Scotiabank Annual Financial Markets Dinner

The Future of the Euro?

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It's a great pleasure to be here today in Toronto, and I would like to thank Scotiabank for inviting me to speak at its Annual Financial Market Dinner.

When Barry Wainstein asked me for the title of my talk - and informed me that the audience would probably be interested in my views about Europe - I opted for the easy solution and proposed "The future of the Euro". After all, the main thing I've being doing over the last nine months, after having left the ECB, has been to attend "the future of the euro" conferences.

The surprise came when I found out – in reading the printed version of the program – that a question mark was added at the end of the title. So the title now reads: "The future of the euro?" suggesting that maybe the euro's future could be in question. And maybe it is, indeed.

I would like to sound less pessimistic, and propose a new title for my talk, "the Fall of the euro", Fall meaning Autumn. Indeed we are at the start of the 14th Fall of the euro, since it was launched on 1 January 1999; and if we want to understand how this Fall may develop, and possibly the next few ones, it might be useful to look at some of the past ones.

I would thus like to start by looking at a five pictures, taken in September of the past few years.

Let me start with September 1992, twenty years ago. On 5-6 September, in Bath (England) the Finance ministers and central bank Governors of the then 12 members of the European Union were meeting to address the mounting foreign exchange crisis which was affecting the European exchange rate mechanism. At that meeting, the President of the Bundesbank, Helmut Schlesinger, said at least four times no – it is reported - to the request of several other participants to reduce German interest rates to ease the tensions which were pushing the DM up against all other currencies. He even threatened to leave the room when Norman Lamont addressed him one more time with the same request.

We know the consequence of that decision, or non-decision. The Lira exited the mechanism few days later, followed by the Pound and the Peseta. Only as the crisis intensified towards the end of September, did the Bundesbank agree to unlimited interventions to defend the parity between the Franc and the Deutsche Mark. In the following months Italy went very close to a default, with skyrocketing interest rates on its debt. All European countries went into a recession. The ERM was revised one year later.

The Bundesbank decision turned out to be a mistake. The apparently high inflation and monetary development during the Summer of 1992 were hiding a sharp slowdown of the European economy, including Germany. It proved that in an integrated financial system, with full capital mobility, monetary policy cannot be decided by the central bank of one country, on the basis of that country's own interests.

The second picture is September 2000, the IMF meetings in Prague. The picture that I want you to focus on doesn't portray the protesters outside the meetings, forcing ministers to take the subway back to their hotel, but the G7 meeting which agrees to support the intervention in the foreign exchange markets to stop the depreciation of the euro, which had fallen from 1.17 dollars at the start of EMU to .82 dollars, in the midst of increasing worries about the sustainability of the euro. There were increasing concerns at the time that the fall in the value of the euro would fuel self-fulfilling expectations and a loss of confidence in the single currency that would lead to its disintegration. The intervention worked and the euro gradually recovered and actually went from being undervalued to becoming overvalued, moving above the level of 1.60 to the dollar, in the Spring of 2008.

The third picture is September 2008, right after Lehman brothers' bankruptcy. Markets collapsed, as we all recall. Coordinated actions by European and US authorities contributed to restore some confidence and avoid the meltdown. The Heads of Government of the euro area met in Paris a few days later to announce a joint plan to address the crisis and contain the contagion to Europe. There were no doubts at the time that without the euro the financial crisis, which had originated in the US, would have had even more disastrous effects on the European economies.

The fourth picture is September 2011, one year ago. The ECB had just started a new program of interventions in the Government bonds markets of Italy and Spain, on the basis of a commitment by these two countries to implement rapid adjustment and structural reforms. The effectiveness of these interventions was nevertheless hampered by the partial backtracking by the Italian Government after the first few days, which led to a re-negotiation of the fiscal package. This is one of the many episodes of failed coordination between the ECB and the Governments of the euro area, which has led to a loss of confidence among institutions. As a result, the ECB started to phase out the interventions in the bonds markets and turned to refinancing operations directly with the banking system, with longer maturities – the so-called LTRO.

The last picture is taken about 10 days ago, when the ECB decided to take away from the table the so-called convertibility risk - in other words the risk of exit from the euro, or a euro break up – for all those countries which abide by the necessary conditionality associated with being a member of the Union. That was the practical implementation of the statement “we will do all that is needed” to avoid a fallout of the euro.

You could thus close the circle of the five pictures taken over 20 years, by noting an interesting common feature. Again, two decades later, the President of the Bundesbank said no. The difference is that this time it is not relevant.

What is the common theme of all these pictures? There are probably more than one, but the one which should strike most is that looking back to 1992, or even 2000, the Europe of today is very different from the one of those days. Not everything is that different, as some stereotypes have not changed. But it’s different in the sense that the crises of the past have always led to steps forward being made in the build-up of a stronger and more complete union.

In other words, if we look at the European construction today and compare it with 20 or 10 years ago, you can observe that it has strengthened substantially, taking stock of the crisis which developed at each stage.

There is a famous sentence of Jean Monnet, one of the founding fathers, “Europe will be forged in crises and will be the sum of the solutions adopted in these crises”.

Over the last months we were repeatedly told that the euro was entering a decisive week, and that it would not survive the failure to act by European authorities. And still it survived.

Last week was one of those weeks, with the decision by the German Constitutional court on the European Stability Mechanism, the Dutch elections, the ECB decision, etc…

We will probably have more of these weeks in the near future, for sure. The question is whether they will end up as nicely as the last one. Too many times in the past did we have the opposite result.

Looking at the past experience, and trying to understand the future of the euro, three questions come to mind.

First, why hasn't the process of political and institutional integration started earlier, to avoid getting into the repeated crises that the euro went through?

Second, why, in spite of all the steps forward which have been accomplished, the crisis has not been solved?

Third, can the next crises – or the next steps of the crisis - be resolved in a similar way as in the past, so that the process of European integration can move forward, and make the euro a truly viable currency?

The last question is obviously the most interesting one. But I want to spend a few words about the other two, because they can provide some elements to address the last one.

Let me start with the first question, which is often asked this side of the Atlantic. It's the usual *"we told you so"* comment, that I often hear in Cambridge.

We knew from the start that Europe was not an optimal currency area, that the adjustment mechanisms were not in place to address major asymmetric shocks, that the one- size-monetary policy would not be able to fit all. We knew that without a unified fiscal policy, or even a single banking regulatory system, it would be very difficult to hold together the various pieces of a monetary union.

So why did Europe nevertheless move forward?

The same question can be phrased for the future. Now that we have experienced that it doesn't work, unless all the pieces of the missing puzzle are rapidly put together, wouldn't it be better to step back and revise the whole construction, possibly with a smaller group of countries?

The typical answer to this question is that the creation of the euro is not a project based on sound economic fundamentals but it's part of a political objective, which is to maintain peace in Europe.

That was certainly the starting point for the founding fathers. This is not the right answer today.

The answer can be found in the first picture that I mentioned at the beginning, with finance ministers and central bank governors fighting to defend monetary and financial stability in Europe. Europe may indeed not be an optimal currency area, in the way Nobel price winner

Robert Mundell (a Canadian) defined it in a seminal paper, as it does not have all the adjustment mechanisms required for a currency area to function properly, namely labor migration, full capital market integration, fiscal transfers. This was certainly recognized at the time but the question is whether there was a better alternative. The question is whether Europe (Continental Europe) is an area where it is optimal or desirable for currencies to float.

Since the breakdown of the Bretton Woods system European countries have tried to find a better system. They tried to stabilize exchange rates with a view to discourage beggar-thy-neighbor policies in a highly integrated economic and financial environment. They tried with the so-called “Snake” in the early Seventies, then with the exchange rate mechanism, which turned out not to work as expected, especially since the ultimate decisions were taken by one country, as in that 1992 picture.

The move to the euro area was thus certainly not considered as a first best solution, but possibly the least worse, in light of the fact that the other ones which had been previously experimented failed. To some extent, the expectation was that some of the missing conditions would develop over time, as a consequence of the monetary unification, such as the integration of markets.

To some extent, many knew that the monetary union was born imperfect. But that was probably the only way to give birth to it. Indeed, it is very difficult to create the perfect institutional framework from the very start. The main reason is that institutional change requires political consensus. In order to create such a consensus, among the various constituencies – including those that may lose from such a change - it must be clear that the change is necessary in order to achieve a specific objective, and this must be apparent to all.

Let me be concrete. After the various exchange rate crises of the 1970s’ and 1980s’ a consensus emerged that exchange rate stability could not be achieved in a fully integrated economic and financial area if each country implements its own monetary policy. It’s the impossible trinity theorem. The solution to such a problem is to move to irrevocable fixation of exchange rates and a single currency. Even national central bankers, which were the main losers from monetary union, in terms of their individual power to implement their own monetary policy, in the end got convinced. They only insisted that the monetary union be built with adequate safeguard for the independence of the central bank.

Another inconsistency is that a single currency area can hardly work without a single regulatory system and an integrated supervision. Many people agreed with such an analysis, at least in theory. I wrote it myself in 2000, in a book published together with Daniel Gros. But not necessarily all agreed that it was necessary in practice. This was the line taken by those in charge of banking supervision at the national level, which would have lost power had the decision been taken to move supervision at the European level. They started developing counter arguments, for instance that it was complicated to merge supervision, that national expertise is required, that markets are global and if integration is needed it would have to take place at the global level, not only in Europe, etc. Ultimately, the main argument was: "*if it ain't broke, don't fix it!*" Against such arguments it's very difficult to respond that sooner or later it will break down. Politicians are not attentive to such arguments. The people even less.

Under such circumstances the lobbies of the Turkeys (who never vote for Christmas) have an easy way. With monetary union the members states had already given up their sovereignty for monetary policy. If they gave up other powers they would soon disappear.

The lesson is that you need a crisis for institutional change to happen. Otherwise the "ins", those who live in the pre-existing institutions will try to oppose change at all costs.

This was the case also for fiscal policy. The view put forward at the start of Monetary union was that rules would be sufficient to ensure that fiscal policy would remain aligned to the requirements of the single currency. Nobody thought – or did not want to think – that rules can be breached or, more important, that crises could put public finances under pressure in a way that can make them unsustainable. And hardly any rule can prevent that from happening.

This implies that a financial crisis was probably needed in order for a large part of the population and policy makers to realize that we can't really have a currency union without a single banking regulator. A fiscal crisis was needed for all these people to realize that tighter rules and a safety net is required for a currency union to function properly.

We got the crisis. And the crisis has contributed to such an awareness, which was not there at the start.

The mechanism that I just described is not that peculiar to Europe. Think about the history of the US, for instance. Budgetary rules were implemented only after several States went bankrupt and the Federal Government refused to bail them out, in the middle of the

Nineteenth Century. The Federal reserve was created only in 1913, in order to address the issue of the lender of last which had produced severe banking crises. The federal budget, and many federal programs were ultimately introduced as a way out of the Great Depression in the 1930s.

If you think about the main factors which have led to the federal structure that the US currently has for the conduct of economic policies, the more relevant ones are probably the Great depression, the state and banking crises of the mid 1800s and the civil war.

The important lesson to take from the European history is that each time a crisis has emerged, and has shown the limits of the European construction, the decision has been taken to move forward, rather than backwards. This is the reason why last week the European Commission has presented a project to centralize banking supervision, in a far reaching way, which would have been unthinkable only a few years ago.

This leads me to address the second question. Why the decisions to move forward which have been taken over the past couple of years have not stopped the crisis? Two and a half years after the start of the Greek crisis the situation has not improved, and may have even worsened.

The answer lies in the different speed of adjustment of financial markets compared to political processes. This is not to blame politicians, as they are only one part of the political process, especially when it comes to giving up sovereignty. You also have the people - i.e. the voters – the constitutional courts, the technocrats, the ratification processes, etc. Each of these steps takes time, in terms of days, weeks, sometimes months, while financial markets may act within minutes or seconds.

In reality, things are even more complicated, because the political process is not independent of the way in which financial markets behave, and vice versa. The interaction may at times become quite unstable.

The experience of the last couple of years shows that political authorities tend to act only under the pressure of financial markets, because that's when they see the dangers of not acting. The same applies to voters, who do not necessarily always trust what politicians recommend as being necessary, especially if they do not perceive the state of crisis. This was the case in Germany, for instance, where people did not perceive the crisis in the same way as in peripheral countries, because their assets had not been negatively affected nor was the economy performing as badly as in the other countries. In Germany the tendency has been to think that the problem lied in the other countries and that there was very little that they could do about it.

In May 2010, for instance, the German Finance Minister asked ECB President Trichet and IMF Managing Director Strauss Kahn to testify in front of the German Parliament to explain the gravity of the crisis, the risks of contagion and why action was needed. German parliamentarians could simply not understand why Germany was asked to contribute to helping other countries.

The loop between financial markets and the political process may work in a perverse way. Financial markets have often reacted positively to some of the important decisions which have been taken over the past couple of years. However, this has led the political authorities to relax, or even reverse some of the decisions which had been taken, in the expectation that the temporary improvement in market sentiment was permanent and independent of the actions which had been taken. As a consequence, markets started reversing their views in an even more dramatic way, leading to a loss of confidence in the politicians' willingness to address the problem. This is moral hazard.

The perverse interaction between markets and politics was made even worse by the lack of understanding by politicians about how markets really work. One example is the decision taken by the European Council in October 2010 about the so-called Private sector involvement in crisis resolution. It was decided that any financial support provided to a member of the euro area would have to be accompanied by a parallel forced bail-in of private creditors, banks in particular, in the form of debt restructuring.

The reasoning behind the decision sounded nice and politically attractive: if taxpayers have to put money to help other countries, creditors who lent recklessly, should do the same.

In practice, however, this decision represented a total innovation compared with the IMF practice over the previous 40 years, according to which the provision of official sector money, under specific conditions, aims at catalyzing private sector money in a voluntary way. The result of the PSI agreement was to scare away the private sector from investing in the euro area. This has penalized market access for countries which were experiencing difficulties and accelerated the crisis.

Finally, another issue which was not always fully understood both by political authorities and market participants, together with many academics, is that the euro is not a fixed exchange rate system but a currency union. Many thought, over the past couple of years, that countries could come in and out of the euro, or even take a sabbatical, as easily as one could devalue its own currency in the past. It has taken some time, and the near drama of Greece exiting the euro, to realize that such an act would have enormous economic, social and political consequences, not only for the country which leaves but also for the integrity of the union as a whole.

This issue seems now to be better understood and the exit is seen by most political authorities –including in Germany - as something to avoid as much as possible.

Let me turn now to the last question. Given the experience of the past, and the need for Europe to further integrate in order to complete the design of the single currency, will it succeed in doing so? And under what conditions?

A simple extrapolation of past developments may suggest that the process of integration will continue, but that the path will be very volatile.

Let me give you a few elements of the path.

The first is the decision of 6 September, by the ECB to take away from the table the so-called convertibility risk. In other words, the ECB will do “whatever it takes” to avoid that a country which fulfills the criteria for staying in the union and implements the policies accordingly, leaves the euro.

This means that the risk of a break-up of the euro is seriously reduced.

The second element of the path is the trajectory towards greater integration. The broad lines of this path have been designed in the report which was presented at the June European Council. They will be further developed over the coming months by a specific task force headed by the President of the European Council and will be submitted to the Heads of Government by the end of the year.

I will not elaborate too much on this aspect, but the direction is clearly one of greater integration and greater political legitimacy. The State of the Union address by Barroso, last week, also makes suggestions in that direction, much more courageously than in the past, with a greater involvement of the European Parliament. I just mention one proposal, which is aimed at increasing the legitimacy and political integration of the union, that the next President of the Commission should be the person at the top of the list of the party which will get more votes at the next European Parliament election, which will take place in 2014.

The third element is represented by the series of initiatives that will be put in place in the near future to fill the various steps foreseen in the integration path I just mentioned.

The first initiative is the banking union, starting with the centralization of supervision at the ECB. The first proposal has been tabled by the European Commission and has been discussed by Finance ministers last week end and will be negotiated over the coming months. Another step is the crisis resolution regime for ailing banks, which is also under discussion, on the basis of a Commission proposal.

A further step, which has not been discussed yet, is the strengthening of the safety net to support countries which are at risk of losing market access. The current resources are clearly not sufficient to face potential requests by Spain and Italy.

There is then the discussion about increasing the mutualization of risks, in particular concerning public finances, and the possible move towards debt issued jointly by the member states under the form of Eurobonds. The discussion of such a solution entails a further move towards even greater political integration, with powers being given to European institutions to over-rule decisions made by national Governments and parliaments on budgetary issues.

To sum up, there is a path and there are concrete actions being taken. Why am I thus concerned that this path will be volatile and turbulent?

There are two main reasons. The first is that the various steps foreseen in the way forward are mainly of a financial nature and do not address the fundamental question of the economic divergences which have been accumulated between the member states. The second is that the adoption of the various steps entails political choices which should not be taken for granted, especially in view of the persistent divergences that I just mentioned.

To explain the issue let me describe what can be considered as a good scenario.

The ECB decision of 10 days ago has contributed to reduce the risk of exit. Spreads have come down substantially. Confidence has come back, as can be shown even by the improvement in the exchange rate of the euro.

A positive scenario could develop if the countries which are currently experiencing most difficulties use this improved environment to further strengthen the adjustment effort, adopt the reforms necessary for improving the investment climate, accelerate the process of bank restructuring and re-capitalization.

A more favorable economic environment would contribute not only to ease the burden of the fiscal adjustment but also to restore market confidence. After years of investing in low risk assets many market participants would be keen to start buying higher yields, as they have signaled over the last few days.

In other words if the developments recently experienced in Ireland, and partly in Portugal, would generalize, risk appetite would rise again, increasing the probability of a virtuous circle.

A solution to the Greek request for having more time to implement the adjustment, based on an acceleration of the funds' disbursement, would also contribute to improve market sentiment.

As the economy gradually picks up and the reforms start producing their effects, the social tensions would ease in debtor countries. In creditor countries the perception that the support provided to countries in difficulty was used effectively to improve competitiveness and restore market access would alleviate the fears that the measures which have been adopted recently would transform the monetary union in a transfer union. The political climate required for pursuing the path towards further integration would be greatly improved.

We can now think of what the opposite scenario would look like.

If the economic situation remains weak or even worsens, the prospects for fiscal adjustment may be further delayed and the debt may actually increase over the next couple of years in several countries. This could alert markets to renewed sovereign risks.

The weakening of economic conditions could generate reform fatigue, and even lead to reverse some of the measures which have been adopted recently. The improvement in market conditions which followed the ECB announcement could create the illusion that the worse of the crisis is over, and relax the adjustment effort in all areas, from the fiscal to the banking sector.

For fear of the stigma attached to IMF and EU conditionality, Spain and Italy might be reluctant to apply for the programs, as required in order to be eligible to the ECB's activation of the Open Market Transaction program.

At the European level, the agreement on the banking union could turn out to be more difficult to achieve than expected, because of contrasting interests at stake.

Under such a scenario, financial markets could lose confidence again in the ability of the European authorities to manage the situation and fully implement their commitments. A new sprout of instability may arise.

If I follow the reasoning developed earlier, i.e. that national and European institutions tend to act only under the pressure of the markets, I would have to conclude that this second scenario, which is characterized by renewed bouts of instability, cannot be totally excluded.

This leads me to the second reason for my concerns. How stable is the relationship between market pressure and political action, going forward? Can there be breaking points that could lead to tail risks materializing?

If the economic situation worsens, and financial instability bounces back, the political tolerance for supporting the reform process in debtor countries, and for supporting further European integration in creditor countries, may wane.

When the economy gets worse, a natural tendency develops in all countries to blame others, and Europe is the best candidate for playing the role of the "other", for being the scapegoat. This happens both in debtor and in creditor countries. In debtor countries, Europe is blamed for not being able to help and to find the right solution to the crisis. In creditor countries, Europe is blamed for trying to shift the burden to them and not putting enough pressure on the undisciplined ones. This leads to a re-nationalization of public opinions, media, political elites.

We observe this development every day in Europe.

In such an environment, moves forward can be made only with gradualism. However, when market conditions deteriorate excessively, gradualism is not sufficient and the risks of tail event rise.

In the end, it ultimately boils down to the faith that each of us has in the rationality of human beings, including political authorities.

If they are able, as they have been able so far, to ultimately understand that the alternative is much worse than proceeding in the direction of further integration – to use JK Galbraith's words *"that the unpalatable is preferable to the disastrous"* – one can be confident that the euro will have a future, possibly a brilliant one.

This process may take some difficult curves, as a look into the abyss may be needed from time to time. But over time the hard road pursued in the adjustment process should lead to a more stable and prosperous union.

In this respect, last week's outcome of the Dutch elections, which have rewarded the moderates and penalized the anti-Europeans is a good signal.

In any case, there are a lot of ifs in the analysis I just spelled out, and therefore a lot of risks. So, we will have in the future several more "crucial weeks" for the euro, more doomsday forecasts, more predictions of an inevitable death of the euro.

It makes me think of a famous sentence by Mr De la Palisse, which may apply to the euro. I will quote it in French: "*Un quart d'heure avant sa mort, il etait encore vivant*" (which may be translated in English as: "Fifteen minutes before dying, he was still alive"). The euro is still alive.

Thank you for your attention.