Banco de Portugal
EUROSISTEMA

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**Encontro Empresarial Luso-Alemão**

Address by Governor Carlos da Silva Costa[(1)]

## 1. An inconsistent quartet

In the last two years, the European Union (EU), and the euro area in particular, have been at the center of the crisis and under close scrutiny by the international community. Among other things, the crisis has shown that **the EU was built on unbalanced and inconsistent pillars**, which ended up making the whole structure unstable and vulnerable. In fact, the euro area governance model was based on an "inconsistent quartet"**:**

(i). ***"No bail-out"*** - it is forbidden for one Member State to assume the debts of another;
(ii). "***No-default"*** – there is no mechanism in place for orderly debt restructuring;
(iii). "***No-exit***" – the possibility of leaving the euro is not foreseen;
(iv). ***Fiscal sovereignty of the Member States*** - in contrast with monetary unification, Member States maintain responsibility for fiscal policy, subject to common rules and procedures at the EU level.

The crisis has shown that this framework was not structurally robust. And the EU failed to put in place, in an effective way, the rules and the institutions that would ensure compliance with the underlying conceptual framework. This resulted in high and unsustainable public debt levels, major macroeconomic imbalances and in the accumulation of tensions, undermining the effectiveness of monetary policy. **Important feed-back loops between the financial sector and national sovereigns have also developed and confidence has deteriorated considerably**.

**Besides the four inconsistent pillars that I have mentioned, there was an absent or ignored one: the pillar of banking union**. I would even add **a sixth pillar: a credible backstop mechanism, to provide liquidity to euro area countries** that are not able to obtain financing in the market due to reasons linked to the market itself and not for solvency reasons.

[(1)] As prepared for delivery.

**Definitely, the governance model needs a banking union**. It is vital to de-link the fortune of banks from that of their national sovereigns, to safeguard overall financial stability and to overcome the fragmentation of the EU banking system. **Market fragmentation, financial volatility and increased uncertainty impact negatively on investment and therefore on long-term economic prospects**. In face of increased volatility and uncertainty, potential investors will tend to defer their investments, scale down initial plans, or simply divert them to other locations. The reduced investment that still takes place will most likely be concentrated on less risky activities, providing quick returns, rather than on innovative projects that raise long-term potential growth. **The higher the volatility and the tighter the credit constraints imposed on the real economy the greater the negative effect on growth.**

## 2. The EU response to the crisis – building a new future for Europe

The EU response to the crisis, initially hesitant, has gradually gained momentum, and important steps have already been taken in many areas, including the reform of the financial sector supervisory framework and of economic governance (e.g. "six-pack"; "Fiscal Compact"; European Stability Mechanism (ESM)). **The four Presidents' report and the conclusions of the 29 june Summit, in particular, represented a major shift in the EU policy in terms of breaking the vicious circle between banks and sovereigns.** The ECB actions to provide liquidity to the banking system have also played a crucial role in stabilizing markets and safeguarding the financial system.

**We are at a decisive juncture for the EU and especially for the euro area**. The European project is still work in progress and the ongoing discussion on the path for a genuine EMU is vital to address the inconsistencies of the EU model and to shape Europe's future. **Addressing these inconsistencies means that the future of Europe has to be built through greater integration.**

Currently there are **four main "construction sites"** in the EU: (i) **banking union**; (ii) **fiscal union;** (iii) **stronger economic integration**; (iv) **enhanced democratic legitimacy and accountability**. In all these sites, the works should continue at a good pace, in a coordinated manner and, above all, with high quality materials, so that the new foundations are solid enough to support structurally stronger "buildings", able to endure possible future storms.

**<u>First construction site: the banking union</u>.**

The process towards establishing **a banking union** is already underway. To fully accomplish its purpose, the banking union has to comprise **three key elements**: (i) **a supranational supervision framework with centralised decision-making and**

**decentralised implementation, applicable to all banks**;(ii) **a single deposit guarantee scheme**; (iii) **a EU bank resolution fund**.

As regards the design of the Single Supervisory Mechanism (SSM), it should be guided by the following key principles: **unity; accountability; level-playing-field; and effectiveness and efficiency.** This means that **all banks** of participating Member-States - **without any layers or bank segmentation** - should be under the unified supervision and the ultimate responsibility for supervision should lie with the ECB, **adequately based on a network of national supervisors**.

With all banks under unified supervision, bank deposits of euro area citizens should also be guaranteed at the European level. **This means that the banking union should include not only integrated supervision but also shared mechanisms for deposit guarantee and for bank resolution, thereby aligning supervisory and "safety net" responsibilities.** To **avoid moral hazard concerns** – linked to a potential sharing of legacy risks – a transitional period could be envisaged, during which the responsibility for reimbursements should lie with the national deposit guarantee systems (with the possibility of borrowing from the ESM, as a backstop, if needed). After the transitional period, full mutualisation of deposit guarantee and resolution mechanisms should be pursued. Without establishing these common mechanisms the banking union will stay incomplete and the de-linkage between banks and national sovereigns will not be ensured. **As the setting up of the SSM is moving faster than the other two key elements, it is crucial to establish a clear and time-bound roadmap.**

**<u>Second construction site: the fiscal union.</u>**

**On the budgetary front**, the EU needs to further develop its budgetary framework so as to ensure sound and sustainable fiscal policies. I have already mentioned some important decisions that have been taken in this area. However, further progress is necessary (e.g. the "two-pack"), including a qualitative move in the direction of a fiscal union. It is important to stress that **although the existence of high-quality rules (clear, well designed and consistent) is very important, on their own they do not ensure compliance.**

**<u>Third construction site: stronger economic integration</u>.**

Additional steps have also to be taken towards stronger economic integration, building on the European Semester and the Euro Plus Pact. There has to be stronger coordination of economic policies and each and every Member State should pursue its economic policy as a matter of common interest. **Particular emphasis should be put on areas with a potentially larger impact on**

**competitiveness, economic growth and employment, while promoting social cohesion.**

**Fourth construction site: enhanced democratic legitimacy and accountability**

**The EU also needs strong institutions, with legitimacy, to ensure enforcement.** The crisis is also making the EU rethink its institutions and ponder what "European integration" should mean from a political viewpoint. **If the EU ignores the political dimension it won't be able to move towards increased fiscal and economic integration, by lack of democratic legitimacy and accountability**. In this respect, it is necessary to reconcile the need for a response with legitimacy vis-a-vis the whole and the need to ensure that all parties (however small) are represented and take part in the EU decision process.

Looking back, we realize that periods of tension and crisis have normally been followed by further strengthening of the EU framework and further integration. The EU has already evolved from the customs union to the internal market, to the exchange rate mechanism and to the economic and monetary union. I am convinced that with more or less controversy, the EU evolutionary process will eventually lead to increased budgetary, economic and political integration. We cannot miss this unique opportunity to introduce fundamental changes and deep-rooted reforms. We have a huge responsibility towards present and future generations: the responsibility of safeguarding the conditions for prosperity and welfare and ensuring that the EU has a leading role in the international arena. **No Member State, irrespective of its size or economic importance, no EU institution and no citizen is exempt from this collective responsibility.**

## 3. Concluding remarks

Let me conclude by also stressing the importance of ensuring that citizens in every Member State realize that the new rules, frameworks and institutions being developed are not an external *diktat:* **they are necessary to the survival of the group and of each of its members.**

**Group solidarity coupled with individual responsibility will lead to a stronger euro**, the common currency of a group of countries which share a single monetary policy; which will engage in a banking union; and which will operate in a framework of binding budgetary rules and institutions that will ensure their enforcement. The euro area will also be an area where countries share more sovereignty, with increased legitimacy, accountability and solidarity; **and where all European institutions become increasingly responsible for the "whole" and not merely for the sum of the parts.**

**The initiatives at the EU level should complement and support the efforts that are being pursued at the national level,** which have been particularly strong and demanding in countries (like Portugal) that have lost access to market financing and are currently under adjustment programs.

The frontloading of European initiatives is complementary and critical for the success of the frontloading of national adjustment processes, like the Portuguese one. It means that it is a way of boosting success of Member States efforts.

**So, progress towards further integration, including the setting up of a fully-fledged banking union has to go hand in hand with the front-loading of national efforts to address domestic imbalances.**

In addition, an important principle of the EU Treaty is that **each individual member state should treat its economic policy as a matter of common interest**. It is therefore in the pursuit of common interest that domestic policies need to be defined and implemented. This means that those countries in the European Union where there is some room of maneuver to boost short term growth should use that room of maneuver.

**We are playing a game which is either a positive sum game, where all Member States will be better off, or a negative sum game, where we will all lose.**

Thank you.