



BANCO DE PORTUGAL
EUROSISTEMA

Reform and Prosperity in the Monetary Union

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Seminar on Governance and Policies for Prosperity in Europe
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Two biases in the response to euro area crisis

1

Reactive bias

- **Acknowledge** problems **too late**
- **Take too long to react**

2

Country bias

- Countries look at problems **from their own angle**
- Characterization of the situation tends to depend on the **perception of large Member State(s)**

Self fulfilling problems

Decisions do not correspond to the average or mode

High adjustment costs



- I. Rules are the basis of mutual trust in the European Monetary Union**
- II. Rules and procedures should promote the resilience of convergence paths**
- III. Create a “European Fiscal Council” for surveillance**
- IV. Create a “European Monetary Fund” for crisis management**



I. Rules are the basis of mutual trust in the European Monetary Union

- **Maastricht Convergence criteria** (inflation, budget deficit, public debt, long-term interest rate, exchange rates)
- **ESCB Statute** (price stability; ECB independence)
- **Stability and Growth Pact; Treaty on Stability, Coordination and Governance** (budget deficit, structural deficit, debt-to-GDP ratio)

In Europe the concept of sustainability implicit in the rules is not merely based on market principles



Self-imposed mutual trust mechanisms are essential to the functioning of the group



II. Rules and procedures should promote the resilience of convergence paths

Stability and prosperity of the euro area as a whole depend on stability and prosperity of each Member State

At national level

Polices that support sustainable economic growth in the medium term

Which means ensuring:

- **Sustainable external accounts**
- **Sustainable public and private debt**
- **Safeguard competitiveness**



- 1** **Countercyclical Fiscal Policy**
- 2** **Macroprudential policy to manage the buildup of risks**
- 3** **Incomes policies to ensure that wages develop in line with productivity**



II. Rules and procedures should promote the resilience of convergence paths

At European level

Surveillance and monitoring the sustainability of national policies (fiscal and income policies) with power to require corrective action

Necessary but not sufficient to guarantee the optimization of economic growth

We need an **integrator power of national economic policies** that takes into account the path of **potential output and employment in the area as a whole.**

This entity should worry about:

- economic growth of the area as whole
- cross-country development disparities



III. Create a “European Fiscal Council” for surveillance

- Create an independent body for fiscal surveillance - **European Fiscal Council** - to assess sustainability and resilience of public finances of Member States and issue opinions. This would avoid the politicization of the assessment.
- The Fiscal Council assesses compliance of national policies with the union self-imposed rules **but it does not interfere with the political choices**. The trade-off between equity and efficiency is a national decision, while it cannot be ignored at the European level.
- The **nature and quality of national policies** affects the potential output of a country and therefore the **policy leeway within the rules**.
- **Needed policy action** related to the Fiscal Council opinions will have to be **enforced by the Eurogroup**.



IV. Create a “European Monetary Fund” for crisis management

**While rules must be applied forcefully
unsustainable policy paths cannot be ruled out**

Create a mechanism to provide technical and financial support to countries facing unsustainable situations

The mechanism must be based on a contractual approach:

- Commitment to an economic and fiscal adjustment path
- Financial assistance conditional on the adjustment progress
- Conditionality should focus on the quality of policies to achieve the objectives

The governance of this mechanism could be organized in the context of the creation of

European Monetary Fund

Independent of Member States and "empowered" to act quickly and decisively in a crisis
(endowed with skills and financial capacity)



- EU and the euro area are a unique construction built up on the basis of **mutual trust** and not power
- **Cost of going backwards** would be huge
- Crisis has shown **current institutional setting is far from satisfactory**:
need to combat reactive and national biases
- But, the crisis has also shown that **“Europe moves”**
- A reformed and stronger European Union depends on **realistic ambition**: look for “positive sum” moves



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