Completing Economic and Monetary Union

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Thank you very much for inviting me to this 500th session of your committee. It is a great honor and privilege for me to be here today.

I have read your proposals for the next European legislature not only with great interest but also with a lot of sympathy. There is no alternative to a completion of EMU. The European elections were a real shock but they a not an argument for sticking with the status quo. Yes, the number of European citizens who are deeply dissatisfied with the current state of the European Union and of the European Monetary Union is growing. But this should not lead to a standstill. Rather it should be a strong incentive to improve Monetary Union. It must be completed in a way that it is better tailored to the needs of the European economy and its people. The most dangerous development would be a wait and see approach. There are obvious institutional and political deficits that have to be tackled within the next few years. If we do not find effective solutions to the problems of unemployment, low inflation and weak growth the European elections in 2019 could lead to a real disaster.

The roadmap which you have developed for the next European legislature is as comprehensive as ambitious. In my short intervention I have to focus on the elements which I regard as especially relevant for the economic sphere. Thus I want to talk first about the "European plan for growth and employment" which is designed as a short-term solution. Then I want to discuss in more detail the four pillars for completion of EMU.

1. European plan for growth and employment

I very much share the view of the committee that we need a real pact for growth, jobs and stability to boost the recovery and create the conditions for debt to be repaid. There are no doubt obvious improvements in the EMU's economic conditions. Since Mario Draghi has made its impressive "Whatever it takes" statement almost two years ago we have seen an impressive stabilization of European financial markets. The very fact that the ECB did not have to buy a single bond since then clearly shows the herd behavior of financial markets. In addition, the recession which has affected the euro area in 2011 has come to an end and we see signs of a recovery.

No time for complacency

But in spite of these and other positive signals especially from the countries that were most seriously affected by the crisis there is no reason for complacency.

- Even under the assumption that the euro area will grow by 1.2 percent in 2014 and by 1.7 percent in 2015 (OECD forecast) the situation on the labor markets will remain completely unsatisfactory. This applies above all to countries like Spain and Greece where the unemployment rate will still be around 25 percent in 2015.
- In addition there is little hope that we will see an improvement in the field of public finances. The relation of gross public debt to GDP will increase in 2014 and 2015. In 2015 the OECD expects a rate of 147 percent for Italy and 142 percent for Portugal. Thus, in spite of so much austerity the sovereign debt crisis has not been resolved. On the contrary, mainly as a consequence of high negative multipliers of the fiscal consolidation measures, the relation of debt to GDP has become more severe. For the euro area in total this ratio will increase from 89 percent in 2009 to 107 percent in 2015.
- Finally, many banks of the euro area are still in a rather weak condition. The deleveraging continues. In the countries that are most seriously affected by the crisis interest rates are at high levels which are incompatible with the overall economic situation.

Risk of deflation

The unsatisfactory perspective for the euro area is even more threatening as the inflation rate is now much too low. With 0.5 percent it is significantly below the ECB inflation target of below but close to 2 percent. Low inflation and even more so deflation are especially dangerous in an environment with high public and private debt levels. Low inflation could easily turn into deflation if more and more countries try to overcome their competiveness problems with policies of wage restraints or outright wage cuts. As the European Central Bank has more or less reached the limits of its interest policy it could offer little help in a deflationary scenario.

A paradigm change is needed

Thus, your committee rightly emphasizes the need of an European New Deal. The euro area is in need for a paradigm change. After focusing on rescue and consolidation by fiscal restrictions, now the focus must shift to recovery and consolidation by growth enhancing measures. This leads to the fundamental question of a trade-off between consolidation and growth. In the view of my government this trade-off does not exist. And in fact it is true that Germany has been able to achieve a relatively good growth performance with a very low government deficit and a very high current account surplus. But the German approach is not a viable solution for a major currency area. A large current account surplus is only possible if there are also countries which incur the deficits. Thus, if we focus on large currency areas we can clearly identify a trade-off between austerity and growth. In the period 2011 to 2013 the fiscal deficits of the United States and Japan were more than twice the deficit of the euro area. The deficit of the United Kingdom was almost twice the euro area deficit. But did the fiscal prudence of the euro area lead to more growth? Of course not. In the 2011 to 2013 period the euro area has been almost stagnating (0.2 percent growth per annum), while in the UK and Japan the annual growth rate was one percent, and in the United States it was even more than two percent.

In my view your economic and social pillars contain all relevant elements of such a new approach. I find the model of partnerships with mutually agreed contractual arrangements especially promising. But the underlying philosophy should not be that countries are allowed fiscal laxity because they implement structural reforms. The opposite is true: structural reforms which aim at a strengthening of market forces will only be successful if there is a strong positive demand pressure in the market system. This is exactly what we experienced in Germany. Our reforms and our wage moderation in the first half of the last decade caused a five year-long economic stagnation in Germany (1st quarter 2001 until the 4th quarter of 2005). In the end the reforms did only pay off because of the strong demand from other countries, first from other euro area countries and then from emerging market economies.

European New Deal based on two pillars

Thus, your committee is right that the euro area needs a real plan for growth and employment. But I think a European New Deal should from the very outset be based on two pillars. In addition to the elements that you enumerate for macroeconomic stimulation it should also entail a microeconomic pillar which focusses on structural reform issues. You have developed this within the context of deepening and completing EMU within the next legislative term. I think we need this as soon as possible. A convincing growth strategy, especially for the German media and economists, must include a microeconomic pillar which entails the necessary structural reforms in addition to a macroeconomic pillar with demand-side oriented measures.

Golden rule for the macroeconomic pillar

For a relevant growth contribution of the macroeconomic pillar we need above all more flexibility in the implementation of the rules of the Stability and Growth Pact. In fact, during the last year the SGP has been applied in a much less rigid way than before, which is in my view an important reason for the turnaround in the peripheral countries. But we have to discuss the fundamental rationale of the EMU fiscal rules. In my view the golden rule for public finances must be rehabilitated. According to this rule which is widely shared by economists, even by the rather conservative German Council of Economic Experts, a government should be allowed to finance net investments with deficits. This does not mean that other measures like an increased activity of the European Investment Bank are not needed. But including the golden rule into the SGP and the fiscal compact would provide much more fiscal space for the EMU member countries.

Ideally each country should formulate its own growth program for a four year period. On the micro side it should contain the most important structural reforms for that period. This would require a prioritization of reforms which is sometimes difficult to identify. On the macro side governments should present the investment projects that they want to finance with additional deficits. In order to achieve consistency at the euro area level the national growth programs should be evaluated by the Commission and the Council. Such a monitoring would allow to identify synergies. At the same time projects with low productivity but which benefit certain national interest groups could be avoided.

With such a coordinated two pillar strategy there is a small chance that European New Deal will not be immediately rejected by the German public. Many Germans fear that an additional leeway for fiscal deficits will reduce the incentives for structural reforms and that in addition the money will be wasted for useless public projects. Thus, a credible and comprehensive framework is required demonstrating that such fears are unfounded.

2. Deepening and completing EMU

But the roadmap of your committee is more ambitious than this. For deepening and completing EMU it proposes above all a mechanism for Eurobonds, especially in the form of the debt redemption pact that was proposed by our council. We need such instruments if we want to create a more stable architecture of EMU.

The specific insolvency risk of EMU member countries

The fragility of EMU and the crises that we have experienced are to a large part due to the separation between running a common currency and intergovernmental economic governance. As a consequence the member countries of EMU are confronted with an insolvency risk which does not exist for other advanced economies. Countries like the United States or the United Kingdom are indebted in their own currency. They have central banks that are fully committed to maintaining the governments solvency if private lenders are unwilling to buy government bonds. In contrast EMU membership implies that the debt of all member countries is redenominated from the national currency into the euro. Thus governments have all their debt in euros but they no longer have a national central bank that would be able to buy these assets. For many years financial markets did not regard this insolvency risk as a relevant problem. But when the crisis started in 2010 they increasingly became aware of the specific nature of the EMU member's government debt. This led to a vicious circle which could only be stopped by Mario Draghi's announcement of the OMT program on 26 July 2012.

So far this announcement effect has worked remarkably well but we should be aware of the fact that such emergency support cannot provide a substitute for a stable architecture. In fact the OMT has not yet been tested by a real storm on financial markets. In addition, due to the limitations required by the German Constitutional Court, it is not 100 percent secured that the German government would endorse an ESM program which is necessary for the implementation of OMT.

Debt redemption pact or blue/red-bonds

Thus, it is perfectly sensible to take advantage of the tranquil period and to think intensively about mechanisms which strengthen the architecture of EMU on a sustainable basis. The decisive element of a more resilient institutional framework is some form of joint and several liability. The main models are the debt redemption pact which would transfer all debt above the 60% threshold in Eurobonds. A specific feature of this approach is the temporary nature of the scheme. The participants are obliged to redeem these bonds after 20 to 25 years. In the end, joint and several liability would be removed. The alternative is the blue/red-Bond proposal. According to this scheme all government debt below 60 % would qualify for joint and several liability. There is no obligation to reduce the debt for which a joint liability is provided. In my view, among the two alternatives, the blue-Bond proposal is the more realistic option as it will be extremely difficult for countries like Italy to reduce the debt level to 60 % within the required timeframe. I also think that a stable monetary union requires a major amount of 100 percent stable assets not only on a temporary but also on a permanent basis.

Joint liability requires more political integration

So far all these proposal were met with a lot of skepticism especially in Germany. The Grand Coalition, which was very vague in its coalition agreement as far as European integration is concerned, has clearly stated that they have no intention to implement the debt redemption pact. Therefore, I think that joint debt issuance will only have a realistic chance if it is accompanied with a major step towards political integration. Above all it would require that the sanction mechanism for excessive deficits has to be transferred from the intergovernmental level to the supranational level. From the very beginning it was not a good idea that a club of finance and economics ministers is entrusted with the task of sanctioning themselves. What is needed is something like a European finance minister elected directly by the European Parliament. As a part of the Commission he would be responsible for the monitoring and if necessary the sanctioning of national fiscal policies. Compared to the Troika, this would lend much more legitimacy to the whole process of budgetary surveillance. In this context it would be also necessary to develop better sanction mechanisms.

Instead of fines which would make the financial situation of a country even worse, the European institution should have the authority to impose temporary increases of taxes or across the board expenditure cuts.

3. A new convention

Therefore it is very important that your committee has stressed the need to relaunch political Europe as a whole. The institutional set-up that I have sketched in my short intervention cannot be achieved through enhanced cooperation. Your roadmap envisages a new Convention that should finish its work before 2019 when the next European elections will be held.

I am well aware of all the difficulties that are associated with such a big institutional step. But it would be extremely risky to rely on the current institutional framework for the time being. Its lines of defense in the case of financial market attacks are either insufficient (as far as fiscal policies are concerned) or untested and legally contested (as far as monetary policy is concerned).

Thus, given the long time-frame of institutional reforms the discussion should start as soon as possible. I hope that the new Parliament, the new Commission with the valuable support of your Committee will tackle this important task successfully.

Let me end by congratulating not only for your 500th session but for all the important contributions that this Committee has made in the last 57 years for European integration and the citizens in Europe.