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Economic Challenges Facing Europe and the World

Panel Discussion of Deputy Governor of the Bank of Italy

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Germany and Italy have been called on to chair the G20 and G7 in economically and politically turbulent times, in the world at large as well as in our common European home. Several years down the road, the legacies of the global financial crisis and of the sovereign crisis in the euro area are still apparent. Sluggish growth, high private and public debt, unemployment and underemployment, as well as a general sense of disillusionment among broad swathes of the population are affecting many countries to varying extents. These facts and feelings are also engendering widespread ‘anti-globalization’ sentiment, as well as doubts about the European project.

This reaction has deep-rooted causes on which I shall spend a few words later but first of all, let me point out that this is one of the most compelling reasons why coordination between the German and Italian presidencies is so important. We must exploit synergies and join efforts to reach the broadest possible consensus among advanced and emerging economies, taking actions that can stem what I see as a potentially dangerous spiral of rising disaffection and protectionism.

The Italian Presidency will continue the work of past G7s in well-known areas, combating money laundering and terrorist financing, fostering international cooperation among tax authorities and enhancing cyber security (the latter an increasingly pressing issue on today’s global agenda). But there is also the intention to promote an open-minded and broad debate on two issues that that go some way to addressing the concerns I mentioned earlier.

The first issue, financial regulation, has been at the centre of our agenda since the outbreak of the global financial crisis, when the G20 and its technical bodies took on the task of redesigning financial sector regulations to avert similar shocks in the future. The past few years have seen a comprehensive, radical overhaul of financial regulation. It seems reasonable now to step back for a moment and look at the bigger picture. Have we done enough? Or is it possible that we have been doing even too much?

The re-regulation of the banking system has certainly been necessary, timely, and – within the limits of human fallibility – I believe it has done a lot to make banks safer. But we need to know where to stop, at least for some time. We need, first, to give a minimum of stability to the regulatory framework; second, to take stock of the work done and gain experience to evaluate its longer-term effects; third, and perhaps most importantly, strike a balance between securing the financial system and avoiding rules that would overly penalize risk-taking, without which no growth is possible. At the beginning of this year the group of central bank governors and heads of supervision of the G20 instructed the Basel Committee to refrain from 'significantly increasing overall capital requirements'[1] at this stage. The Basel 3 package is currently being finalised on this premise. While agreement is not yet assured, I think we are close. Let me take this opportunity to say that my firm view is that an agreement is necessary to give certainty to the financial world. The conditions are there and we should not miss the opportunity.

Assuming such an agreement can be reached, in the field of banking regulation the next few years should be devoted to maintaining the regulatory system, not to overhauling it radically once again; we also need to review the rules, by checking for any embedded procyclicality or other unintended consequences, rather than establishing further capital requirements.

Efforts to limit banking risks, however, are only part of the answer. The financial landscape is changing apace. The growth of intermediaries outside the banking sector points to the need for new micro- and macro-prudential tools. Work has begun in this area but much remains to be done.

Furthermore, a host of innovations (digital currencies, distributed ledgers, peer-to-peer lending, crowdfunding, to name but a few) have opened new frontiers for financial services and started to blur the boundaries of the financial sector itself. There is great potential for financial inclusion and efficiency gains here, but there are also implications for monetary operations and transmission, as well as new risks to stability, integrity, and end-user protection. This raises issues about the

[1] Group of Central Bank Governors and Heads of Supervision (10 January 2016); as Stefan Ingves, chairman of the Basel Committee, recently noted, this must be one of the most frequently cited phrases in regulation debates these days.

perimeter of financial regulation and the appropriate regulatory and policy measures. The FSB and various standard-setting bodies have already conducted a broad discussion on general themes like definitions, opportunities and risks; it is now time to turn to discussing concrete policy questions. A key point at this stage is to decide what requires swift international coordination, and what is best left, at least for now, to jurisdiction-level experimentation.

The G7 and G20 have a key role in steering the process of finalising the post-crisis financial regulation.

The second issue that the Italian presidency intends to move forward on is that of inclusive growth. Here, too, there needs to be interaction between the G7 and G20, not least because economic and social marginalization is a concern for advanced and emerging economies alike.

Inequality is a new subject to acquire top priority in the G7 agenda, but it is now at the forefront of the political debate. Its causes, trends and political consequences are discussed daily by the media and have become a popular topic in economic research as well.

Let me first state one fact that is too easily forgotten. Globalization has been an enormous driver of growth in emerging countries, including in the two largest countries in the world. It has thus reduced overall world inequality. It has lifted millions, indeed hundreds of millions, out of poverty.

At the same time, inequalities within countries have increased. This is most obvious in a number of emerging economies. But in advanced economies too, the benefits of globalisation have not been equally distributed. Growth has been more subdued than in emerging economies; the income of the median household in many countries has stagnated over the past decades; the middle classes' perception of the future has worsened.

While this fact is more or less universally true, the causes and effects differ somewhat across countries. In Italy, for example, where the recession has been more severe and protracted than in other advanced economies, younger generations have been hit hardest, with high (though now decreasing) rates of unemployment, a greater risk of poverty, and reduced income and career opportunities.

In any event, the perception that there is a need to counter rising inequality and mitigate its consequences is widespread. Policy options to deal with this fact will be the focus of the discussions that we propose to stimulate within the G7 and G20.

However, one should be aware that perceptions of economic unfairness and concerns about diminished lifetime prospects, while important, are hardly the whole story; dissatisfaction and disillusionment in our societies, and growing diffidence towards international and supranational institutions, are likely to have broader causes. In other words, the perception that something has gone wrong extends beyond the losers from globalization (as some analyses of the votes in the U.S and U.K. have suggested)[2], and comprises a range of countries with different trends in growth and inequality.

This is certainly not the right occasion, nor am I the right person, to propose an exhaustive analysis of this extremely complex phenomenon. The question of what ultimately 'lies behind it', and where it will lead, is a very broad question, which must be left to future historians. Many factors are surely at play; most entail both opportunities and risks. Let me briefly allude to two points.

First, the fact that we are no longer in a world dominated by a clash between opposing blocks, where long-standing ideologies offered a general frame of reference for political debate, but one in which, to borrow Bauman's[3] term, social and political identities are more 'liquid', has freed minds, which is good. But it also risks making some policy debates narrow and context-free, and fostering identities based exclusively on the narrow local community or on ethnicity, feeding fear or hatred towards those outside a restricted group.

The explosion of social media and of new ways of sharing information and ideas, unfiltered by political and cultural elites, is also likely to have played a role.

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[2] Danny Quah and Kishore Mahububani, Project Syndicate, Dec 9, 2016 'The Geopolitics of Populism'.

[3] Zygmunt Bauman, 2000, *Liquid modernity*, Cambridge (UK), Polity.

Certainly, there is something very positive and intrinsically democratic about the ease with which so many people can access information and knowledge once reserved to privileged groups and rich societies. On the other hand, users may at times be left with no idea as to the reliability of the facts and depth of the analysis. (Umberto Eco, who passed away earlier this year, would have put it more strongly). In an ideology-free world, this may lead to uninformed policy discussions. Free, unfettered debate is a blessing; the lack of reality checks is not.

The reason why I mentioned all this is that I want to devote the second part of this speech to Europe, and attitudes towards the European project, which is certainly suffering as a result of this mood of disaffection and exacerbated localism. Consensus around Europe, which was once very strong in countries such as Italy and Germany, can no longer be taken for granted. People have started questioning what it is for, and what is in it for them.

The issue of the ultimate goal of European integration remains very much one of beliefs and identities and I shall not discuss it here (though I shan't resist confessing to my own at the end). Regardless of such preferences, and just taking as given the considerable degree of integration that has already been achieved, it is fair to ask whether European institutions actually serve their purpose reasonably well, and what can be done to improve how they work. While the disaffection of Europe's citizens may well be more general in its origins, it cannot be addressed without first answering this question.

There are many ways to do so, but let me propose here an institutional perspective which, I believe, has implications that tend to go largely unnoticed but are far from inconsequential.

If we look at the architecture of the European Union, it is possible to observe that it now bears a very close resemblance to 'normal' constitutions as far as Parliament and the judiciary are concerned, but not at all for the executive branch.

Today the EU has an elected Parliament with a central institutional role; it co-decides on legislation, mostly on a par with the Council; it has budgetary and oversight powers; in short, though within a narrower mandate, its status, composition and powers are largely comparable to those of parliaments in any democratic polity.

The Union also has a judicial system that ensures the uniform interpretation and application of EU law. While the make-up of its constituent courts is somewhat unique, and while its rulings are obviously confined to matters that the Treaties assign to the Union, the attributions and actual functioning of the European Court of Justice are akin to those of an ultimate court of appeal or a constitutional court in many democracies.

The executive function, to the extent that this concept can be applied to Europe, is more unusual. The EU is in the unique position of having two institutional branches with powers of political direction, the Council and the Commission, with very different compositions and sources of legitimacy. Moreover, each branch exercises different functions beyond those typical of governments.

The European Council, made up of the heads of the governments of the member states, provides 'impetus' and, in a rather vaguely defined but practically important way, sets the policy agenda. It has maximum influence in foreign and security matters. At the same time, national governments, represented at a lower level in the Council of the EU, also play a key role in the legislative process.

The European Commission, on the other hand, currently resembles in many ways a government in a parliamentary system. The Commission's President, while proposed by the Council, must survive a vote in Parliament; Commission members require Parliament's consent. This is not just nominal: after the 2014 elections, Parliament made it clear that it would vote down any nominee except the *Spitzenkandidat* of the party that got the most votes. Like a normal government, the Commission manages and implements EU policies and the budget, and represents the Union outside Europe. But it lacks a clear ultimate power of direction.

At the same time, in certain fields and with respect to its general function of 'custodian of the Treaties', the Commission plays a role that would typically belong to the domain of independent, quasi-judicial regulatory authorities, for example by enforcing competition rules. As an executive body, it is essentially political; as a technical authority, it is bound by objectivity and independence. The two do not square well: making discretionary policy choices and impartially enforcing technical rules are not the same thing.

I would also mention in passing that this complexity is heightened by the distinction between the EU and the euro area, the latter having a Euro Summit for agenda-setting and a Eurogroup in a coordinating role.

Why do I mention this? Because, regardless of what one thinks about any further moves to full political union, the amount of sovereignty that has already been pooled at the European level, especially in economic and financial matters, is very substantial. When Europe was mostly about things like fishing quotas and agricultural prices, important as these matters are, one could more or less live with a suboptimal arrangement. Now that it has a key role in certain issues that go to the heart of the political debate in any country, such as budget balances and financial stability, this is no longer the case. The issue of a proper executive must be addressed.

The lack of a conventional executive branch is paralleled by the lack of some of the instruments typically available to a government. On the eve of the single currency Tommaso Padoa-Schioppa noted that the Union's 'capability for macroeconomic policy is, with the exception of the monetary field, embryonic and unbalanced: it can avoid harm (excessive deficits) but it cannot do good (a proper fiscal policy). (…) It is thus right not only to applaud yesterday's step but also to underline its unfinished nature, the risks and the rashness'.[4]

Without any clear institutional framework for discretionary political action, but in view of the massive transfer of sovereignty, European economic governance has largely been based on rules: budget rules, the ban on rescues between member countries, rules on banking supervision and resolution, and so on. Rules are necessary, but there is a limit to what they can achieve. You cannot run a large, advanced, diverse economy on autopilot.

[4] *Corriere della Sera*, 3 May, 1998.

Most transfers of sovereignty in fiscal and financial matters have been prompted by crisis situations. Since the eruption of the sovereign debt crisis, emergency measures have been progressively accompanied by reforms of EU governance and especially of the euro area, starting with enhanced public finance rules and macroeconomic surveillance. In the summer of 2012, the 'Four Presidents' Report' envisaged complementing or replacing national intervention tools with common instruments. For banks, the report proposed transferring supervisory responsibility to the euro area and establishing joint crisis resolution and deposit guarantee mechanisms, to be supported with public funds through the European Stability Mechanism (ESM). As to public finance, in addition to implementing the reforms already approved (the Six Pack and the Fiscal Compact), it proposed gradual steps towards the creation of a euro-area budget and the issuance of common debt. Most of these proposals were taken up again in subsequent reports, including the 'Five Presidents' Report' of June 2015.

Restrictions on the use of national mechanisms were put in place quickly. But the introduction of European instruments has been partial and virtually non-existent on the fiscal side. Member states are now constrained by more rules that say what *cannot* be done, while the EU has not gained more powers to decide what *should* be done, nor has it the tools or institutional framework to implement the policies that are needed. This creates a situation of vulnerability: there is a danger that national and European authorities will be unable to react appropriately to shocks.

By way of example, let's consider fiscal policy in some detail.

It goes without saying that fiscal rules are necessary in a monetary union. They serve as a coordination mechanism, ensuring that all national fiscal policies contribute to maintaining financial stability in the area. Poor compliance with fiscal rules in the period preceding the crisis justified their being strengthened.

Coming from a country with a high public debt, I am especially conscious of this. Let me be absolutely clear: the Bank of Italy has constantly reminded Italian authorities of the importance of fiscal discipline. At Parliamentary hearings on budget plans I have not failed once to underline the strategic nature of the objective of debt reduction.

The issue is about what you can realistically achieve through a system based mainly on rules. Simple rules do not work well in practice. It would be unreasonable to take decisions on the fiscal stance without considering the cyclical situation of the economy, or exceptional circumstances. In the absence of a substantial EU budget, some degree of flexibility in the rules constraining national budgets is unavoidable.

Thus realism has required the introduction of more and more elements of flexibility, and these in turn have required more safeguards to fend off abuses. With exceptions and counter-exceptions, over time the fiscal rules and their application have become exceedingly complex. It now takes a specialist to navigate the various definitions of objectives and constraints in the Stability and Growth Pact. Certain definitions, like the 'structural' budget, rely on statistics that are open to interpretation and debate: there are many possible measures of the output gap, for instance. Waivers for exceptional circumstances require, by definition, a discretionary assessment. The system is too intricate to be transparent to the public, nevertheless, it remains incomplete: in the real world, there is no such thing as a 'complete contract'.

This is one case where the ambivalence between the Commission's political and technical roles is apparent. There are tensions between the impartial, technical, rule-based assessment that it is called on to perform, and the multitude of real-life circumstances that it faces, in a climate where discussions often reach a heated political temperature. In this context the Commission is unavoidably prone to accusations of arbitrariness.

The absence of a substantial European budget and the complications of the Stability and Growth Pact are interconnected. With some fiscal capacity at the European level, the constraints on national budgets could be made simpler.

The Commission's recent focus on an appropriate fiscal stance for the euro area as a whole, and attempt to quantify it for the first time, are welcome developments. My point here is not to discuss whether this quantitative assessment is correct, a subject of intense debate. My point is to stress that in our current decentralized policy setting, implementing whatever aggregate fiscal stance one thinks appropriate is difficult, and may result in a suboptimal distribution of efforts across countries.

Automatic stabilizers embedded in a common budget, on which the discussion has mostly focused so far, would partially free national budgets from the pressures arising from adverse cyclical conditions. A common budget, however, could also be used to adopt discretionary measures consistent with the cyclical conditions in various economies and in the euro area as a whole.

Discretion does not mean total freedom from constraints: just as they have been introduced at the national level, constitutional limits on spending or deficits can be set at the European level. It only requires acknowledging that it is impossible to govern public finances by rules alone; that no complete contract exists in public finances that can allow a democracy to dispense with open, transparent debate on budget decisions; and that, to the extent that spillovers and the common good require the imposition of significant constraints on national budgets, some fiscal space must be found at the European level.

Just to be clear, a common budget for the future does not imply mutualisation of past debt. That is a different discussion.

No mechanism should entail permanent transfers across member states. Not only would this be politically unfeasible. My own experience with regional differences in Italy tells me that structural fiscal compensation of economic disparities eventually does not end them – it entrenches them. So, for instance, any EU-wide automatic stabilisers should be designed to be geographically neutral in the long run.

The need to complement rules that constrain local action with the constitutional capacity to act at the European level could be illustrated using several different examples besides the fiscal budget.

Bank supervision and resolution is another obvious example. Time constraints prevent me from going into detail on this; I will leave that for another occasion. But let me just briefly say that, while banking union has progressed considerably, it must ultimately incorporate all the elements envisaged in the original design: a single supervisor, a single and effective resolution mechanism, with pooled resources and the determination to use them when necessary, a common deposit insurance scheme, and finally a European public financial backstop. This requires effective European resources and decision-making powers, so that institutions can act swiftly, boldly and freely when needed.

Building the capacity to act at the European level, and not just rules to constrain national action, requires trust and institutional foresight. Many would say that the current circumstances make such steps politically difficult. There can be no question of trying to forge ahead with measures that many citizens are not prepared to accept. Still, I think it is useful to point to issues in the functioning of European institutions that experience and reflection tell me are important.

A Europe that can only say ‘no’ is no consensus winner anyway.

I may be biased by a personal lifelong commitment to Europe. I often tell the story that my two grandfathers fought on opposite sides during the Great War. They might well have killed each other. They were, however, on different fronts, and they didn’t. That’s why I say sometimes that Europe is, literally, in my DNA.

I understand very well that such memories come to mean progressively less to younger generations. But the young are also those who seem to feel the most disaffected, the most estranged from the ‘establishment’, and the most in need of clearer, brighter long-term prospects. If something does not seem to be working, it is no use refraining from suggesting improvements, such as one can think of. If these suggestions have any merit, the time will come when they become feasible.