Vítor Constâncio: The macroeconomic and the financial landscape in the aftermath of the 2007 crisis – new challenges and perspectives

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the High Level Policy Seminar, European University Institute, Florence, 7 June 2011.

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Ladies and gentlemen,

Thank you very much for the invitation to join you today at the European University Institute for this high level policy seminar. It is an apposite time to take stock of the lessons of the recent crisis; the actions that have been taken in response; and the measures that are needed for the future.

I believe that the recent financial and economic crisis has revealed some fundamental lessons about the functioning of the euro area – lessons which policymakers have been obliged to learn and act upon to build tomorrow's European structure.

We learned that preventing future crises requires action across a range of policy areas encompassing fiscal, economic and financial policies.

On the other hand, we learned that these policy areas are interconnected – fiscal imbalances can undermine the financial sector; financial sector imbalances can weigh on the credibility of the sovereign; both can spillover into the real sector, and vice versa.

Responding to these lessons requires a holistic encompassing concept of economic governance. This implies a high degree of institutional coherence and co-ordination which is not easy to achieve – even unitary states like the U.S. have struggled to put in place such a comprehensive approach.

In the euro area, it requires establishing a comprehensive set of rules and institutions to guide economic policies towards mutually beneficial outcomes. In the absence of a central political authority, such rules and institutions are essential to overcome collective action problems and prevent free riding – to maximise the common good as opposed to private utility.

The key to effective rules and institutions is as follows: their scope must be commensurate with the scope and degree of economic and financial integration in the euro area. Otherwise, authority lags behind integration and crises cannot be efficiently forestalled.

In general, policymakers have recognised that fundamental changes to economic governance are needed after the crisis. But my main contention today is that the reforms put forward in response, whilst very important, do not yet meet sufficiently the criterion for effectiveness.

If we truly recognise the lessons of the crisis for the euro area, economic governance must be more ambitious.

Let me begin by recalling these lessons and their implications for economic governance.

Lessons from the crisis

By now we know all the lessons from the crisis and I apologise for reminding you of some of these but I need to do it for the sake of my later arguments. The crisis revealed five important lessons.

The ***first lesson*** was that the euro area lacked an institutional framework to identify and correct macroeconomic imbalances.

For countries that share a single currency and cannot devalue, maintaining nominal price and cost growth in line with the euro area as a whole is essential. From 1999 onwards, however, developments have not followed this path.

Some euro area countries experienced strong nominal divergence caused by unit labour cost increases and excessive credit growth, leading to declining competitiveness. At the same time, large current account imbalances reflected a build-up of public and private sector debt, creating external vulnerabilities that were exposed when the crisis broke.

Establishing a permanent framework for surveillance of such imbalances is essential for the future.

The ***second lesson*** was that the implementation of the Stability and Growth Pact (SGP) did not contribute to fiscal polices consistent with membership of a single currency.

In an economic and monetary union, fiscal policies have to be consistent with rates of sustainable growth and price stability. Instead, despite the "good times" between 1999 and 2008, fiscal policies were largely pro-cyclical: few countries maintained a budgetary position in structural balance and many ran deficits. Peer pressure to correct imbalances was largely absent.

In some cases, this indiscipline precipitated serious fiscal challenges when recession began in late 2008. In others, fiscal policy reinforced nominal divergence and macroeconomic imbalances.

A more effective SGP is therefore required for *all* euro area countries.

The ***third lesson*** was the absence of appropriate frameworks for policy co-ordination in areas essential for competitiveness and sustainable growth.

For example, a number of euro area countries internalised the fallacy that temporarily elevated national productivity and inflation rates warranted persistent wages increases out of line with the euro area as a whole.

This may apply if inflation differentials are driven by healthy catching-up effects, but in many cases they were largely the outcome of inappropriate macroeconomic policies and debt-financed booms in domestic demand. Wage developments were therefore not sustainable.

Much greater policy co-ordination is now needed to reinforce the euro area dimension in national economic policymaking – in particular that a medium-term inflation rate of below, but close to, 2% over the medium term is the appropriate benchmark at the national level.

The ***fourth lesson*** was that financial supervision in the Europe was lagging behind financial integration.

Monetary union led to a structural increase in financial interlinkages within the euro area, in particular via the growth of systemically relevant large cross-border banking groups. Yet, the regime for financial supervision remained fragmented.

National supervisors that were supposed to supervise cross-border banks had no mechanism to resolve conflicts. The EU level financial services committees had only advisory powers and the ability to issue non-binding guidelines and recommendations.

The result was that a large build-up of systemic risk in the financial sector went largely unnoticed – risk which in many cases was ultimately transferred to the balance sheet of the sovereign.

A supervision regime commensurate with the reality of financial integration in the euro area is therefore an urgent need.

The ***final lesson*** was that sovereign debt challenges in individual euro area countries – no matter their size – can undermine the stability of the euro area as a whole. To the surprise of some, "sudden stops" episodes occurred in the euro area, as if the single currency was not a

common currency of all members. Since member countries do not control their currency, they are vulnerable to liquidity episodes and multiple equilibria. Creditors' assessment can change e.g. by effect of contagion, even when fundamentals would not justify it.

The high degree of financial integration within EMU means that, if left unchecked, contagion in the banking sector can spread rapidly via cross-border holdings of sovereign debt. For sovereigns themselves, sudden shifts in market re-pricing of risk can lead to unexpected liquidity challenges.

These dynamics underscore the importance of strengthening the mechanisms that prevent such risks – the SGP, surveillance of broader macroeconomic imbalances, and stronger financial supervision.

However, the liquidity dry-outs and the contagion risks also call for stronger backstop mechanisms, to provide significant, albeit temporary, liquidity assistance.

For the same reason, a permanent crisis management framework is appropriate for the euro area.

First responses

These lessons show us that the crisis was an interlinked phenomenon involving the public sector, real sector and financial sector. Consequently, a comprehensive response to the crisis needs to address all these sectors and the ways in which they are interconnected.

So far, there has been important progress in all 5 areas I identified.

There is strong momentum behind reinforcing economic governance to prevent and correct fiscal and broader macroeconomic imbalances.

The package of legislative reforms now undergoing final discussion, introduces a new surveillance framework for macroeconomic imbalances, with an alert mechanism based on a scoreboard of key indicators. An enforcement mechanism allows the Council to fine euro area countries in case of repeated non-compliance with recommendations. This closes an important lacuna in the economic governance framework.

The new legislative package also reinforces the SGP to focus more on fiscal sustainability and reducing government debt levels.

Member States with a government debt exceeding the 60% of GDP will have to observe a debt-reduction rule or face an excessive deficit procedure – backed by more effective financial sanctions and new political and reputational measures. Commitments would be more solidly anchored at the national level through new minimum requirements for national budgetary frameworks.

Important steps have also been taken towards improving policy co-ordination.

The "European semester" was introduced on 1 January this year to encourage better *ex ante* co-ordination of economic policies. From now on, national programmes for fiscal and economic policies will be submitted and assessed at the same time. This should create more consistency between policy recommendations and improve timing with national budgetary cycles.

Euro area leaders have decided to deepen further policy co-ordination by creating the "Euro Plus Pact". The Pact aims to address deep challenges related to competitiveness and productivity in the euro area. Hence, it rightly focuses on key indicators of competitiveness divergences such as unit labour costs, and key structural rigidities related to wage setting, competition and the labour market. The ECB very much welcomes this increased focus on the euro area.

Major reforms have already taken place in the field of financial supervision.

Following the recommendations of the de Larosière Group, the European System of Financial Supervisors (ESFS) was established to reinforce the European framework for micro- and macro-prudential supervision.

It comprises the three new European Supervisory Authorities (ESAs) for banking, insurance and securities markets; and the European System Risk Board (ESRB), which will monitor, identify and prioritise systemic risks to financial stability. This framework will play an important role in managing the interdependencies of a closely integrated single European financial market.

In addition, efforts are underway to establish an EU framework for cross-border crisis management in the banking sector.

Finally, euro area leaders have agreed to establish a permanent crisis management facility, the European Stability Mechanism (ESM).

The ESM builds on the ad hoc stability facilities established in 2010 to arrest contagion and thereby preserve overall financial stability in the euro area. By providing bridge funding, it will create breathing space for euro area countries in financial difficulties to implement a deep adjustment programme, correct imbalances and regain market access. In spite of some shortcomings stemming from the rigidity of its instruments, the creation of the ESM is of enormous importance.

The way ahead

These measures – although at varying stages of development – represent an important step forward towards remedying the problems of economic governance in the euro area.

Whilst necessary and important, they will have to be further reinforced, recognising that what may be sufficient for the 27 Member States is not enough for the euro area. The reform of governance of the euro area should not be hampered by the need to decide anything according to the least common denominator among the 27 members of the EU. The decision of 17 countries to share a common currency has far reaching consequences and requirements that should be fully recognised.

The euro area is a highly integrated economic and financial area which needs to be managed through common decisions. However, aside from monetary policy, it lacks powerful decision-making institutions. This means that rule-based frameworks must act a substitute for centralised authority.

For ***fiscal and economic issues***, a unitary state would have a Finance Ministry which both defines and vetoes fiscal and broader economic policies. EMU must achieve the same effect through its economic governance framework. The recognition of this requirement was certainly behind the recent proposal presented by President Trichet for the creation of a European Finance Ministry.

We know from the crisis, and from learning-by-doing, that soft rules will not achieve the desired outcome. They allow for multiple equilibria – some of which are sub-optimal for all parties.

Strengthening the rules governing fiscal and broader macroeconomic policies is essential to guarantee equilibria that are mutually beneficial.

The legislative package on economic governance I described above is now being negotiated between the Commission, the Council and the European Parliament, with the goal of strengthening the rules for surveillance of fiscal and broader macroeconomic policies. In the ECB's view, the Council position is insufficient and needs improvement in a number of areas.

Greater automaticity is needed in preventing and correcting national economic policies that stray from a sustainable path. Political discretion should be limited when unsustainable

policies put the stability of the euro area as a whole at risk. Credible economic governance needs to be consistent and predictable. It also needs to be backed by timely, tough sanctions to encourage compliance.

More ambitious policy requirements would better match the current reality of the ***euro area***. It makes sense for macroeconomic surveillance to have a clear focus on the euro area countries with the greatest vulnerabilities. Fiscal surveillance should avail of ambitious benchmarks when establishing an excessive deficit and setting the adjustment path towards a country's medium-term budgetary objective.

Much closer alignment is needed between ***commitments at the EU and national levels***. The perception that "Europe" imposes policies on countries, when they have been agreed by their own politicians, is not helpful. National authorities need to take ownership of their European commitments.

This means anchoring EU rules in their national legislation and making them mandatory and being held to account by domestic parliaments. Major improvements are also needed regarding the production and quality of fiscal statistics.

Anticipating the final result of the negotiations, the ECB is encouraged that the amendments proposed by the European Parliament go in the direction of significantly strengthening economic governance. We welcome the ambition the European Parliament has shown towards greater automaticity, the broader and timelier use of sanctions, and reducing room for halting or suspending procedures against those Member States breaking the rules.

I hope that the negotiations will allow the texts to be significantly improved along these lines.

For ***financial supervision issues***, the aim of the euro area should be to construct a supervisory framework that reflects the single market in financial services. This would eventually imply a single financial supervisor enforcing a single rule book across all relevant financial institutions.

We should not be surprised if this takes time to achieve in Europe. It remains a complex issue even in unitary states. The United States, for example, has seven different supervisory authorities and nationwide interstate branching has only been allowed since 1997.

In the medium-term, the establishment of the European System of Financial Supervision is appropriate for the EU27. However, I believe that a special regime for financial supervision is warranted for the euro area.

Euro area financial institutions require a different quality of supervision as they lack an exchange rate to "bottle up" cross-border capital flows, thus heightening the potential for systemic risk. Another aspect that sets the euro area as a special case stems of course from the existence of a central bank providing the liquidity and acting as lender of the last resort to the banking sectors of all countries belonging to the area. The need for a more significant European perspective in banking supervising should be evident when we reflect on the instrumental role of European banks from all countries in the creation of negative macroeconomic imbalances. Criticism made by some commentators that the ECB could have done something to control the credit boom in some member countries is totally unfounded as the ECB was not given legal competences in that area and banking supervision has been kept prominently as a national competence. This should be changed in the future as the banking crisis in a Member State can in the end affect the whole area. It can affect in particular the liquidity provision and the transmission mechanism of the single monetary policy.

One approach to better reflect the euro area dimension in financial supervision would be to grant the European Banking Authority more binding powers over national supervisors in euro area countries, so as to ensure a more convergent rule book and supervisory practices. It is worth remembering that in 12 of the 17 members of the euro area, the respective central banks have responsibilities in banking supervision. After the crisis, the trend in several

countries has been to change the system of banking supervision by giving that responsibility to the respective central banks. Regarding macro-prudential policies, the Eurosystem (the ECB plus the National Central Banks) was already given a special role in supporting the mission of the European Systemic Risk Board. All this points to a possible future development in the direction of giving a more significant role to the Eurosystem in the supervision of banks, in particular of large cross-border banking groups.

Developments of this kind would provide more effective tools to address financial sector imbalances that are particularly dangerous within the euro area – and thus prevent negative feedback loops emerging between the financial sector and the sovereign.

In this way, strengthening the euro area dimension of financial supervision would support the overall functioning of the economic governance framework.

A truly European system of financial supervision would also require a European resolution fund with a mechanism for burden sharing between Member States. Whilst this is not viable in the near term, within the euro area there is some interesting progress in this direction via the stability support facilities that have been created in the context of EU/IMF programmes for some euro area countries.

The use of stability facilities to provide loans for banking sector recapitalisation reflects the recognition that crisis management for sovereigns and for financial institutions is increasingly intertwined. Perhaps over time this will provide the foundation for a more integrated European system of public and financial sector crisis management.

Essentially, strengthening the rules governing fiscal, economic and financial policies is about defining what should be avoided in EMU, for the good of all its members.

However, the euro area also faces urgent questions about what can, or *should* be done.

In a unitary state, the party of government would set this agenda. In the euro area, it is the role of policy co-ordination. Co-ordination is essential to provide the euro area with leadership and ensure that all countries progress on the same trajectory.

At present, the major challenge requiring greater coordination is ensuring sustainable and balanced growth across the euro area. Projections of the euro area's growth prospects remain weak, depressed by the fiscal burden of age-related expenditure, slow productivity growth, and ongoing debt sustainability challenges.

In this context, a comprehensive programme of growth-enhancing structural reforms is essential to elevate growth potential. This means that euro area countries must fully implement the Europe 2020 strategy, supported by intensive monitoring and follow-up. The key to the success of the Euro Plus Pact is also implementation.

As it is inter-governmental and relies on voluntary commitments, there is much scope to selectively implement certain reforms. This was the flaw of the Lisbon Agenda and it should not be repeated.

Political ownership by the Heads of State or Government is therefore critical to ensure that all euro area countries set ambitious commitments and rigorously apply them.

Over time, Member States could demonstrate their commitment to deep structural reform by incorporating the key elements of the Euro Plus Pact into the legislative framework on economic governance, and therefore giving them binding legal force.

Strengthening policy co-ordination creates solidarity and substitutes for the fact that the EU is a political community without a nation.

On the one hand, it makes the collective responsible to the individual. Intrusive mutual surveillance ensures that each country realises its growth potential.

On the other hand, it makes the individual responsible to the collective. Implementing necessary reforms reinforces overall stability and shows commitment to the euro area as a whole.

Conclusion

A famous resident of the city of Florence, Niccolò Machiavelli, wrote these well-known words in the Prince, Chapter VI:

> *"It must be considered that there is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle than to initiate a new order of things."*

Nevertheless, having understood the lessons of the crisis, it would be irresponsible for policies makers not to try.

Strengthening economic governance is essential to create sustainable growth and job creation in the future, whilst preserving the national diversity that makes Europe unique.

It is fundamental to the success of a union with a centralised monetary policy and decentralised economic policies, which is not a political union.

It is important to see the challenges currently facing Europe in this broader context – and take the actions that are commensurate with it.