Carlos da Silva Costa: Exiting the financial crisis and strengthening European integration

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Conference of the Portuguese Association of Insurers "Where is Europe going?", Panel I "What is the future of the euro?", Lisbon, 24 October 2013.

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"*The countries that share this conception should be able to go further together, without excluding the others, since they can still live in a greater community of exchange and co-operation."*

Jacques Delors

Introduction

The financial crisis began five years ago now, but its effects are still felt today, both in the financial markets and in the real economy. The international financial system has gradually returned to health, but fragilities remain. World economic growth remains weak, with a persistently high level of uncertainty and important vulnerabilities and risks with potentially significant consequences.

Even though the financial crisis began across the Atlantic, ***the consequences for the euro area were considerable and still persist.*** Despite the latest indicators showing encouraging signs of a gradual resumption of economic activity, unemployment remains historically high (12%) and varies widely across countries.[1] Public debt is above 90% of GDP,[2] which poses an additional challenge in a context of weak growth prospects. In turn, the financial markets remain highly fragmented, with continuing strong links between banks and their sovereigns. Thus we must stay vigilant and work consistently towards making the euro area more balanced and resistant to shocks, anchoring measures taken to a long-term strategy.

The crisis has taught us important lessons, including the following***:*** (i) the importance of financial stability; (ii) the negative effects of high levels of public debt; (iii) the scale and speed of contagion effects; (iv) the flaws and inconsistencies of the EMU's institutional architecture.

The challenges brought by the crisis have also served ***as a catalyst for unprecedented decision-making, which will define a new "design" for Europe***, strengthening integration. The European Union of today is not the same as the one of five years ago and surely will be very different from the one of five years hence. As *Jean Monnet* wrote in his memoirs, "***Nobody can say today what the institutional framework of Europe will be tomorrow because the future changes, which will be fostered by today's changes, are unpredictable."***

If we look at the history of European integration we can see that ***the times of crisis were also the moments of adjustment and reform*** which led to higher levels of integration. Crises are opportunities to reflect on the rules and institutions in force, ***and it falls to policymakers to take and manage these opportunities in a concerted manner.***

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[1] According to Eurostat data, the lowest values in August were in Austria and Germany (4.9% and 5.2% respectively) and the highest were in Greece and Spain (27.9% (June) and 26.2%).

[2] Various pieces of research, using different methodologies, suggest that high levels of public debt, normally above 90%, have a negative effect on economic growth.

So, ***when we ask "Where is Europe going?", we have to start by asking, "Where has it come from?"*** That will give us a better understanding of what went right and wrong, and of which path to take to build a new, more sustainable future for Europe and the euro.

The financial crisis and the institutional weaknesses of the euro area

The way the euro area was shaken by adverse circumstances has revealed the existence of ***significant flaws and inconsistencies in its institutional architecture and economic governance model***. In a context of great uncertainty and financial instability, the limitations of this model in confronting and managing exogenous shocks and protecting the Member States and the euro area itself were laid bare.

When the financial crisis hit, ***the lack of alignment and solidity of the euro's foundations allowed the entire structure to sway***, affecting economic agents' confidence and expectations dramatically. At one point, with the sovereign debt crisis intensifying and spreading, the euro area became the centre of world attention ***and the sustainability of the integration process itself started to be questioned by the markets.***

The crisis exposed very clearly the weakness of the economic pillar, in other words the "E" of Economic and Monetary Union, making it necessary to urgently think of ways to make it more robust and more balanced with "M", the monetary pillar. In effect, ***the single currency was founded on an unbalanced structure, comprising a solid monetary pillar and a weak and underdeveloped economic pillar***. The monetary pillar has been successful in carrying out its role: the euro has won its position as an international currency and price stability has been achieved. In contrast, the insufficiencies of the economic pillar have allowed ***inadequate economic policies in certain Member States, unsustainable public finance positions, the accumulation of significant macroeconomic imbalances and large divergences in competitiveness***.

A posteriori, one may say that ***not only was the euro area's institutional framework insufficiently robust, but also its implementation was weak in the first years of the EMU.*** Europe was unable to create effective mechanisms and institutions to ensure that the underlying conceptual framework was applied and complied with. Therefore***, the future of the euro depends on addressing the initial inconsistencies and discrepancies, opening the way to a higher level of integration and mutual confidence.***

The national and European dimensions of building a new future for the euro

But the Member States cannot wait for the problems to be addressed only at European level, in Brussels, in Frankfurt or in Strasbourg. On the contrary, exiting the financial crisis and defining "where Europe is going" requires ***consistent and coordinated action at Portuguese and European level***. The national and European dimensions cannot be decoupled, they are complementary and mutually defined.

Thus it is key that the public understands that ***the new rules and mechanisms being developed are not an external imposition and are vital for the survival of the group and of each one of its members.*** No Member State, irrespective of its economic size or importance, no European institution and no European citizen are exempt from this collective responsibility.

At <u>national level</u>, ***structural reform and solid and sustainable policies*** are needed. Countries like Portugal that have accumulated considerable macroeconomic imbalances in the past have to ***press ahead with efforts to "put their houses in order",*** so as to recover credibility and confidence in the markets. This means that they have to set the high levels of public debt on a downward path (within a framework of credible fiscal strategies) and proceed with structural reform, to increase medium-term growth potential and promote competitiveness.

But it is also important to ensure that ***national policies are complementary,*** so that a country's policies, including fiscal policy, take account of the room for manoeuvre available, making the whole process more stable. In the euro area, this discipline means recognising and accepting that ***national economic policy-making is a matter of common interest.*** In the absence of a unified centre of power, the effectiveness of the policy depends on the effectiveness of the coordination of the national policies and the fairness of the measures.

At EU level, the way out of the financial crisis involves building a stronger and more resilient EMU, both when faced with external shocks (common or specific) and risks from inconsistency between Member States' policies. For this, it is key to continue ***strengthening the institutional framework and the governance model*** in the euro area.

Strengthening integration means strengthening rules and institutions

Europe needs ***solid and effective rules and institutions*** that preserve the fundamental values of the European project and that are able to manage the strong interdependence of its members, in a context of collective decisions. Quoting Jean Monnet again, "***nothing is possible without individuals, but nothing is lasting without institutions***".

The EMU is a complex construct, a union of sovereign states making up a single market and sharing a single currency. ***States that are at the same time independent and interdependent, united and diversified, whose actions are linked and bound by common rules and institutions, while retaining sovereignty.*** For this complex construct to be sustainable and balanced, a governance model is needed that ensures that the Member States and the European institutions perform their roles adequately. This means responsible economic policy-making by the Member States and rigorous monitoring and surveillance by the union.

Consequently, deepening European integration also means greater integration through the rules and institutions. The euro area needs ***effective rules and institutions that frame and control the interdependence between the stability of the whole and the stability of each Member***, preventing excessive imbalances from arising and limiting contagion effects. Institutions able to ensure the collective's control of each of its parts (minimising moral hazard), but also the scrutiny of each of the parts as regards setting and implementing shared goals.

It is important to note that ***having rules is a necessary but insufficient condition***. The rules and institutions ***form the foundations of any society***, but they must be ***applied effectively and respected.*** However, in society, the legal system and police authorities may compel the general public to follow those rules. This does not happen in the governance of the euro area, ***the mechanisms for monitoring the application of the rules are essentially political*** and have proved insufficient for ensuring that the national governments develop appropriate and consistent policies.

Europe needs a strong institutional framework as well as the means and will to ensure that it is complied with. This means creating ***a coherent and credible framework of rules and incentives, using a stick and carrot approach, which underpins and guides national and institutional behaviour***, aligning it with common interest. Stronger institutions, clearer and fairer rules (equal treatment for all Member States) and an appropriate stick/carrot system will help improve vital coordination of economic policies.

Great progress has already been made towards strengthening rules (for example, the six-pack, the two-pack, the Fiscal Compact) ***and institutions*** (for example, the new financial supervision architecture, strengthening the role of the Eurogroup). However, there is still much to do to build a new European institutional architecture.

The new institutional architecture

Indeed, progress of the greatest importance has already been made, following the European Summit of June 2012, the so-called "Four Presidents' Report"[3] and the "Blueprint"[4] of the European Commission. One might also say that ***the June Summit was an important milestone in the integration process***, since it signalled that at the highest level the European leaders agreed to pursue wide-ranging institutional and governance reform which will mould the political and economic situation in Europe for generations to come.

Europe's physiognomy is being changed through four work-streams: (i) banking union; (ii) fiscal union; (iii) economic union; (iv) strengthening of democratic legitimacy and accountability. I would like to briefly turn to these four work-streams.

- ***Banking union***

The banking union work-stream is one of the most urgent and central aspects of this collective reform effort, as it plays a key role in effectively and sustainably breaking the negative two-way link between the banks and their sovereigns and re-establishing the normal functioning of the markets.

Effectively, ***the fragmentation of the financial markets along national lines has been a dominant feature of the euro area crisis.*** This fragmentation harms the transmission of monetary policy to the real economy and leads to ***unsustainable differences between Member States*** with regard to credit conditions facing households and enterprises (in particular SMEs) of comparable quality and solvency, ***creating unequal conditions of competition.*** For the question posed to this panel ("What is the future of the euro?") to have a positive answer, it is crucial to restore confidence in the European banking sector and eliminate that fragmentation. ***The solution involves creating a banking union that complements monetary union.***

An important development in this area was the ECOFIN Council's approval on 15 October of this year of the ***Single Supervisory Mechanism*** (SSM), under which the ECB becomes responsible for supervising euro area credit institutions. ***This is a fundamental and indispensable pillar of banking union.***

However, ***to be complete, banking union has to include two further pillars:*** (i) a ***Single Resolution Mechanism***; (ii) a ***Single Deposit Guarantee System,*** thereby aligning supervisory responsibilities with those of a safety net. ***A single supervisory mechanism that is not accompanied by European deposit guarantee and resolution mechanisms represents a banking union still under construction.*** Only a banking union based on all these pillars will create the conditions for economic agents to make decisions based not on expectations about the sovereign risk of the country where the banks are headquartered, but according to the risk profile of the bank itself, irrespective of location.

Thus it is important to continue work on the pillars still missing, taking the proposals presented by the European Commission as a basis. On the other hand, we should not lose sight of the path leading to full banking union as a whole. ***The lessons learned from the financial crisis advise us to redouble our efforts in exercising prudence and good sense in managing the transition process.***

- ***Fiscal union***

Inadequate fiscal policies in certain Member States in the period before the crisis has shown the need for developing a European-level ***integrated framework of rules and procedures***

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3 "*Towards a Genuine Economic and Monetary Union*", December 2012.

4 "Blueprint for a deep and genuine Economic and Monetary Union", European Commission, November 2012.

promoting fiscal policies that are more sound and sustainable and more coherent. Indeed, in the absence of rules and institutions that ensure the continuity of the convergence process, different preferences tend to emerge among the euro area countries, jeopardising the stability of the whole.

Some of the most important pieces of the fiscal "jigsaw" already exist (the six-pack, the two-pack and the Fiscal Compact). ***I would highlight here*** the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (commonly referred to as the Fiscal Compact),[5] ***due to its structural importance and its implications at national level***. Indeed, with regard to its transposition, Member States have adapted their national legislation and fiscal frameworks,[6] with most countries making important progress also in establishing independent monitoring institutions. ***This is an example of the credibility of the fiscal strategies, rules and procedures outlined at national level benefiting from the new European framework.***

However, despite notable progress made to date, further steps are still necessary to ensure that all the pieces of the fiscal jigsaw fit together into a complete and consistent whole and that nothing is missing or left over. In particular, it is necessary to ensure that the large set of rules approved to-date is complemented with institutions and mechanisms that allow them to be applied and complied with. I would say that Europe needs ***qualitative change towards fiscal union.***

- ***Economic union***

Building a true economic union that strengthens the "E" of the EMU ***requires an integrated economic policy framework capable of monitoring, assessing and coordinating essential economic measures and reforms.*** Emphasis must be placed on the areas with potentially greater impact on competitiveness, economic growth and employment, while promoting social cohesion. If implemented adequately, structural reform may contribute to increasing economic growth and reducing inequality, thereby creating a "double dividend". The "Euro-Plus Pact" and the "European Semester" are important milestones on the road to greater economic integration.

- ***Strengthening of democratic legitimacy and accountability***

As the euro area moves towards greater integration, the "political work-stream" gains additional importance, which requires the strengthening of democratic legitimacy and accountability in joint decision-making. ***If the political dimension were ignored, Europe would not be able to evolve towards greater fiscal and economic integration, due to lack of legitimacy and accountability.***

The political dimension will have to ***reconcile two concerns: the need for responsiveness that is mandated by the "whole" and the need to ensure that all parties are represented and informed and take part in the decision-making process***. That is why the European Parliament and the European Commission in the future will have to be more representative and answerable to the euro area as a whole. However, it should be understood that despite being inseparable from the other three work-streams, the ***"political work-stream" has its own different and slower tempo,*** like any sovereignty-sharing process, ***and must not hold back the others.***

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[5] In force since 1 January 2013.

[6] With varying degrees of speed and taking various routes, namely in terms of detail of the rules and the hierarchy of instruments in the respective legal order.

Solidarity to protect group cohesion

Before concluding, I would like to touch on an aspect that I see as fundamental to the future success of the euro: ***solidarity***. We should be aware that even with adequate rules and institutions, an economic and monetary union is not immune to exogenous shocks and specific problems in each of its members. Aside from asymmetric shocks, ***even symmetric shocks may have asymmetric effects***, penalising some countries more than others. Thus, measures designed to strengthen the economic pillar must also include ***solidarity mechanisms*** which support Member States facing serious financial difficulties or strong market pressures, ***protecting the stability of the euro area as a whole and preserving group cohesion.***

These mechanisms must be robust, with sufficient financial resources and designed to respond quickly and effectively, while at the same time promoting accountability and avoiding moral hazard. ***The more robust and credible these "backstops" are, the less likely they are to be used for real.***

To address this concern, the first temporary European mechanisms were established in May 2010: the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). Replacing these was the ***European Stability Mechanism*** (ESM), created in 2012, now a permanent facility. This mechanism is an ***indispensable complement*** to the reforms mentioned above and an important milestone in the profound transformation under way in the euro area.

As Robert Schumann stated in 1950: "***Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."***

Final observations

I would like to conclude, ***answering the question put to this panel*** ("What is the future of the euro?") ***on a confident note.*** I am convinced that the euro area will not only survive this crisis but also will emerge stronger and more united than before. ***Europe has faced difficult crises in the past, while not of this magnitude, which were ultimately overcome and led to the bolstering of European integration.*** I believe that this time will be no different.

The European project is still a work in progress and, as we have seen, has flaws in its foundations. We cannot miss this unique opportunity to strengthen these foundations, through profound reform that is key to increasing stability and resilience in the euro area, completing the single market and strengthening the European Union's international role. ***Coherent economic policy, sound, effective and accountable institutions and greater solidarity are crucial for Europe to overcome the crisis and restore sustainable growth and employment.***

We should ensure that the European Union is a "positive sum game", in which everyone benefits and where the distribution of gains between countries is balanced. As an integral part of the whole that is the European Union, the euro will prevail as the common currency for a group of countries that share a single monetary policy; that will establish banking union; and that will operate within a coherent and binding framework of rules and under institutions that ensure compliance with those rules. ***The future of the euro area will involve greater sharing of sovereignty, with increased legitimacy, accountability and solidarity, in which European institutions are increasingly answerable for the "whole" and not only for the sum of its parts.***

The success of the European Union is important not only for Europeans but also for global geopolitical equilibria.

Thank you very much.