

Fabrizio Saccomanni: The European Union and the global crisis - the implications for banks, finance and economic policy

Remarks by Mr Fabrizio Saccomanni, Director General of the Bank of Italy, at the Federal Ministry of Finance, Berlin, 8 February 2011.

* * *

1. Introduction

Since the crisis that disrupted the world economy in 2007, financial tensions have affected the eurozone as well. Last year saw moments of crisis in the sovereign debt markets for eurozone countries that threatened to compromise the monetary policy transmission mechanisms. In the international and especially the British and American press, economists and financial analysts hypothesized or predicted sovereign defaults, some countries' exit from the monetary union, and an end to the euro. Even my old friend Otmar Issing, one of the founding fathers of the euro, in an article in the *Frankfurter Allgemeine Zeitung* last November that had echoes across the globe, warned governments in the eurozone that the very survival of the currency was at risk. How have we got to this point? Are the risks for the euro really so serious? Can they be mitigated and managed? These are the issues I would like to address today. First, I will recount the phases in the crisis, showing how, after originating in the United States, its repercussions spread to the European Union. I will also describe the situation in Italy, which differs from the other "peripheral" countries in terms of the structure of its economy, the solidity of its banking system and the outlook for the public finances. Second, I will examine why Europe came unprepared to manage a global crisis, lacking the necessary tools and procedures. As has often happened in the history of European integration, the crisis has spurred the EU to adopt a series of measures to strengthen economic governance and crisis management. I conclude by sketching out what I consider to be the crucial items on the European agenda if we are to come through the crisis and promote sustainable growth in the European Union.

2. The global crisis and its impact on the European Union

The developments of the financial crisis that struck the world economy in August 2007 are familiar enough, so I will just summarize what to my mind are the main repercussions on the European Union. I will argue that the crisis had three distinct phases, each with distinct implications for the various EU countries.

Phase one. The first phase – that of financial "toxic securities" – began in the United States and spread to Europe through the banking systems in which these high-yield, high-risk financial instruments accounted for a large share of financial intermediation. The network of "vehicles" created especially to market these products proved a particularly important channel. Over time, this network had become a veritable "shadow banking system", operating outside all supervisory control. As was widely reported, during this phase many banking crises required government support measures. Italy was one of the least affected countries, and no Italian bank was placed under public control. The Bank of Italy prevented the creation of any "shadow banking system" in Italy, and banks' liquidity positions were monitored daily. London's much vaunted "light touch" approach to supervision was never adopted in our country. Government financial support to banks was a mere 1.3 per cent of 2009 GDP in Italy, as against 51.9 per cent in the UK, 32.2 per cent in Spain, 20.6 per cent in Germany, and 18.4 per cent in France. Italian banks' recourse to ECB refinancing was extremely modest, even at times of acute liquidity shortages in interbank markets. No Italian bank is featured in the ECB's list of "persistent bidders". A number of lessons for regulation and supervision in Europe can be drawn from this phase of the crisis. First, the rules and

procedures of banking and financial oversight need to be harmonized in order to avoid disparities in treatment among institutions operating in different countries. Second, we cannot permit substantial volumes of banking and financial business to escape all prudential supervision through recourse to off-balance-sheet transactions and vehicles. Finally, experience has demonstrated the greater efficiency of systems in which banking supervision is entrusted to the central bank. Central banks, in fact, are well placed to detect crises early, because they are in direct daily contact with the money markets and the payments system.

Phase two. The second phase of the crisis was marked by the sharp slump in economic activity in 2009. To combat the recession, the ECB adopted a highly expansionary monetary policy, and fiscal stimulus was introduced in almost all EU countries. During this period, the Italian economy was among those hardest hit. GDP fell by 5 per cent in Italy, as against 4.7 per cent in Germany, 2.5 per cent in France, 3.7 per cent in Spain and 4.9 per cent in the UK. The recession was especially hard on the small- and medium-sized enterprises that are the backbone of Italy's industrial sector, with immediate effects on output and employment. However, the high public debt prevented us from adopting the sort of economic stimulus measures that other countries did. The only available option was to increase the support to unemployed workers. Even so, unemployment in Italy held at about the level recorded in Germany and in France, and well below that in Spain. The lesson of this second phase is the extraordinary success of the economic policies adopted, which effectively limited both the depth and the length of the recession. There were none of the disastrous consequences seen in the Depression of the 1930s, and the recession lasted for just one year. Already in 2010 the whole of the EU saw a sharp upturn. But it was also plain to see that the recovery differed from country to country. Countries with public finances in order and debt at tolerable levels were able to react more quickly and effectively to the recessionary trends triggered by the crisis. Countries like Italy, with a large debt burden, had to limit fiscal stimulus to the utmost and accept a slower pace of recovery. Differences in factor productivity, export competitiveness and labour market flexibility also weighed in. Finally, it was seen how in a globalized system the financial markets have little "patience" for expansionary fiscal policies that are not accompanied by a specific, credible plan to bring deficit and debt down to levels deemed sustainable in the medium term. This kind of "market discipline" does have validity, even if excesses were not lacking. The financial operators, analysts and rating agencies that in 2008 had clamoured for massive monetary and fiscal stimulus to combat the crisis, by 2009 were already voicing worries over the growth in the public debt and calling for an exit strategy, warning of serious repercussions on the markets in the event of delay or hesitancy.

Phase three. The third phase of the crisis, in which the EU still finds itself, began with the "discovery" of the critical state of the public finances in Greece in early 2010 and the rapid contagion of most of the European sovereign debt market. Despite the vigorous measures taken by the ECB, the Eurogroup countries and the EU, there were recurrent tensions throughout the year, fuelled by financial speculation and rumours of default by this or that sovereign debtor, the demise of the euro, or the break up of the EU. Again, the impact of the crisis was not uniform. The interest rates on government securities fell in Germany, at times to just over 2 per cent, but rose to record levels in Greece, Portugal and Ireland. Interest rates also increased in Spain and Italy, though less sharply. Italy's spread, which before April 2010 had been higher than Spain's, has remained consistently lower since then, confirming the market's positive assessment of Italy's public finance management in this phase of the crisis. In absolute terms, since the beginning of monetary union the rate on ten-year Italian government bonds has kept constantly between 4 and 5 per cent, an entirely natural and sustainable level for long-term securities. The market's assessment also reflects the low level of private debt in Italy, the soundness of the banking system, the high level of households' real and financial wealth and, finally, the size and diversification of our manufacturing industry, active in all the main sectors. Finally, it takes account of the fact that, based on the multi-year financial stability plan already approved by Parliament, the deficit/GDP ratio should drop below 3 per cent in 2012 and draw close to 2 per cent in 2013, on the way to

achieving a balanced budget in the subsequent years. It would appear, in short, that the market considers Italy capable of addressing its structural problems.

It is undoubtedly too soon to draw definitive lessons from this phase of the crisis, which is not yet over. But some preliminary observations can still be made. First, the public finances are in better shape in the euro area as a whole than in the other major economies, the US and Japan. The deficit/GDP ratio for the euro area was 6.3 per cent in 2009 and is forecast to fall to 3.9 per cent in 2012. The corresponding figures for the US are 12.9 and 6.7 per cent; for Japan, 10.2 and 8.1 per cent. In 2012 public debt in the eurozone is forecast to reach 88 per cent of GDP, compared with 103 per cent in the United States and 239 per cent in Japan. So we can say that the euro area as a whole does not have the problem of fiscal imbalance. Further, the European balance of payments is in equilibrium and the euro, albeit with some volatility, has held strong against the other main currencies throughout the crisis. However, it must be acknowledged that some euro-area countries do have excessive levels of debt and deficit, which if not properly dealt with could pose risks to the stability of the euro area and the euro. However, the experience of the crisis demonstrated that the EU lacked the instruments either to prevent or to manage problems of this kind. The eurozone could count on the monetary policy of the ECB and the Stability and Growth Pact. The ECB has ensured price stability in the medium term and supplied economies with the liquidity needed for the functioning of the banking and financial systems, but it cannot shoulder the burden of solving problems of public finance without betraying its constitutional mandate. And the Stability and Growth Pact had already been violated before the crisis precisely by the large countries, Germany, France and Italy, which instead should have set the example for the rest. Quite possibly it is unrealistic to expect the EU to handle the risks of financial globalization armed only with a “policy” – strong and efficient, but of limited scope – and a “rule” – clear and simple, but which each country is free to interpret as it sees fit. If we want to preserve our European currency, then, we must expand the European Union’s economic policy arsenal and adapt it to the reality of the global economy and finance. All the eurozone countries must take part in this effort, because the creation of the euro has brought benefits to each. Germany gained a large domestic market free from restrictions and competitive devaluations. In 2009, 61 per cent of Germany’s trade surplus came from trade with the rest of the eurozone; and adding the other member countries, the EU provided fully 87 per cent of the German surplus. When the euro was created, Germany had an external current account deficit equal to 1.4 per cent of GDP; today it has a surplus of 5 per cent. Meanwhile, Germany’s partners benefited from the monetary stability ensured by the euro and lowered their interest rates very close to German levels. The “founding pact” underpinning Economic and Monetary Union has therefore been respected by all; so if imbalances in competitiveness, productivity and the public finances persist, it is up to the European Union to equip itself with the instruments and procedures to induce its member states to eliminate them.

Before turning to the possible remedies for the Union’s inadequacies, I would like to sketch the reasons why the EU was caught unprepared to face the global crisis.

3. European construction: forever unfinished?

It may well be asked whether the founding fathers of the European Community and then of Economic and Monetary Union deliberately planned to leave the European construction half-finished, with an ambitious and absorbing mission but without the means to accomplish it. Based on the historical record, my answer is no. From the time of Jean Monnet, Konrad Adenauer and Alcide De Gasperi, but also later, with Helmut Kohl, François Mitterrand and Altiero Spinelli, European construction was always conceived as a gradual and pragmatic process aimed at eventually achieving that “ever-closer union among the peoples of Europe” envisaged since the Treaty of Rome of 1957. And this vision was shared by the authors of the Delors Report, all the governors of the European central banks among them, which in 1989 set out the stages for realizing the Economic and Monetary Union. On the occasion of

the European Council meeting in Dublin in the spring of 1990, Helmut Kohl and François Mitterrand wrote a letter to their colleagues arguing the need to proceed with political union. In November 1991, in a speech to the Bundestag, Chancellor Kohl said: “Political union is the indispensable counterpart to economic and monetary union. Recent history, and not just that of Germany, teaches us that the idea of sustaining economic and monetary union over time without political union is a fallacy”. In May 2000 Foreign Minister Joschka Fischer, speaking here in Berlin, at Humboldt University, albeit in a personal capacity, lucidly underscored the need to give the EU the effective ability to act by creating a European Federation, with a government endowed with executive power and a parliament wielding legislative power. And I could cite other European leaders.

European construction was conceived, then, as a gradual process open to all countries that share its objectives and satisfy certain political, institutional and economic conditions. There was a wide political consensus in Europe on the unwritten principle that the two processes – strengthening the institutions of the Community and enlarging it to new members – had to proceed in step. And the two processes did develop in parallel, in a balanced and harmonious manner, at least until the changeover to the single currency, even though every phase of enlargement was accompanied by a period of intense debate on the Union’s internal rules. This drew European governments’ attention away from the outside world, preventing the EU from playing a significant role on the global political and economic scene. But after the break-up of the Soviet bloc and the creation of the euro, this parallel progress came to an end. Top priority was assigned to enlargement, with no fewer than 10 countries, mostly central and eastern European, included all at once in 2004. The decision had found broad support among governments throughout the EU, albeit not always for the same reasons, but it caused anxiety and concern in the population. Politically, the enlargement meant the end of the historical division of Europe wrought by the Iron Curtain, and in this light it was viewed with great favour, especially in Germany but generally in all the countries. In addition, enlargement meant an expansion of the internal market and, potentially, a “dilution” of the influence of the eurozone continental bloc of countries, a prospect that certainly did not displease the United Kingdom. For the population, instead, the prospect of an open-ended Europe that might include all the Balkans and even Turkey fuelled fear of mounting immigration that would have shattering effects on the labour market and on ethnic and social equilibria. In this context, the effort to strengthen the enlarged EU’s capacity for action did not find political support even in founder countries such as France and the Netherlands. The outcome, in 2005, was the failure of the draft Constitutional Treaty around which a broad consensus had formed in the European Convention. The more modest Treaty of Lisbon, approved by the governments of the Union at the end of 2007, when the global crisis had already begun, did not enter into force until the end of 2009, when the crisis had already unleashed its devastating effects, after a long and difficult process of ratification by parliamentary vote and referenda.

An outside observer might find it incomprehensible that the European Union, for fear of the impact of enlargement, deliberately deprived itself of the instruments that would have served to manage the problem better. Actually, as so many times in the history of European integration, the crisis obliged the governments to reopen the “building site” of European construction. In a brief span of time major reform projects have been completed and new initiatives launched that can greatly strengthen the EU’s economic governance. This is not the place to go into the details of what is being done in the “building site”. But I would like to convey the importance of the changes to the institutional framework. Before the crisis, the eurozone’s sole instruments were, as I said, monetary policy and a weak rule, the old Stability and Growth Pact. With the reforms already decided or at an advanced stage of discussion, the EU and the eurozone have adopted instruments for intervention in three important areas: banking and financial supervision, economic and budgetary policy coordination, and crisis management mechanisms and procedures. The first two reforms should improve the ability of the EU to prevent the build-up of unsustainable financial imbalances, and hence the emergence of crisis situations. The third reform will enable crises

to be managed in an orderly manner by facilitating the adjustment of disequilibria. Let us briefly see what is involved.

The reform of the supervisory architecture. Three new independent authorities have been instituted, responsible for the microprudential supervision respectively of banking, insurance and the financial markets. They began operating on 1 January of this year. Their main task is to make the supervisory rules uniform in the respective sectors and to harmonize the supervisory practices of the national authorities, for the coordinated pursuit of their objectives of intermediaries' stability, capital adequacy and liquidity. Specifically, the European Banking Authority will also be charged with preparing and conducting a new stress-test of European banks after the exercise conducted last July, which was severely criticized by analysts and market participants for its leniency and lack of transparency. It is absolutely essential that the new test adhere to internationally accepted standards and methods, and that markets be promptly informed of the results; and it is necessary that any bank that fails to pass take adequate measures to strengthen its capital. Alongside the microprudential supervisory authorities, a macroprudential supervisory body will operate at the ECB to monitor systemic risk. The European Systemic Risk Board will analyse the evolution of the credit and financial aggregates to determine whether unsustainable imbalances with systemic implications are being created. The Board will be empowered to recommend to the competent authorities that they take the measures necessary to prevent "speculative bubbles" in the financial and property markets.

Economic policy coordination. The changes in this area, designed by the task force under President Van Rompuy, envisage a significant strengthening of budget discipline through a reform of the Stability and Growth Pact and a new mechanism of surveillance on macroeconomic disequilibria and vulnerabilities. The new Stability Pact will stress medium-term fiscal sustainability and trends in the public debt, imparting operational and quantitative content to the Treaty's debt criterion. Budgetary coordination will begin each year with the so-called "European semester", a simultaneous assessment of both the budgetary measures and the structural reforms proposed by the individual member states. The Pact will have both a preventive and a corrective "arm", plus a broad spectrum of measures and sanctions to apply progressively in each. The new surveillance procedure will stress macroeconomic imbalances and suggest the economic policy measures needed to deal with them; in cases of recurrent non-compliance, sanctions may be imposed. The legislative acts for the institution of these new instruments are still under discussion. It is important, while retaining the objectives, to accord greater operational importance to prevention than to inevitably tardy corrective measures. In any case, it is important that the Commission's power to issue warnings and recommendations to divergent countries be applied uniformly and not subject to the approval of the Ecofin Council.

Crisis management. Under the pressure of global markets, in 2010 the European Union created the machinery for financial assistance to member states in difficulty. At the same time, the ECB introduced a plan of market purchases of government securities to ensure the proper functioning of the mechanisms of monetary policy transmission. After bilateral interventions for Greece, the European Financial Stability Facility and the European Financial Stabilization Mechanism became fully operational, with overall nominal capacity of €500 billion. Naturally, these are mechanisms for conditional support tied to severe adjustment plans agreed with IMF, EU, and ECB. The Stability Facility has already made a highly successful international bond issue to raise funds to support Ireland. These instruments will remain in being until 2013, when a new, permanent mechanism is slated for creation through a Treaty amendment. The new mechanism will be activated by a procedure to determine whether the applicant country is insolvent. If it is, it must negotiate a restructuring of its debt with private creditors and becomes eligible for financial assistance only if the debtor position has been made sustainable. These changes move in the right direction, but so far financial analysts have remained sceptical. They maintain that the Stability Facility does not have the "firepower" for peak needs, if the sovereign debt crisis

should spread to major countries like Spain or Italy. I myself consider this scenario most improbable, but I do think it would be good to increase the Facility's effective size, which is certainly smaller than the nominal amount, and above all to enhance its operational potential.

4. Conclusion

The global crisis, with its repercussions on the European Union, is not yet over. There are still strains in the banking systems and the public finances of a number of member states. Uncertainty and volatility continue to beset the financial markets. Economic activity is expanding this year, but growth is expected to slow in 2012 in both Germany and the United States. There is no denying that the prime responsibility for putting their public finances and banking systems in order rests on the single countries. Italy is fully aware of this necessity and will do its part, as it always has. It is just as obvious, however, that countries with a common currency are under a moral obligation to cooperate for the adjustment of the imbalances and to prevent contagion that would destabilize the currency. The measures taken in this regard have significantly enhanced the EU's capability for effective economic governance even in times of crisis. But the unique European construction is still hard for outsiders to fathom, even those who invest in our financial markets and our currency. So we must make a special effort to communicate better, to make our institutions and procedures more transparent, and to put an end to destabilizing speculative attacks. We need institutional arrangements that are adequate to the economic and financial challenges that the EU and the eurozone will face and that do not require periodic reinterpretation or amendment of the Treaty. Every time the Union reopens Treaty talks, as at present, our partners and the markets wonder whether we are about to take a step forward or a step back. The time for clarity on the economic governance of the European Union is now.

Yet the Union cannot solve its structural problems by fiscal consolidation alone. Consolidation is necessary to stabilize the financial markets and to leave more room for private investment. But we must also undertake a strategy of structural reform to increase the European economy's growth potential, to reduce unemployment, especially among young people and women, and to correct the disparities within the euro area in productivity and competitiveness. These are reforms that can and must be undertaken by all the countries of the Union. This is not the place to set out the details of this plan, which for that matter is specified both in official EU documents, such as the 2020 strategy, and in private writings.¹ In brief, the need is to complete the internal market through further liberalization in services such as mass retailing, transportation, construction, finance and the professions, where the EU lags behind its main competitors. Action is needed for the full integration of energy markets, which are still fragmented at national level and dominated by local monopolies that impose high costs on firms and households. And as the Monti Report notes, we must reinforce the physical infrastructures needed to underpin a huge internal market: the transport and telecommunications networks, the energy grid and the water supply system. Experience shows that these processes of liberalization and integration stimulate research and innovation, which are the prerequisites for new investment and productivity gains. This agenda is ambitious, and in some respects will be unpopular in the short run. It therefore requires strong leadership by the main European players. We have already missed a number of good opportunities – Maastricht, Amsterdam, Nice, and lastly Lisbon – to rise to this difficult challenge.

¹ M. Monti (2010), "A New Strategy for the Single Market", Report to the President of the European Commission José Manuel Barroso, 9 May; G. Amato, R. Baldwin, D. Gros, S. Micossi and P.C. Padoan (2010), "A Renewed Political Deal for Sustainable Growth within the Eurozone and the EU", CEPS Policy Brief, no. 227, 30 November, Centre for European Policy Studies, Brussels, and EuropEos, Rome.

Let me conclude these remarks with the words of a dear friend of mine and an unwavering champion of European integration – Tommaso Padoa-Schioppa, who passed away prematurely in December. In a bitter reflection in 2006, after the failure to ratify the European Constitutional Treaty, Tommaso called on Europe to exercise “active patience”, admonishing us that “completing the construction of a united Europe requires truth and clarity on the basic questions, the rejection of ambiguity, convincing arguments why Europe is necessary both to the prosperity and security of our member countries and to peace and order in the world.”² This admonition has lost none of its relevance.

² T. Padoa-Schioppa (2006), *Europa, una pazienza attiva – Malinconia e riscatto del Vecchio Continente*, Milan, Rizzoli.