

Euro Area Governance and the Global Crisis¹

Vítor Gaspar²

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I want to thank Erik Jones for his kind words of introduction, Francisco Torres for his invitation to come and speak to such an impressive gathering of experts on Political Science and Paulo Vila Maior for his hospitality here at Universidade Fernando Pessoa.

I will be speaking about the Governance of the Euro Area in the context of the Global Crisis. I have changed the focus slightly relative to the title announced in the Conference programme.

In January 1st 1999, eleven member states abandoned their own national currencies and adopted the euro as their single currency. The European Central Bank, one of the most independent central banks ever created, was entrusted with the conduct of the single monetary policy, aiming at delivering price stability over the medium term. Ten years later the euro was the single currency of sixteen member states of the European Union. It covered a geographical area with a population of about 325 million people – about 5 per cent of world population – and producing more than 16% of World GDP. In spite many skeptical comments, after the first decade, the euro has been a success!

At this point a frank and open warning is in order. My professional career, outside University, started a little over twenty years ago. My job was to follow European monetary negotiations. I have been associated with European monetary integration ever since. For example I represented the Portuguese minister of finance in the negotiations that led to the Maastricht Treaty, I was chairman of the Group of Alternates of the Monetary Committee, that prepared the Stability and Growth Pact, I was the first Head of Research at the European Central Bank, involved in the preparation of the ECB's monetary policy strategy and, more recently, before returning to the Eurosystem, I was the Head of the Bureau of European Policy Advisers to the President of the European Commission. Clearly with a career around European monetary

¹ The text is somewhat longer than the version delivered. The spoken version was shorter in order to allow for lively interaction with the Conference participants.

² The views expressed are my own and do not necessarily reflect those of the Banco de Portugal or the Eurosystem.

integration I do not claim the viewpoint of the detached, impartial or judicious spectator. Recently, at the Federal Reserve of Dallas, I delivered a lunchtime address with the title “The Euro’s Second Decade: Success Continues!” The organizer, responsible for inviting me – Francisco Torres – is well aware of my biases. That makes me particularly grateful for the opportunity to address such a distinguished gathering. The views I will be expressing are my own and do not necessarily reflect those of the Central Bank of Portugal or the Eurosystem’s.

My own biases may be, on reflection, entirely appropriate. Currently there is a tremendous degree of skepticism concerning the governance of the euro area. Contributions coming from the US are particularly telling. Skepticism in the US about the euro area has been consistently throughout the whole process. My friend Lars Jonung, has summarized some extreme American positions (made between 1989 and 2002), as echoes of an older comment about European integration, in general: “It’s a bad idea; it won’t happen; it will be disaster!”³ Lorenzo Bini Smaghi, member of the Executive Board of the European Central Bank, refers to a recent visit by an US academic, who admitted his surprise at finding ECB staff convinced that the euro would survive this crisis⁴. Therefore, it turns out, that positions such as mine are necessary to have a rich, diverse and hopefully enlightening debate. I expect that my remarks will justify a lively response.

The remainder of my talk is structured as follows: I will start arguing that the first decade of the euro has been very successful! I will focus on the single monetary policy and on the role of the European Central Bank, in the context of the stability-oriented economic constitution of the euro area. I will then mention briefly some broader questions which were considered very relevant at the beginning and, finally, I will conclude reviewing key challenges for the second and following decade and prospects for success.

The shift to monetary union was first and foremost a change in monetary regime. With the aim of making price stability a permanent feature of EMU, the Maastricht Treaty granted the ECB an independent status and established price stability as the primary goal of the new central bank. A crucial element to evaluate success of the single monetary policy is to look at inflation expectations. The point is of relevance for all central banks in general. In a 2007 speech on the

³ The paper is joint work with Eoin Drea: “2010. It Can’t Happen, It’s a Bad Idea, It Won’t Last: U.S. Economists on the EMU and the Euro, 1989-2002. *Econ Journal Watch* 7(1): 4-52, available at <http://econjwatch.org/articles/it-can-t-happen-it-s-a-bad-idea-it-won-t-last-us-economists-on-the-emu-and-the-euro-1989-2002> .

⁴ Lorenzo Bini Smaghi, The Financial and Fiscal Crisis: a euro area perspective, Speech delivered at Le Cercle, Brussels, June 18, 2010 available at http://www.ecb.int/press/key/date/2010/html/sp100618_1.en.html

determinants of inflation and inflation expectations, Chairman Bernanke stated that “The extent to which inflation expectations are anchored has first-order implications for the performance of inflation and the economy more generally”. The statement echoes the view from Paul Volcker, who wrote: “I have one lesson indelible in my brain: don’t let inflation get ingrained. Once that happens, there is too much agony in stopping the momentum”.⁵ It is, therefore, very important that reputable monetarist economist Manfred Neumann⁶, who was previously skeptical, wrote: “After almost ten years of operation the ECB has reached the status of an international leading central bank that serves the citizens of the euro area well by providing and safeguarding an internationally demanded stable currency”. Neumann’s comment is included in the book *Euro: the First Decade* that I edited jointly with Marco Buti and other colleagues at the European Commission and that has just been released by Cambridge University Press.

Looking at information from financial markets it is fair to say that the European Central Bank has been credible from day one. This view has been confirmed by analyses of quantitative and qualitative survey information. The ECB has clarified that price stability means keeping inflation below (but close to) two per cent over the medium term. For most of the time inflation has been close to (but not below) two per cent.

The point I want to stress, however, is how well-anchored medium-term inflation expectations have been in the recent past, in spite of very pronounced fluctuations in headline inflation. Specifically, while headline inflation increased sharply up to mid 2008 and fell fast after that, reaching negative territory, inflation expectations varied very little, close to the central bank’s definition of price stability. Well-anchored inflation expectations constitute an important contribution to preventing self-fulfilling deflationary spirals that constituted one of the major risks, in the context of the Global Crisis. The example provides an illustration of the “first order implications” from well-anchored inflation expectations, for the overall performance of the economy. But the ECB, and the Eurosystem, made important additional contributions to stability in the euro area, in the context of the Global Crisis. For example it avoided, for participating countries, additional disturbances coming from foreign exchange markets. Last

⁵ The quotes from Bernanke and Volcker are taken from Gaspar, Smets and Vestin, Inflation Expectations, Adaptive Learning and Optimal Monetary Policy, chapter prepared for *The Handbook of Monetary Economics*, edited by Benjamin Friedman and Michael Woodford, forthcoming with Elsevier, North-Holland. The paper provides full references for the quotes. The paper is available in draft form at http://www.ecb.int/events/pdf/conferences/monetaryeconomics/item3_paper.pdf?c58bb7a23b9e504e06814058a93ad24d

⁶ Manfred Neumann, 2010, ECB’s Monetary Policy, chapter 7 in Marco Buti et al. (eds.), *The Euro: the First Decade*, Cambridge: Cambridge University Press.

but not least, the functioning of the Eurosystem's operational framework, for monetary policy implementation, subsumes the lender of last resort function, thereby contributing to stability in financial markets⁷.

The euro area is a dynamic entity and its process of enlargement is ongoing. After its creation in 1999, the monetary union extended its border on four occasions; first to encompass Greece in 2001 and then to take in four of the new Member States: Slovenia in 2007, Cyprus and Malta in 2008, and Slovakia in 2009. The EU treaties provide a clear institutional path for euro adoption. Each of the twelve Member States of the fifth and sixth enlargement (i.e. those of 2004 and 2007) is expected and is willing to adopt the euro as their national currency. Each of the four enlargements of the euro area so far has been very successful; the changeover from a national currency to EMU was smooth both from a national and EMU perspective. Most likely, the euro area membership will approach 25 by the end of the second decade, and the monetary union borders will be progressively indistinct from those of the EU.⁸

At the beginning, questions about the euro area, extended well beyond central banking and the enlargement of the euro area and included at least the following: would the transition from national currencies to the euro proceed without disruption? Would the single monetary policy be perceived as credible? Would the fiscal rules – embodied in the Stability and Growth Pact (SGP) – ensure budgetary discipline? Would the institutional architecture of the euro area prove flexible enough to withstand the pressure of unforeseen change? Would enlargement of the euro area proceed smoothly? Would a monetary union be sustainable in the absence of a political union? Or even, how would the public react to the euro banknotes without national symbols?

I think that after the first decade, and with regard to all these questions, the euro has been successful beyond expectations. I do not have time to document this assertion but I am well prepared to discuss it in case there is interest.

⁷ The classical lender of last resort function, as defined by Bagehot, can be characterized by the following principles: (1) The lender of last resort aims at protecting the integrity of the financial system rather than individual institutions. (2) It supports the central bank's monetary policy objectives. (3) Insolvent institutions should be allowed to fail. (4) Only institutions which are illiquid but solvent should receive lender of last resort assistance. (5) Lending of last resort should be conducted at penalty rates. (6) Lending of last resort should only be granted against good collateral. (7) The conditions ruling lending of last resort should be announced and well-understood in advance of the event of a crisis. The marginal lending facility defines the upper end of the interest rate corridor, for overnight interest rates and satisfies Bagehot's principles. In addition the central bank may provide additional liquidity to the market through open market operations.

⁸ Note, however, that the EU is also itself a dynamic entity and may be enlarged again over the next years.

More importantly I was asked to speak about the future of euro area governance, given the Global Crisis. At this point in time, the first thing that is important to realize is that the Global crisis will have long lasting consequences. For the euro area the main aspect to stress are the clear evidence of strong interdependence and spillover effects; high and rising unemployment; enduring vulnerability in the financial system; high deficits and significant increases in government deficit to GDP ratios and, last but not least, significant cross-country divergences. Moreover, adjustment after the crisis will have to include transformational change associated with demographic trends, globalization and technological change. The crisis has not changed the nature of the challenges associated with these fundamental long term trends. Nevertheless, it does add a ring of urgency to the process of change. The Global Crisis has launched a transformational agenda that will mark decades to come.

Earlier in my talk I gave a list of questions that were frequently asked at the beginning. I have asked Francisco Torres and Erik Jones whether I should allow time for Q&A. They said yes! That is absolutely fine with me. However I want to propose an innovation. I provide questions and you will contribute the answers. A possible list is:

- Will the ECB manage successfully its exit from its current exceptional stance and continue its impressive record in maintaining price stability over the medium term?
- Will the framework for financial supervision and regulation prove effective? Will the new European Financial Stability Risk Board and the European System of Financial Supervision work well? How will the ECB, in particular, and central banks, in general, adapt to the new systemic risk management framework?
- Will the single currency continue to be an important driver of deeper integration in the single market?
- Can rules and procedures, aiming at fiscal discipline in the euro area, effectively mitigate the deficit bias in government finance and ensure sound public finances in view of the on-going demographic transition and of the need to provide for fiscal space?
- How to protect financial stability, of the euro area as a whole, in the face of turmoil in sovereign debt markets?
- Will further enlargement of the euro area proceed smoothly?

- Will participating Member States be able to adopt the necessary measures in order to facilitate structural adjustment and ensure the transition to a competitive position compatible with sustained growth?
- Will the euro area be able to develop a coherent position in international monetary forums? Will it be able to co-operate, with the US and others (e.g. in the context of the G-20) to better governance at the global level?

If you consider the list of challenges you will see that the European Union, the euro area and each Member States have been working hard and fast to meet challenge after challenge. The process has not been smooth at national or at international level. It is in the essence of open, democratic processes that different, contrasting and even incompatible viewpoints get a hearing and fiercely compete to provide the basis for social and political coordination.

In my view progress in many dimensions has been truly impressive. A major revamp of the financial and regulatory architecture is already under way. Proposed legislation foresees the creation of the European Systemic Risk Board and of three European supervisory authorities⁹. The proposals are being considered following a procedure of co-decision. It is envisaged that the new organizations will be operating already in 2011. The process has been fairly rapid with less than one year between the appointment, by President Barroso, of the de Larosière high-level group, on October 8, 2008 and the presentation of legislative proposals by the European Commission, on September 23, 2009. In the autumn of 2010, the Commission¹⁰ will round-up the package with an action plan on crisis management that will include a complete set of tools for prevention and resolution of failing banks.

Member States have responded to concerns about fiscal sustainability and turmoil in sovereign debt markets with strong fiscal and, in some cases, also structural actions and plans. Unprecedented financial support has been made available to preserve the overall stability of the euro area and of the European Union. The European Financial Stability Facility was created and Klaus Regling has been appointed to become its first CEO (starting July 1, 2010).

⁹ The three authorities are the European Banking Authority (COM (2009) 501, 23.09.2009), the European insurance and Occupational pensions Authority (COM (2009) 502, 23.09.2009) and the European Securities Markets Authority COM (2009), 503, 23.09.2009.

¹⁰ The Commission has presented a systematic time table of past, on-going and future initiatives concerning the regulation and supervision of the financial system in the Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, *Regulating Financial Services for Sustainable Growth*, Brussels, COM (2919), 301, final, 2/06/2010.

Clearly developments in sovereign debt markets impose a deep reflection of the economic governance of the euro area. That is the mandate of the van Rompuy task force, created by decision of the March European Council. The task force will examine questions of fiscal discipline and surveillance; divergences among Member States and trends and prospects for Member States' competitive positions; and, finally, crisis management (including financial assistance and conditionality). The task force has committed to complete its work and report back with concrete proposals in the autumn.

The enlargement of the euro area will proceed with Estonia, in January 2011¹¹, and further candidates for membership will follow.

The EU is deeply engaged in the governance process at global level as testified by the contributions made public ahead of the G-20 summit in Toronto.

The euro area has an economic constitution based on stability. The forces of integration, bringing member states, people and corporations closer together, are very strong. The euro area was extremely successful in its first decade and – I hope and expect – will be very successful in future decades as well.

In case the answer to all the questions listed above is in the positive it will be fair to say in ten years time that the euro area has (again) been successful beyond expectations!

¹¹ European Council Conclusions of 17 June 2010, paragraph 26, "The European Council congratulates **Estonia** on the convergence it has achieved, based on sound economic and financial policies, and welcomes its fulfillment of all the convergence criteria as set out in the Treaty. It welcomes the Commission's proposal that Estonia adopt the euro on 1 January 2011" available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/115346.pdf .