Carlos da Silva Costa: What lessons from the crisis for EMU and how will life be in the future?

Introductory remarks by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the IE Business Leadership Forum "What lessons from the crisis for EMU and how will life be in the future?", Lisbon, 14 February 2019.

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As prepared for delivery.

Good afternoon ladies and gentlemen,

I would like to thank Mr de la Dehesa for the kind invitation to join you today and for his introductory remarks – I was delighted to accept this invitation.

Following the 10-year anniversary of the Great Financial Crisis and the 20-year anniversary of the introduction of the euro, now is a good time to reflect upon the lessons we have learned and how these must shape our reaction to the challenges ahead.

Also, with so many people in the audience taking a particular interest in the Portuguese economy, it would be remiss of me not to make some observations on the state of the Portuguese economy and the key challenges we face.

The European project as we know it is a political endeavour, characterised by waves of integration over the last few decades. Each step calls for a new one, as the institutional set-up is limited to addressing what is required at each point in time, without sufficient capacity to react to the unforeseen. In many cases the deepening of the integration process has been motivated and steered by successive crises.

The Maastricht framework and its implementing agreements, such as the Stability and Growth Pact, put in place strict fiscal rules for Member States. Countries would maintain their fiscal independence, while respecting limits on the size of public debt and deficits. The 'no bailout' clause meant that no Member State could expect the Union to bail it out, while respecting the monetary financing prohibition.

The link between the financial system and the sovereign was absent from the Maastricht context. As with fiscal policy, financial sector supervision, including both micro-prudential and the then still nascent macro-prudential supervision, the resolution of financial institutions and lender-of-last-resort functions were kept in the hands of national authorities.

Against this background, the Great Financial Crisis revealed the need for stronger economic governance, better coordination of EU Member States' policies and far-reaching reforms of the financial sector.

In response, improvements were introduced into coordination procedures with the creation of the European Semester and the scope of monitoring/coordination being broadened beyond the budgetary area by including external imbalances.

Going forward, monitoring macroeconomic imbalances and coordinating economic and fiscal policies will need to be further strengthened.

We must, however, be aware that, even with appropriate rules and institutions, a monetary union is not immune to exogenous shocks and specific problems in any of its members.

During the Great Moderation, Member States postponed structural reforms and the adjustment of

their economies to globalisation. Costs were absorbed by public expenditure until it was no longer possible to do so.

Today we face the problem of finding ways to increase productivity and innovate in order to increase potential output and preserve our social model.

This reinforces the importance of working at the structural level, focusing on productivity growth, sustainable employment growth and the reduction of indebtedness.

In parallel, the Economic and Monetary Union (EMU) must have stabilisation mechanisms which can support Member States facing serious financial difficulties while safeguarding the stability and cohesion of the group.

Currently, several proposals for macroeconomic stabilisation in the euro area have been presented: investment stabilisation, reinsurance of national unemployment schemes, rainy day funds, etc.

The need to provide EMU with a stabilisation mechanism was one of the lessons of the financial crisis and the reason for the creation of a permanent institution, the European Stability Mechanism (ESM).

The ESM is also under reform to strengthen its role, its capacity to act and the effectiveness of its instruments. This reform needs to be ambitious.

I have often argued that the ESM should evolve towards a genuine European IMF-type of institution. An institution with a clear mandate, with adequate means and independence from Member States. It should be robust, adequately resourced and designed to respond quickly and effectively, while promoting accountability and minimising moral hazard.

I would like to turn to the financial sector where reforms were most visible.

In the years preceding the Global Financial Crisis there was a strong increase in risk-taking and leverage. Bank credit expanded disproportionately compared to economic growth. Risk was spread across continents and across institutions.

As the Great Financial Crisis unfolded, governments of fiscally strong countries resorted to bailouts when banks that had become too big, complex and interconnected were at risk of failure. Letting them fail would have meant that households and businesses would have been unable to access their money, finance their projects or make payments.

In Europe, the crisis evolved and morphed into the sovereign debt crisis, making the sovereign-bank nexus even more evident. To safeguard financial stability, countries were exposed to risks that in certain cases were not compatible with the sustainability of their public debt.

As a result of the growing discontent that followed, to reduce the risk of moral hazard, sever the bank-sovereign doom loop and protect the taxpayer from shouldering private sector losses, there was a strong impetus against using public money in establishing a safety net for the financial system. Bail-in principles in resolving banks prevailed, and there was a general aversion to bailout provisions.

The post-crisis financial sector reforms were thus designed to strengthen financial stability by focusing on improving banks' resilience, ending too-big-to-fail, breaking the bank-sovereign loop and reducing financial fragmentation.

Efforts went into developing a harmonised regulatory framework, with stricter requirements on capital and (private) loss-absorbing capacity to protect taxpayers, while reinforcing risk prevention and reduction.

In the euro area, Member States launched the first steps of the Banking Union and its institutions – the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) – but the political will to complete the architecture has waned in recent years with policy-makers focusing excessively on the 'risk reduction v. risk sharing' debate.

Currently, the Banking Union is missing critical elements – a fully-fledged European Deposit Insurance Scheme (EDIS), a backstop to the Single Resolution Fund and the provision of liquidity in resolution – which jeopardises its fundamental benefits.

In this incomplete setup, banks are today 'European in life but national in death'. Supervisory and resolution decisions are mostly taken at the European level, but the ensuing consequences still lie with taxpayers at the national level as recent cases have highlighted. This may have a potentially serious impact on national budgets, as the ultimate guarantor of financial stability remains national.

In view of the mismatch between European oversight and national liability, the different stakeholders' objectives and interests are unaligned. It is important to consider who is actually looking after financial stability.

Looking back to recent cases of banks under stress, we need to ask ourselves what political landscape we would have today, had certain authorities not acted the way they did in order to preserve financial stability.

Few things can be more destructive to citizens' trust in the European institutions than threats to financial stability, perceived as risking their savings. Such threats can have direct effects on citizens' frustration with European institutions and traditional political parties associated with them.

Moreover, regulation-driven consolidation has become an imminent risk, fostering concentration at local level and the comeback of too-big-to-fail. Existing regulatory requirements were not thought of as a way to promote consolidation but are currently working in that direction.

Driven by profitability and efficiency concerns, recent calls for the creation of pan-European banks capable of competing with larger institutions outside Europe as a matter of national sovereignty have added pressure on regulators and policymakers to review existing rules.

This in turn has implicitly put on the table the return of too-big-to-fail with the ensuing moral hazard, raising further bailout expectations. It also undermines the level playing field within the euro area as fiscally strong countries can support their banking systems, while others cannot.[1]

Looking ahead, it is essential to ensure at EU level the separation of supervisory from regulatory functions for the political legitimation of regulatory standards. The overlap of regulatory and supervisory territories guarantees compliance with the principle of central responsibility for financial stability.

Before concluding, and as promised at the beginning of my address, I would also like to spend a few minutes on the challenges faced by the Portuguese economy in view of the interest expressed by some of you.

As you well know, in the first half of 2011 Portugal had to resort to official financing under an assistance programme negotiated with the European Union and the IMF. The programme ended in 2014. Public and private indebtedness had accumulated as a result of a credit boom since the mid-1990s, with the bulk of credit being channeled to financing consumption and low-return investments, largely in the non-tradable sector.

As the international and European crises unfolded, the high and rising level of external

indebtedness, coupled with weak growth of potential output, fuelled investors' concerns about our capacity to pay back our debts. This ultimately resulted in the country's inability to fund itself on the international markets.

The adjustment programme has widely been regarded as a success. In my view, this success was due to three factors:

1. Programme ownership. Portugal was committed to the implementation of the programme, it was accepted by the population and there was a constructive dialogue with social partners. This ensured the success of the quarterly reviews.
2. The speed and intensity of the response from the tradable sector, in particular the exports that rebalanced the external accounts and mitigated the impact of lower domestic demand on the non-tradable sector.
3. The maintenance of confidence in the banking sector as evidenced by the behaviour of deposits. This was crucial to preventing the economy from collapsing with a credit crunch and avoiding the imposition of capital controls.

It is important to remember that an adjustment programme is always a short-term programme whose effects are only sustainable if there are structural and institutional adjustments that prevent repetition of the conditions that led to the need for adjustment.

Over the last decade, Portuguese GDP has remained 30–40% below the EU average, without converging towards the richest economies.

A lasting trajectory of growth and convergence towards our European partners depends on our capacity to generate and maintain high levels of employment and productivity. This is a necessary condition to (i) bring our workers' wage levels closer to European standards; and (ii) finance the welfare state in a context of unfavourable demographic developments.

The challenge is thus one of activating the 'levers' of employment and productivity.

Portugal has had historically low levels of capital per worker. Adverse developments in business investment during the crisis, with a reduction of 34% between 2008 and 2013, contributed to capital shortages.

It is therefore vital to increase investment and take advantage of that recovery to learn from past mistakes, scrutinising investment projects in a far more demanding way. The infrastructure and support services are available, the investment in the non-tradable sector has been made. Now that must be capitalised upon, creating capacity in the economy's tradable sector.

The recovery in investment is, however, constrained by the (still) high indebtedness level and low savings rate of the Portuguese economy. This means that the increase in investment will have to be financed through an increase in equity, either from existing shareholders, or the entry of new domestic or foreign shareholders.

In Portugal, employees' skills have improved considerably in recent years but gaps remain in relation to European averages. The formal education of our workers must continue to improve. In particular, those in employment the longest but with fewer qualifications have a lot to benefit from life-long learning, which enables them to transform their skills and better take advantage of the jobs of the present and future.

Moreover, we also need management models that encourage openness to risk and favour decentralised decision-making. Enterprises with a more decentralised management are more open to disruptions and thus more innovative.

The promotion of innovation is also a 'lever' that needs to be activated. Economies' capacity to

innovate depends on a whole ecosystem of factors, such as:

- The existence of a culture of merit and entrepreneurship and the capacity of society to deal with and learn from failure;
- The spread of knowledge within the corporate sector and enterprises' capacity to absorb that knowledge, whether in the creation of new products or new production processes – so-called 'radical innovation' – or in the improvement of existing products or processes – so-called 'incremental innovation'; and
- The suitability of the financial system, particularly the capital markets, to finance innovative projects. Financing radical innovation or start-ups is far from being part of the primary mission of the banking system because innovative processes have long maturities and high risk levels and failure rates.
  Financing innovation requires specialised operators and an institutional framework suited to participating in such risks. In Portugal, these specialised operators are still underdeveloped and have limited possibilities of becoming associated with larger-scale foreign operators.

Let me conclude.

First, on Europe. While we should not underestimate how much has been achieved in recent years, we can't ignore that the European Union architecture needs to be reinforced further to withstand the impact of a future crisis to preserve financial stability and ensure social cohesion.

Secondly, as regards Portugal, the challenge we are confronted with is that of generating and maintaining high levels of employment and productivity to ensure a lasting trajectory of growth and convergence with our European partners.

In both cases we're talking about the deep institutional and structural foundations of the economy. The task is hard, and it will take time to complete and bear fruit. This means we need to start right away and we need to be determined, tenacious and focus on what really matters from a long-run perspective.

Thank you for your attention.

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[1] Beck, T. (2019), "Europe's banking union – two steps backwards", VoxEU.org, 4 February.