently was procyclical during the boom. The new rules may prove to be procyclical too, but in the opposite direction.
Europe needs a banking policy.

That means taking a European view about the size of banks, their interconnectedness of banks, the" too big to fail" problem, and a host of other difficult questions.

But unless we restore our banking system, confidence will not return, small businesses will not thrive and we will lack the necessary credit to tackle our structural problems.

For example, Europe has only 0.6% of the world's oil reserves, but it consumes 17% of the world's oil production.

A recent paper commissioned by the German Ministry of the Environment suggested that achieving a 30% reduction in Europe's cO2 emissions by 2030 could add 0.6% to European GDP growth and create 600000 jobs in renewables, smart grids, insulation , public transport etc.

Maybe this will not work, but necessity is the mother of invention. The industrial revolution started in Britain in the 18th century, rather than on the continent, because labour costs were higher in Britain. This gave British eighteenth century industrialists the incentive to adopt labour saving machinery .

Perhaps the high cost of imported oil and gas will now give Europe the necessary incentive to adopt radical energy saving technologies. But that cannot happen unless we have a properly functioning banking system all over Europe to lend to the entrepreneurs who make the breakthroughs.

To conclude, I would say that the problems the European Union faces today are challenging not only politically, but intellectually. But they are problems that the rest of the world will have to face sooner or later. Europeans are the world's pioneers of economic integration.

Those who founded the European Union had enormous intellectual self confidence. That self confidence must be rediscovered. There must be a coming together of minds in place of the institutional rivalry that sometimes characterises European Union politics. Lessons must be learned and problems confronted honestly, but once that is done, we must work together to find practical and imaginative solutions.

To sustain an economic and monetary union in the long run, we need to create a true European demos, and a European patriotism. That is needed to make politically acceptable the occasional transfers of funds from one part of the union to another, that help a single currency to work. We have not created a European demos, nor have we created a common European patriotism, as has unfortunately become all too obvious.. But that is an argument for another day.

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