Carlos da Silva Costa: Policies and governance framework required to ensure Europe's prosperity

Opening address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Seminar on "Governance and Policies for Prosperity in Europe", Lisbon, 10 April 2015.

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Minister of State and Finance, Ladies and gentlemen,

First of all, I would like to thank the Minister for her invitation to deliver the opening address in this seminar, in which we reflect on the policies and governance framework required to ensure Europe's prosperity. I hardly need to highlight how opportune this is.

Recent years have seen deep changes in Europe. In many cases, such changes went beyond what was thought possible not long ago. Developments so far, however, are not enough to sustainably ensure the prosperity of the economy in Europe and all its Member States. In my opinion, this is the appropriate time to consider long-term issues, and to discuss what is missing in the Economic and Monetary Union (EMU), so that it may function smoothly.

The EMU is the result of shared sovereignty among Member States. It is built on ongoing negotiations and on catching up from different starting positions, safeguarding national cultures and identities, while at the same time ensuring the sense of belonging within a group. This involves an institutional framework with a large capacity to understand and manage the differences and link the interest of the whole with the specificities of the parts, in order to ensure that the whole is greater than the sum of the parts.

Opening this seminar, I would like to convey to you five messages regarding the reflection on the policy and governance framework required to ensure prosperity in Europe.

The first message is that, most of the time, the European response during the crisis has been reactive, delayed and built from national perceptions of the problems faced by the Union and, in particular, the euro area.

In effect, two types of bias in the Monetary Union decision-making process have come to the fore during the crisis:

- A reactive bias of the decision-making process: the problems were not foreseen and initially there was even a tendency to deny them. As a result, the problems were only acknowledged belatedly and the willingness to reflect jointly on the causes and necessary answers was delayed. For instance, in 2010, at the start of the sovereign debt crisis, it was extremely difficult to recognise that we were facing a common problem;
- A national bias in the characterisation and evaluation of the problems: a tendency to perceive others' problems and their solutions based on one's own situation, i.e. on the individual country's specific situation. In other words, the evaluation of the whole is based on an evaluation of its parts, instead of, as would be desired, evaluating the whole situation and its interaction with each of its parts. As is known, the whole is greater than the sum of the parts. For this reason, considering the whole from the viewpoint of one of the parts is necessarily simplistic and biased. The crisis has highlighted the tendency of all Member States to bring their own ways of facing the problems and their own a priori considerations to group discussions. In this context, the particular problems and the specificity of the viewpoints tend to take precedence over the vision of the whole. Therefore, inter-Member State balance has been contaminated by the rationale of relative size, which runs counter to the rationale underlying the European Union.

We cannot have an EMU with an institutional framework that, instead of promoting the resolution of the problems, exacerbates them and, in some cases, makes them self-fulfilling. In this instance, the adjustment costs are considerably worsened, from the point of view both of each part and of the whole group, either the euro area or the European Union.

The second message is that the constitutional rules contained in the Treaties are the basis for mutual trust among the Member States composing the European Union.

The rules forming the basis for mutual trust in the EMU are enshrined in the Treaties, ranging from the Maastricht convergence criteria and European Central Bank Statutes, with regard to monetary policy and financial stability objectives, to the ceilings on fiscal deficits and public debt set out in the Treaty on Stability, Coordination and Governance. Facing such diverse economic, social, cultural and political situations, European countries have had to base their notion of belonging and therefore mutual trust on rules that ensured the relationship among group members was balanced, eliminating both hegemony/dominance risk and moral hazard (the attraction of free riding). Thus, shared sovereignty, aggravated by different preferences and different institutional frameworks and cultures, has imposed the need to identify the required minimum conditions for the functioning of the Monetary Union.

This means that the group had to adopt rules not deriving from market sustainability principles, but rather from the need to install and operate self-imposed mutual-trust mechanisms. The observance of these rules, which I will call constituent rules, is key for the survival and development of the whole, i.e. of the group. Therefore, these rules can only be changed by a decision of the same nature. Compliance with them is fundamental in order not to jeopardise the group.

The nature of derivative rules, such as, for instance, those in the Stability and Growth Pact or the Macroeconomic Imbalance Procedure, is different from that of constituent rules, given that they are not cornerstones for the survival of the group. These rules are instrumental for the resilience of the group when, due to endogenous or exogenous circumstances, the whole or the parts deviate from compliance with the rules supporting the group aggregation and, in particular, underlying mutual trust among its members. Even though they are also the result of a group decision, they may take different forms, depending on the specific circumstances faced by the whole and/or its parts, provided that they are consistent with the key or constituent rules. Derivative rules may also be somewhat flexible, provided that they do not jeopardise compliance over time with the group's key rules. They can therefore change according to the social and economic environment of the whole and its parts, namely when considering a shorter or longer deadline for convergence towards compliance with the rules of belonging to the group. This decision must be taken by the group, in terms of the need to ensure convergence of the parts towards compliance with the principles underlying the levels of shared effort achieved so far and, as a result, mutual trust requirements.

In my opinion, this clarification is very important. It is not the market that disciplines EMU, but rather its members, based on the rules to which they are committed. Until 2010, Europe was indulgent regarding the implementation of the rules, and considered that the markets would monitor and discipline; the markets, in turn, were indulgent in their evaluation of Member States' economic situations, precisely because they considered that the rules would be complied with. These positions led to a misconception: that it would be possible for the whole to function, disregarding compliance by its parts with the constituent rules. This situation of mutual deception cannot be repeated.

The third message I would like to convey is that the rules and operational procedures must promote the resilience of sustainability trends in reply to shocks.

It is clear for all of us today that the stability and prosperity in the euro area as a whole depend on the stability and prosperity of its individual members.

Therefore, at national level, it is fundamental that Member States adopt policies supporting medium-term sustained economic growth. This means ensuring the:

(i) (Sustainability of external accounts;

(ii) Sustainability of public debt;

(iii) Sustainability of private debt;

(iv) Socio-economic cohesion expressed in employment levels aligned with the size of the labour force, in productivity and income levels aligned with public and private consumption prospects, and in the capacity to provide support to dependents and those excluded from the labour market, either temporarily or permanently.

In order to reach these goals, it is necessary to implement counter-cyclical fiscal policies, macro-prudential policies limiting the indebtedness of private economic agents, and income policies safeguarding the economy's competitiveness. This means it will be necessary to create an institutional framework ensuring that wage and price formation simultaneously take into account the objective of nominal monetary policy stability, the safeguarding of business competitiveness in the tradable sectors, and investment attractiveness. This investment attractiveness is very important because, on the one hand, it increases productivity and, on the other, it widens the productive base, and, as a result, the opportunities to create further employment and employment with higher value added per asset. Virtuous dynamics such as these require: i) the implementation of an institutional framework ensuring, in the context of sectoral and corporate business, the alignment of real wage growth in the tradable sector with a rise in the sector's productivity; and ii) growing regulatory competitive pressure ensuring efficiency gains and, therefore, cost reduction in the non-tradable sectors and, in particular, in sectors with low competition. In this vein, it is also necessary to carry on structural reforms removing obstacles to competition, creating a more favourable environment to business development, and promoting the absorption of know-how and corporate investment in research and development. Moreover, it is crucial to ensure that the allocation of internal savings, especially via bank credit and public nature instruments, is based on efficiency principles and therefore on the economic and financial return of the investment projects. This condition is essential for promoting an efficient allocation of resources and optimisation of potential growth associated with the volume of disposable savings.

At European level, a framework for the monitoring and surveillance of national policy sustainability (most notably, fiscal and wage and price-setting policies) must be implemented and equipped with effective corrective instruments. As part of this, steps must be taken to safeguard the resilience of national adjustments, ensuring that the economy – through its macroeconomic fundamentals – is able to return to a sustainable path following deviations resulting from (internal and external) exogenous shocks or erroneous economic policy decisions. This is a particularly important point in the ongoing discussion about the flexibility of fiscal objectives for a given Member State. Indeed, what truly matters is whether the sustainability plan/path is resilient, in other words, whether its mechanisms can return it to a path complying with the constituent rules, which serve as the basis for the group and its activities. Naturally, resilience increases proportionally to the better quality of growth. As such, the sustainability of a given country's financial consolidation and maximum growth are not mutually exclusive. On occasion, means are confused with goals, such as confusing structural reforms, which are a means, with the goal of ensuring potential growth compatible with increased resilience in the economic and financial path of a given economy. Structural reforms leading to increased resilience in economies as a response to shocks are those that guarantee: (i) employment growth compatible with social cohesion in the long run; (ii) sustainable public finances; and (iii) a response to population developments.

A Monetary Union with sustainability mechanisms favours economic growth, but does not guarantee the aggregate's maximum and sustainable growth. It ensures sustainable public finances, but not a growth path consistent with the natural rate of unemployment, which means that it can coexist with a suboptimal equilibrium. The nature of national economic policies and the coordination of such policies at aggregate level are inextricably linked to the sustainability and quality of the development model for each economy participating in the euro area. Therefore, it is crucial to define, put in place and legitimate a power centre that works on the premise that the whole is greater than the sum of its parts. This means that it is necessary to guarantee the set-up and proper functioning of a coordinating power for national economic policies bearing in mind not only the parts but also the path of potential output and employment in the euro area as a whole and, for that purpose, has its own means as well as indirect means to manage aggregate demand, investment and potential output.

In the EU institutional framework, this role should be played by the Eurogroup. It is responsible for acting as a coordination centre and ensuring the consistency of national policies, making use of the entire range of instruments created by the EU, such as centralising the optimisation of the aggregate's path by monitoring spillover effects on its constituent parts. This is, unsurprisingly, a paradigm shift: it entails moving the focus from financial or regulatory instruments to policies. Until now, the EU tended to believe that it was enough to create instruments, as they would induce policies, as was the case of the European Social Fund and the European Regional Development Fund. However, those same instruments served/induced different policies and consequently, different efficiency levels for both the parts and the whole. This should be viewed from the opposite perspective: instruments do not induce policy optimisation; policies require and warrant the use of instruments and, as such, they should be employed according to the policies' level of consistency with the general interest.

The fourth message that I would like to convey is that responsibility for compliance with fiscal rules should lie with an independent entity.

National budgets are a matter of common interest, given that the debt sustainability principle is an integral part of the institutional principles enshrined in the Treaties. As a constituent rule in the EU, it must be safeguarded while ensuring its independence, technicality and neutrality.

I therefore believe it is crucial to establish a central independent entity capable of assessing and issuing reasoned opinions on the fiscal adjustment path followed by Member States – a European "Public Finance Council". This "Public Finance Council" would gauge national policies' compliance with the EMU's self-imposed rules, but it would not interfere with political choices, provided that they were compatible with long-term sustainability. This means that if a country prefers to adopt an approach that favours equality over efficiency – defining efficiency as public expenditure yielding returns – it would not be bound by an obligation to follow a sustainability path. However, we must bear in mind that the sustainability path would not be the same. It is crucial to reach a balance between two situations at opposite ends of the spectrum, both of which unfeasible: (i) to grow in the future without creating conditions for consensus in the present; and (ii) creating conditions for consensus now, but neglecting future economic growth. The nature and quality of national policies affect a country's potential output and, consequently, the political room for manoeuvre within the rules.

Any policy measure identified as necessary in the scope of the "Public Finance Council" would have to be decided by the Eurogroup, which, as I have mentioned before, should be responsible for the aggregate's economic policy and its consistency with national policies.

The fifth message that I would like to convey is that, in order to act quickly and decisively in times of crisis, we must establish a European Monetary Fund.

We must take an institutional leap and turn the European Stability Mechanism into a European Monetary Fund, so as to put in place a specialised entity to manage imbalance situations that a Member State may have to overcome. Imbalances may occur following the adoption of national policies that are unsustainable in the long run, due to asymmetric effects of common shocks or specific shocks resulting from circumstances outside the scope of economic policy-makers. In such cases, there must be an institution independent from Member States, empowered and qualified to negotiate with the country in question on matters of financial assistance with associated conditionality. Empowered, in the sense that it cannot depend on the approval, by national parliaments, of conditions and amounts needed for that purpose; and qualified, in the sense of having the technological and technical means that make it possible to act in a quick and informed manner. The adjustment programme should be defined on the basis of a contractual approach (and not by imposition) to ensure the policy's ownership by the beneficiary country. The existence of a European Monetary Fund would help turn conditionality into the joint adoption of a programme of internally consistent adjustment policies that are also consistent with the restoration of a resilient convergence path towards compliance with the group's underlying rationale, which I previously called constituent rules. The creation of a European Monetary Fund, with a clear mandate, means and independence of action from Member States and removed from the concept of guardianship, will put in place the necessary conditions for the development of win-win solutions, which is a pillar for the aggregate's cohesion.

Final remarks

In conclusion, I would like to stress that, when reflecting on the policies and the governance framework that are crucial to guarantee Europe's prosperity, we must separate what is possible from what is desirable. I have focused my speech on what is possible, but I would like to approach an issue that falls within the scope of what is desirable, in other words of what is impossible right now but indispensable in the medium run. I mean the need to reflect on faster responsiveness and the political upgrading of the European Commission, while safeguarding its specificity: the monopoly initiative, the coexistence between its political-lawmaking and executive functions and – the cornerstone of its institutional role – the equal representation of Member States in its collegiate managing body.

These days, the European Commission is a key body for ensuring the existence and functioning of the European Union as a whole and crucial in terms of thinking and projecting this aggregate in the future. Indeed, as European integration progresses further, the European Commission has evolved from being a fundamentally lawmaking body to being an entity that today combines executive and legislative functions. Given the European Commission's current architecture, it is very difficult to combine both functions. In my opinion, the Commission should, in the long run, adopt an internal organisation model similar to that of the European Central Bank. This means establishing a Board of Commissioners comprising a commissioner from each Member State, who, in the scope of a collegiate body, will participate in the decision of policy guidelines and associated legislative proposals, and an Executive Board that will manage the day-to-day business and the implementation of policies defined by the Board of Commissioners. The Executive Board would consist of a small group of commissioners, in proportion to the scope of executive powers entrusted to the Commission, appointed on a rotational basis amongst Member States. For instance, the definition of an energy policy or the European digital policy should be a task for all commissioners (and not only the commissioner in charge of such areas), but decisions on the purchase of a building or on staff policy could be delegated to the Executive Board.

In this context, we should revisit the concept of subsidiarity, but in contrast to what was used in the past (when it only gave powers back to local authorities). We must develop on a bidirectional concept, locating at aggregate level issues that are being handled in a disperse and uncoordinated manner by the parts, to the detriment of optimisation. The principle of equality between Member States tends to be sacrificed to the principle of "who moves first" or "who weighs more", as was the case, for instance, in energy policy.

This is something we should ponder on, even though this falls within the scope of what is desirable, and, therefore, for the medium run.

Thank you very much.