Carlos da Silva Costa: The importance of strengthening European integration to ensure the success of the Portuguese adjustment

Article by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, published in Diário Económico Newspaper, 31 December 2012.

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The flaws in the architecture of the European Economic and Monetary Union

Today it is clear that the architecture of the Economic and Monetary Union was flawed and incomplete from the start, which made it unable to ensure economic and financial stability when exposed to abrupt changes in market uncertainty and risk perception. In some cases, these flaws have heightened the difficulties faced by Member States, which in turn explains why the contagion effects among euro area economies have surpassed expectations.

The flaws in the architecture and institutional framework supporting the establishment of the Economic and Monetary Union necessitate an urgent rethink of this model to ensure that the euro area is stable and resilient both to common and specific exogenous shocks and to risks of inconsistency among the policies of the various economies. This is to ensure that the construction of the euro area is supported by all pillars determining its stability and resilience and that it relies on rules and institutions controlling the mutual interdependence between the stability of the whole and each of its parts.

The construction of a new future for Europe

The flaws in the architecture of the euro area and the lack of appropriate rules and institutions to promote the stability of the whole and its parts explain why the sovereign debt crisis was deeper and more protracted than initially expected. These flaws also explain why resolving this crisis and restoring sustainable and job-creating growth in Europe requires measures both at national and European level. In the euro area, these two dimensions complement and determine each other: the stability of the whole does not tolerate a lasting divergence/instability in one of its parts. Likewise, the stabilisation of one of its parts depends on the nature of the impulses it receives from the whole.

National policies to restore debt sustainability

First, the countries that have accumulated significant macroeconomic imbalances in the past and that were faced with market-based funding constraints in the context of the current crisis need to adopt policies to restore public debt sustainability, financial stability and competitiveness, thereby recovering their credibility and confidence. This is the case of Portugal. The strategy established in the Economic Adjustment Programme for Portugal – which relies on fiscal consolidation, financial stability and structural reforms – is crucial to eliminate the macroeconomic imbalances and structural blockages that have led us to this crisis. In spite of the considerable challenges facing the Portuguese economy and society, the progress achieved with the implementation of this strategy is already clearly visible today, particularly in the correction of the external imbalance.

Need for measures at European level to enhance the growth potential of the economy

Compliance by a euro area country with the adjustment programme is a necessary though insufficient condition to ensure the success of the adjustment process. In fact, the ongoing adjustment effort at national level needs to be complemented by initiatives at European level that enhance its effectiveness.

This means that the credibility of the ongoing adjustment programmes must be validated and sustained by the European context: first, through the adequacy and quality of the rules and institutions which frame and govern the euro area and each of its parts, thereby annulling the perception of a risk of fragmentation and of moral hazard; second, through mechanisms to ensure liquidity (which mitigate the risk arising from asymmetric shocks), mechanisms to monitor/encourage structural reforms (which, by nature, yield medium term results), and mechanisms to safeguard the stability of the financial system; last but not least, through an effective and ex ante practice of cooperation and coordination of the macroeconomic policies of euro area countries to ensure the stability and growth of both the whole and each Member State.

In the short term, the euro area needs to have ***instruments to respond quickly and effectively to financial stability problems***. Important steps were taken in this regard with the creation of the European Financial Stability Facility and then the European Stability Mechanism.

In addition, ***the process of coordination of economic policies at European level*** must be strengthened and improved. The main concern should be to ensure that national policies complement each other. In particular, it is important that the fiscal consolidation path of each Member State takes into account its room for manoeuvre in order to make the process more stable as a whole.

It is also desirable to implement investment projects at European level with a proven impact on potential output, for example in energy and telecommunications. These projects are expected to contribute to a more integrated, efficient and competitive economy taking full advantage of the benefits of the European Single Market.

The new European institutional architecture

Building a new European institutional architecture rests on four pillars: banking union, fiscal union, economic union and the strengthening of democratic legitimacy and accountability. We must ensure that the construction of each one of these pillars is progressing well and in an articulate manner. We must also ensure that the materials used in this construction are of high quality, so that the new building is structurally solid and able to withstand future shocks.

To ensure this high quality we must immediately promote, on the one hand, the shared notion of common interest and willingness to minimise moral hazard; and, on the other hand, policies aligned with the stability and economic growth objectives. These materials must take the form of institutions assuring group control over the integrating parties, in order to minimise moral hazard undermining group efficiency and cohesion; it shall also ensure the scrutiny of each member on the manner in which the objectives pursued by the group are established and put into practice, which is a condition for accepting the constraints defined by the group. These institutions will make it possible to recover, under shared sovereignty, the loss of individual autonomy arising from the need to comply with the group's regulations.

The importance of mitigating moral hazard cannot be underestimated, given that it may obstruct mutual aid and solidarity among Member States. Minimising moral hazard is a necessary condition of confidence and mutual aid among group members, implying participation rules and compliance-monitoring mechanisms and institutions.

In order to overcome the crisis that has been undermining the European project, the sense of urgency, diagnosis and the convergence of willingness are not enough. It is essential to establish and implement ***a new institutional framework*** ensuring the move to a new mutual confidence stage. The future of Europe therefore involves the mandatory deepening of financial, fiscal, economic and political integration of Member States.

Banking union

The design of the banking union has been drawn up. This is a key pillar to solve the financial fragmentation in the euro area and to break the link between sovereign risk and banks' risk.

Currently, euro area corporations experiencing similar situations in terms of profitability and risk are faced with rather differentiated credit conditions merely for geographical reasons. Portugal must overcome this problem, in order to strengthen the competitiveness of Portuguese corporations.

In my opinion, a complete banking union should encompass three key elements: (i) a ***Single Supervisory Mechanism***, applicable to all credit institutions, involving centralised decision making and decentralised implementation; (ii) a ***Single Deposit Guarantee System***; and (iii) a ***Single Resolution Mechanism***.

The Single Supervisory Mechanism was recently approved by the Council of the European Union. Under this new mechanism, the European Central Bank (ECB) shall be responsible for carrying out supervisory tasks over credit institutions in the euro area Member States. There will be, however, a coordinated distribution of tasks between the ECB and the national supervisory authorities, depending on the size of banks and national banking systems.

With all banks in the euro area under unified supervision, responsibility for deposit guarantee and resolution shall be held at the level where supervisory powers are exercised, i.e. at European level. Banking union must therefore cover not only integrated supervision, but also shared deposit guarantee and bank resolution mechanisms.

If a single supervisory mechanism is not accompanied by European deposit guarantee and bank resolution mechanisms, it represents banking union under construction and therefore an incomplete separation between sovereign and banking risk.

Fiscal union

Lack of fiscal discipline among Member States during the pre-crisis period revealed the need to strengthen the European fiscal policy institutional framework.

Important decisions have already been taken in this field, involving a range of regulations to promote fiscal discipline in Member States (for example the so-called “six pack” and “fiscal compact”). However, work for the construction of that pillar is still currently under way. These regulations must be complemented by institutions assuring their effective implementation. Indeed, Europe needs a qualitative change towards fiscal union.

Economic union

The achievement of a genuine economic union requires the establishment of an institutional framework able to assess, coordinate and monitor Member States’ economic policy measures and reforms. Special emphasis should be placed on areas with a potentially higher impact on competitiveness, economic growth and employment, simultaneously promoting social cohesion. Member States’ economic policies and macroeconomic imbalances are an issue of common interest and therefore require a “win-win” concerted response. The “European Semester” and the “Euro-Plus Pact” are important improvements in this area.

Strengthening democratic legitimacy and accountability

To move towards more integrated fiscal and economic policies we need to implement mechanisms ensuring democratic legitimacy and accountability in joint decision-making. If this political dimension is ignored, we will not be able to evolve towards greater financial, fiscal and economic integration, for lack of legitimacy and accountability.

This political dimension of the integration process must reconcile two sources of concern: the need for a legitimate response vis-à-vis “the whole”; and the need to ensure that all parts, irrespective of their size, are represented and participate in the decision-making process.

In particular, the so-called “community method” must be revitalised, in tandem with restoring the European Commission’s central role, by strengthening its effectiveness and legitimacy.

This subject requires separate attention. I have already tackled it in a number of public addresses, as for instance on the occasion of the European Courts of Auditors meeting in Estoril this year.

It must be understood, however, that the political pillar, although going hand in hand with the pillars of greater financial, fiscal and economic integration, has its own different timeframe. The construction of the other pillars cannot be delayed for the launch of the work on the strengthening and reconstruction of the political pillar. The time criticality of the problems requires prompt responses to the Economic and Monetary Union's flaws. These are likely to be a catalyst for responses of political organisation and legitimacy that are less grandiose, but certainly more efficient, as they are based on the resolution of actual problems (as may be expected from an evolutionary/gradualist model, such as has been the case in Europe, as opposed to the institutional/constitutional model, which is a federal integration-like model).

By way of conclusion, I would like to stress once again that European development is very important for the success of Portugal's adjustment. Determined domestic policy action is essential but not enough. The European context must validate the credibility of the adjustment in every euro area economy. The level of certainty, quality and vigour of the new euro area mechanisms and institutions are key to strengthening market confidence and are therefore an indispensible complement to national adjustment effects. This means that there is a virtuous relationship between the so-called frontloading of national adjustment processes and the frontloading of the European integration process. For this reason, the Governing Council of the ECB has repeatedly advocated that the response to the sovereign debt crisis should be the responsibility of the European Council and that the costs and depth of the crisis were inversely related to the celerity and forcefulness of the response. The Portuguese and the citizens of other Member States must understand this: the regulations and mechanisms under development in Europe are not the result of some external imposition, but are rather inherent to the integration stage representing a successful Economic and Monetary Union and are therefore essential for the prosperity of Europe and each of its Member States.