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Reflexions on Unconventional Monetary Policy Measures and on European Economic Governance:

Towards an Economic and Fiscal Federation by Exception

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(gesproken woord geldt)

It is for me an immense pleasure and a great honor to be here in this very impressive University to deliver the Mandeville Lecture. I feel particularly honored to be invited by such a great Institution of a country, The Netherlands, which I admire for his culture, his sense of liberty, his dedication to free speech and, last but not least, his invention of modern market economies.

The name of this lecture, the Mandeville Lecture, is itself very impressive. The "Fable of the Bees" was published in 1705 and 1714, namely more than sixty years before Adam Smith "The Wealth of Nations". There are a number of important differences between Mandeville views and Adam Smith concept of "invisible hand": the "vicious greed" of Mandeville goes beyond the concept of "self interest" of Adam Smith. And whilst Adam Smith suggests that collective economic prosperity would be a natural spontaneous consequence of the interplay of self interests, Mandeville would call public authorities to channel appropriately the manifestations of "vicious greed" to ensure prosperity of the society.

But even these differences make Mandeville particularly stimulating in our today's context! That unfettered greed necessitates appropriate public regulations to make sure that it contributes to overall public interest appears now natural. So that, as is the case with great thinkers, Mandeville thoughts can be seen as influencing significantly different schools of minds, from Adam Smith's foundation of free market economics to the praxeology of Austrian economics and also to present days reflexions on the best ways of optimizing public regulations in modern economies.

Since mid-2007, the advanced economies have experienced extraordinary demanding and difficult times. We have experienced a succession of shocks that were unseen in the advanced economies since World War II. I am convinced that these shocks of 2008 and 2009 were potentially ever graver than those which triggered the 1929 crisis. Had the central banks and the public authorities not embarked on prompt and decisive actions, I trust that we would have experienced not only a great recession but a deep and rapidly unfolding depression.

I have been myself closely associated with many crises that have hit various components of the global economy over the last 35 years: the Latin America debt crisis of the 1980's, the African debt crisis, the collapse of Soviet Union, the Asian crisis to name only a few. All continents of the world have been successively called to drastically change their strategy, to adjust, and to go back to sustainable policies in the fiscal, structural macroeconomics fields. In this perspective the fact that the advanced economies were hit in 2007-2008 is less surprising. They were practically the only ones that were spared from adjustment since World War II. In a way it was their turn!

The Dutch philosopher Baruch Spinoza famously said “if you want the present to be different from the past, study the past”. Indeed we are called to study the past and to better understand what happened. This study should apply both to the ancient past and, even more, to the very recent past, marked, since the start of the crisis, by phenomena that were previously unseen. A much deeper understanding of the highly unexpected and strikingly rapid unfolding of monetary, financial and economic events over the five last years seems to me one of the major preconditions for paving the way for a better future. It is with this in view that I propose to concentrate our attention to-day upon two major issues. First, on monetary policy in the crisis and the role of so-called “non standard” measures. Second, on the future of the Euro area economic governance in the light of the lessons drawn from the crisis.

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I - Monetary policy in the crisis

I - 1. The principle of separation between conventional and unconventional measures

The widespread introduction of so-called non standard monetary policy measures by major Central Banks has been a defining characteristic of the global financial crisis.

Across central banks, there has been no “standardization” of non standard measures: approaches are distinct, tailored to the respective economies and their structures. We have seen enhanced credit support, credit easing, quantitative easing, interventions in foreign exchange and securities markets, and the provision of liquidity in foreign currency – to name but a few of the measures taken[1].

These tools have been used to support the functioning of the financial sector, to protect the real economy from the fallout of the financial crisis, and, ultimately, to preserve price stability over the medium term.

There are two distinct views on non standard measures[2].

Some view them as the continuation of standard policy by other means. Once nominal interest rates cannot be lowered further, central banks use other tools to determine the monetary policy stance – that is, to contribute in the desired way to economic, financial and monetary developments in pursuit of price stability[3].

To illustrate this view, I would compare it to – once the end of the road has been reached – engaging the four-wheel drive. Central banks expand their balance sheets and inject liquidity so as to influence the structure of yields and returns and thereby stimulate aggregate demand. This approach would be broadly in line with the theoretical analyses and prescriptions of Friedman, Tobin or Patinkin. The logic of this approach is essentially sequential: first the standard measures, then the non standard measures. If this sequential logic were also to be applied to the exit, it would

[1] For a summary, see: C. Borio and P. Disyata (2009), “Unconventional monetary policies: An appraisal”, BIS working paper No 292.

[2] See Jean-Claude Trichet, Reflections on the nature of monetary policy non standard measures and finance theory – 18 November, 2010.

[3] For a discussion of this perspective, see: A. Orphanides and V. Wieland (2000), “Efficient monetary policy design near price stability”, *Journal of the Japanese and International Economies* 14, pp. 327-365.

essentially mean unwinding non standard measures first and subsequently raising interest rates.

Let me suggest a different view of our non standard measures. Say that key interest rates are to be set at levels we consider appropriate to maintain price stability, drawing on our regular comprehensive assessment of economic and monetary conditions. In other words, in this perspective, policy makers would follow standard practice in this regard. Their interest rates can be more or less significantly positive, or very close to zero, or at zero level.

But whatever the level of nominal interest rates, on several occasions, particularly in time of acute crisis, the monetary policy stance established in this way faced obstacles in being transmitted to the economy. During the financial crisis, market functioning was impaired, at times very profoundly. In response, one might act to overcome some severe malfunctioning that was hampering the channels of transmission of monetary policy. Non-standard measures would be introduced to help restoring a more effective transmission of our monetary policy stance to the wider euro area economy[1].

Staying with the image of the road, I would say that the metaphor suggests to remove the major roadblocks in front of us, so that the policy stance could be transmitted to the economy in the intended way. <u>The logic of this approach is therefore parallel and supportive</u>: if the transmission of the standard measures is

[1] For a discussion, see: D. Giannone, M. Lenza, H. Pill and L. Reichlin (2010), "Non-standard monetary policy measures and monetary developments" in J. Chadha and S. Holly (eds.) *Lessons for monetary policy from the financial crisis*, forthcoming

impeded in a very significant way, non standard measures can offer support. This logic has potentially clear implications for the exit: in this perspective, we can determine standard and non standard measures very largely independently of one another. Policy makers will not be bound to unwind non standard measures before considering interest rate increases; or to put interest rates to the zero lower bound before considering the introduction of non conventional measures. In this perspective, it would be legitimate to take those decisions independently. One set of measures –the so called “standard ones”- depends on the medium and long term outlook for price stability; the other -the non standard- depends on the degree of dysfunctioning of the monetary policy transmission through the financial system and financial markets.

With this overview of guiding principles in mind, I would like to discuss in more details the two crucial elements of the monetary policy discussions during the financial crisis in more detail: the role of standard policy measures in pursuing price stability; and the support provided by the non standard measures that we have introduced since the start of the crisis. Let us see what we have precisely done in the case of the ECB.

I - 2. <u>Standard measures in the face of financial crisis</u>

Changes in the ECB’s key short-term interest rates – in other words, standard policy measures – have remained the key instrument of monetary policy in the euro area. I trust that these rates have always been set at levels which the Governing Council has deemed appropriate for the delivery of price stability over the medium term.

In considering the implementation of standard monetary policy measures during the financial crisis, two issues are worth particular attention.

First, the close relationship normally observed between the key policy rate and short-term money market rates assumed a more complex form during the crisis. It was important to recognize that in times of crisis a broader set of market interest rates, extending beyond the very short-term money market rates, was relevant in signaling the monetary policy stance, given the segmentation of financial markets, also taking into account that only a fraction of the banks had access to the unsecured Eonia rate[1]. Hence, the new positioning of the overnight money market rate -inside the “corridor” signaled by the main refinancing operation and the deposit rates- was considered acceptable in these exceptional circumstances as a means of helping to offset the impaired functioning of the money market and, in particular, the abnormally high level of spreads on the term money market rates.

The second point I would like to highlight concerns the question of “forward guidance” or “pre-commitment” regarding the future path of key ECB interest rates.

[1] See: M. Lenza, H. Pill and L. Reichlin (2010), “Monetary policy in exceptional times”, *Economic Policy* 62, pp. 295-339.

I must confess that I have some difficulty to decide whether we are in two very different conceptual schools on the two sides of the Atlantic or whether it is also a question of semantics and of presentation. One school stresses the Central Bank view on the probability of realizing a certain path of short term interest rates over a considerable period of time –for instance the high probability of having very low interest rates until 2014. The second school stresses the importance of preserving price stability over the medium and long term, in line with the definition given by the Central Bank: in this second concept, one also stresses explicitly the goal of having a low path for an important other indicator, namely the stability of low medium and long term inflation expectations in the years to come.

There is no doubt in my mind that the commitment on “low interest rates for a considerable period of time” is conditional. Nobody would trust that interest rate can remain very close to zero level or at zero level whatever happens, over a period of several years. By the way it is always underlined by the Central Bank of the first school that the commitment is not unconditional. It has been said clearly by Ben Bernanke in many occasions. And it goes without saying that when one stresses the stability of long term inflation expectations over time it means that the interest rates of the main refinancing operations of the Central Bank of the second school would be designed to deliver this stability, taking into account the changes that might occur in the economic and financial environment. So, in both cases, short term interest rates can move and should move, depending on circumstances.

You will not be surprised that, all taken into account, I have a clear preference for the “second school” posture of no “medium term pre-commitment” on the interest rate path together with sticking to a solid commitment to deliver long term price stability. This also means preserving low medium and long term inflation expectations over time, therefore, all things being equal, helping preserving medium and long term nominal and real interest rates favorable to growth which is, if I understand well, the main goal pursued by the first school of minds.

I - 3. <u>Non-standard measures in the face of financial crisis</u>

In the very challenging context of financial crisis, standard monetary policy proved insufficient. Standard measures have been complemented by non standard measures, which have aimed to help restore the effectiveness and transmission of interest rate decisions.

As I mentioned at the outset, the ECB did not embark on non standard measures because we had attained a zero level and thought that the scope for further standard easing of the monetary policy stance was exhausted. Our first non standard decision - namely the unlimited supply of liquidity at fixed rates provided appropriate collateral was given- was made the 9th of August, 2007 when the minimum bid rate of our main refinancing operation was at 4,25%. And when the key rate was reduced to 1% in May 2009, I remarked: “We did not decide today that the new level of our policy rates was the lowest level that can never be crossed, whatever future circumstances may be”. We judged then – as I understand the ECB does now – that the positive level of our key rates was the right one to preserve price stability over the medium term, whilst at the same time we considered that non standard measures were necessary.

Our view was that non standard measures were required to ensure that the stance of monetary policy would be more effectively transmitted to the broader economy, notwithstanding the dislocations observed in some financial markets.

I - 4. The conditions to be met for implementing unconventional measures

To sum up, the "non standard" measures are, in my view, first, independent from the "standard" measures, second, aiming at helping restore a better transmission of the interest rate policy in times of abnormal functioning of monetary and financial markets, and third, transitory by nature.

It is obvious that, if they are not very carefully monitored, they might have themselves the unintended consequence of creating a financial environment which could be abnormally benign for private markets, for commercial banks and for sovereigns. This, in turn, could contribute delaying the necessary improvements in rules and regulations of the financial sector, balance sheets repair of financial institutions, structural reforms of the economies and fiscal adjustment. This is true in all advanced countries. That is the reason why it seems to me that non standard measures must satisfy the five following conditions.

- First, they must be as precisely as possible commensurate with the degree of dislocation and disruption of market they must contribute to counter. It is naturally always a matter of judgment. I have to say by experience that it often calls for an initial diagnosis as lucid as possible, sometimes for a quick and expeditious decision and for a constant follow-up. In most cases, the non standard measures must be tailored to avoid the total disruption of markets that could gravely hamper the transmission of monetary policy. If these measures do not avoid the disruption of markets, it would be clear that the measures failed. But if they do avoid this potential disruption it is always possible to think that they were “over dimensioned”. This is the reason why it is always so important to weigh very carefully the dimension of the measures and be sure that their size is always commensurate to the potential disruption. That is the reason why the Governing Council of the ECB never hesitated to increase or decrease the size -in particular the duration- of the non standard supply of liquidity depending on the abnormality in the functioning of the financial system.

- Second, the measures must be accompanied by messages as forceful as possible to commercial banks to urge them to address resolutely their medium term recapitalization and balance sheets repair issues. To the extent that banks are, by far, the main instrument utilized for the “non standard” refinancing in the case of ECB, this message is particularly important in Europe. This calls also for the messages of the central bank to be fully understood and correctly transmitted by the supervisory authorities in each particular jurisdiction.

- Third, the measures must be accompanied by clear and unambiguous messages, when and where needed, to countries concerned. When the non standard measures are necessary, in particular, because of disruption of markets due to loss of confidence in the sovereign signature, the messages must be as clear and quick as necessary in order to avoid the failure of the measures themselves and/or the creation of an artificial financial environment that would pave the way for major additional difficulties in the future. The messages sent in August 2011 by the ECB Governing Council to several governments in Europe are cases in point in this respect.

- Fourth, in the case of Europe, an additional condition would be to ask the European Institutions as well as the governments to embark collectively on a significant improvement of their economic governance, including the close monitoring of the individual countries economic and budgetary policies. This condition explains why the ECB governing council, which had always called for improving economic governance, had been so vocal on this issue, since the start of the crisis and the ensuing decisions to embark on non standard monetary policy.

- Fifth, there is a last condition which I trust important. To the extent that the combined non standard measures of the central banks of the advanced economies are creating, at the global level, a very substantial structural change in the monetary and financial environment of the global economy, it seems to me necessary for the full constituency of Central Banks to call for the appropriate reinforcement of global governance. As long as the non standard measures are considered necessary by

Central Banks I am convinced that they are entitled to be the most vocal advocate of the necessary reforms of global finance and the necessary adjustment of global imbalances within the framework of the G20, the decisive contribution of the International Financial Institutions, and the effective mobilization of the Central Banks and of the Financial Stability Board.

The last important decision taken unanimously by the Governing Council of the ECB, at the beginning of December 2011 on the 3 year-Long Term Refinancing Operation meets, in my opinion, the previous five conditions. The duration, in particular, was appropriately dimensioned, taking into account the aggravation of the threat of a major dysfunctioning of the European banking sector as a whole, in October, November and at the beginning of December last year.

As regards the four other conditions I note that whilst taking this decision the ECB Governing Council and its President, my successor, made loud and clear the importance of reinforcing banks balance sheet, adjusting individual country's strategies and improving governance at the level of the Euro Area and Europe as a whole. It is clear that in these domains complacency would be the worst possible attitude. It is urgent to implement comprehensively and decisively the decisions already taken and the orientations already approved. This includes the fifth condition, namely the reforms that have to be pursued at the global level with full respect for the principle of a global level playing field.

I - 5. Unconventional measures: raison d'être?

Not only the Central Banks of the advanced economies have referred to somewhat different monetary policy conceptual frameworks over the last years, they have also taken different decisions since the start of the crisis. A number of them have decreased nominal interest rates to zero level, or very close to zero. Others have maintained their main refinancing rates at a certain distance from the zero lower bound. They have also embarked on significantly different non standard measures, some engaging in very substantial purchases of private securities, others embarking on large amounts of purchases of treasuries, combined or not with private securities, whilst some were very much concentrating on the supply of liquidity to commercial banks. It is relatively easy to understand why the nature of the non standard measures has been significantly different on the two sides of the Atlantic. The financing of the economy is itself structurally different: the banks playing a decisive role in the financing of Europe and the financial markets are dominating the financing of the United States.

But a fact is striking. Whatever differences are observed as regards, first, the monetary policy conceptual approaches, second, the decisions taken on interest rates and, third, the various channels that are utilized as regards the non standard measures, the volume of those non standard measures is significant in all the big advanced economies concerned.

I suggest that the appropriate metrics for measuring the non conventional monetary policies is the increase of the size of the balance sheet of the Central Bank which is due to outstanding monetary policy operations. More precisely, I propose to compute this increase since the start of the intensification of the financial crisis, namely since mid-September 2008 when Lehman Brothers collapsed.

According to this metrics, the size of the balance sheet of the ECB increased by around + 10% of the GDP (from around 6% to around 16%). The equivalent increase for the Federal Reserve System would be around + 12% of the GDP (from 6% to 18%) and + 15% of the GDP in the case of the UK (from 6% to 21%). For Japan, the growth since mid-September 2008 would be + 12% of the GDP (from 15% to 27%).

These figures call for three observations:

– First**,** it is interesting to note that the Central Banks of the U.S., the Euro Area and the U.K. had the same order of magnitude of outstanding monetary policy operations before September 2008: around 6% of the GDP. Bank of Japan appears to be in a different situation with 15% of the GDP. The explanation seems simple: Japan is experiencing a situation of crisis since a much longer period of time and had already considerably increased the volume of its non standard measures to cope with its own long standing crisis.

- Second, there are some differences between these four major Central Banks: the ECB is at the lowest level of increase due to outstanding monetary policy operations. But as already noted, it is striking that –in terms of percentage of GDP- the increase of the Central Banks balance sheets observed in these major advanced economies is of the same order of magnitude: for instance 10% for the Euro Area, 12% for the U.S.

- Third, until now, the non standard measures, which should be transitory by nature, seem to become, three years and a half after the intensification of the crisis, a more permanent feature of the advanced economies than it was originally thought and than it is certainly desirable. Japan, which was the first advanced economy to experience a long standing structural crisis, is a case in point.

In the present episode of the global crisis of the advanced economies, a common feature of all major economies is that they apparently need a very substantial additional financial intermediation operated by the Central Bank at a level of 10 % to 15% of the GDP.

Even after the longstanding particular experience of the Japanese economy, no economic analysis had suggested ex ante that we could experience such a generalized situation in all major advanced economies. I think it is urgent that Academia elucidates the factors that would convincingly explain that present situation, and would permit to foresee the future of the unconventional measures.

I see, in particular, two conjectures that could and should be tested. I hope that we will find out that the first is the right one.

First conjecture - According to the first conjecture, we would be experiencing a transitory phase in the advanced economies as a whole. A significant level of non standard measures would be of the essence during the time when banks and financial institutions would actively improve financial situations and achieve their balance sheets repair, when governments would proceed to adjust their fiscal and macro-policies and when the new national and global rules, regulations and macro-prudentials would be well established and implemented.

This conjecture is fully in line with the five conditions I mentioned earlier for Central Banks to embark on non standard measures. I hope very much it is the right one: if it is true, it will mean that the present situation is certainly not a "new normal" and that the present exceptional high level of central bank intermediation is indeed transitory, provided the hard work, which is overdue, is done by the public and the private sector. The exit might be relatively slow and gradual but it would be certain, again provided the national, continental and global "cleaning up" is done.

Second conjecture - According to the second conjecture which, I hope, will be demonstrated false, but that we have to consider seriously, the present exceptional high level of central bank intermediation could be more permanent. In this perspective, this intermediation could be necessary to counter a hypothetical unfortunate emerging property of the new global financial system: the existence of a quasi permanent systemic tail risk. This tail risk would not necessarily be the same on the two sides of the Atlantic and in Japan. It could be for instance the threat of a seizing up of key financial markets in the U.S. or the menace of an interruption of the normal functioning of the banking sector in Europe. But, according to this conjecture, a significant degree of potential systemic instability would characterize the present advanced economies.

As I said, I hope very much that this second conjecture is wrong.

Why do I say that we have to consider seriously this conjecture? Not only because we see –five years after the start of the global crisis of the advanced economies mid 2007- that non conventional measures look solidly integrated into policies of all major advanced economies' central banks. Not only because the Japanese economy signals that such a situation can last for an even more considerable period of time. But because our understanding of the underlying causes of the dramatic intensification of the crisis mid-September 2008 and the sequence of events which follows, remains poor.

As long as we do not make sufficient progress in this understanding, we cannot exclude totally the presence of such systemic tail risks in our new globalized economy.

I would like precisely to address now the issue of the necessary improvement of our macroeconomics and finance theory in the light of the crisis.

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II – The future of the Euro area economic governance

When people seek a justification for European integration, there is a tendency to look backwards.

In particular that European integration has banished the spectra of war from our continent, is always stressed. European integration has delivered the longest period of peace and prosperity in European history.

This perspective is entirely correct. But it is also incomplete.

There are many more reasons for striving towards “ever closer union” in Europe today than there were in 1945. And these are entirely forward-looking.

65 years ago, the distribution of global GDP was such that Europe had only one role model for its single market: the United States of America.

Today, Europe is faced with a new global economy, reconfigured by globalization and by the emerging economies of Asia and Latin America.

It is a world where economies of scale and networks of innovation matter more than ever. By 2016 -that is, very soon- we can expect the Euro area in terms of purchasing power parity to be below the GDP of China and over and above the GDP of India. Together, these two countries would represent around twice the GDP of the euro area.

Over a longer horizon, the entire GDP of the G7 countries will be dwarfed by the rapid development of the systemic emerging economies.

Europe has to cope with a new geo-political landscape very profoundly reshaped by these emerging economies.

And Europe is also faced with new global challenges, such as climate change and migration, where effective solutions are possible only at the European and international levels.

In this new global constellation, European integration -both economic and political- is central to achieving prosperity and influence. For an outward-looking, export-oriented country like Germany, this is profoundly in its interests.

The challenge is to set the correct path of European integration. Getting this right is essential to realize fully our continent's tremendous potential. Let me therefore lay out a vision for the Europe of tomorrow.

The creation of Europe's economic and monetary union is unique in the history of sovereign states. The Euro area constitutes a "society of states" of a completely new type. We have created progressively a concept which goes far beyond the Westphalian concept of sovereign states.

Like individuals in a society, Euro area countries are both independent and interdependent. They can affect each other both positively and negatively.

Good governance requires that both individual Member States and the institutions of the EU fulfill their responsiblities.

We have observed the functioning of the Euro area for 13 years. As all advanced economies, we have experienced the shock of the crisis over the last five years. It is time now to draw lessons from these first years.

The acronym EMU -Economic and Monetary Union- is made of three letters E, M and U which means that we must have, and have indeed, two Unions: a monetary union M U, and an economic Union E U.

II - 1. <u>Successes of the Monetary Union</u>

I will not expand too much on the successes of monetary union. Let me only mention the following elements:

- First, the new currency, starting from scratch has maintained price stability for an entire continent of seventeen countries and 332 million people. The average yearly inflation over the first thirteen years has been 2.03%.

- Second, savers and market participants are trusting the Euro to keep its domestic value as well in the future. The inflation expectations that one can draw from the financial markets are, for the next ten years, around 1.9% - 2%, in line with the definition of price stability of the ECB.

- Third, the track record of price stability and the anticipation of future price stability are not only fully in line with the mandate received by the European Central Bank and the Euro system from the European democracies, but also better than what had been displayed in Europe before the Euro. For example the Bundesbank, exemplary for its capacity to ensure price stability, could display an average yearly inflation from 1955 to 1999 of around 2.9%.

- Fourth, this level of stability and of credibility has been attained despite several oil and commodities shocks and the impact of the worst crisis in the advanced economies since World War II.

- Fifth, also to be noted, this level of stability was not attained to the detriment of job creation. Since the setting up of the Euro, the 1st January 1999, up to the end of last year the Euro area has created 14.5 million new jobs. During the same period, the United States have created between 8.5 and 9 million new jobs. This is not to say that there is not a big and grave unemployment issue in Europe: we have still a lot of hard work to do, including eliminating structural obstacles to growth. And in the U.S., an episode of very active job creation took place in the 1990's. Still the comparison, which is not known, shows that there is no obvious inferiority on this side of the Atlantic: all advanced economies have to improve their employment situation.

The success of the currency, the success of the Euro itself, does not explain why Europe is today at the epicenter of the present crisis of the advanced economies. There one has to consider the weakness of the Economic Union.

II - 2. <u>Weaknesses of Economic Union</u>

It is not the Euro area as a whole, on a consolidated basis, which is presenting major weaknesses: the current account of the Euro area is balanced, the public debt outstanding as a proportion of GDP is well below the Japanese public debt outstanding and the yearly public finance deficit is well below the equivalent figures in the U.S., in Japan and in the U.K. Still several factors, in particular the absence of effective surveillance inside the Euro area, have created a large dispersion of situations between countries as regards fiscal soundness, competitiveness and therefore credit worthiness. This explains why some countries are regarded by investors and savers as vulnerable.

The weaknesses of the Euro area economic governance can be summed up in six propositions:

- First, the Stability and Growth Pact designed to ensure sound fiscal policies in the Euro area has not been correctly implemented. Furthermore, in 2003 and 2004, the major countries, namely France, Italy and Germany, engaged in a dramatic move to weaken the Pact. The defense of the Commission, of the ECB and of the small and medium sized countries contributed to avoid the dismantling of the “letter” of the Pact. But the “spirit” of the Pact has been gravely impacted.

- Second, the governance of the Euro area did not comprehend monitoring and surveillance of competitiveness indicators, of nominal evolutions of prices and costs in any particular nation and of national external imbalances within the Euro area.

  In the view of the ECB, this was abnormal. In 2005, long before the crisis, I called on behalf of the governing council, for an appropriate surveillance of a number of national indicators including the unit labor costs evolution.

- Third, no crisis management tools had been envisaged at the start of the Euro. One has to recognize in this respect that “benign neglect” was generalized all over the world at the time of the setting up of the Euro, particularly in the advanced economies.

- Fourth, another weakness of the Euro area has been the unsatisfactory completion of the single market in the domaine of goods and particularly services. This weakness of the single market of the European Union as a whole -the 27- is particularly resented in the Euro area where it hampers the functioning of the competitive channel essential for a correct adjustment of the economies concerned.

- Fifth, similarly the relatively slow implementation of the structural reforms foreseen in the Lisbon agenda and in the 2020 programme which were, and are, engaged at the level of the European Union as a whole, is hampering the smooth functioning of the Euro area.

- And sixth, last but not least, the high correlation between the credit worthiness of the commercial banks of a particular country and the creditworthiness of the signature of the sovereign creates an additional vulnerability which is particularly damaging in the Euro area.

In many domains, fortunately, important progresses have been made. The “six packs” are incorporating very significant improvements of the Stability and Growth Pact as well as the creation of a new “pillar” for the surveillance of competitive indicators and national imbalances. New significant crisis management tools have been put into place. And there is a consensus to consider that the completion of the single market and the structural reforms that are overdue at the level of the 27 are important endeavors for the stability and prosperity of the European Union even if there are still resistance here and there.

As regards the banking sector, I trust that a banking Union, helping to disconnect the commercial banks from the creditworthiness of their sovereign, is an appropriate concept. Its implementation could start with the direct recapitalization of some banks, in Spain in particular.

But I would like to stress more particularly the benefits that governance in the Euro area could draw from a significant change in the process of close monitoring of national policies embedded in the two surveillance pillars mentioned earlier. Instead of imposing fines to the countries that would transgress the rules and not apply the recommendations, I would suggest to “activate” a new decision making process. In these exceptional circumstances, the European authorities, Commission, Council and -this is essential- Parliament could decide directly on measures immediately executed in the country concerned. It would be in the domain of the budget and of some part of economic policies a concept of “activation of a Euro area federation by exception”.

II - 3 <u>A Euro area economic and fiscal federation by exception</u>

I see several important reasons for such a concept of “activation of a democratic economic and fiscal federation by exception” to be worth exploring.

- First, the concept according to which sharing a single currency also means accepting limitations to fiscal sovereignty is not new. The Stability and Growth Pact comprehends the possibility of imposing sanctions -in the form of fines, including very significant fines- if a government, or a Parliament, or both are not meeting the Stability and Growth Pact provisions and not respecting the Commission and Council recommendations.

  The new concept I suggest studying, draws the consequences from the fact that the fines have proved ineffective. But again, limiting fiscal sovereignty in exceptional cases was already in the Maastricht Treaty.

- Second, it is in line with the concept of subsidiarity which has been applied since the introduction of the Stability and Growth Pact. As long as the policy which is pursued is in line with the framework, there is no sanctions. When the policy pursued is threatening to contradict the overall limits incorporated in the framework, the procedure leading to sanctions is activated.

- Third, perhaps the most important element of the new proposed concept, would be its strong democratic anchoring. One has to be sure that the activation of the “federation by exception” is subject to a fully democratic decision making process, and that democratic accountability is undisputable. That is the reason why the European Parliament should be called to play a fundamental role in the decision, on top of the traditional role played by the Commission and the Council. More precisely, for the decisions to be effective, the European Parliament would have to approve by a majority vote the measures proposed by the Commission and already approved by the Council. Naturally, as long as the Euro area does not coincide with the European Union as a whole, only the members of Parliament elected in the countries members of the Euro area would vote.

It would be necessary to organize in the best fashion possible the dialogue between the European Parliament and the national Parliament of the country concerned. In these exceptional circumstances, where the stability and the prosperity of the Euro area as a whole would be at stake, the national Parliament should have the possibility of explaining why it could not implement the recommendations proposed. Symmetrically, the European Parliament could explain why the stability and the prosperity of the Euro area as a whole is at stake. That being said, in the activation of this “federation by exception”, after a deep and appropriate dialogue between the two Institutions, the last decision would belong to the European Parliament.

- Fourth, the legitimacy of the participation of all members of the European Parliament elected in Euro area countries seems to me very strong. It would indeed be their own electorate’s stability and prosperity which would be put at risk in such exceptional circumstances where one particular economy behaves dangerously.

The Euro area is presently learning the hard way that the level of interconnectedness between economies inside a single currency area is such that even an economy of a modest size can impact significantly the Euro area as a whole.

- Fifth, even in a very long term perspective, it may appear appropriate for the European future federation to adopt such a concept of “activation by exception” of the economic and fiscal federal governance. The scope of interventions and the measures taken by the federal institutions would so rely on the principle “as little as possible in normal times, but as much as necessary in exceptional times”.

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These are new ideas which might be worth examining. I have had occasions before to suggest the setting up of a ministry of Finance of the Euro area. This ministry would have the responsibility of the activation of the economic and fiscal federation when and where necessary. It would be responsible for the handling of the crisis management tools like the ESM. It would also be responsible for the handling of the banking union. And it would represent the Euro area in all international institutions and informal groupings, G7, G8, G20, etc.

The minister of Finance, in charge of this ministry, would be member of the future executive branch of the European Union, together with the other ministers responsible for the other federal departments.

In this perspective, the Commission would appear naturally to be the anticipation of the future European democratic government as has been suggested by Minister Wolfgang Schäuble, in his recent Karl der Grosse prize speech, with his proposal for an election of the President of the Commission. The Council appears to be the anticipation of the future European upper chamber. And we already have the lower chamber already elected by all European fellow citizens.

I am fully aware of the boldness of some of the ideas presented here. But I really think that it is necessary for the Europeans -as well as for all advanced economies- to draw all the lessons from the past and present events. It is time for us to clarify the nature of the "quantum leap" that is necessary for our future governance. One thing is sure: this governance would have to be fully effective when demanded by circumstances. It would have to be fully democratic with a deep and decisive involvement of the European Parliament.

Jean Monnet said famously: "People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them". I strongly believe it is time to move ahead.

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