The federal enterprise:

from monetary to economic union

# Europe: from monetary to economic union and beyond

Speech by the Senior Deputy Governor of the Bank of Italy and

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**Europe's pendulum**

The dream of a united Europe is an ancient one. In the distant past it was even a reality, under the Romans for example, and later under Charlemagne. The rise of the nation state in modern times almost extinguished that dream: it was revived in the latter part of the last century, after the Second World War.

Exhausted by the bloodshed and mass destruction, Europe had also lost its geographical centrality and economic hegemony. In reviving and advancing the European cause the original visionaries – such as the Italians, Rossi, Spinelli and Colorni – were now flanked by pragmatic politicians such as Monnet, Schuman, Adenauer and De Gasperi.

No less idealistic, this second group of men nonetheless embodied a new and audacious vision. Let us immediately seek, they said, *not* the continent's political unification, seeing as how the wounds of the animosity that pitched the European peoples against each other continue to fester, but let us instead set out on a less worn and longer path. A path that addresses people's most pressing needs: in times of peace, the economy is all.[1]

During those years the advanced economies were rebuilt from scratch. Cross-border commodities trading was a formidable ingredient in this renewal. Prior to the war, autarchies and dictatorships had cast a pall of protectionism throughout the world. With the advent of war, trade was annihilated. Its resumption was exactly what was required. This was how the European Coal and Steel Community (ECSC) first, and later the European Economic Community (EEC), came about. They reaffirmed free trade as an engine of development and prosperity, but also marked the dawn of a new rapprochement between the peoples of Europe, an idea that was steeped in politics and through which the European project could be promoted.

This year we celebrated the sixtieth anniversary of the Treaty of Rome, which established the EEC. We all recall how the 1950s and 1960s were a golden age of economic growth for Europe, especially for the two vanquished countries, Italy and Germany. Between 1949 and 1970 Italy's GDP grew more than threefold in real terms; per capita output rose from 36 to 65 per cent of that recorded in the USA. The German economy obtained even better, though comparable, results.

The spirit of Europe was also slowly developing in the collective consciousness.

The long forgotten Werner Plan of 1970 was a first attempt at monetary unification, but it was immediately abandoned owing to its evident anachronism. Europe was poised on the brink of that fearsome decade, the 1970s, when the world reverberated with economic, social and political upheaval. The international monetary system built in 1946 had imploded. This was no time to pursue monetary chimeras in Europe.

In the decade that followed, the pendulum swung back towards the real economies and trading in the goods they produced. It was at this time that the single European market was completed.

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[1] See Mario Draghi's speech delivered on the occasion of the Award of the Gold Medal of the Jean Monnet Foundation for Europe, Lausanne, 4 May 2017, 'The Monnet method: its relevance for Europe then and now'.

In the 1990s plans for monetary unification were back on the table. The stakes were high: the objective was to disprove the economists' argument, set out in textbooks, that there could be no single currency in a 'sub-optimal' area, i.e. one without full labour mobility and a common budget. A leap of faith was needed, relying on the most powerful symbol of them all – money – to drive European economies towards further integration and to deliver the ultimate objective of political unification.

The political protagonists of the day were Mitterrand, Kohl, Delors and Ciampi. In the Bank of Italy, Tommaso Padoa-Schioppa was the chief advocate of Europe, employing strong economic arguments, notably a 'theorem that is well-known in economic doctrine and history and with which few disagree: free trade, complete freedom of capital movements, fixed exchange rates, and autonomous national policies cannot coexist in the long term. These four elements form an "inconsistent quartet" that can be reconciled only by transforming the fourth element into monetary union, or by eroding the first three in varying degrees'.[2]

In a book penned almost twenty years ago,[3] I wrote how those men came from 'a generation that had not forgotten the conflicts in Europe and the ensuing destruction…their commitment, their most solemn public declarations, fuel the perception of those involved and of ordinary citizens that in the mind of its leading architects the European construction is more political than economic'.

The euro was adopted on 1 January 1999; the first banknotes entered into circulation exactly three years later.

Did they win the challenge? For a decade it seemed that they had. But in Europe tensions were bubbling under the surface and in 2010-11 they exploded into the sovereign debt crisis. The trigger was the discovery that Greece's public accounts were in a much more disorderly state than the Government of the time had officially declared.

Public opinion in Europe has changed since then, at times even turning hostile to the European project, though not always to the same degree and with about-turns regularly recorded in national elections.

Put very simply, the peoples of Northern Europe and their political representatives complain of a chronic tendency on the part of those in the South to live above their means, partly owing to the European Commission's lack of determination in enforcing the rules and – as some claim – to the excessive laxity of common monetary policy. This has led to sometimes brusque calls for structural reform to make the weak economies more competitive and less prone to tolerating economic rents and privileges.

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[2] Padoa-Schioppa, T., *The Road to Monetary Union in Europe: The Emperor, the Kings, and the Genies*, Oxford University Press, 1994 (second edition 2001).
[3] Rossi, S., *La politica economica italiana 1968-1998*, Laterza, Bari-Rome, 1998. The fifth and last edition of that book, titled *La politica economica italiana 1968-2007,* was published in 2007.

On the other hand, in the South there is a growing suspicion that monetary union was a mistake, if not the very instrument by which the countries of the North have prospered to the detriment of the others, de facto stripping them – with the help of European bureaucracy – of their sovereignty.

These opposing visions have combined to produce a highly critical view of the European institutions. At the very outside, both fronts claim that, without a radical change in the status quo, the countries of the South would do better to leave the euro area, in an 'orderly' fashion of course, and wrest back control over their economic and political destinies.[4]

I will not return to the objective and technical reasons why the idea of a country leaving the euro area is catastrophic, first and foremost for the country itself, and why the chance of an orderly departure is doomed from the outset.[5]

What is instead noteworthy today is the sentiment that has gained traction in Europe, and not just among the 'populist' movements, of widespread distrust and disaffection towards Europe.

**The case of banking union**

The case of banking union is a good example of the contradictions of the European construction in these post-crisis years.

In 2007-08 the US financial crisis finally spread to the rest of the world. It became apparent that a huge financial bubble had formed and that the key multinational financial players, banks and others, had expanded to a point where they were too deeply entangled with worldwide finance and too large for governments and supervisory authorities to allow them to fail.

The collapse of Lehman Brothers that the US authorities did allow to happen – for reasons that future historians will clarify – caused a global upheaval and seriously alarmed everyone. The authorities in the leading countries rushed in with taxpayers' money to shore up their banks, large and small, that had succumbed to the financial panic.[6]

The Americans did it; and the Europeans did it too, spending almost 6 per cent of the EU's GDP in public money on rescue operations. Germany played a prominent role, with 12 per cent of its GDP. In Southern Europe, Spain and Greece took the same path, using EU funds obtained with the instruments available at the time (the European Stability Mechanism, ESM).[7] Italy did not: ostensibly it did not need to because its banking system had gambled very little on the derivatives table and NPLs were still well below the peaks of 2015.

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[4] For an example of this 'coincidence of opposites', compare Stiglitz, J. E. (2016), *The Euro: How a Common Currency Threatens the Future of Europe,* W.W. Norton & Co., 2016 with Sinn, H.W. (2016), *The Euro Trap: On Bursting Bubbles, Budgets, and Beliefs,* Oxford University Press, 2014.

[5] Giunta, A., Rossi, S., *Che cosa sa fare l'Italia*, Laterza, Bari-Rome, 2017.

[6] Rossi, S., *Processo alla Finanza*, Laterza, Bari-Rome, 2013.

[7] Greece had already obtained financing from its European partners before the ESM, both in the form of bilateral loans and through the European Financial Stability Facility (EFSF), forerunner of the ESM.

The financial panic had serious repercussions for the real economies, to the point of triggering a Great Recession in many advanced countries. In Europe, this dire situation was compounded by the sovereign debt crisis, which I have already mentioned briefly. That crisis had political roots more than economic ones, and it called into doubt the unquestionable, i.e. the irreversibility of the euro, among the public, governments and international financial investors. When the European crisis erupted, government bond yield spreads sky-rocketed between the countries that it was widely believed would inherit a devalued currency if the euro broke up and the countries whose currency would appreciate and they have not returned close to zero since.

All banks have a large volume of sovereign bonds on their balance sheets. Hence, the value of Southern European banks has had the same fate as the countries themselves and their government bonds in the opinion of wholesale lenders (primarily foreign banks and international investors). The banking union project was conceived precisely to sever this link and therefore originated as a step forward in the European construction. The basic idea, as I have explained on other occasions, is that a bank established in Europe is of concern to everyone, not just to its home country.[8]

From the very outset this idea came up against the now rampant distrust between Northern and Southern Europe. The banking union project thus became a means not only to sever that perverse banks-sovereigns connection, but also to prevent, or at least impede, the use of public money to save a bank, be it the home country's money or that of all the European members.

The supervision of sound banks was brought under one roof in Frankfurt, that of ailing banks in Brussels.

The banking union framework that has eventually taken shape does in fact have its own logic and its own raison d'être, even though they are not the original ones. It can be criticized for being somewhat disjointed and for making its rules on banking crises retroactive. Italy is paying the highest price because it has been cornered by the new approach – no more bail-outs, only bail-ins – just when its banks' NPLs were piling up owing to the gravity of the double-dip recession, heightened in some cases by mismanagement and even outright criminal behaviour.

Voices are occasionally raised to ask why Italy did not object to some of the banking union rules that are deemed inappropriate. The answer is straightforward: it objected on a technical level, but could not do so on a political level. But the technical level held no sway and the final decision was rightly an entirely political one. Politically, Italy was in an exceptionally weak position in Europe between the summer of 2012 and the end of 2013 owing to domestic upheavals. At the time, the new system was coming into operation with the Bank Recovery and Resolution Directive (BRRD) and the European Commissions' Communication re-interpreting anti-trust measures to exclude any form of state aid, or equivalent, to banks unless shareholders and subordinate creditors suffered losses (known as burden sharing).

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[8] Rossi, S., *L'Unione Bancaria nel processo di integrazione europea*, address given at the CUOA Business School, Altavilla Vicentina, 7 April 2016.

Justifiable and timely criticism of rules and actions is not anti-Europeanism, quite the opposite. As the Governor of the Bank of Italy said two weeks ago, the aim of the criticism is not 'to question the path of European integration',[9] but to make it easier, pointing out what appears to be the right direction.

Banking union is still missing two logically very important pieces: 1) the availability of common public funds to support 'resolution' procedures in the case of ailing banks (the Single Resolution Fund's fiscal backstop) and 2) a common bank deposit insurance scheme (again with a common public backstop). But we must be realistic: as long as there is mutual distrust throughout Europe, those two pieces will remain missing. It is right to continue demanding them in the name of the economic and institutional logic of the European construction, but for the time being it is just wishful thinking.

**Should we drive Europe forwards or backwards?**

We are alternating, at this moment in history, between optimism and pessimism as to the fate of the European experiment. Others more competent than myself can give their reasons in support of either position.

But it is nonetheless difficult to contribute constructively to a debate rife with unilateral positions, bitterness, and the tension that is now typical of public discourse. If the European Union is a zero sum game in which inevitably someone wins and someone else loses, if it is only a stage on which all the actors are in conflict (North against South, member states against EU institutions), then there is no room for mutually beneficial solutions or, to borrow from economic jargon, Pareto efficiency.

However, there are many good reasons to believe that this is not how things really are. The single market, the free movement of everyone and everything, and the single currency are tools that provide the citizens of member states with 'European public resources' that individual states alone would not be able to dispense.

Are these are the only advantages of a confederation, or of the European Union? Perhaps not.

More than 70 years have passed since the end of the War. Those between the ages of 20 and 35 have no memory, not even second-hand, of that distant yet devastating conflict. The reason for the economics-based choice of Europe's founding fathers no longer exists. The time has come to tell Europeans to unite under a single roof because it is the only way to ensure peace and security, both internal and external, as well as education and innovation, engines for economic development in the modern age. These two spheres, together with equal opportunities among all citizens, are the fundamental mission of every democracy; they far exceed the economy and finance.

[9] Visco, I., *The Governor's Concluding Remarks*, 31 May 2017, https://www.bancaditalia.it/pubblicazioni/interventi-governatore/integov2017/en-cf-2016.pdf?language_id=1

The European pendulum, which has swung for 70 years between these two points, must now be stilled. Europeans must be offered ambitious political objectives to rekindle their willingness to stay united and to discourage them from pushing for greater national sovereignty.

There is a European identity: outside Europe, its citizens are European before they are Italian or German. We can deny or forget that fact, but it will leave us all weaker and more at risk. If we rediscover it and strengthen it, then we will all be better off.