Banco de Portugal
Report of the Conference

The euro 20 years on

The debut, the present and aspirations for the future

BANCO DE PORTUGAL
EUROSYSTEM

15 Nov. 2019
Banco de Portugal
Museu do Dinheiro
Lisboa

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Report of the Conference on The euro 20 years on: the debut, the present and the aspirations for the future

BANCO DE PORTUGAL
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Lisboa, 2020 • www.bportugal.pt

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Foreword

2019 marked the first two decades of the euro. On 15 November 2019, Banco de Portugal hosted a high-level Conference, in Lisbon, to commemorate the 20th anniversary of the euro.

This report brings together the presentations delivered at the Conference, entitled "The euro 20 years on: the debut, the present and the aspirations for the future". The aim of both the conference and this report was not only to celebrate this key milestone but also to assess these first two decades of the euro, as well as reflect on its future:

1. Which are the main challenges ahead?
2. How should the EMU evolve?
3. What should we aspire to for the future role of the euro at the global level?

These are essential questions, which we must all reflect upon in order to contribute to further strengthening the European project, bearing in mind the profound and rapid changes that have been taking place in the world in the last few years. It is fair to say that the objectives of this Conference were fully achieved.

Banco de Portugal would like to thank all the persons who contributed to the successful completion of this project, both for the organisation of the Conference and the preparation of this report.

Programme

9:00 – 9:30	**Opening remarks**
	Carlos da Silva Costa, Governor, Banco de Portugal
9:30 - 10:30	**Keynote lecture**
	Jean-Claude Trichet, Chairperson of the Board of Directors, Bruegel
11:00 - 12:45	Session 1: Monetary and Fiscal Integration
	Chair: **Nuno Alves**, Head of Economics and Research Department, Banco de Portugal
	Niels Thygesen, Chairperson, European Fiscal Board
	Nazaré Costa Cabral, Chairperson, Portuguese Public Finance Council
	Eduardo Paz Ferreira, Professor, University of Lisbon School of Law
14:00 - 15:45	Session 2: The fundamental principles of the Monetary Union
	Chair: **Pedro Machado**, Head of Legal Services Department, Banco de Portugal
	Peter Praet, Former Executive Board Member and Chief Economist of European Central Bank
	Luís Silva Morais, Professor, University of Lisbon School of Law
	Clara Raposo, Dean, Lisbon School of Economics & Management (ISEG)
15:45 - 17:30	Session 3: The geopolitical dimension of the euro
	Chair: **Francisco Seixas da Costa**, Ambassador
	Paul De Grauwe, John Paulson Chairperson in European Political Economy, European Institute, LSE
	Carlos Moedas, Former Commissioner Research, Science and Innovation, European Commission
	Wolfgang Münchau, Associate Editor, Financial Times
17:00 - 17:30	**Closing remarks**
	Luís Máximo dos Santos, Vice-Governor, Banco de Portugal

Opening remarks, Carlos da Silva Costa[1]

Governor, Banco de Portugal

Carlos da Silva Costa, Governor, Banco de Portugal

It is with great pleasure that I welcome you to this Conference that marks the first 20 years of the euro. Now is an opportune moment to take stock of these two decades and to reflect upon the lessons we have learned and on how they should shape our response to the challenges ahead. The start of a new EU institutional cycle also adds importance to this reflection.

I totally concur with Mario Draghi when he said, in January, at the European Parliament, that "The euro is the most tangible representation of European integration that our citizens encounter, on a daily basis"[2]. Indeed, the euro is the most visible face of the collective will of 19 Member States

[1] As prepared for delivery.

[2] Speech by Mario Draghi, President of the European Central Bank, at the session of the plenary of the European Parliament to mark the anniversary of the euro in Strasbourg, 15 January 2019.

that have decided to share a common destiny and who believe that together they are stronger. Other Member States are expected to join them in this joint endeavour very soon.

The European Economic and Monetary Union (EMU) is a unique case of monetary integration and its construction has never been easy or consensual. From the outset, the EMU was criticised, and several voices – especially from the other side of the Atlantic – predicted a short life for the euro.

I would say that the birth of the European single currency project was accompanied by "two fairy godmothers" with negative omens for its future:

1. The theory of optimal currency areas[3] (OCA), including the criteria deemed necessary for a region to qualify as an OCA and benefit from a common currency;
2. The idea that without effective federal power there could be no successful single currency.

> Twenty years later, and contrary to the views of the prophets of doom – which recently seem to have become very active again – the euro is here to stay.

It has become stronger over the years, and popular support is currently at historic highs[4]. The single currency functions like a common language: it brings people closer in many ways and creates a social bond and a common identity[5].

> The euro's resilience shows that its main foundations are sound and that its founding fathers were steering the European project in the right direction. The euro is not the result of a single political decision. It is the result of successive political decisions and the evolution of the European integration process.

The euro is a logical and necessary consequence of the single market. Currency fluctuations – even when resulting from the normal functioning of the markets – translate into subsidies/penalties for economic agents and create uncertainty. They distort competition, generate trade reallocations not based on economic fundamentals and cause social discontent.

[3] For a survey of literature on OCA theory see Dellas, H. and Tavlas, G S. (2009), "An optimum-currency-area odyssey", Journal of International Money and Mongelli, F.P. (2002), "'New' views on the optimum currency area theory: what is EMU telling us?", Working Paper Series, No 138, ECB Finance, Vol. 28 (7).
[4] European Commission (2019), Standard Eurobarometer 91 - Spring 2019.
[5] Otero-Iglesias, Miguel (2017), "The euro as a social bond: why do Eurozone citizens still back the single currency?" Real Instituto Elcano, 25/IV/2017.

It was evident that the Exchange Rate Mechanism of the European Monetary System was not compatible with the degree of openness of the economies participating in the single market and the existence of autonomous monetary policies.

It was this inconsistency that led to the 1992-1993 currency crisis, which clearly showed in practice that an internal market without a single currency is necessarily an unstable equilibrium. The euro has safeguarded the integrity of the single market and has delivered two decades of price stability.

The euro has fostered confidence and brought important and tangible benefits to European households, businesses and governments. Naturally, it has also introduced new requirements with regard to the behaviour of economic agents as well as new rules and institutions. It made the need for adequate policies, sound public finances and financial discipline of private actors more visible.

A single currency implies a single monetary policy and, in a context of markedly heterogeneous national revealed preferences, there is a risk of inconsistency between national economic and fiscal policies and the common monetary policy. It was therefore clear from the outset of EMU that it would be necessary to create discipline, rules and institutions that would reduce disparity in order to ensure stability.

The EMU rests on a comprehensive set of rules and on a non-federal institutional framework based on a sharing of sovereignty between Member States and, above all, on mutual trust. This means that its success hinges on its members making every effort to understand each other and to mutually realise their interests. In a nutshell, the euro is the result of a dialectic process between solidarity and responsibility towards a common good.

The functioning of EMU is based on permanent negotiation and approximation of different starting positions, safeguarding national cultures and identities while guaranteeing a sense of belonging and a "group identity". This implies an institutional framework with a great capacity to understand and manage differences and to facilitate the interaction between the interests of the whole and the specificities of the parts. The principles of collective ownership and consensus must always be kept in mind.

The European regulatory framework and the architecture of the EMU have significantly evolved and consolidated over the years, notably in response to the sovereign debt crisis in the wake of the global financial crisis.

In fact, the sovereign debt crisis in the euro area brought to the forefront the weaknesses of the EMU framework, exposing the particular vulnerability of euro area Member States to changes in markets' sovereign risk perceptions. The link between the financial system and the sovereign was absent from the Maastricht context and the "no bailout" clause meant that no Member State could expect the Union to bail it out, while respecting the monetary financing prohibition.

To face the huge challenges posed by the crisis it became clear that decisive and urgent action had to be taken to ensure stronger economic governance, better coordination of Member States' policies and a sounder financial sector.

Far-reaching improvements were introduced into the regulatory and institutional framework, the economic coordination and surveillance procedures (e.g. the European Semester and the Macroeconomic Imbalance Procedure) and the European financial sector, which underwent a remarkable transformation.

Since the outset of the crisis, the ECB has played a crucial role and helped saving the euro. With its unconventional policies, it allowed the time for political agents to adjust their fiscal policies, to adopt structural measures and to agree on regulatory and institutional improvements needed for a sustainable EMU.

In the euro area, the Banking Union was launched. Its initial design envisaged a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a common deposit guarantee scheme underpinned by a single rulebook. The SSM and the SRM have been successfully implemented. However, the political will to complete the Banking Union's architecture has waned in recent years with policy-makers focusing excessively on the risk reduction versus risk sharing debate. The fact that some critical elements of the Banking Union are still missing undermines its fundamental benefits.

While we must not underestimate the remarkable progress that has been achieved in recent years, we should acknowledge that Europe's financial architecture still needs to be further strengthened to withstand the impact of a possible future crisis. This must be a priority for policy-makers and relevant institutions because not many things can be more destructive to public trust in European institutions than threats to financial stability. In particular, decisive political will to move forward with the completion of the Banking Union and the development of the Capital Markets Union is much required.

Furthermore, in this still incomplete EMU, the interaction between monetary and fiscal policies, their roles and limitations for macroeconomic stabilisation and the adequacy of the current Stability and Growth Pact are ever more at the forefront of the policy debate. All these issues need to be addressed.

I have already underlined the importance of a coherent and sound legal and institutional framework. 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.

The EMU needs stabilisation mechanisms to support Member States facing serious financial difficulties while safeguarding the stability and cohesion of the group. This need is one of the major lessons of the financial crisis and the reason for the creation in 2010 of a temporary rescue fund, the European Financial Stability Facility (EFSF), and subsequently, in 2012, of a permanent institution, the European Stability Mechanism (ESM).

Both the EFSF and the ESM have played a vital role in safeguarding the stability of the euro area as a whole, functioning as a common firewall and providing support to the most affected Member States to resume or maintain access to sovereign bond markets. Together with fiscal and structural reforms at European and national levels, the ECB's unconventional monetary policy and the establishment of the Banking Union, these funds were instrumental in dealing with the worst of the crisis and to save the integrity of the euro.

Reform of the ESM is on-going to reinforce its role, its operational capacity and the effectiveness of its instruments. This reform must be seen as an integral part of the agenda on deepening EMU and needs to be ambitious.

I have always argued that the ESM should evolve towards a true European Monetary Fund, a robust crisis management body, incorporated into EU law. An independent and accountable institution with a clear mandate and adequate resources and firepower. These are necessary conditions for the development of win-win solutions. The work currently underway on the ESM Treaty should therefore not be seen as the final result, but as a step towards a more ambitious long-term goal.

Let me conclude.

During its first 20 years of life – and contrary to the initial bad omens – the euro's institutional framework has proven its ability to overcome the difficulties stemming from the coexistence of economies in different stages of development, and sovereignty-sharing mechanisms have acted as a proxy for a central political power.

Today's conference calls upon us to assess these first two decades of the euro as well as to reflect on its future:

1. Which are the main challenges ahead?

2. How should EMU evolve?

3. What should we aspire for the future role of euro at the global level?

These are very important questions, which we must all reflect upon in order to contribute to further strengthening the European project, bearing in mind the profound and rapid changes, at all levels, that have been taking place in the world in the last few years.

In the current globalised, competitive, digitalised and interlinked environment, there is an increased need for euro area countries to work together to exercise sovereignty and make their voices heard. We should always bear in mind that sharing sovereignty is not a synonym of loss of control or power. Internal cohesion and “teamwork” will help protect Member States from external pressures and spillover effects, and empower their policy choices.

Member States must therefore persist in working together in a committed way to continue the journey that started in 1999, so that European citizens can fully reap the benefits of their common currency. Cooperation within EMU will also support an increased role of Europe and the euro in the world.

I am sure that today's discussion will be very fruitful and will bring new, good ideas to help equipping the euro area with the tools it needs to withstand headwinds and to prosper.

Quoting Robert Schuman: Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity . And it goes without saying that solidarity must go hand-in-hand with responsibility, which entails rules and mutual surveillance institutional mechanisms.

Before giving the floor to Jean-Claude Trichet, I consider it both an honour and a duty to underline the important role he has played at several stages during the EMU creation and consolidation process, notably in the pre-Maastricht political negotiations and as President of the ECB.

Dear Jean-Claude, the floor is yours.

Thank you.

Keynote lecture Jean-Claude Trichet[6]

Chairperson, Board of Directors, Bruegel

Jean-Claude Trichet, Chairperson, Board of Directors, Bruegel

"Merci beaucoup Carlos!

Monsieur le Gouverneur, I was not expecting that you would be so kind with me, speaking in French at the end of your speech. It was very clear that it was your own improvisation, if I may, thank you very much indeed.

I experienced the crisis during four full years. Because the subprime crisis started in 2007 and Lehmann Brothers was in 2008. My term ended in October 2011.

The unfortunate start of our crisis of sovereign risk started by end of 2009 and, in 2010 was the peak of the crisis. The letters that you mentioned were written in 2011, August 2011, sent to Prime Minister Zapatero and Prime Minister Berlusconi, in situations where the ECB took a series of very bold decisions, which were the purchase of treasuries of Spain and Italy on the secondary market, after the purchase of treasuries of Portugal, Greece and Ireland in May 2010. The purchase of treasuries of Italy and Spain, namely combating a massive speculation on 37% of the GDP of the

[6] Transcript of the intervention.

euro area. That was what we had to do at the time. So I have to say it was a really difficult time, with high responsibility of the Governing Council in exceptional circumstances.

I have to say that at that time the Governing Council was incredibly solid and incredibly attached to our common goal of preserving stability in the worst circumstances. But that is another story. You gave me an incentive to mention that.

> But let's go back to what we are celebrating, and it's clearly the success of the Euro that we are celebrating. I am speaking of a historic endeavour, of a very bold ambition, a premiere in the history of humankind that was never observed before.

A large group of European countries deciding after World War Two, after a dramatic period of time, to embark on a process of integration. With an enormous ambition in terms of their unity.

You referred to Robert Schuman, in the speech you mentioned, the first speech of Robert Schuman was in 1950. We are now 69 years afterwards, more than 2/3 of a century. We could also start from the Rome treaty a little less than 2/3 of a century ago.

So, 2/3 of a century of very bold and remarkably successful historic endeavour. We should never forget the necessity to replace this endeavour in a long term historical perspective, because a lot of judgment on what is being done today are based upon short term considerations and there is a tendency to say there is a lot of the drawbacks, that there is a lot of the weaknesses that we are observing. But again, it's a historic process. We have to judge the process on the basis of this historical time. And of course, as you said already Carlos, the Euro is at the vanguard of this integration process. It's a very powerful symbol, but also a very powerful achievement in terms of this integration, and you wisely said, that the common market in 1956 and then the single market, were calling for a single currency.

What would be of the single market of the United States of America, if they had different currencies in Massachusetts, in Florida and in California?

I would also add that when we started the common market and then the single market endeavour, we had clearly the idea that we should benefit in Europe of the same kind of economy of scale that the US economy benefited from.

That was the idea and the only other model that we had at the time of a very big and powerful single market with a single currency was the United States of America.

Today we still have the United States of America. But we also have India, China and, very soon, other countries, in Asia. We have a new constellation of many single markets with single currencies.

We are in a world where the argument of the founding father of Europe for the European integration is multiplied by this large number of big new comers in the global economy: the new emerging countries of larger and larger dimensions.

I mentioned that “en passant”, because when I'm told by some that it is about time for the European to split now, to be smaller and to reject the European unity endeavour, I think it's totally irresponsible, of course.

We have to be more united than ever in the present world, in the world which we contributed to construct after World War II.

Now let me embark on my main points. I would like to make three points.

> First, that the Euro as a currency is a great success in terms of credibility, stability and resilience. And you were very wisely stressing that in terms of the popular support, as a matter of fact, the bottom line is that popular support is probably the main success of the Euro.

Second point I would like to make is that the Euro is more of a success, and I think I have to make the point because it is something which is not easily recognised, in terms of the real growth measured during the period starting from its inception until today, even if we have to reflect more on the issue of lack of sufficient nominal and real convergence inside the currency area.

And the third point I would like to make is that in a medium and long term historic perspective, the EMU calls today for further significant, very significant, reinforcement of its economic, fiscal and financial governance.

And again, Governor, you will not be surprised to see that I would stress also some points that you made.

I insist on judging what's happening in Europe with a sufficient length of time. I had the curiosity to look again to the United States of America. The single market with a single currency of the US was not achieved in a short span of time. Certainly not in 20 years, certainly not in 40 years. When the US had the first "coinage act" of 1792, they didn't have a Federal Reserve Act. The Federal Reserve Act was voted in 1913.

So, you see, between the first start of the monetary integration of the US and the Federal Reserve Act, you had 120 years of maturing, and since the Federal Reserve Act and today, you had again more than 100 years.

So when we look at what we are doing, we should never forget that we are making history, and history has to be judged with the appropriate yardstick.

I will go quite rapidly on many dimensions of the success because I think that we all agree on that. Nobody is really challenging today that the Euro is a credible currency that is inspiring confidence.

At the inception of the Euro, I was told myself as member of the Governing Council, then as President of the ECB, that it was likely that the Euro would rapidly disappear. Many were convinced that we had embarked on too bold an endeavour, and that we will probably observe the dismantling of the Euro and of the euro area.

Of course, it intensified considerably at the moment of the crisis, and scepticism was generalized. Particularly on the other side of the Atlantic and by way of consequence, everywhere in the world.

In comparison with these gloomy predictions, the Euro has proved credibility both domestically and internationally.

Today, very often, one says the dollar is over dominant and the Euro does not really exist as an international currency. We heard that particularly after the Iran's new decision of the United States. I draw your attention to the fact that it's more complicated than that, and that, as far the currency is concerned, the success is not disputable in terms of "global payment currency": in the last observation you have a euro which represents around 36% of the global payment currency proportion, when the US dollar represents something like a little more than 44%.

So, it's the same order of magnitude. Where you have a much bigger difference is in terms of the amount of foreign exchange reserves, or in terms of currency denominated loans and international loans. According to these indicators, the Dollar represents 60% and the Euro around 20% of the outstanding amounts.

It is not because the euro does not exist or is not credible, because in terms of global payment currency I gave you the figure. It's because global markets don't concentrate only on the currency. They concentrate on a currency with a signature, and in the case of the Dollar, the usual benchmark signature is the US Treasury which is the signature of the political federation.

In our case of course, there are the Treasury of Portugal, the Treasury of Germany, of France, of Italy, and each segment of the financial market is very small in comparison with the US. And of course, the dimension, the depth, the liquidity of the market depends on the size of the treasury debt outstanding.

The liquidity and depth, the volume of transactions between the US Treasury transactions on the one hand and the German or French treasuries transactions on the other hand are in the proportion of around 1 to 25. So, don't be surprised if there is undoubtedly still a big difference in the utilisation of the financial instruments denominated in Dollar and in Euro. It's not abnormal. It's only because we don't have a political federation. It is history in the making, as I was saying.

But again, in terms of credibility, in terms of introducing a highly significant structural change in the core of international monetary system, the euro, as a currency, did exactly what it had to do.

As regard to the stability of the euro, it is clear also that, contrary to many expectations, we delivered price stability. When I was in the Governing Council at the very beginning of the euro, and then when I took the helm after Wim Duisenberg, the sentiment of many was that we could not deliver price stability. That we would necessarily have some kind of "average currency", merging currencies with a past record of stability and currencies with the past record of instability, and the average of these currencies would necessarily be an unstable currency, a currency which would not keep its value.

I don't insist on that because everybody sees that it is not the case. Problem is that inflation is too low in some respect today, so it's exactly the contrary of what was expected by many. But over the first 20 years of the Euro we posted an average euro inflation of around 1.75%, which is not bad in terms of a currency issued by a Central bank, which says that the yardstick for stability is less than 2, but close to 2.

I have also to mention that it is much better than any European national currency as an average for 40 years before the euro, including the Deutsche Mark or the guilder. We have to have that in mind, because it proves to which extent some pessimistic expectations were really plain wrong.

So that is a success. But my memory and the memory of Carlos and memory of I guess many in this room, is that it was not expected at all, and all the covers I had of the news magazine, during all my term, in many countries, not only one country, but many countries in Europe, was that we would probably shrink at a certain moment, that we would not be a good store of value, that the value of the Euro would evaporate.

Resilience is something which goes without saying now. But it was not obvious. The beginning of the great financial crisis started in 2007. You might remember that the ECB took a very bold decision in 2007 to give liquidity without any limit. The 9th of August 2007 episode in the subprime crisis in Europe in particular, we were asked 95 billion euros. We gave 95 billion euros.

It was a first in central banking. In August 2007, the ECB was criticised to be much too bold, much too aggressive in those circumstances.

But we did it with success, and we had then, of course, to embark on all the difficulty created in September 2008 by the bankruptcy of Lehman Brothers. I was at the helm of the ECB, as you said Governor, and we could have had 10 Lehman Brothers in Europe had the ECB and all national

Central banks not been extraordinarily active together and with the governments. I remember my call to various heads of state and government to stress the gravity of the situation, my participation in a Council of Ministers in Belgium to convince them they had to step in and, more generally, my expositions in the European Council on the extreme gravity of the situation.

So, it was very difficult obviously. And I have to say that the courage that the government demonstrated at the time was worth noting, because it was always politically extraordinary difficult, to take those decisions and to pave the way to have no new dramatic bankruptcy.

So, let me only mentioned the fact, as a bottom line for resilience, that we were 12 when I was given the presidency of the ECB in 2003, we were still 12 at the end of the 2006, immediately before the start of the subprime crisis episode. And, during and after the crisis erupted, in 2007, 2008, 2009, 2010, and after 2011 we had seven new countries coming in so that we were twelve before the crisis and we are nineteen today. Seven new countries coming in at a time of acute crisis is an unchallengeable demonstration of resilience. Far from being dismantled, we could enlarge by 60% the dimension of the Euro area in terms of number of member countries!

So again, bottom line, incredible level of resilience in very difficult circumstances. Now this resilience should not drive us to forget the many weaknesses of the Euro area that were at the source of the sovereign risk crisis.

First, we did not apply correctly the Stability and Growth Pact (SGP). I had myself to pronounce my first speech in December 2003 in the European Parliament to defend the SGP at a time when Germany, France, under the presidency of Italy, were saying, we should not apply the SPG.

Today I hear again a lot of rumours that the Stability and Growth Pact is not necessarily appropriate, that we should borrow much more, taking advantage of a very low interest rate and so forth.

I heard that earlier. For me, it is “déjà vu”. I heard that before Greece went into the dramatic crisis, and the financial market was absolutely on board in 2004, 2005, 2006, 2007, 2008 and even at the beginning of 2009 to finance the deficit of Greece without any problem. Then at the beginning of 2010, the market changed dramatically its mind. So again, let's be very cautious and prudent in this respect.

Second, we had no surveillance of the cost competitiveness of member countries, and that was something which was pretty abnormal. We had no secondary legislation to monitor that, and the ECB was more or less substituting the commission in presenting at each Eurogroup the evolution of the unit labour costs, the evolution of the competitive indicators in the various countries. With a strong warning that the Euro area was not correcting the sustained divergences that we were observing since the start of the Euro.

Third, another element is that we had no banking union. We also had nothing to fight against speculation, we had to invent everything. I could add that we were miserable as regards implementing the structural reforms that were overdue, and still are. And that the single market, which is the pillar of the European construction, was and is far from being fully achieved. I will go back to that.

Now let me turn to the popular support. The conventional wisdom was, and still is, that popular support is lacking for the European integration project. Part of it comes from what happened in the US and in the UK, the evolution of our own public opinion, the frustration of a large part of the population of the advanced economies and the frustration which is demonstrated vis-à-vis the governments and national institutions. It was apparently natural to think that this frustration would be also directed against Europe.

But it's not the case in continental Europe. If you look at the survey “Eurobarometer”, you see something which is very important, and I draw your attention to that, because it has to be better known and understood.

In the European Union, the frustration of the citizens is directed more at the national institutions than at the European institutions. It is particularly striking when comparing confidence in the national parliaments and in the European Parliament: 51% for confidence in the European Parliament versus 34% for national parliaments; it is even more to the advantage of the European institutions as regards the absence of confidence: 36% against the European Parliament vis-à-vis 60% against the national parliaments. When we compare the European Commission to the national governments, we obtain the same kind of figures.

The bottom line is that the so-called populist sensitivity is present in continental Europe and Ireland as well as in the US and the UK. But it is directed much more against the national institutions than against Europe.

This popular support, which is obvious in the survey, explains why Europe was resilient in the crisis. It explains that there is a sentiment of our fellow citizens, even if they are frustrated for many reasons, and we could come back to that, they nevertheless are trusting that they are better together than being alone, in each of their country. They are eager to continue to have unity in Europe and it's particularly visible with the Euro.

At the inception of the Euro, it was not expected that after 20 years, 76% of the euro area citizens would be backing the euro (81% in Germany, a very large majority in Portugal, a very large majority, more than 2/3, in my own country), this is something which is very important.

I said already that on top of stability, on top of resilience, it is certainly something which has to be noted as a very, very important success. And again, it was not really expected, and until now you have to explain that to friends on the other side of the Atlantic because they have a difficulty to understand, taking into account all what they are reading.

So a word on growth, because it's also often forgotten, only to mention the fact that when you look at growth per capita since the beginning of the euro until now, and you compare with the United States, we are a little bit below the US in terms of growth per capita, that depends on the methodology, according to the World Bank, we're probably at the level of 1.1% over that period of time, the US being at between 1.2 and 1.3, so you see a slight difference.

Undoubtedly, we have a lot more to do. The level of our growth potential is insufficient. We have structural obstacles to growth, but nevertheless, as you see, in terms of GDP per capita, growth is of the same order of magnitude on both sides of the Atlantic. When we are deemed miserable in terms of growth, it is because one does not take into account demographics, and, of course, demographics make a big difference. When you look at Japan, it is even much more miserable. And again, demographics are explaining that, by the way, it is a bit surprising to see that in the long run, all the advanced economies, in terms of growth per capita over a long period of time are more or less hovering, a little bit over and above 1%.

Which, of course, is something which is a problem, per se, because it's a big diminishing of growth in comparison with what we had before, so again, that is something which is very important.

Now, all that being said, we have to be aware of the fact that economic convergence between Member States must make further significant progress.

According to the IMF, and I trust that these studies are very reliable, the situation of the euro area is nuanced. The paradox, of course, is that the “rapprochement”, the convergence, in real terms between the first grouping of countries that entered the euro area, the first 12, have not reinforced their convergence inside this group, which calls for further understanding of what's going on in this group.

The newcomers, the seven newcomers I mentioned previously are converging towards the average. It is true that they were also starting from a situation which was less flattering for most of them. And we can understand why the figures are showing better convergence, but again we have a problem, and I think that this has to be looked after very carefully. It seems to me, that one of the major challenges that we have now would certainly be to do all what we can to reinforce convergence. It calls for good economic governance of the Euro area as a whole but also, of course, for each particular nation to do all what it can to catch up. We all know that real growth is made of productivity progress. So, all what can augment productivity progress will be welcome.

Now that being said, we also have to be fully aware of the fact that even in a single market with a single currency that had developed over, say, 200 years, namely the United States of America, you do not have necessarily convergence as a natural product of the single market with a single currency.

I had the curiosity to see what the standard of living was for the state of Mississippi compared to Massachusetts. The numbers of US Bureau of Economic Analysis say, around 33.5000 dollars on the one hand and 71.500 dollars on the other hand, namely, practically the same gap between Greece and Germany than between Mississippi and Massachusetts.

We have been running a single market with a single currency for 20 years. The US did it for 200 years. So again, it's also a wakeup call for us. You cannot count on some kind of automatic equalization of standard of living as a natural consequence of the fact that you have a single market with a single currency.

It means that if we want to have a full success in this respect, we need a very active combination of good management at the level of the euro area as a whole and good national management.

So, let me know embark on the other part of my speech.

Strengthen the economic and financial governance of the euro area. I already mentioned that we had a lot of weaknesses that explain why we had to cope with the sovereign risk crisis as a specific European crisis.

The two first crises - the subprime crisis and the post Lehman bankruptcy crisis - were concentrating on lack of credibility of private signatures. Then we had the public signature crisis and unfortunately, for that crisis, the Europeans were at the epicentre.

I remember a breakfast with Ben Bernanke in Basel where we met every month to discuss what was happening in Europe at the time. So, it was the start of the acute problem of Greece and with the sentiment that we also had a potential problem in Portugal and Ireland. And I remember Ben telling me exactly that. He told me "Jean Claude, now it's your turn". He meant: "I had the weight on my shoulder of the post Lehman Brothers crisis and now you have your own job to do, because it is coming in Europe".

The epicentre of the crisis had crossed the Atlantic. Then, what were the main weaknesses that were explaining this crossing of the Atlantic of the crisis.

First, as I already said, we did not respect the Stability and Growth Pact. The Stability and Growth Pact has some constraints, but also some room for manoeuvring. As you know, at the present moment one of the problems is some national constraints are significantly higher in some countries than the constraint of the Stability and Growth Pact.

The national rules that Germany, for instance, has, are much more constraining than the Stability and Growth pact. The Stability and Growth Pact would permit a large room for manoeuvring in the case of that particular country as well as of a few other countries.

But I would call personally to continue to pay great attention to the fiscal policies. Because again, what happened in the past can happen in the future. We can have a new move of the market which would put into question the signature and the credit worthiness of some fiscally poorly managed countries and, we could then be in a situation again, which would be very difficult to cope with.

So, I stress that the reinforced Stability and Growth Pact with the Fiscal Compact and all what went with it is not to be put aside as some good advices are suggesting.

Now let me point out another point, which is, in my opinion, decisive. It is the Macroeconomic Imbalance Procedure (MIP). I consider the MIP as important as the SGP. Since 2005 the central back circulated in the Eurogroup the competitive indicators of all countries member of the euro area, and major elements of the imbalances, domestic and external current account imbalances and competitive indicators.

I naively thought, when we had, as a consequence of the crisis, a new set of secondary legislation, namely the Macroeconomic Imbalance Procedure, we could expect that taking the lesson of the past and the impact of losing cost competitiveness for some countries, we would have a very attentive follow up of what was happening in this respect. I'm not sure that it is the case, I considered myself when I was President of the ECB, that the MIP would be as important as the SGP. And we have to understand something which is also very important in Europe, that when you are in a single currency area where the price stability is defined as less than two but close to two - say oscillation between 1.7,-1.9% inflation over a medium-long term period - each particular country national inflation must also oscillate in the medium-long run around 1.7-1.9%.

If a particular country is permanently over and above, it loses competitiveness and there is no currency correction because there is no currency realignment inside a single currency area.

So, it's very important if any country doesn't want to be put in a situation where mass unemployment would be structural, because of the loss of competitiveness. Also important to be followed with great care if for instance, you have countries which are very competitive, have full employment and have a national inflation which is permanently below the average inflation of the euro area as a whole. This is also an imbalance which cannot be sustained in the medium and long-run and it would create a problem for the ECB because too low national inflation in the highly competitive countries would constitute the inflation ceiling for the other countries, that could not afford to lose more competitiveness vis-à-vis those which are the best performers.

So, we have something which is very important in the structure of 19 countries set up with a single currency. We must all oscillate around the average, which is the benchmark for the euro area as a whole. I draw your attention to that because, I'm making a lot of speeches in various countries, I don't think it is understood, particularly in those countries that have already full employment, that we are counting on them to accept a normal functioning of market economy and then to have some push of the wages and salaries in those countries, in order for the room for manoeuvring for the others to be there and for the ECB to have the possibility of reaching its own goal, which is very important to avoid the materialisation of deflationary risk.

So, you see, I spent a little time on that point. I think it is very important to fully understand the functioning of a set of 19 countries inside a single currency area. And again, I was expecting, I have to say, that we would recognise when we had the appropriate MIP secondary legislation that we should rigorously apply it.

Another element I want to mention is the European Stability Mechanism only to back what you said, Carlos. I think you had an important point also to say. This is a major new institution. I was recomputing the callable capital of ESM which is more than 700 billion euros to my knowledge. There is no other multilateral institution with a callable capital of that dimension in the world: even the World Bank has not got a callable capital of that dimension.

Also, it is a triple A signature because it has been constructed in terms of legal construction in an extraordinary demanding way. And so, there is no problem for the ESM Bonds to have the Triple A statute. It's also something which is important to realise.

Let me also say that I am in favour of a Minister of Economy of the euro area.

I trust that, sufficiently strong, if we want the Stability and Growth Pact to be fully applied and well applied. If we want the Macroeconomic Imbalance Procedure to be fully applied, well applied, if we want the representation of the euro area, I would say, to be really fully represented with the appropriate credibility, it seems to me that we cannot count on one minister being simultaneously the President of the Eurogroup. Because having two hats is not easy. A national Finance Minister, representative of its own interest, in his own government, to play fully the role of the President of Eurogroup, which is a different, very difficult role, is obviously very demanding. And I also trust that it is not obvious that a commissioner can be both, Commissioner for the Euro and Commissioner for the EU as a whole.

So, I think that we have to continue reflecting. I made that proposal for the first time when I was awarded the Karl der Große Charlemagne prize. I trust that it is still something which we should have in mind. I know that it's difficult, the proof of the difficulties is that I made the proposal, eight years ago and it is not applied. But I draw your attention to the fact that it might be very useful.

Also I think that we should reinforce the democratic legitimacy of EMU in giving the last word to the members of the European Parliament when we have, if we have, I hope we won't have, a new major difficulty between one particular country on the one hand and the Institutions of euro area (Commission, the Eurogroup and the Heads in the European Council) on the other hand.

It happened in the past at certain moments. You'll remember the Greek case. There is no way of solving difficult issues through a series of successive happening, with the heads of state and government discussing, and the rest of the world being suspended to the final communiqué of the Heads of state and government.

We experience that with Greece several times. I think it's not normal. We should have a normal established procedure to solve problems. We should be able to refer to a clear procedure and to tell both the European Council and the country concerned: "Well, the last word is to the European Parliament. In its format euro area, these MPs have been elected by universal polling, universal suffrage, they represent the people, the people of your own country and the people of the euro area as a whole. We expect them to be in very close connection with the national parliament of the country concerned and they should have the last word".

It would be good because it would also reinforce the democratic legitimacy of the decisions taken in the Euro area.

You remember I already said that the European parliament has the trust of the people of Europe. Nobody can say: "Put aside the European parliament, it is not credit worthy, it is not reliable". I think the European parliament is reliable, and of course, if you give more responsibility to the European parliament, then you can expect that it would even reinforce its present reliability.

Now you mentioned a lot of points. I subscribed to all what you said, Carlos. I would only mention the budget of the euro area because decision has been taken to create a budget of the euro area. I take it that it is a very important decision. I also take it that where it starts is not exactly what we should expect in the medium term, or medium and long term, because it's much more directed towards helping a particular country to embark on structural reforms, which is good. But what we would probably need in case we have in the cycle of the euro area, not the cycle of one particular country, but the cycle of the euro area as a whole a problem of some magnitude, it's clear that a stabilizing mechanism, a neutral budget that would be called to help in terms of depressive episode of the cycle, and would accumulate capital in the period of the affluent episode of the cycle, so that would not be a system of permanent transfer to finance any particular country or, even the euro area as a whole, would be badly needed, in my opinion.

Peter, I know that you called for that yourself regularly and I also trust that one day we will recognise that this is clearly what we should consider as the evolution of the budget of the euro area. That being said, I accept fully that it was a big progress to start a budget with less ambition and the decision was not easy to take. There was a lot of discussion and I think that it is, on the column of positives of the recent, much recent, decisions that were taken in Europe. And I could again go further in making a proposal.

Let me only say at this stage that of course we concentrate on EMU. The conference is on the Euro after 20 years. That is not only the euro in Europe. I only mentioned that the euro without a signature of the dimension of the US Treasury signature has unfortunately no hope of having the depth and the liquidity in its own market as the US dollar has.

And that also is a way to establish a link between the currency and other elements that are not of economic and monetary nature only, but of a political nature. I think that we should never forget that on top of what we discussed today, we have certainly a lot of things that could be imagined at the level of Europe. In terms of defence, domestic and external security and diplomacy to exist at geostrategic level.

I mentioned the constellation of single markets with a single currency in the present world, which is very impressive. They all have a political federation or centralised states. They have geostrategic capacity that the Europeans do not have. Even if, and this is the paradox also of the present situation, there is in Europe, when you ask the Eurobarometer survey, a big support for joint diplomacy amongst our fellow citizens, joint Defence and a joint domestic and external security.

So, the paradox is that there is if we could proceed in this direction, and of course, it would be step by step. There the popular support for going further exists, and I think that the humiliation, for instance, of the European in the Iran issue, which was resented by all nations, as well as by European institutions, is based upon the fact that we do not have the same geostrategic capacity as the United States.

The kind of attitude that the US has naturally, because they have their own federal government. When I was asking the European firms, corporate businesses, why they were not taking advantage of the possibility of avoiding the Dollar and utilizing the Euro, that had been set up very wisely by the commission, they were telling me "But because it's not the problem, the problem for us is not the dollar. The problem is all our interests in the United States of America that are at stake, if we don't respect the new rules that the US had decided".

You concluded with a quotation, if I'm not misled, of Minister Shuman and I have too a quotation of Jean Monet that I think is very important also in the present juncture, he said, "Premature ideas do not exist. One must bide one's time until the right moment comes along".

That's why it is not appropriate to say you're a dreamer. You invent new ideas and concepts that they are not yet feasible. Still a true European has the obligation to reflect in the longer term, and stand waiting when it's ripe for taking such new decisions. And because you mention a part at the end of your speech in French, I will both quote a French sentence of Jean Monnet also, and maybe try to translate it.

I think it's very nicely said:

"Those who do not want to start anything because they are not sure that things will go as they have imagined them are condemning themselves to be immobile."

He also said that nobody can say today the structure on the shape of Europe where we will live tomorrow, because the changes triggered by today changes are very difficult to foresee, very difficult to predict. And I think again, this is the mark of history in the making. We are making history.

Thank you for your attention!

Session 1: Monetary and fiscal integration

From left to right: Eduardo Paz Ferreira, Nazaré Costa Cabral, Niels Thygesen and Nuno Alves.

Chair

- Nuno Alves, Banco de Portugal

Speakers

- Niels Thygesen, European Fiscal Board
- Nazaré Costa Cabral, Portuguese Public Finance Council
- Eduardo Paz Ferreira, University of Lisbon School of Law

Topics for the session

The European Monetary Union is a unique case of monetary integration. The interdependence between a single monetary policy and a set of national fiscal policies was well perceived from the beginning of EMU and became salient throughout these 2 decades. Polices reflected the interaction between the rules and incentives embedded in the EMU architecture, which has evolved over time. Today, the interaction between monetary and fiscal policies is again at the forefront of the debate. This session aims at assessing the dynamics of monetary and fiscal integration during the first 20 years of the euro and discussing the challenges ahead.

Amongst the questions that may be addressed in the session we would propose the following:

i) Did the interaction between monetary and fiscal policy during these two decades proceed as foreseen by the founding fathers of EMU?

ii) Is cooperation between a single monetary authority and 19 fiscal authorities desirable?

iii) Is the current Stability and Growth Pact adequate to address the challenges of the euro area? What changes would be warranted?

iv) Would the current European institutional framework be able to address a situation where monetary policy had limited space and fiscal policy had to face a cyclical downturn?

v) What is the role of Fiscal Councils – including their cooperation – in shaping fiscal policy for the euro area as a whole?

vi) What has been the contribution of monetary and fiscal policy in driving the centripetal and centrifugal forces in the euro area?

vii) Which force will dominate the next 20 years? Is further political unification required to deepen the EMU?

Niels Thygesen[7]

Chairperson, European Fiscal Board

Governor Costa, President Trichet, Ladies and Gentlemen, it is a hard act to follow you as the two first speakers with all your direct experience over a very long time span. But your two rich statements have in one respect, made my task easier; I do not have to repeat several important points that have been made.

I have one little comment on the title of the conference. To me, it is not a 20-year but a 30-year anniversary. I had the honour of taking part in the Delors Committee, which worked in 1988-89 to draft the first outline for an Economic and Monetary Union - which was close to what was agreed in the Maastricht Treaty three years later. This first outline even predated the fall of the Berlin Wall, a momentous event. We recently celebrated that three decades had passed. It is important to emphasise, and President Trichet hinted at that: the decision to embark on the EMU process preceded the economic and political upheaval which we watched in Berlin and elsewhere in Central and Eastern Europe. EMU was a decision based on mostly solid economic arguments, not just a by-product of political events, as many political scientists and politicians like to claim.

Let me start with a brief overview of my agenda: First, the motivations and the design of EMU as they were perceived in the formative years 1988-91. Second, some comments on the so called 'purist' future central bank, underpinned by rules for national fiscal policy. Why did this asymmetry go so far in the monetary direction, relying on a much looser framework for the other main instrument, fiscal policy? Third, a brief overview of the criticism and the revisions of the Stability and Growth Pact (SGP) in the first and relatively harmonious decade of EMU, after it had started in 1999. Fourth, the dramatic phase of the European Economic Recovery Programme (EERP) of coordinated expansion followed by painful efforts to exit from that and consolidate public finances, while creating a new set of rules for EMU. Fifth, the filling-in soon thereafter of some missing pieces of the original construction: a safety net in the shape of the European Stability Mechanism (ESM), joint bank supervision, and, finally, the ECB's bold effort to remove redenomination and deflation risks through the announcement of a contingent plan for purchases of sovereign bonds. I conclude with brief remarks on two topics of the recent past: the debate on how to reform the fiscal rules and governance - involving some proposals that I have been involved in advancing as Chair of the European Fiscal Board - and some comments on improving the macroeconomic policy mix. This latter topic offers the opportunity to look back to the first theme in my presentation: the motives for building EMU. Although the title of this presentation is 'Monetary and fiscal integration in EMU', I shall devote most of my comments to the latter area.

[7] Transcript of the intervention. The supporting presentation is available at: https://www.bportugal.pt/sites/default/files/0101_sessao_1_niels_thygesen.pdf

Motivations for and design of EMU

The motivations and for EMU were, above all, linked to efforts to eliminate, or at least to reduce, the disturbances from spillovers of divergences - real or perceived - in national monetary policies into the currency relationships of participants in the Single Internal Market. This programme had been developed in 1985-86 and was to be completed by 1992; it would have been difficult to adopt this detailed and demanding agenda, if the risk of important changes in competitiveness through exchange-rate realignments which had marked the European Monetary System (EMS) were to persist.

In addition, though the EMS had delivered much progress, notably a good deal of inflation convergence, it was becoming harder to manage with the higher degree of capital mobility then underway. Fixed-but adjustable exchange rates are difficult to reconcile with the liberalization of capital accounts. It does not take much imagination to see that both economic and political events in the participating countries over the past two decades would have played havoc with any stability of an intra-European exchange-rate system of national currencies. And currency movements would have been more likely to amplify than to narrow national divergences in economic performance and policies.

There was also an external argument, often forgotten, that the single currency would make Europe more robust and cohesive when disturbances arose from the dollar and from energy markets. The lessons from such disturbances in the 1970s and 80s were that they accentuated intra-European currency tensions. In addition, moving towards monetary unification would relieve Germany in her role of being in the forefront of criticism - in the G7, the IMF and other global fora - of economic policies in Europe as a whole.

I have a personal recollection to support the latter point: the first time I became convinced that monetary union was becoming possible in Europe was when Karl Otto Pöhl, then President of the Bundesbank, expressed a strong interest in having a system where that particular role was Europeanised, not only falling on the Germans. Other German policy-makers shared that attitude at the time, and they will have been reminded of the issue of excessive exposure recently when EMU has offered protection against renewed US criticism of German economic policies and of the current account surplus - and even (erroneously) of currency manipulation.

These motivations for EMU are all largely monetary, and they make it more understandable why fiscal policy was treated differently from monetary policy in the Maastricht Treaty. But still, of course, one has to ask the question could rules for national fiscal policy really be adequate as an adequate underpinning of a fully centralised monetary policy?

The answer given at the time by both academics and policymakers, was broadly yes. In 'normal' times spillovers from fiscal policy across borders in Europe are not very important. They are contained more or less within the national borders partly because they were, to a considerable extent, offset by movements in interest rates. That could be illustrated by some of the more dramatic events around German unification. The neighbours complained about higher German interest rates, but their economies were first stimulated by the demand spill-overs from the increase in German public expenditures and (construction activity). In EMU the interest-rate impact on others would become more subdued through a joint monetary policy. There seemed to be no really convincing economic case for EMU-imposed constraints in the form of intrusive 'coordination' of national fiscal policies at most times.

However, very high public debt, if it were to develop, would have the potential to trigger undesirable financial instability with spillovers within the EMU. Hence rules to constrain national fiscal policy would become appropriate at that stage. And protection against "fiscal dominance", a concept much used at the time - or encouragement of "monetary dominance", a term President Draghi used in his farewell speech in Frankfurt, was seen as essential for the ability of a future European central bank to stick to a policy of medium-term price stability. And not only central bankers recognised that argument, though they were particularly keen on it; several national central banks obtained de facto independence nationally to a large extent in the decade prior to the ,such of EMU, notably by withdrawing from direct responsibilities to support their government bond markets. In the Maastricht negotiations most Finance Ministers revealed their preference for a degree of external pressure through EU fiscal rules to contain overly rapid growth of public expenditures and debt.

The fiscal rules were to be supplemented by a no bailout rule for governments and by prohibition of lending to public institutions. This combination of constraints were seen as providing desirable, economically adequate and politically acceptable protection for the future joint monetary policy and of the central bank to conduct it. A major concern at Maastricht was to make sure that EMU would not become a club of highly-indebted countries, usually pushing for low interest rates to ease their mounting costs of debt service.

A 'Purist' Central Bank - and rules for both monetary and fiscal policies

What is a 'purist' ECB? The focus was to give the independent ECB the best possible start for a stable monetary policy. That implied not only removing the It from the role of lender-of-last-resort to governments; it also meant that the ECB should be restricted from assuming a major role in financial rescue operations and in foreign-exchange operations.

More remarkably, in the European Union, whether at communitarian level or at intergovernmental level, no framework was defined at the time in the area of financial stability until after the crisis of 2012. What the ECB was not to do, apparently should not be done at all at the EU level. That was, in retrospect, the main missing piece in the EMU construction, more so than the, in retrospect, weak fiscal framework. The relative success, even the popularity, of a rules-based monetary policy - inflation targets were growing in importance and refinement at the time around 1990 - was to provide inspiration for the future ECB, which duly adopted its inflation target in 1998. The rules-based approach also inspired the design of fiscal policy; there was an effort in the Delors Committee, to learn from the experience of fiscal federalism in large countries, where the federal level of government tends to rely on elaborate rules to guide sub-federal institutions.

Both of these analogies have proved somewhat deficient as inspirations for EMU. Fiscal policy has, in contrast to monetary policy, several objectives, and they occasionally conflict. Monetary objectives are closer to being one-dimensional, though the single target may be very difficult to attain, as the ECB has experienced.

As regards the second point, responsibility for stabilisation in large countries lies overwhelmingly at the federal level, in contrast to EMU, where national governments have remained in charge of stabilization since 40 to 50% of GDP passes through the public accounts. Leaving room for national automatic stabilisers was certainly a major ambition in EMU; they are stronger in Europe than elsewhere. It was hoped that, together with the joint monetary policy, this feature would provide adequate scope for stabilization in the face of both asymmetric, i.e. nation-specific, and symmetric shocks affecting the whole of EMU.

In EMU that division of labour was expected to allow the fiscal rules to focus on longer-term sustainability of public finances as the primary objective - a lexicographic ordering of objectives, if you want a technical term. But that model was found to be challenged even in relatively normal times; a contribution from discretionary fiscal policies beyond the automatic stabilizers could not be left aside, raising the trade-off between sustainability and stabilization as a repeated challenge - unlike the situation in federal countries, where public finances at the sub-federal level do not have to assume any counter-cyclical role.

One may wonder why it took quite a few years for discretionary national fiscal policies to obtain recognition for a stabilising role in EMU. A likely reason was the many examples prior to Maastricht of pro-cyclical national policies over two decades. The credibility of a potential counter-cyclical role had been severely undermined. This does not mean that there remained no defenders of such a role; France and Italy showed attachment to it at Maastricht, but incorporating it in the fiscal rules did not get broader support. The informational requirements for moving in that direction were seen as too demanding. So, like for monetary policy, there was only a single mandate for national fiscal policies - assure sustainability.

The first decade - relatively harmonious, but growing imbalances

The first decade of EMU marked some reforms of the fiscal framework. But that decade was a relatively harmonious one, despite the joint attack by Germany and France on the SGP in 2003. One explanation for that 'harmony' was the overstretched and the weak German public finances that resulted from unification.

Public debt grew nearly in step with that of France until 2004. The clear creditor-debtor divide that we have seen subsequently in the euro area did not in this period split the two core countries. The 2005 reform that resulted from the German-French attack, repaired a potentially pro-cyclical feature of fiscal policy, at least for countries that had been a bit careless in looking at the 3% rule for the deficit as a target, not a ceiling; Spain had defended the firmer view already at Maastricht, and the terminology of a 'reference value' had left the issue unclear.

The difference in perception is significant. If the reference value of 3% is meant to be a ceiling, countries should aim to stay a cautious distance below it. A symmetric target where you could be above or below, but you should not deviate too far on either side. That was really not the philosophy in Maastricht, but it was seen as such by several countries.

The problem was that the structural deficit, the cyclically adjusted deficit, which replaced the headline 3% deficit as the main policy indicator in the preventive arm, was unobservable and subject to major revisions. Offering recommendations in terms of this indicator, derived from the notoriously uncertain output gap, and relying on aggregate tax elasticities which also proved unstable, was bound to lead to misguided advice and frustrations.

The years 2005-08 just prior to the financial crisis were marked by three omissions in surveillance. First, underestimation by most national governments of the strength of the upswing relative to the potential long-term growth rate was largely due to misinterpretation of the structural deficit; the economies were more stretched than perceived. *Ex post*, sizeable positive output gaps were identified for this period. Second, there was a disregard of growing current imbalances inside EMU, despite the good habit of monitoring them closely that had existed in the EMS. And despite, I may add, the efforts of Jean-Claude Trichet, to remind governments in the Eurogroup and elsewhere about the growing imbalances and their underlying causes. Thirdly, linked to these external current account imbalances was the risk of a sudden reversal of the capital flows that financed the large deficits, particularly since they had not been used for building a future growth in the economy, but for consumption and construction. The combination of these three blind spots in surveillance turned out to be explosive, bringing the apparently harmonious first decade with EMU to a brutal end.

Crisis, the response of the EERP - and the consolidation

Some would say the crisis really started in 2007, and Jean-Claude Trichet also referred to the signals of financial tensions which were spreading from the US. But this episode was handled very smoothly by extraordinary liquidity infusions by the ECB, so much so that European fiscal policy makers remained relaxed until the autumn of 2008. The major downturn that then became inevitable with the Lehman crisis in September was handled through the only example in EMU history of a coordinated counter-cyclical effort - the European Economic Recovery Plan (EERP) of approximately 1.5% of collective GDP - a boost to demand which required temporary disregard of the fiscal rules. The aggregate size of the stimulus was certainly not inappropriate, but the effort was insufficiently differentiated between EMU participants. The German boost to demand was (fittingly) the largest, but too much fiscal stimulus came from weak and vulnerable economies.

The combined impact of the downturn and of the recovery programme was a jump in the debt ratio on average in EMU from the fairly stable level of 60% which had existed over two decades to more than 90% in 2010. Coupled with a dramatic worsening of Greek public finances, much of it initially underreported, tensions in financial markets were aggravated by the sudden prospects of sovereign debt restructuring. These events assured that the main thrust of the review of the SGP from 2010 on had to reemphasise sustainability as the primary element in fiscal rules. There had to be a firm and early exit from the unorthodox EERP to convince markets - and governments - that there would not be any repetition.

The surveillance process was intensified and streamlined through the European Semester, guidelines for debt reduction were made more operational, and the voting system in the Eurogroup was redesigned with the aim of reinforcing the role of the Commission as guardian of the Treaty; the French and German joint attack on the SGP had made it unlikely that governments themselves could handle this task. There was also an effort to decentralize surveillance by entrusting to independent national fiscal councils a role in monitoring macroeconomic and budgetary forecasts as well as compliance with national fiscal rules.

The tightening of the rules contributed to a double-dip recession in 2011-13, unique to EMU, making this period a major example of pro-cyclicality - a large negative fiscal impulse in a period of crisis. In fairness, the recession was not only a function of the rules, but also of wrong forecasts. And the contractionary impact was aggravated, as monetary policy was reaching the lower bound for interest rates. Above all, the legacy of pre-crisis vulnerabilities delayed the recovery which finally began towards the end of 2013.

Filling-in some missing pieces

The so-called 'Six and Two-Pack', the legislative reform of the SGP, did not stand alone. It was accompanied, probably made possible, by the filing-in from 2012 of three missing pieces of European integration:

- a lowering of financial risks to public finances by early steps towards banking union with joint supervision of large banks, placed at the ECB;
- the set-up of a safety net through an intergovernmental institution, the ESM, to provide conditional loans to governments that were about to lose or had lost access to financial markets; and not least
- the official Outright Monetary Transactions (OMT) decision by the ECB, indicating willingness to buy sovereign bonds, contingent on the issuer having signed up to an ESM adjustment programme.

Without these fiscal/monetary and regulatory/supervisory steps, the SGP might not have survived the crisis, when risks of redenomination into national currencies and of deflation intensified. But in late 2013 an upswing, lasting about six years, began - at first tentatively, but gradually picking up speed until 2017-18. What has been the contribution of the fiscal framework in recent years and how should one assess the policy mix?

The fiscal rules and the need for further reforms

How have the fiscal rules worked since this financial crisis prompted legislative revisions - and since the recovery started in late 2013? The Commission was legally mandated to produce an assessment of the fiscal rules before the end of 2019. This review has been delayed until February 2020 by the nomination of the new Commission. After that there will be a consultation process, notably with the Council and the Parliament; the Commission is unlikely to advance proposals until late 2020. But President Juncker asked the EFB to provide input into the exercise; we published our 'assessment report' last summer, presenting it to the College of Commissioners, to the ECOFIN Council and to the European Parliament, all in September.

We were challenged to see the mandate we got, since it contained no less than three objectives for the fiscal rules, not just one. President Juncker asked:

- Have the rules ensured sustainability of public finances - the classical objective?
- Have the rules promoted counter-cyclical stabilization, or at least minimised pro-cyclical experiences?
- Have the rules improved the quality of public finances?

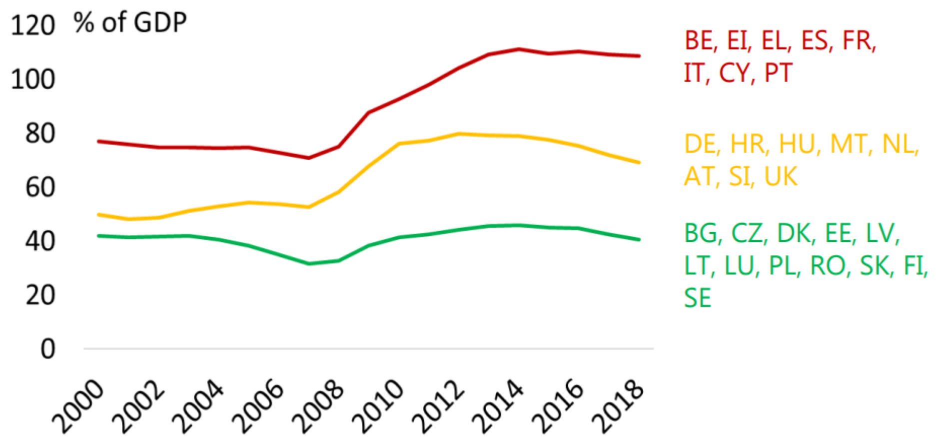
These three criteria go well beyond the emphasis of the first element - sustainability - which the architects of the legislative reforms of a decade ago primarily had in mind. But they no doubt reflect well the flexibility with which the Commission has gradually come to implement the fiscal rules since 2015. In their attitudes to this evolution, Member States are divided into two groups of about the same numerical size; one welcomes the flexibility and would like to extend it further, while the other group finds the rules are being eroded by flexible interpretations during a period when highly-indebted countries should have been building up more buffers in their budgetary positions. Both groups, however, seem to have acquiesced in the current state of affairs, despite the conflicts and even mistrust that it has entailed, both between the two groups and between either of them and the Commission.

Let me summarize the main conclusions drawn by the EFB, based on a detailed recording of case studies, supplemented by interviews with a number of senior national or EU officials who have held EMU responsibilities in EMU since 2010.

First, sustainability has certainly improved in the aggregate since 2010; headline deficits have been reduced from 6.5 to below 1% of collective GDP, while compliance with the fiscal rules has improved, except with respect to debt reduction. A declining debt ratio would be the main evidence that sustainability has improved, and the decline since 2010 by about 10 percentage points to an average around 86% by 2019 is not that impressive. And progress remains very uneven, with 6-7 countries remaining above a 90% debt ratio (see Chart 1). Progress in consolidation on this measure is concentrated in a median group of countries, comprising the strong economies of Germany and the Netherlands, while a large number - many of them smaller non-euro countries - exhibit stable low debt ratios around or below 40%. And the positive verdict on aggregate consolidation obviously has to keep in mind that the recovery over 2014-19, stimulated by exceptional monetary accommodation, has made a major contribution to the consolidation observed. The record on compliance with the rules on deficits is not promising either, once EMU is disaggregated into national data; one observation of some concern is that four countries have never submitted a fully-compliant Draft Budget Plan (DBP) in the 2014-19 period. The submission of DBPs has become an important addition to surveillance, leaving the

Commission with substantial rights of initiative. But only on one occasion - the confrontation with Italy in 2018 - has the Commission asked for a revised DBP.

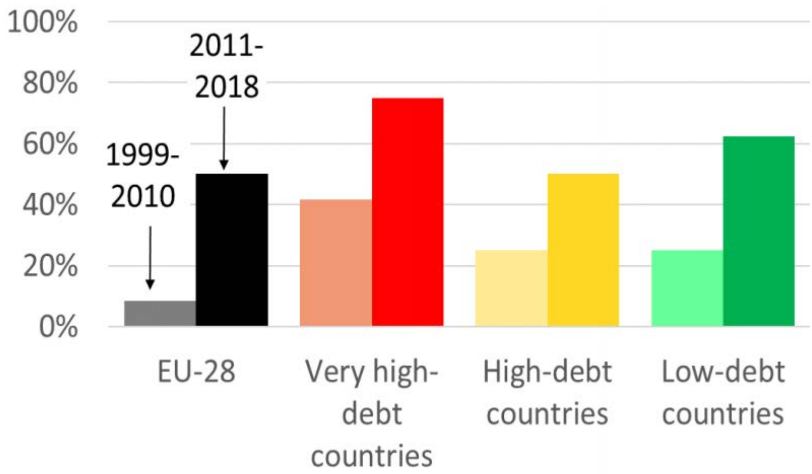
Chart 1 • Average Debt-to-GDP ratio



Note: Countries are grouped based on their average debt levels in 2011-2018.

Second, have the rules improved the elements of counter-cyclical stabilisation in national fiscal policies? As mentioned already, the 2011-13 period was marked by a strongly procyclical phase when priority had to be given to improving sustainability; the frequency of pro-cyclically has risen since the first EMU decade (1999-2010) before the rules were revised; and recent years have seen mildly pro-cyclical policies, as many countries failed to build fiscal buffers in 2017-19. Pursuing 'broadly neutral policies' in such an environment helps neither sustainability, nor stabilization. The one important example of counter-cyclical policies is the 2009-10 phase of the EERP. On the whole, the reputation of fiscal policy as a stabiliser has certainly not been improved over the two decades of EMU. This overall impression can be illustrated by looking at the frequency with which discretionary fiscal policies have offset the workings of automatic stabilisers (which provide an image of the cycles). This offset as an indicator of pro-cyclical policies has increased for the EU27 as well as for the three groups of countries (classified by debt levels) from the first to the second decade of EMU (see Chart 2).

Chart 2 • Frequency of fiscal policies in a pro-cyclical direction

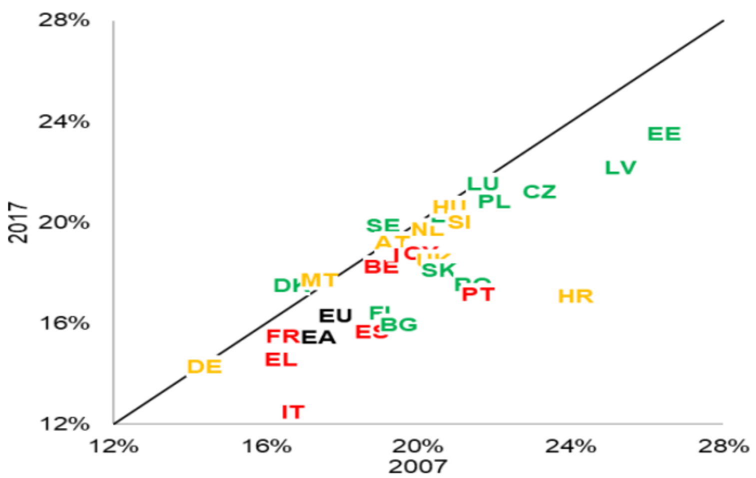


You may recall my initial argument that efforts at tighter joint management of national fiscal efforts were found unnecessary at Maastricht, because cross-border spill-over effects were thought to be too weak to justify them. However, in the climate of very stable and low interest rates that we have seen recently and are likely to continue to observe for some time, spill-overs tend to become more important, as the impact of fiscal policies is no longer offset by monetary policy. To the same extent as in 'normal' times. That puts more emphasis on designing a fiscal framework which leaves better room for the potential stabilising properties of national tax and expenditure policies than can be observed in the past.

Third, achieving the improvement of quality of fiscal public finances is an ambiguous objective; officials in finance ministries become very sceptical when they hear about the 'quality' of public finances. They have no doubt heard the term from spending colleagues at home. In the EFB we interpreted President Juncker's question to ask: How have growth-enhancing expenditures fared during the period of crisis and post-crisis? Looking first at public investment, the brunt of cutbacks of public expenditure was on investment during the crisis - and that public investment has not recovered in the way one would normally expect after the crisis, despite well-intentioned flexibility provisions to protect investment since 2015. Unfortunately, these provisions proved largely inapplicable; the conditions for accessing them were very tough. No country has qualified to benefit recently, since it must have a clear negative output gap; and there was no Member State in that category after 2016.

In our EFB report we illustrate the evolution of the 'quality' of public finances by means of a broader definition than public investment; the OECD's Classification of the functions of government (COFOG) definition of productive public expenditures including notably education, R&D and transport. Is one possible indicator. If one looks at growth-enhancing expenditures in this broader definition as a share of total public expenditures in 2017 relative to the pre-crisis year 2007, the general tendency over the decade is downwards, not least in the countries in the very-high-debt category; in other words, debt creation has not favoured the public expenditures that add the most to future growth (see Chart 3).

Chart 3 • Productive public expenditure as share of total public expenditure, 2017 versus 2007



Note: Productive public expenditure includes expenditure on R&D, education and transport (COFOG classification).

Summing up this very short overview of our assessment of how the fiscal rules have worked, one conclusion is that trying to achieve broad and often conflicting objectives through fiscal rules, seems overambitious. This is particularly the case in the absence of both any central fiscal capacity at the level of EMU and authority to 'coordinate' policy through national policy recommendations. The Commission's efforts to implement - so far without disapproval from the Eurogroup/Council - the rules flexibly have, despite the best intentions, been somewhat lacking in economic principles. Rather than addressing explicitly the trade-offs between the three broad objectives, flexibility has been applied in an opaque, piece-meal way: by reinterpreting policy indicators, by accepting 'broad compliance' ex ante, and by allowing future commitments to replace current action as observed for Italy.

The main weaknesses of the current rules that the EFB identified were:

- Putting excessive reliance on policy indicators that are unobservable in real time - that may be a feature of most indicators policies - but often even ex post due to major revisions, and allowing cherry-picking between alternative indicators, notably the structural balance and expenditure benchmark. Countries will then choose whichever indicators is less unfavourable to them;
- An annual, rather than a longer-term perspective has been encouraged. That has meant that back-loading of fiscal adjustments to the later years in a 3-4 year budgetary planning period has been relied on by many national governments;
- Increasingly bilateral surveillance procedures have become dominant rather than reliance on genuine multilateral peer pressure in the Eurogroup/Council;
- Lack of support for applying sanctions. The existing financial sanctions mechanism has not been applied, maybe rightly so. But, if sanctions are to be retained, one would need to move to more incentive-based (positive) features rather than the negative ones, currently in the shape of financial sanctions.

In that light main EFB proposals are:

- to achieve simplifications in reaching the original sustainability objective, define for the very-high-debt countries a net-expenditure growth benchmark lower than the long-term potential growth rate to target a slowly declining path for the debt ratio path over a long horizon, best after differentiated national debt targets; leave other countries to observe only the 3% headline deficit.

- to protect against the major pro-cyclical fiscal policies observed in the past, define a general escape clause to be applied parsimoniously on the basis of transparent economic analysis, then supplemented, rather than replaced by bilateral negotiations of a more political nature; focus on 'gross policy errors'.
- to design a limited or target 'golden rule' to protect categories of new/net public investment expenditures of high EU priority in the European Union, e.g. digital infrastructure, mitigation of climate change, possibly other priorities, provided they are sufficiently delimited to be open to monitoring.

The Macroeconomic Policy Mix

Let me conclude by returning to the issue of designing an appropriate policy mix in EMU, thereby returning to my first theme of reviewing the motivations and the design of three decades ago. The initial concern for EMU, as I mentioned, was to protect the coming ECB as the central, yet fragile, new institution against potential fiscal dominance by a number of highly-indebted governments. No real coordination of the joint monetary policy with the aggregate of fiscal policy was to be on the agenda. In fact, the agendas of the monetary and the political authorities were deliberately designedly to allow for a minimum of overlap. The ECB was to focus - of necessity - on the aggregate performance of the euro area, while the Eurogroup was to monitor national economic performance and non-monetary policies.

For the initial decade and a half after 1999 both the monetary and political authorities accepted the principles of this division of labour. The ECB continued to follow them by making its OMT programme contingent on a country having entered into a conditional programme with the political authorities in the ESM; this reduced risks of any favouritism vis-à-vis individual Member States. And when asset purchases were undertaken from 2015 on, they were made proportionately, i.e. on the basis of the ECB capital key, to underline their nature of monetary policy operations rather than efforts to stabilize individual national bond markets. On their side, the Finance Ministers in the Eurogroup largely paid lip service only to 'the appropriate fiscal stance of the Euro area' when the Commission made recommendations on this basis; the basis of surveillance remained firmly at the national level.

However, a speech in Jackson Hole by President Draghi in 2014 was a call for an adjustment of the policy mix, hence bringing back to the agenda the division of labour. The ECB has argued for a more expansionary fiscal stance, properly differentiated, to adjust the policy mix at a time of extreme monetary ease, perceived risks of deflation, and very limited prospects of reaching its chosen inflation target of 'under, but close to 2%' within any shorter horizon.

The new leadership in the ECB has announced a wide-ranging strategic review of its policies in the course of 2020. The timetable coincides closely with the consultation process of the fiscal rules and governance launched by the Commission for 2020. This coincidence offers an opportunity to review and update also the policy mix, including the division of labour between the ECB and the Eurogroup and the main policy indicators monitored in their respective frameworks. Most governments follow indicators of the real performance of their economies - output and employment - for which recent developments have been less unsatisfactory than the stubbornly low inflations rate relative to the chosen target has been to the ECB. On the other side, the more the ECB itself acknowledges the need to differentiate policy advice in the fiscal and structural areas between EU Member States - both because it is increasingly obvious and because it increases the pressure on the ECB to depart from its aggregate perspective, if the divergences are not addressed. The need to bring the barely overlapping agendas closer should be made a central topic in the policy reviews by both the monetary and the fiscal authorities. The urgency of such an exchange of views is enhanced as the two reviews will take place in an economic environment of recession rather than of the continued slow, but fairly stable growth which was assumed when the strategic reviews were first announced. With a worsened outlook, the danger of fiscal dominance may become more of a relevant concern to the ECB than could have been imagined at the start of EMU 20, or rather 30, years ago.

Thank you very much for your patience.

Nazaré Costa Cabral[8]

Chairperson, Portuguese Public Finance Council

I - First of all, let me start by thanking the Governor of Banco de Portugal, Mr Carlos Costa, and the Vice-Governor, Mr Luís Máximo dos Santos, for this kind invitation. I am very honoured to be here today. I also present my compliments to all the other members of this panel.

The topic that I have chosen to present here today – The Reform of the Economic and Monetary Union (EMU): From a Fiscal Union to a Fiscal Capacity – intents to address some of the challenges posed in the title of this Conference, which is about the debut, the present and the aspirations for the future regarding the euro.

I have decided to explore one of the issues that has been most discussed in recent years by academics and policy makers in the EMU and that concerns the evolution from a typical 'fiscal union' to this new notion of a 'fiscal capacity'. Despite being a renovated discussion, its origins are ancient.

In fact, they are at the heart at the beginning of the EMU with the so-called 'founding fathers' of the EMU, who have started the discussion on this issue, the conception of a fiscal union and how to transpose it to the European level. I will mostly highlight some of the basic insights of the Fiscal Federalism theory and explain how this has evolved in the European case.

Considering the current scenario in EMU, I will try to catalogue several proposals made in the aftermath of the crisis and that can actually embody this idea of fiscal capacity. The nature of these instruments is also different, so we can try to catalogue them and to analyse the respective basic features.

Before that, I start by recalling two main stages in the European integration process. The first stage dates back to the 1970s and 1980s. In this regard, the seminal reports shall be recalled, mostly the 'MacDougall Report' in the 1970s and the 'Padoa-Schioppa Report', in the 1980s. We can see that these Reports were very much influenced by the theoretical prescriptions of the Fiscal Federalism theory.

In fact, in the MacDougall Report, for example, the basic idea was that the fiscal union should precede the creation of a monetary union. We should first construct a fiscal union and then move on to the monetary union, and not the other way around.

The Fiscal Federalism theory (notably the studies that had been made since the 1950s by Musgrave, Tiebout, Olson, Oates, Stigler and Buchanan) was very influential in this Report.

However, the fact is that this proposal of first creating a fiscal union and only after constructing a monetary union was not followed. In fact, a monetary union was created without implying a (full) fiscal union.

On the other hand, the first years of the EMU were successful. The optimistic view that was present in the 'One Money, One Market Report' (1990) prevailed. The optimistic idea was that the construction of the monetary union would by itself ensure the synchronization of the business cycle, asymmetric shocks would become more symmetric and so the monetary union would by its

[8] Transcript of the intervention. The supporting presentation is available at: https://www.bportugal.pt/sites/default/files/0102_sessao_1_nazare_costa_cabral.pdf

own nature ensure the required stabilizing mechanisms for the entire area and for each of its Member States.

Moreover, it was expected that the centralization of fiscal rules (an idea of coordination of the fiscal policy) would be enough to ensure a smooth functioning of the currency union, preventing the 'deficit bias' of (national) Governments' action and avoiding that national fiscal profligacy could spill over to other countries of the area, putting a pressure upon both the interest rate and the exchange rate of the euro. And so, with common fiscal rules adopted in 1997 in the 'Stability and Growth Pact', the idea was that this would be enough to ensure a smooth functioning of the monetary union, and that the fiscal and economic problems that might arise would be properly addressed.

In sum, the monetary union could survive without relying on a true fiscal union.

Of course, after the recent financial and sovereign debt crises, much of this optimism was questioned.

In turn, I think that in recent years we have seen the appearance of a new model that I qualify as a "nuanced" fiscal union model. Well, of course, there are significant differences when we compare these proposals with the previous insights underlying the MacDougall Report based, as we have seen, in the fiscal federalism theory.

And this new 'nuanced' fiscal federal model relies on two main ingredients. Firstly, the development of the so-called private risk-sharing mechanisms. This is very much influenced by the 'Optimum Currency Areas' theory, a theory developed in the 1960s but that regained importance in the EMU after the recent crisis. The focus is on strengthening private shock absorbers in the monetary union, notably market mechanisms as prices and wages flexibility and the mobility of factors (labour and capital). This can be the first condition to bring the monetary union closer to a true 'Optimum Currency Area'. In this regard, the banking union and the construction of the capital markets union are two basic steps needed to reinforce this private risk-sharing mechanisms within the monetary union.

The second ingredient is what I call a limited acceptance of governmental risk-sharing mechanisms. And in recent years, these mechanisms have been labelled precisely as a 'fiscal capacity'. Further on, I will identify the four main modalities that can be adopted to substantiate this idea of fiscal capacity, all depending on the policy decisions that will be taken in the near future by the new European leaders, in particular by the European Commission.

II - Before that and to better understand these proposals, let me briefly recall the basic ideas of the Fiscal Federalism theory. The theory relies on two basic steps.

The first step is 'functions assignment'. First, we must assign functions to all different government levels. Note that fiscal federalism should not be confused with political federalism (the existence of a federation), because fiscal federalism is, in fact, a way of assigning functions and revenues amongst different layers of government, regardless of the type of organization that is behind those assignment rules. So, we can be in the presence not only of federal states, but also in face of unitary states and even in face of international or supranational organizations, as it is the case of the European Union (EU).

Regarding the functions assignment, I recall this seminal contribution from Musgrave, where he identified the basic fiscal functions, i.e. allocation of resources, macroeconomic stabilization, and (inter-individual) redistribution. And according to Musgrave himself, the allocation of resources lies at the heart of fiscal federalism. So, according to these premises, we can see that the best candidate for decentralization is the allocation of resources.

Of course, according to the nature of the public good, if we have a public (collective) good which benefit has a geographical scope confined to the local jurisdiction, then of course this public good must be developed by the local government (e.g. street lightning). On the other hand, if we have a national public good, this good has to be provided by the national government (e.g. national defence). Moreover, if the good presents spill over effects or if economies of scale occur in its production, this can also give a rationale in favour of centralization, that is, for an upgrading in the decision level.

Then we can say, regarding the other two functions, stabilization function and redistribution function, that typically they are said to be better assigned to the central level. And this is natural, for example, with respect to monetary policy, which is a very important component of the stabilization function. It is typically assigned to a central bank. So, according to this line of reasoning, also in the case of fiscal policy the role of stabilization should be assigned to the central government.

Moreover, we can also say that stabilization goes hand-in-hand with redistribution. Many of inter-individual redistribution instruments, either on the revenue side or on the expenditure side also play a significant stabilizer role. This is typical in the case of income taxes and social contributions (on the revenue side), and in the case of social benefits (on the expenditure side), including firstly unemployment benefits, but also other kinds of income support.

Regarding 'revenues assignment' (the second step of fiscal federalism), it is said that there are three kinds of 'orders of financing' of these different government layers.

The first order of financing corresponds to 'tax revenues assignment', according to normative criteria that help explain which taxes should be assigned to each of these levels of government. The second order of financing corresponds to 'intergovernmental transfers' that are typically transfers from the centre to the lower levels. Finally, the third order of financing – should I say residual – is 'sub-central borrowing'.

With respect to tax assignment, the basic idea is that usually taxes that are related to the pursuit of the redistribution function should be preferably allocated to the centre (because, as seen before, this is a function of the central government). Moreover, some kind of taxes with an incidence upon mobile factors should also be allocated to the centre. Why? In order to prevent the dislocation of factors or in order to prevent 'beggar-thy-neighbour policies', predatory competition, in sum, any kind of action that can jeopardize the good functioning of the internal market of that country or territory.

In contrast, when we are dealing with the taxation of immobile factors, the respective tax revenue can be better assigned to the lower levels of government, precisely because the tax base is immobile.

Besides tax assignment, there is another issue, which is tax autonomy. Now we are dealing with tax powers. Which level of government should have what kind of tax powers, not only the creation (*ex novo*) of taxes, but also other tax powers, e.g. the definition of the tax rate, tax credits and tax reliefs, etc. The question is whether and in which way the different layers of government share these kind of powers, or if they should be instead mostly assigned to the central government.

Then, the second order of financing corresponds to intergovernmental transfers, that is, grants from central governments to the lower levels. Grants from the centre are made to correct vertical and horizontal fiscal imbalances. On the other hand, they are distributed amongst recipient governments according to some kind of distributional formula. For example, according to the criterion of 'tax capacity', for which governments with lower tax capacity should be net recipients from this kind of grants, whereas other levels of government with a higher tax capacity should be net donors to poorer regions.

Let me now mention an interesting point. If you look at the fiscal federal experiences in Europe and in other parts of the world, you can see that it is not very usual to find 'anti-cyclical grants' or grants that are specifically made to have this kind of stabilizing effect. As I said, the system of grants is usually made with a purpose of convergence, long-run convergence, or in order to address those abovementioned problems of horizontal fiscal gaps.

In this regard, there are only few exceptions, for example in Canada and in Germany, in this latter case with the Länderfinanzausgleich (LFA). But, apart from these cases, it is not very usual to find grants designed to pursue this anti-cyclical effect. This is important, because next I will talk about one of the modalities for the fiscal capacity, which involves precisely the creation of anti-cyclical funds at the EMU level.

Then we have, of course, the third order of financing, which is borrowing. Here, the basic discussion is how to combine the autonomy of the Member States (or regions or local governments) – their capacity to borrow or to issue debt – with the existence of hard budget constraints. How can these budget constraints be hardened? There are several ways to do that, either ex-ante or ex-post mechanisms. With ex-ante mechanisms, borrowing can be controlled through market discipline or through the adoption of fiscal rules. As Professor Neils Thygesen has already mentioned, this latter option – the model of fiscal rules – is the one adopted in the case of the EMU. They are in fact quantitative fiscal rules, applicable to the main fiscal variables (e.g. budget balance, structural balance, debt ratio and expenditure). Then, we have also ex-post mechanisms to harden these budget constraints, basically by limiting the possibility of a bailout from the centre to the lower levels (which is also an important rule of the EU Treaty).

After this brief characterization of the basic premises of the Fiscal Federalism theory, I can now say that it has been very difficult, not to say impossible to transpose them to the EMU level or even to the EU level.

This is so, firstly because E(M)U has an atypical nature. Secondly, EMU is not politically embedded, to now use the words of Kathleen McNamara (in a book edited by Mark Blyth in 2015). Moreover, the EU is a club with heterogeneous preferences, an idea mentioned by the important political scientist Giandomenico Majone in 2014 and also by well-known economists as Annette Bongardt and Francisco Torres in their own papers and books.

And there is also this mutual prejudice both from EU Northern and Southern countries. While some Northern countries see Southern countries usually acting with fiscal profligacy and opportunism, Southern countries look at Northern countries as if they were insensitive, lacking a sense of solidarity vis-à-vis the South. And well, this kind of prejudice arguments impair a sense of cohesion that should be the first prerequisite for the transposition of fiscal federalism insights to the E(M)U landscape.

Being more specific, I think that with respect to functions assignment, some of the elements of the Fiscal Federalism theory are there, but many are not. First of all, EMU is a disjointed territory, although the initial intention was that all EU members should become EMU members as well. But for the time being, we have a disjointed territory, because whereas the EU budget – that could in a way personify this idea of fiscal union – is a budget for 28 (27!) members, while central monetary policy covers only 19 out of his 28 (27) members.

With respect to the other fiscal function – allocation of resources – there are two additional drawbacks in the transposition of the Fiscal Federalism theoretical prospects. First of all, the EU is not an all-purpose organization. Although it has evolved a lot since Maastricht and it is not only an economic organization (including other pillars, as internal affairs and the EU citizenship dimension), it is still basically an economic organization.

Secondly, the principle of subsidiarity, that is a fundamental principle of the EU Treaty relying on an idea of decentralization, is a very broad principle, in the sense that some public goods that could be assigned to the central level are not. This is the case, for example, with national defence that remains highly decentralized in each of the Member Countries.

On the other hand, with respect to the allocation of resources, it is interesting to note that some kind of public goods, notably because they benefit of economies of scale or entail spill over effects, have already been centralized at the EU level. This is clearly in line with Fiscal Federalism reasoning. It is the case with environmental policies, transports and communications, competition and regulation. They have been indeed assigned to the central level, step by step, in a process conducted progressively.

But the similarities with the normative view of Fiscal Federalism stop here. And this is so not only due to the small dimension of the European budget (which indeed can be compared to a central government budget), but also because neither the respective taxes nor its expenditures are designed to play this kind of redistribution and/or stabilizing role. We can see that these typical central functions are not really allocated to the EU central budget.

Moreover, the multiannual fiscal framework of the EU budget is very inflexible and clearly insensitive to the business cycle, which jeopardies the capacity of the EU to have a cyclical adaptation to the EU business cycle or of each of its Member States business cycles.

In particular, with respect to revenues assignment, we can see that they are not cyclically sensitive (at least as they are at the national level) neither in the case of the VAT-based resource, nor even in the case of the Gross National Income based resource, because this resource is mostly made to ensure the EU budget balance.

In turn, EU grants are not typically equalization grants, although they have this purpose of long-run convergence and they do not pursue any kind of anti-cyclical objective.

Finally, with respect to the centralization of fiscal rules (as mechanisms of hardening the budget constraints and controlling Member States borrowing), Professor Thygesen has already mentioned them. Note that the EMU model is atypical because we find, on the one hand, the centralization of fiscal rules but, on the other hand, there is the prohibition of bailout. This means that the E(M)U model is actually a mixed model between the so-called US model (that combines decentralized fiscal rules with the prohibition of bailout, at least in principle) and the German model (that combines the centralization of fiscal rules with the permission for a bailout from the centre to the sub-central governments, i.e. the States).

III – Now, the fundamental question, when we try to evolve to this new fiscal capacity is whether the basic features of the Fiscal Federal model are still there.

And my opinion is that, with the first proposals made after the sovereign debt crisis regarding the creation of a governmental risk-sharing mechanism, we can see this should not work through the normal interplay of redistribution with stabilization functions (stabilization as an invisible effect of the action of taxes and expenditures also pursuing redistributive goals). The new mechanisms should rather be conceived as direct and visible stabilizing instruments and even to act as typical insurance mechanisms with the one and only purpose of acting as a shock absorber.

In turn, as typical insurance devices, they should have some basic features: firstly, they should be automatic, in the sense that the trigger should automatically activate the mechanism and the reaction would also be also automatic; secondly, they should be made mostly to cover large and idiosyncratic shocks; thirdly, they should not imply permanent transfers, being neutral in the long run; finally, they should include safeguards to address moral hazard, either *ex-ante* or *ex-post* safeguards.

Additionally, there are some remaining qualification issues or questions to be answered. Should this fiscal capacity be included in the EU budget or should it be an outside mechanism? Should it refer only to EMU countries or to cover all EU Member States? Will it be financed through the existing own resources system or will it imply the creation of new taxes? Will these taxes be cyclically sensitive or not? And the respective expenditures should be cyclically sensitive or not?

Would this instrument typically act as an anti-cyclical fund or instead should be a convergence-type fund? And lastly but not the least, will these mechanisms have a borrowing capacity?

To conclude, allow me to identify the four basic models that can eventually embody this idea of a fiscal capacity in the EMU. The first model is the creation of a European Unemployment Benefit Scheme (EUBS). The second model corresponds to the creation of anti-cyclical funds. The third model corresponds to convergence-based funds. The fourth model implies reshaping the European Stability Mechanism (ESM) in order to transform it into a typical fiscal institution, and firstly as a fiscal backstop to be used in certain private markets.

Detailing the nature of these instruments, it can be said that the EUBS is typically an insurance mechanism, including an automatic response to economic shocks. It is therefore an automatic and visible transfer scheme, also including several safeguards to prevent moral hazard.

As for the anti-cyclical funds – I recall in this regard several proposals such as the ones made by Jürgen von Hagen and Pisani-Ferry at Bruegel –, they can also be considered as visible risk-sharing mechanisms made to address macroeconomic shocks, with features of insurance devices.

Then, in the third place, we find what I call convergence-based funds. In this regard, I consider that there are two basic approaches. The first one, a bottom-up approach, is associated to the Juncker Plan and to the launching of the European Fund for Strategic Investment. This Fund was based on an idea of promoting investment and then through investment, to have some kind of multiplier effect involved. The second approach – the most noteworthy in the last months – involves the creation of the so-called Budgetary Instrument for Convergence and Competitiveness (BICC).

Finally, the last modality of a fiscal capacity implies reshaping the ESM, according to the idea that this can evolve to a European Monetary Fund and even to act as a typical fiscal institution. Firstly, the ESM can be used as a fiscal backstop, for example, within the course of the development of the banking union (a backstop of the European Deposit Insurance Scheme) and finally act as a Debt Agency for the EMU.

Which model will prevail is still to be decided. Note that a combination of solutions can eventually occur.

In any case, there are for sure important policy decisions to be taken in the next months, regarding the final design of the new fiscal capacity for the EMU.

Thank you very much for your attention!

Eduardo Paz Ferreira[9]

Professor, University of Lisbon School of Law

My first words are of greeting and thanks to the Governor of Banco de Portugal, Carlos Costa and the Vice-Governor, Luís Máximo dos Santos. I would also like to extend a special mention to Elisa Ferreira, in this transition period between her vice-governorship of Banco de Portugal and the European Commission, the Board and management of the Bank, as well as the audience in general, many of whom I am very used to meeting at this type of session, Nuno Alves and the other participants on my panel.

I apologise to the foreign participants, but as there is an excellent simultaneous translation service, and having been informed that this was to be a bilingual conference, I could find no reason to speak in English, especially as there is no linguistic homogeneity and the conference is taking place at Banco de Portugal in Lisbon.

I congratulate the Governor and Vice-Governor for this initiative, the theme of which is obviously especially dear to me. Considering the importance of this debate and the quality of the talks I listened to, despite not having been able to listen to them all, I have understood the contribution this conference will make to future reflection on Economic and Monetary Union.

Above all, I should mention that Banco de Portugal has put itself in a position of particular prominence by organising this high-level conference as we mark an anniversary - the twentieth - of the euro, of the Economic Union, although the date has been commemorated discreetly, without fanfare, or those very pretentious or ambitious proposals for its future. Such ideas normally appear on these anniversaries and it is considered appropriate to launch new proposals to put right what is wrong.

And, although the twentieth anniversary of the euro would have been a good occasion to reflect on the achievements of the Economic and Monetary Union, how it was reached, as well as what still needs consolidating.

For this we need to think about the initial goals set out for the euro and how they changed over time, particularly the weaknesses that the single currency showed in dealing with crisis situations.

On 19 February 2019, three senior figures in the Commission, Marco Buti, Maya Jollès and Matteo Salto published a state of play article in Vox on the euro and its future prospects, and I quote:

"In spite of the existential crisis in 2011-2013, membership to the Eurozone has continued to grow. In its short lifespan, the euro has become an anchor of economic and financial integration. In late 2018, the Eurobarometer survey showed that around two-thirds (64%) of euro area citizens think that having the euro is a good thing for their country and about three-quarters (74%) think that having the euro is a good thing for the EU, the highest level since the question was first asked in 2004."

At the same time, over two-thirds - 69% of the euro area - thought that there should be greater coordination of economic policies, giving special emphasis to the themes debated here.

I believe that in Portugal, it was Ricardo Paes Mamede, an exceptional economist with his feet firmly on the ground and of whom I am very fond, who was the first person to try to publish a state

[9] Transcript of the intervention.

of play on the euro. In an article published in *Diário de Notícias* on 9 January 2019 entitled "20 years of the euro: a devastating balance", where he writes and I quote:

"Two decades have passed since the euro replaced the escudo and various other national currencies. Despite the round number, there were no great celebrations, which is not strange. Irrespective of the love one may have for the theory of European integration, it is difficult not to conclude that the single currency fell far short of the promises and expectations it encouraged. Evolution of Portuguese economic indicators is clear. Since records began, there has been no 20-year period in which GDP growth was so low, the average unemployment rate so high and the external deficits so expressive. Considering purchasing power, Portuguese average income is today further from the euro area average than it was 20 years ago."

This is certainly not a success story.

Interestingly, on the same date, 9 January, I found a text by Barry Eichengreen, on a website - *Brave New Europe* - called *The Euro at 20: An enduring success but a fundamental failure*, where Eichengreen claims:

"So the euro will stumble forward. No one will be happy with its operation. Equally, no one will leave. Progress will be minimal, since there is no appetite for the political union needed to support fundamental reforms. As a result, the euro remains vulnerable to another crisis. The next crisis could heighten the perceived urgency of fundamental reforms and lead Europe's citizens to accept the modicum of political integration needed to implement them. So reformed and restructured, the euro would operate better. Or the next crisis could empower anti-elite, nationalist, anti-EU – that is to say populist – politicians, making it impossible to implement even the modest reforms agreed in 2018. In which case the euro will function even less smoothly. Only one thing is certain. History doesn't run in reverse."

For better or worse, and both arguments are sustainable, what is a given, and in fact very curious is: the euro is here to stay. That is, the euro did not suffer the fabulous destiny of Amélie Poulain, to recall the now-classic French film, but rather had a future that was relatively disquieting whose development was difficult to determine.

But what is certain is that it has survived. And why has it survived?

It has survived thanks to the general inertia of the forces opposed to the euro which fail to offer a realistic proposal to replace it; through the perception that people have of an enormous void that would replace it, even at the worst moments of its crisis. And then we must not forget that there is always the "devil you know" that keeps us together. A 20-year marriage is quite long even if it is somewhat unequal, so why bother going through the nuisance of a separation.

The euro is here and, in a generally held view, it is here to stay, so the question should be, under what terms?

In the difficult times that followed the recent crisis, there was an incredible increase in euro-optimism, which is now felt by about two thirds of citizens concerned.

A Lisbon university revealed real enthusiasm for the euro, when in a survey, in nine qualitative questions on the European project, the Portuguese answered that they did not want to leave either the European Union or the euro, 90% in the first case. They do want the European Union to have great decision-making capacity in economic terms, and above all, to have greater political integration, and feel closer to the creation of a United States of Europe than the fragmentation of the European Union. Only in one question were the Portuguese dissatisfied with the European project: they consider the EU undemocratic, and they are right.

The European Union has *hitherto* been more a club of democracies than a democratic club. And note that calling it a club of democracies involves some generosity of spirit or ability to look the other way.

It is interesting that, in Portugal, the euro is seen this way by public opinion. Because if the euro has created winners and losers, Portugal is clearly on the list of the losers.

If, for example, we look at the effects of the introduction of the euro on gross domestic product, we can see a spectacular increase in Germany, and then a slightly less spectacular but nevertheless an increase in the Netherlands and thereafter almost everyone has lost money: gross domestic product has fallen in most countries. Unfortunately it is impossible to demonstrate solidly that economic outcomes in the absence of the euro would have been as certainly negative as suspected.

In a recent study Alessandro Gasparotti and Matthias Kullas, Centre for European Policy, conclude that the euro brought much differentiated gains and losses among Member States.

On the winners side, the greatest beneficiary was Germany, with gains of about €23,116 per capita (€1.9 trillion) with such gains being particularly high following the sovereign debt crisis.

On the side of the losers, Italy stands out, with a loss of €73,605 per capita (€4.3 trillion).

Likewise, Portugal is a loser: €40,604 per capita (€424 billion), that is more than eight times the sum of the loan conceded by the European authorities in the scope of the 2011 bailout granted to the country (€52 billion).

The country has lost uninterruptedly since 2003. Between 2011 and 2014 (during the "successful" Economic and Financial Assistance Programme), Portugal lost the cumulative sum of €19,716 per person; and from 2015 to 2017 (years in which the structural reforms hitherto unleashed were to produce their "desired" effects), lost a further €16,348 per capita.

It is therefore natural for Germany to be very comfortable with the euro. The euro is a currency that makes it possible to ask the question posed by one of the great figures of German culture, Thomas Mann. Was he not right to ask whether one should want a German Europe or a European Germany? Robert Skidelsky, in a curious exercise available in Project Syndicate, compared the treatment of countries in financial difficulties with the identical treatment that Germany had received almost a century earlier with the Treaty of Versailles, stressing that a fair agreement between creditors and debtors is not possible, and that there is a need to preserve political and social peace.

The euro area needs to learn this lesson anew. Supporting his own opinion, Skidelsky recalls the position taken by his mentor, Keynes, a particularly Keynesian position, and quotes: "The policy of degrading the lives of millions of human beings, and of depriving a whole nation of happiness should be abhorrent and detestable", adding that, in Keynes' analysis, austerity is theoretically wrong: cutting income in one country causes lower income in others by spreading depression and ensuring that any recovery will be delayed and weak.

When we think of the reasons leading to this sympathy, this tolerance of the Portuguese for the euro, we find a factor that should be noted, which concerns the effects of the euro on Portuguese public debt. In recent years, and as a result of the European Central Bank's quantitative easing programme, the average interest of Portuguese debt dropped significantly from 3.6 in 2014 to 2.6 as estimated for 2019.

That is to say, to put it simply, instead of €43 billion in interest and costs that might have been paid over five years, if the average interest rate had continued to be that of 2014, the Portuguese Treasury was estimated to have paid €35.6 billion. The ironically so-called *Ministry of Debt* substantially reduced its budget. It is not very common for ministries to reduce their budgets. Only by virtue, as we all know, of some quite involuntary measures.

The 20th anniversary of the euro ends on a sad note with Mario Draghi's departure from the European Central Bank. Mario Draghi was the man who saved the euro, as he himself often points out and has said in several interviews. And so he should, for one should not tolerate injustice.

In this respect, I would like to recall one of the great figures of Portuguese culture, Jorge de Sena, who would now have reached his hundredth birthday and was, as is widely known, extremely vain. He would always praise himself lovingly in any interview, and when asked “Why are you always praising yourself?” he would answer: “Because I do not get enough praise from others.”

I could say that Mario Draghi finds himself in a similar situation, as although he does get more praise, he also gets also a lot of criticism at the same time.

And how astonishing to think about the simplicity with which Mario Draghi saved the euro after successive meetings and summits meant to solve the problem for good.

What did Draghi state in a rather firm voice? “The ECB is ready to do whatever it takes to preserve the euro” and proceeded to announce the quantitative easing programme, which means that such determination is sufficient to achieve remarkable results.

Emmanuel Macron, much to his credit, one of the heads of state or government committed to finding balanced and fair solutions for the European Union, awarded Draghi the *Légion d'honneur* and raised him to the heights of Jean Monnet and Robert Schuman, the founding fathers of European integration.

This is a very interesting development, for one because he foregoes several figures that have featured prominently throughout these decades, and second because it really marks something I believe to be strictly true: the two major novelties are in fact the European Community or, if we prefer, European communities and the Economic and Monetary Union.

Before leaving... and I don’t know if because he was not very sure about his successor, Christine Lagarde, a very nice and charming lady, who has such unstable points-of-view that I am sometimes left perplexed. For example, on austerity, I have already heard her say one thing and its opposite so many times that I am unable to understand her. On inequality, again the same, one moment she worried about inequality the other she totally disregarded the matter. And, therefore, I do not know if for this reason or if to make her life easier, Mario Draghi only left after guaranteeing that the maximum intervention measures would continue, that the quantitative easing programme would continue. And he also pointed out that it was time for governments with more expansionary fiscal policies to work with the European Central Bank to reduce the risks of recession in the economy. Draghi warned that not everything is positive in the euro area. The highest risk is a contraction of the economy and what the monetary union lacks the most is a central fiscal capacity.

I believe that many of us agree with this assessment.

A return to the expansionary policies of the European Central Bank is therefore justified and so I find it a sensible decision. Now, a very unusual thing: if I were a political leader of a Member State of the European Union, were I Minister of Finance, I would rejoice with the ease with which the European Central Bank was lending, becoming an ally for more expansive fiscal policies, especially to those that need it most. But the Eurogroup has reacted angrily to Mario Draghi’s proposal. Maybe some of it was caused by the idea that economists have no business teaching politicians, something I would generally agree with. But when no politicians are able to make timely and appropriate decisions, then bring on the economists!

In particular, Mário Centeno explained that, although countries are ready to act, this will only happen if risks materialise and things get worse. But why? Why is it necessary for things to get worse? Why don’t we prevent things getting worse, with enormous sacrifice from everyone, as recent history teaches us?

The latest views of the European Central Bank, moreover, point out that the risk of recession has increased significantly: this message was conveyed two or three days ago by the European Central Bank.

Returning to the question of political legitimisation and democratic legitimisation – much of what is happening in the Economic and Monetary Union and in the European Union is, in some way, a result of this lack of determination –, I would like to say that were I able to do so, or had I powers to bestow decorations, I too would decorate Mario Draghi.

And allow me, as I finish, to remind you of something that maybe only a few recall: at the moment of euphoria, when the euro started to be an everyday currency, then Prime Minister António Guterres used a sentence that became famous and enthralled Europe. Borrowing from his Catholic education, he remembered the words of Christ: "That thou art Peter, and upon this rock I will build my church", and said: "Your name is euro and on this euro we will build our Europe".

A matter of faith is surely not always one which gives complete results, because at the first sign of crisis the faith of the markets, the faith of the population, disappears.

Ten years after the euro entered the scene, the stage of, say, enchantment had disappeared and a new phase of protests began, which was somewhat similar to the one that welcomed the euro. My dear friend and Professor, João Ferreira do Amaral, has published two books with grand titles: *Porque devemos sair do Euro* [Why we should leave the euro], and *Em defesa da independência nacional* [In the defence of national independence], with him, it is all or nothing.

In fact, the euro failed to show this capacity to sustain the European Union.

The cause returns to the biblical field, but this time I am talking about Vítor Dias, as you know, a former communist politician who left active duty long ago. Vítor Dias went back to the Bible to quote Matthew and say: "Let them alone: they be blind leaders of the blind. And if the blind lead the blind, both shall fall into the ditch."

The idea that the euro would be the fundamental basis is, of course, an idea that makes sense. Jacques Rueff, in the 1950s, said: "Europe will be created by means of a single currency or not at all".

I would tend to think that nowadays the idea is that it is being created despite the currency.

There are still a few things I wanted to talk to you about, but I will save them for another occasion. I am sure there will be one. I wish only to resume the religious tone of these interventions to say that the euro, like the Catholic Church, is in need of a deep reformer. Francis was called by the church.

And in the euro, after Draghi, who will come and restore our trust in the European currency and our faith in its future?

Thank you all for your patience.

Session 2: The fundamental principles of the Monetary Union

From left to right: Luís Silva Morais, Clara Raposo, Peter Praet and Pedro Machado.

Chair

- Pedro Machado, Banco de Portugal

Speakers

- Peter Praet, Former Executive Board Member and Chief Economist of European Central Bank
- Luís Silva Morais, University of Lisbon School of Law
- Clara Raposo, Lisbon School of Economics & Management (ISEG)

Topics for the session

The EMU revolves around a set of fundamental principles which have been laid down in the Treaty and interpreted by the European Court of Justice and by some national constitutional courts. The core principles are formed in essence by price stability as a primary objective, the prohibition of monetary financing, the no bailout clause, and the principle of independence of central banks of the euro area Member States against the overarching aim of deepening financial integration through a single currency. Since the inception of the financial crisis, and in particular the sovereign crisis in the euro area, the Eurosystem resorted to a set of tools and measures of a non-conventional nature which led to tensions on the abidance by such principles. In parallel, risk aversion within the EMU escalated with detrimental consequences to financial integration and to the proper functioning of the monetary transmission mechanism.

Against this backdrop, an array of questions may be raised of which the following could be addressed in the session:

i) Twenty years after the introduction of the euro, how have the fundamental principles evolved since the inception of the EMU? Is there a sort of deep metamorphosis of the EMU if one compares with the original intents of the drafters of the Maastricht Treaty?

ii) To which extent does the shift to quantitative easing, especially the purchase of public sector/private sector assets by the Eurosystem, still fit within the boundaries of the price stability mandate?

iii) With the conferral of new supervisory tasks to the ECB, through the set-up of the SSM as one of the pillars of the Banking Union, is there a tension between price stability and financial stability? Or otherwise has the Eurosystem been able to reconcile effectively both mandates also in view of the national competence on financial stability?

iv) The growing number of complaints lodged by citizens before the German Constitutional Court (BVfG), in particular against OMT and PSPP, with preliminary rulings to the European Union Court of Justice (EUCJ) should be seen as worrying trend which limits the discretion of the Eurosystem to fulfil its mandate? Or should otherwise the rulings both from the ECJ and the BVfG be seen as an outcome which confirms the compatibility of non-conventional monetary policies by the Eurosystem with the fundamental principles of EMU?

v) Are the fundamental principles of EMU not being hampered by the financial fragmentation environment resulting from the sovereign crisis? For instance, to which extent may the price stability mandate be adequately fulfilled in the face of a fragmented interbanking market in the euro area?

vi) Should risk sharing become a fundamental principle of the EMU, eventually subject to stringent conditions on risk reduction to accommodate the constitutional requirements of the BVfG case law (since the Maastricht judgement)?

Peter Praet[10]

Former Executive Board Member and Chief Economist of European Central Bank

My first observation is that the ECB demonstrated over the last 20 years its capacity to decide. It did so sometimes in extremely difficult circumstances and in line with the fundamental principles discussed in this conference. This is a simple but important observation. The Executive Board of the ECB will be renewed soon, with a new President. This federal institution will continue to fulfil its mandate in continuity.

The second observation concerns what Eduardo was saying about the losers and winners. First, it is a complicated question. Blaming the euro is often a political trick to shy away from your own responsibilities. The study that Eduardo has mentioned is very questionable. I will give you the example of Portugal. Basically, the researchers try to assess the counterfactual: "what would be Portugal GDP per capita had it not joined the monetary union?" To do that, they compare Portugal with a number of other countries in the world which showed a more or less similar GDP per capita trend before it joined the monetary union. An algorithm searches for such cluster of countries. For Portugal the cluster of countries of reference are Barbados counting for 33% of the cluster, the second country is Israel, 25%, the third one is New Zealand, 24% and the fourth one is Singapore 18%. The reasoning is that if Portugal had not joined the monetary union it would be much richer, as the four other countries. This is not the way to start a reflection on how to improve the design of the monetary union.

The fundamental principles

The view was that the internal market needed a single currency became widely shared following the monetary disorders of the early 1990s. They posed a major threat to the internal market. Also important was that weak currency countries were paying a high price in terms of risk premia and market volatility.

The Monetary Union project was greatly facilitated by the broad consensus that had emerged after the inflationary period of the mid-1960s to the late 1970s on the importance of price stability for economic welfare. The main elements of the consensus of an effective monetary policy framework were a firm commitment by the central bank to price stability (the mandate), the adoption of a numerical inflation target, and a set of rules regarding independence, transparency and accountability of the central bank. The consensus was also that central banks have a major role to play in macroeconomic stabilisation policy, but that it would only work when inflation expectations are solidly anchored. At the limit, when the central bank reaction function is fully internalised by market participants the economy is virtually on automatic pilot. In the so-called monetary dominance regime, there is little role for fiscal policy in stabilisation policy beyond the automatic stabilisers. Government plays an important role in the provision of public goods and in the allocation and distribution of resources, within a debt sustainability constraint.

[10] The supporting presentation is available at:
https://www.bportugal.pt/sites/default/files/0201_sessao_2_peter_praet.pdf

The consensus supported the so called 'monetarist approach' to the monetary union. Basically it meant that the costs of bringing together countries with different inflation histories under a single central bank with a strict mandate would be limited. Inflation expectations would re-anchor to low levels thanks to the credibility of the new institutional setting. The new currency regime would act as a high power coordination device.

The ECB was granted full independence and assigned a clear price stability mandate under the Maastricht Treaty. Instrument independence was granted, but with important specificities related to the fact that the EMU is not a fiscal union. In the monetary union composed of sovereign countries the 'prohibition on monetary financing' of government spending and the 'no privileged access' to central bank financing, together with the 'no bailout' clause, were intended to incentivise governments to have sound public finances, limiting moral hazard. This was complemented by the Stability and Growth Pact and the surveillance of imbalances.

While there is little role for fiscal policy in stabilisation policy for the euro area as a whole, national fiscal policies were, however, to play a key role in case of asymmetrical shocks. Price and wage flexibility within the internal market would limit the need for governments to stabilise the economy.

Appetite for further building institutional capacity (the so-called 'deepening') beyond monetary policy was limited. The Single Market had its Single Competition Policy, its State Aid control and its Single External Trade policy.

The first decade

The period leading up to EMU resulted in a successful disinflationary process combined with fiscal consolidation. Member States had great incentives to meet the Maastricht convergence criteria.

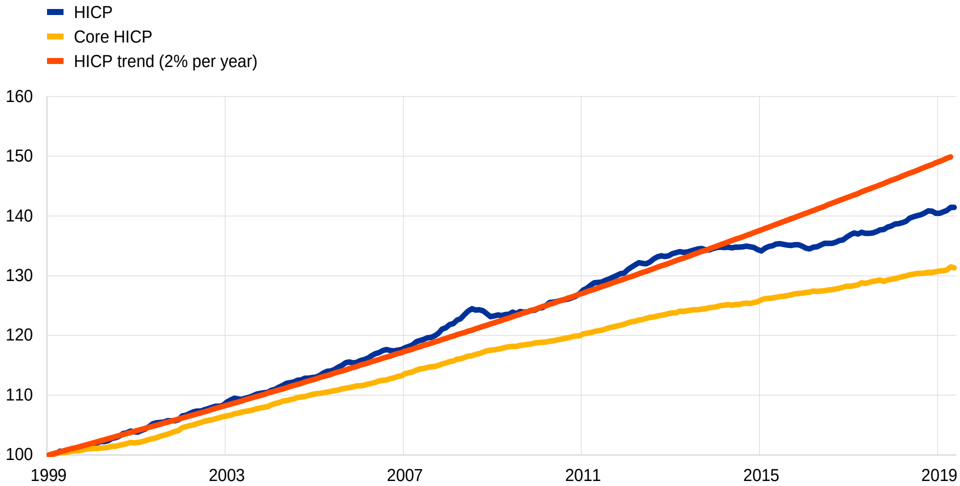
In 1998 the Governing Council defined price stability as a year to year increase in the HICP for the euro area of below 2%, while making clear that price stability should be maintained over the medium term. Following a thorough review of monetary policy strategy, the Governing Council stated in 2003 that, in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2% over the medium term. This clarification was intended to address concerns relating to the perceived asymmetry of the definition of price stability as, under the 1998 quantitative definition, inflation stabilising at any level between 0 and 2% over the medium term could literally be considered as compatible with price stability. The likelihood of hitting the zero lower bound on nominal interest rates during downturns had materially increased in the recently-established low inflation regime that followed the disinflation process, thereby curtailing monetary policy's room for manoeuvre.

An important element of the ECB strategy is that the time horizon over which monetary policy seeks to stabilise inflation varies with the nature of the shocks hitting the economy and the speed at which monetary policy decisions are transmitted to the economy. Supply shocks typically related to commodity or oil price increases, exert immediate upward pressures on prices, but tend to weigh on economic activity. Provided inflation expectations remain well anchored, monetary policy can look through cost-push shocks, thereby avoiding more volatility into the economy. The Great Inflation of the 1970ies is attributable to an adverse feed-back loop between prices and wages triggered by oil shocks.

In the early years of the euro's existence, the ECB faced the challenge of building its credibility in a large economic area consisting of countries with quite different inflation histories. It was therefore essential for the newly established central bank to prove that it was willing and able to ensure price stability and to deliver inflation rates in line with its aim. The quest for credibility came at the same time as a series of one-sided inflationary supply shocks. Oil prices increased more than tenfold over the first ten years of the euro, from about $10 per barrel in January 1999 to $145 per barrel at the peak reached in July 2008, shortly before Lehman Brothers filed for bankruptcy. In spite of these persistent oil price increases there were no clear signs of second round effects passing through to core inflation. This was quite different from historical pattern in a number of countries. Chart 1 shows the trend in price level since 1999. Headline inflation evolved broadly in line with a 2% trend until 2014. Noticeable is that this also implied that core inflation followed a lower trend, drifting away from the 2% trend well before the Global Financial Crisis.

Chart 1 • Euro area HICP

(index, 1999=100)



Sources: Eurostat, ECB calculations.
Notes: Core HICP is HICP excluding food and energy.

The fundamental principles of EMU severely tested

The Global Financial Crisis and the ensuing recession revealed severe institutional weaknesses specific to the euro area:

- Lack of internalisation of the euro in economic behaviour and ineffective surveillance framework, as shown by the building up of competitiveness and public finance imbalances in the first decade.
- Lack of a comprehensive financial stability framework and crisis management institutions.
- Lack of a Euro area macroeconomic stabilisation policy beyond monetary policy.

The consequence was a severe adjustment process which threatened the mere existence of the monetary union.

Monetary policy played a key role in containing the shock, but it had itself to deal with the lack of room of manœuvre in traditional instruments, as interest rates quickly hit the 'zero lower bound'.

The financial crisis resulted in a reassessment of a number of important aspects of the pre-crisis consensus, in particular to give more prominence to financial stability as an objective of macroeconomic stabilisation policies. In response to the crisis, the euro area summit on 28-29 June 2012 decided on a number of institutional reforms to the financial, budgetary and economic policy frameworks of EMU, notably the establishment of the main elements of a European banking union, making explicit reference to the need to break the connections linking sovereigns and banks. This was accompanied by the long-awaited establishment of a permanent backstop mechanism for euro area sovereigns through the creation of the European Stability Mechanism (ESM), which was established in October 2012. These decisions marked an important step forward in strengthening the resilience of the EMU. After President Draghi's remarks on 26 July 2012 the Governing Council announced, at its August 2012 meeting, that it would undertake outright open market operations of a size adequate to achieve its inflation aim. While recalling its aim to 'preserve the singleness of our monetary policy and to ensure the proper transmission of our policy stance to the real economy throughout the area', the Governing Council stated that it would be possible to 'address severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro', and provide 'a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro area'. This bold decision led to a marked and lasting decline in sovereign yields, contributing to a substantial easing in financial conditions.

Yet the subsequent economic recovery, which took place between 2013 and 2014, was moderate, uneven and fragile. Downside risks to price stability were increasingly apparent and the risk of a de-anchoring of inflation expectations from below became real. Faced with these major threats the ECB responded in June 2014 with a package of mutually reinforcing measures organised around three instruments, namely negative interest rates and forward guidance on rates, large-scale asset purchases, and funding for lending (TLTROs). This was unchartered territory. The work of the ECB staff was key in assessing the impact of the non-conventional measures on financial conditions, activity and inflation.

As regards rate policy, the ECB brought interest rates into negative territory in June 2014 when it decided to cut the deposit facility rate to -0.10%, an unprecedented move among major central banks. In view of the Governing Council, it was very important to signal that the lower bound for interest rates was not zero but potentially lower. The rationale was to prevent the economy from falling into a 'liquidity trap' situation. By signalling that rates could be less than zero, financial market investors would have an incentive to purchase long-term bonds on the expectation of further rate cuts. Removing the zero lower bound led to a significant downward shift in rate expectations, thereby helping reduce interest rates along a broad maturity spectrum.

Forward guidance on key policy interest rates heightened the impact of negative interest rate policy. Rate forward guidance started in July 2013 and was effective in decoupling euro area longer-term rates from the United States in the context of the taper tantrum. It also helped to anchor future rate expectations around the path consistent with the monetary policy reaction function, thereby helping flatten the curve at short to medium-term maturities.

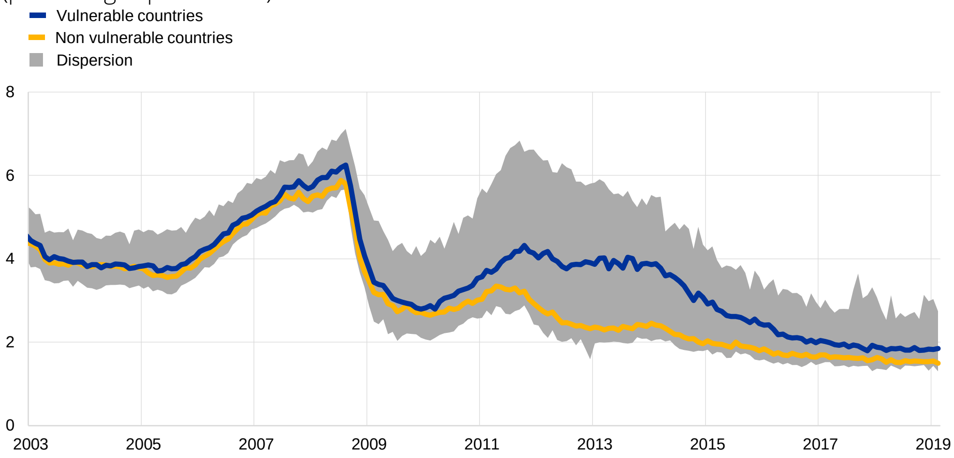
In addition to rate policy, the ECB used its balance sheet capacity – both in terms of size and composition – very boldly to provide further support. This mostly consisted in large-scale asset purchases of private and public sector securities, which helped to lower interest rates further through the 'duration channel'. By removing duration risk from the market, asset purchases fostered a reduction in the term premium required by investors to hold longer-term securities, thereby lowering yields in a wide range of market segments.

The use of balance sheet capacity to steer the monetary policy stance was a fundamental change from the way monetary policy had been conducted traditionally. The traditional demand-driven creation of central bank reserves was replaced with a supply-driven creation of reserves, with both the size and composition of the central bank balance sheet being relevant to the monetary policy stance.

The transmission of the ECB's monetary policy measures to the financial system has been very effective in creating the financial conditions needed to bring inflation rates back to the objective. The policy measures affected all segments of the yield curve, thereby easing financial conditions broadly. Lending rates declined significantly in both vulnerable and non-vulnerable countries, with a visible reduction in the cross-country heterogeneity that had hindered monetary policy transmission prior to 2014 (Chart 2). This considerable easing of credit market conditions in all euro area countries stimulated economic activity.

Chart 2 • Composite indicators of NFCs' cost of borrowing from MFIs

(percentages per annum)

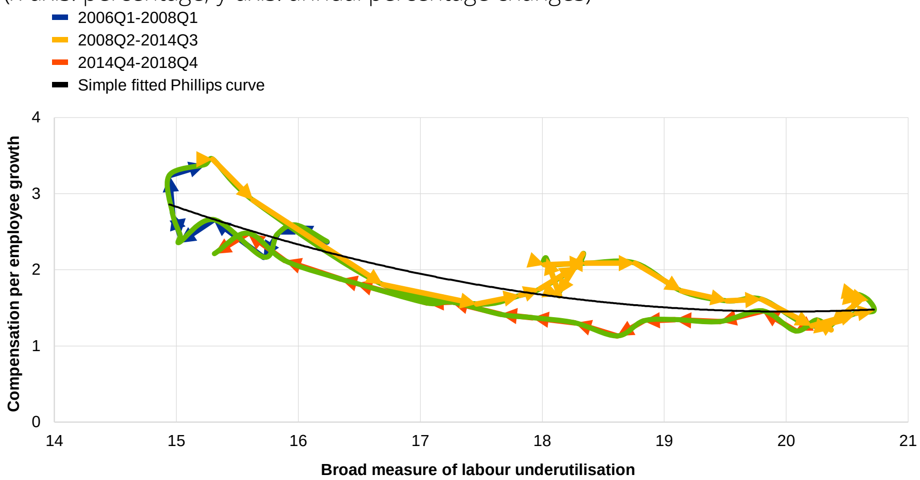


Sources: ECB, ECB calculations.

Notes: The indicator is computed by aggregation of short and long-term rates, using a 24-month moving average of new business volumes. Vulnerable countries are IE, GR, ES, IT and PT. Non vulnerable countries are BE, DE, FR, LU, NL, AT and FI. Within each country group, national rates are aggregated using 24-month moving averages of new business volumes as weights.

Chart 3 • Euro area wage Phillips curve

(x-axis: percentage; y-axis: annual percentage changes)



Sources: Eurostat, ECB calculations.

Notes: The broad measure of labour underutilisation comprises (i) unemployed persons, (ii) underemployed part-time workers (i e. part-time workers who would like to work more hours), (iii) persons who are seeking work but not available, and (iv) persons who are available but are not seeking work (this latter group includes discouraged workers). The measure is computed as a ratio to the extended labour force (i e. the labour force plus those available, but not seeking work, and those seeking work, but not available. The black line represents a simple fitted Phillips curve. The fitted curve is based on data from 2006Q1 to 2018Q4.

The output gap closed rapidly and labour market slack reduced to historically low levels. Nominal wages started to increase but the initial rise in wages was slow in comparison to historical benchmarks, pointing to a relative flattening of the wage Phillips curve for the euro area (Chart 3). Furthermore, the limited pass-through from wages to prices called for a strategy of 'patience and persistence'.

At its June 2018 meeting, the Governing Council communicated that it anticipated to end the Asset Purchase Programme after the end of 2018 and that it would reinforce its guidance on interest rates and on its reinvestment policy. This rotation of instruments from net asset purchases towards more conventional monetary policy instruments was not meant to withdraw monetary accommodation but to preserve the very easy conditions prevailing at the time, but with a different instrument mix.

In the course of 2018, economic conditions deteriorated in particular as a result of what commentators have called a "deglobalisation" shock related to rising protectionism, to policies questioning the prevailing multilateral order and to Brexit. Business confidence was severely hit, resulting in a significant slowdown of business investment and trade. At its September 2019 meeting the Governing Council adopted a new package of measures intended to further ease financial conditions. It has been widely debated if monetary policy is an effective response to such kind of shock. The macroeconomic policy framework whereby monetary policy plays a dominant role in stabilisation policy is again put to the test. This has led to new calls and efforts to further strengthening the euro area policy architecture.

The euro area policy architecture

The Jean Monnet prophecy that 'Europe will be forged in crisis' tends too often to be the way European integration has been progressing. But it is a dangerous and costly pattern.

In the aftermath of the Global Financial Crisis the 2009 European Economic Recovery Plan provided for a coordinated fiscal stimulus amounting to approximately 1.5% of EU GDP. In this context, the euro area fiscal stance loosened significantly in 2009. This countercyclical fiscal easing, combined with monetary easing, supported the strong recovery of 2010.

But countries with fragile public finances were soon confronted with increasing refinancing costs reflecting markets uncertainties on the capacity of governments to support their banking system or simply on the sustainability of their public debt. Inevitably they had to tighten their fiscal stance. This impossible trade-off between fiscal stabilisation and fiscal sustainability in several countries morphed into a systemic crisis that challenged the integrity of the euro. The Treaty on the Functioning of the European Union (TFEU) had not envisaged the possibility of such a dire situation. The entire EMU architecture was based on the assumption that Member States' compliance with the fiscal rules would be sufficient to rule out sovereign debt crises. The reality was a significant procyclical tightening of the euro area stance, precisely at the time when fiscal support was essential to shore up economic activity (Chart 4). This situation led monetary policy to become 'the only game in town'.

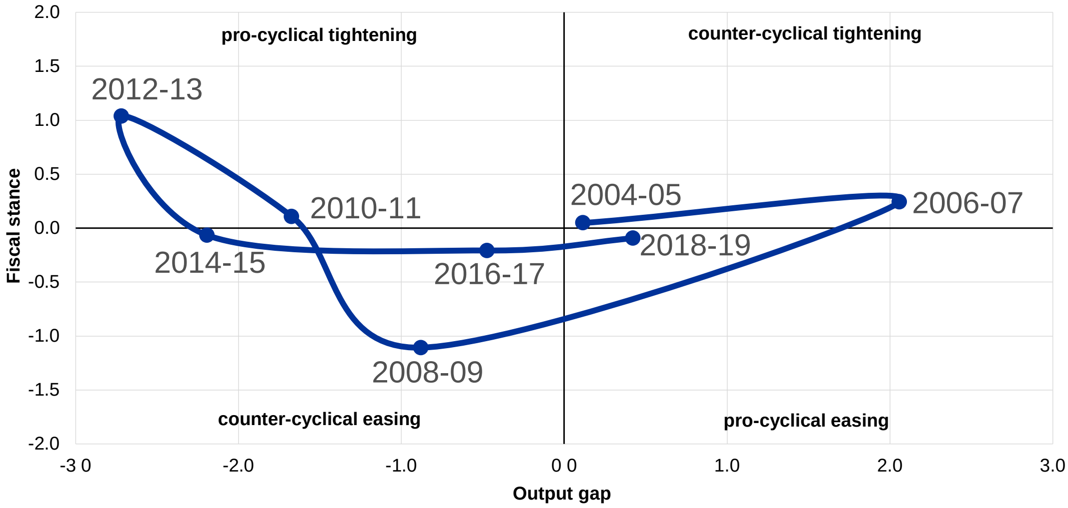
The ECB took full responsibility for the situation and, acting in full compliance with its mandate, adopted bold monetary policy measures, including warding off the risk of the euro area breaking up.

But macroeconomic stabilisation policy cannot and should not be the sole responsibility of the central bank. The TFEU set up a strong institution to manage monetary policy, but resorted to rules and coordination in other economic policy areas. This institutional imbalance reflects the consensus that emerged after the Great inflation period. It has resulted in an overburdened monetary policy. In the future it will be necessary to ensure that the euro area has more room for manoeuvre on the fiscal policy side, including through establishing a fiscal stabilisation function.

Establishing a genuine fiscal capacity for the euro area will be difficult, as Member States still have different visions of what institutional settings are appropriate, in particular to limit moral hazard. Yet the creation of a meaningful fiscal capacity and a euro area safe asset are essential to ensuring the smooth functioning of Europe's EMU.

Chart 4 • Evolution of the fiscal stance and output gap

(% of potential GDP)



Sources: European Commission, ECB calculations.

Notes: Fiscal stance is measured as the change in the cyclically adjusted primary balance for the period up to 2010 as figures are not available for the change in the structural primary balance. For the period 2011 onwards the fiscal stance is measured as the change in the structural primary balance.

European leaders have acknowledged the incompleteness of the euro area institutional architecture. They provided for a sovereign crisis management framework. An amendment to the TFEU eventually made it possible to establish a permanent crisis management institution: the ESM. Responsibility for banking supervision was assigned at EU level to the ECB, with the creation of the Single Supervisory Mechanism. These were bold steps, unthinkable a few years ago.

But it is unfinished work. The lack of a shared vision on the next steps to be taken in the next years is a source of uncertainty, weighing on confidence. The reform of the ESM which is an essential milestone is still under discussion and there is reluctance to bring it under Community law.

Also, the internal market needs to be completed. The euro was founded on the view that the single market needs a single currency. But it also goes the other way around: recent years have shown that the incompleteness of the single market hinders the smooth functioning of the monetary union. In an increasingly challenging international environment, the deepening of the internal market must go beyond the elimination of intra-European barriers. It must be part of a bold strategic reflexion on competition policy, trade policy, industrial policy and cohesion policy.

Decisive steps to complete the banking union and the capital market union are of key importance for a better functioning of the monetary union, particularly after Brexit. It is striking that in the monetary union capital markets still remain segmented along national lines. While causing sizeable microeconomic inefficiencies it also implies at the macroeconomic level limited risk-sharing across countries. More private sector risk sharing is necessary as the establishment of a fiscal stabilisation function for the euro area is likely to take time. But there should be no illusion: creating a deep and liquid capital market is not only a technical question. It enters into domains that have deep cultural roots like insolvency law, corporate law, consumer protection, etc Also a true capital market union will require the creation of a European safe asset which would become the euro yield curve benchmark. While the overall rationale is broadly understood by policy makers, there are quite divergent views on how to do it and at what speed.

Twenty years after its introduction the euro benefits from wide public support. Yet the institutional reforms undertaken are still insufficient for a smooth functioning and resilient monetary union.

Further reforms are urgently needed, considering the international context where the frontiers between economics and geopolitics are increasingly blurred.

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1 – Introductory remarks

Before addressing the specific topic at the core of this short paper, I should start by stating, first of all, that it is a great pleasure and a privilege to participate in the very timely Conference organized by Banco de Portugal, under the general title The euro 20 years on: the debut, the present and the aspirations for the future . I congratulate the organizers - namely the Governor of Banco de Portugal, Carlos Costa, and the Vice Governor, Luís Máximo dos Santos, who significantly open and close the Conference proceedings - for this initiative, marking the 20th anniversary of the Euro. Thanking heartily the Vice Governor, both on personal and institutional terms, for initially conveying this prestigious invitation to intervene in these most relevant discussions[12].

It is actually a double pleasure to participate in these proceedings, given in particular the composition of the second panel of the conference, with my two co-panellists, Peter Praet and Clara Raposo, and our moderator Pedro Machado, and given how challenging it is to discuss, as proposed by the organizers, the structuring principles of the Economic and Monetary Union (EMU).

Allow me also, taking advantage of the opportunity of having with us, President Jean Claude Trichet and, in this panel, Peter Praet, – and because I believe certain things must not be left unsaid – to emphasize here how much the preservation of the Euro and of the monetary union owes to the ECB, to President Trichet, and to the Board team that Peter Praet integrated between June 2011 and June 2019, in a period of considerable turmoil, paying here a modest homage, in the case of Peter Praet, to his contribution as chief economist at ECB, as from January 2012.

It seems also appropriate in a conference that has as its leitmotif 'The Euro 20 years on' to quote from Mario Draghi's farewell speech, in which he considers that the two decades of monetary union, beside a momentous anniversary, correspond more to an occasion to reflect than to celebrate. I would daresay it is a moment to acknowledge the degree of great success of the project

[11] This paper arises from the oral presentation made at the conference. It therefore follows closely the format of such oral presentation and is very intentionally succinct in its content. As per the date of its completion, the text considers developments occurring until 31 December 2019.
References to case law and quotations of relevant authors have, accordingly, been kept to a minimum. Readers interested in more extensive developments and analysis are redirected to previous publications of the author in related matters. Some of his papers and references to academic/research activities in connection with his Jean Monnet Chair can be found at: www.cirsf.eu; and especially at his SSRN Author Page: http://ssrn.com/author=1644131.

[12] Also bearing in mind here his key scientific contribution in these topics, starting from the founding period of EMU and before, when the seeds of that project were still being pondered, namely with his Master Dissertation "The European Monetary System: A Way to the Monetary Union" ("O Sistema Monetário Europeu: Uma Via para a União Monetária"), discussed at FDUL in 1990, and all the discussions in these matters that we have been able to develop in the context of a scientific *meeting of minds* of more than two decades.

(as duly and fairly emphasized by Governor Carlos Costa and by President Trichet in the opening of this conference), but also to **assess its limitations** or, above all, **its persisting risks and how to overcome such risks.**

As regards a desirable critical overall reflection on the Project of the Euro, Mario Draghi has underlined, in that farewell speech[13], two vital lessons for a successful monetary union arising from the past twenty years:

- The **first lesson** concerning monetary policy and the way that policy may be called to face deflationary forces, requiring, as such, flexibility in the toolbox of instruments to fulfil the mandate of ECB, albeit (and I quote here literally Mario Draghi) "without ever exceeding the limits of the law". Although I would venture to add, at the same time, testing in a very demanding manner the very limits and flexibility of the law.
- The **second lesson** underlined by Mario Draghi concerns the institutional construction of EMU and justifies an overall critical reflection about the complex institutional fabric of EMU, taking stock of where we are now and where we may be heading in light of recent developments, particularly in the post-crisis years, that largely coincide with the last decade.

2 – Scope of the analysis focused on key policy principles of EMU

2.1 - I would purport, in this short text, taking a wider approach, to focus my attention in this second lesson arising from the past twenty years, highlighted by Mario Draghi, and concerning a set of core issues related with the institutional construction of EMU.

With that purpose in mind, I shall try to offer an overall picture of the key policy principles of EMU, as designed in the Maastricht Treaty[14] and in the first steps of implementation of the EMU project, and will try to critically ascertain the evolution of such policy principles and the extent to which that evolution – as occurred so far, and as to be pursued in the near future in the context of the legal and economic dynamics of integration arising from the Euro project - **may represent (or not) a qualitative transformation or metamorphosis of the Euro project.**

Focusing on this institutional perspective of EMU, I would recall an expression coined by one of the founding fathers of such Union, Padoa-Schioppa, who suggestively referred to the risk of an 'institutional loneliness' of the ECB[15]. And, in fact, the initial construction of EMU underestimated – but it was the historical context at the time - the powerful forces of financial integration unleashed by the monetary union and the risks these entailed under the impact of a strong international shock originating a banking crisis evolving towards a sovereign debt crisis. Accordingly, the initial institutional fabric of EMU did not contemplate a true dimension of fiscal stabilization involving, as such, at least to a certain extent, some elements of fiscal union (the intensity or contours of which have still to be determined).

[13] Remarks by Mario Draghi, President of the ECB, at the farewell event in his honour, Frankfurt am Main, 28 October 2019, available at:
https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp191028~7e8b444d6f.en.html

[14] On the key parameters guiding the negotiation of contours of EMU in the course of the normative and institutional developments that led to the Maastricht Treaty, see Jean Victor Louis, "A Monetary Union for Tomorrow?" (1989), 26 CMLRev 301 at 302.

[15] Padoa-Schioppa, The Road to Monetary and Economic Union in Europe: The Emperor, the Kings and the Genies, Oxford University Press, 1999.

2.2 - I shall therefore briefly cover some key aspects of this institutional transformation of EMU oriented towards overcoming the gap in the fiscal stabilization function, and the challenges such transformation has endured in the judicial arena, referring here to current and prospective case law of the European Court of Justice (ECJ) and the German Constitutional Court ('Bundesvertassungsgericht') (considering, as well, beside this judicial scrutiny, other challenges in terms of democratic legitimacy of the whole process).

I shall also dwell on the new building blocks of European financial integration related with monetary union, especially the European Banking Union (and to a lesser extent the European Capital Markets Union), bearing in mind their contribution to prevent or invert the trends towards financial fragmentation arising from the sovereign debt crises.

3 – Principles underlying the initial EMU project and their possible transformation *ex post*

3.1 – Let's then set the scene and consider the principles underlying the initial EMU project and the way these evolved or, if the case may be, were transformed, either through extensive interpretation, or through complementary normative steps, gradually fulfilling the initial gaps of the institutional construction of EMU.

The original EMU was effectively based on a set of core 'policy principles'. And I shall refer here to 'policy principles' in a wider sense than strict legal principles, deriving such principles from statutory law, but also from policy statements and consistent practices of key institutional actors (following a 'law in action' perspective).

In a nutshell, and being almost telegraphic in the presentation of such policy principles, reference should be made here to two core principles:

- Firstly, in the monetary field we may consider a principle of separation between monetary and fiscal authorities within a single or core objective of price stability, determining that the ECB conducts monetary policy of the EU in accordance with 127(1) of the Treaty on the Functioning of the European Union (TFEU), thereby maintaining price stability as its primary objective. Furthermore, to the extent that the objective of price stability is not undermined, the ECB shall also support the general economic policies in the Union as its secondary objective;
- Secondly, in the fiscal and the financial regulation and supervision areas (*lato sensu*) there were mere EU level directives or parameters of fiscal discipline, including a prohibition or limitation of cross-national allocation of resources and risks, enshrined in the much discussed and somehow hastily designated 'no bail out clause' of article 125 of the TFEU, and an initial focus on micro-prudential regulation (Basel II style). And, so, basically, in this field, the key policy principle was a marked distinction or separation between monetary authority at central level and financial supervisory authorities (especially the banking supervisory pillar) at national level, although subject to coordination.

Only this type of separation in the context of the initial policy principles of EMU can explain, given the key importance of the banking sector and of the mechanisms of monetary transmission related to it, the truly striking near absence of rules in the TFEU on banks and the banking sector (aside from articles 127, 5 and 6). This contributed, indeed, to fundamental imbalances when the mechanisms of monetary transmission, involving banks, were seriously disrupted in 2008 and afterwards. It also contributed to the serious omissions in addressing core matters of financial stability within EMU in connection with the pivotal position of the banking sector to that overall financial stability[16]. Considering the overall political importance of banks and of the banking system, which should be acknowledged as such, it represented indeed a major imbalance of the initial design of EMU in the European Treaties the lack of provisions addressing the role of banks in the political and institutional contours and functioning of a non-dysfunctional EMU. The lack of a consistent economic and budgetary pillar of EMU is frequently singled out as a major factor for the EMU imbalances, but this lack of normative focus on the role of the banking system, to my mind, has played no minor part in those imbalances.

3.2.1. – Against this initial background, the Lisbon Treaty did not change much in the chapter on economic union compared to the previous Treaty. It introduced the ordinary legislative procedure in Article 121(6) TFEU for adopting measures in relation to the multilateral surveillance procedure. It, furthermore, included Chapter 4 on 'provisions specific to Member States whose currency is the euro' comprising Articles 136 to 138 TFEU. The budgetary surveillance procedure remained untouched, whereas in Article 121(4) TFEU the Commission got a new instrument in the multilateral surveillance procedure, which is the possibility to directly address a warning to the member state concerned. Finally, the reference to the "spirit of solidarity between Member States" in Article 122(1) TFEU was introduced by the Lisbon Treaty.

So, in a nutshell, the Treaty of Lisbon did not change the basic construction of the Economic and Monetary Union, as it was introduced by the Treaty of Maastricht.

The basic construction was characterised by its asymmetry. Whilst the Monetary Union was a supranational one, the Economic Union remained intergovernmental. And this division was in line with the traditional rather technocratic EU policy approach: disciplining national democracies by a common monetary policy instead of replacing their decisions by a common economic and fiscal policy. National economic and fiscal policies should be aligned with certain policy goals set at EU level but without any legally binding enforcement mechanism. They should be disciplined by the markets based on the assumption that, as long as the position of a Member State on the financial markets is the same as of any other private institution, markets would indicate in form of decreasing or increasing interest rates on government bonds whether a national economic and fiscal policy was convincing or not. Therefore the so called 'no-bail-out clause' (Article 125 TFEU); therefore no purchase of government bonds on primary markets by central banks (Article 123 TFEU); therefore no privileged access by central governments to financial institutions (Article 124 TFEU). And the coordination of Member States' economic and fiscal policies was somehow "depoliticised" at EU level by definition[17].

16 P Schlosser, (2016), Resisting a European Fiscal Union: The Centralized Fragmentation of Fiscal Powers During the Euro Crisis, EUI, PhD Dissertation, December 2016; D Schoenmaker, (2015), A Fiscal Backstop to the Banking System, in M Haentjens, B Wessels (eds), Research Handbook on Crisis Management in the Banking Sector; G Gloeckner, J Lindner, M Salines (2016) "Explaining the Sudden Creation of a Banking Supervisor for the Euro Area" in Journal of European Public Policy, 24-8, pp 1135.

17 Various analyses converge in this sense. There is no room here to quote thoroughly on those analyses that reflect such *acquis* in terms of acknowledgement of EMU initial asymmetries or, even less, to discuss extensively the doctrinal contributions in this field (that I am here taking into consideration). See, however, inter alia, P De Grauwe (2013), Design Failures in the Eurozone: Can they be Fixed?, LSE, 'Europe in Question' Discussion Paper Series, LEQS Paper N.º 57/2013, London, February 2013; F. Giavazzi and C Wyplosz (2015) "EMU: Old Flaws Revisited", in Journal of European Integration, vol 37, Issue7, pp 723; European Parliament,

3.2.2 - One key question to debate is the extent to which this basic construction of the EMU can or cannot be changed outside a formal Treaty change procedure

In theory, the Treaties set the limits for secondary law such as the so called 'Six-Pack' or the 'Two-Pack' regulations[18]. However, in my view, the normative building blocks of an evolving architecture of EMU have diversified, as room was opened to international treaties concluded by a subset of Member States, such as the Treaty on Stability, Coordination and Governance in Economic and Monetary Union (TSCG) and, more importantly, the Treaty establishing the European Stability Mechanism (ESM-Treaty).

Fundamentally, the European Court of Justice (ECJ) paved the way in this direction with its 'Pringle' ruling[19] on the compatibility of the ESM-Treaty with EU law when it concluded that the ESM-Treaty – establishing a form of financial assistance for euro area members having economic difficulties - could enter into force, even before the formal introduction of a third paragraph of Article 136 into the TFEU, stating that the euro area Member States might establish a stability mechanism.

In the Pringle case, effectively the ECJ accepted there might be an overlap between economic and monetary policies and started to abandon the initial policy principle I referred before, of strict separation between such domains apparently flowing forth from the Treaties. This Pringle precedent was noteworthy and ground-breaking through its reading of the so called no-bail-out clause of article 125 of TFEU (referred supra, 3.1.).To some extent the ECJ resorted to a legal technicality (not exempt of controversy but effectively sorting out a substantive deadlock in terms of interplay between economic and monetary policies), emphasizing a rather literal reading of article 125, which signalled that the ESM would grant loans to countries instead of directly assuming the debts of those countries (also underlining that ESM loans were to be accompanied by conditionality and were to contribute to the overall stability of the Euro area, which ultimately provided the original basis for introducing the no-bail-out clause in the Maastricht Treaty, with the ECJ thus closing here the circle and combining a literal with also a substantive, finalistic, reading of the relevant provisions of the TFEU).

3.2.3 - Coming back to Treaty changes, it is noteworthy that while specifically chapter 2 of the TFEU on the Monetary Policy is also largely the same under the Lisbon Treaty, there are some exceptions, particularly the fact that the requirement to receive the assent of the European

Implementation of the Lisbon Treaty – Improving Functioning of the EU: Economic and Monetary Policy – Study for the AFCO Committee, Brussels, 2016.

[18] More specifically, I am referring here, to the EU "Six-Pack" relating to the following regulations and guidelines: On fiscal policy, Regulation 1175/2011 amending Regulation 1466/97: On the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies; Regulation 1177/2011 amending Regulation 1467/97: On speeding up and clarifying the implementation of the excessive deficit procedure; Regulation 1173/2011: On the effective enforcement of budgetary surveillance in the euro area; Directive 2011/85/EU: On requirements for budgetary frameworks of the member states. On macroeconomic imbalance, Regulation 1176/2011: On the prevention and correction of macroeconomic imbalances (laying out the details of the macroeconomic imbalance surveillance procedure and covers all EU member states); Regulation 1174/2011: On enforcement action to correct excessive macroeconomic imbalances in the euro area (only applying towards all Eurozone member states, and focusing on the possibility of sanctions and other procedures for enforcement of the needed corrective action plan , to satisfy the EIP recommendation from the Council.
And to the EU "Two-Pack" regulations, relating to the following Regulations: Regulation 473/2013: on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the member states in the euro area; Regulation 472/2013: On the strengthening of economic and budgetary surveillance of member states in the euro area experiencing or threatened with serious difficulties with respect to their financial stability.

[19] Pringle ruling of ECJ, of 27 November 2012, Case C 370/12.

Parliament [under Article 105(6) of the previous Treaty of the Economic Community (TEC)] was replaced by a simple obligation to consult the European Parliament when conferring specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions under Article 127(6) TFEU. And it is worth emphasizing that this corresponded to the only downgrade of European Parliament rights in the Lisbon Treaty and it effectively paved the way or facilitated the key decision of, with the support of the normative basis of article 127 (6) of the Treaty, entrusting the ECB with specific task relating to the prudential supervision of credit institutions by adopting Council Regulation 1024/2013, through the establishment of the Single Supervisory Mechanism (SSM) within ECB, as one fundamental pillar of the European Banking Union Project launched as from the Summer of 2012.

4 – Asymmetries of the Initial EMU Project and the Banking Union as a partial response

It manifestly exceeds the limited purview of this paper to dwell in detail with the building of the European Banking Union in the context of the asymmetries I have been referring as regards the original EMU.

Suffice is to say that given the two original policy principles I have been systematically referring of separation between the monetary domain and both the fiscal and financial supervisory areas *lato sensu*. There were no EU institutions or instruments in place to deal with risks and vulnerabilities either originated or largely amplified by the financial sector. There were neither common instruments in case a sovereign faced a liquidity or solvency crunch nor even common instruments for the surveillance of risk for banks or for their liquidity or solvency crises.

The Banking Union was a partial response to those imbalances, while in itself incomplete up to now, with its pillars comprehending a single rule book for banks, a single supervisory mechanism (SSM) (within the ECB), a single resolution mechanism (SRM) – intended to ensure an orderly way-out for problematic banks - (still in progress and imperfect or incomplete in various aspects), and a much debated European deposit insurance system (still not launched and about which the political debated has been relaunched, notably by Germany, in the last quarter of 2019[20]).

On the whole, and again without time to enter into the details, the initial too rigid separation between the monetary domain and both the fiscal and financial supervisory areas has been gradually – however imperfectly – addressed, bearing in mind macro-prudential policies and concerns and the acknowledgement of a much needed financial stabilization function centred in a new euro crisis management framework for which liquidity instruments of assistance are of the essence. The problem is that, despite institutional building in this domain, those functions are rather incoherently dispersed between various EU actors, including the ECB, the European Stability Mechanism (ESM) or the Single Resolution Board (and the Single Resolution Fund).

In this context, I would also venture to add, closing the circle, that macro-prudential policies and concerns and, above all, the acknowledgement of the need of an overall financial stabilization function are also underlying the building of non-standard measures of ECB in the monetary field

[20] I refer here to the position presented by the German Finance Minister, Olaf Scholz, to unlock the European Deposit Insurance Scheme (EDIS) proposal (which will not be not commented here for lack of time). See on this O. Scholz (2019), Position Paper on the Goals of the Banking Union, Bundesfinanzminister non-paper, November 2019. See, also, Luis Garicano, Two proposals to resurrect the Banking Union: the Safe Portfolio Approach and SRB+, Paper prepared for ECB Conference on "Fiscal Policy and EMU Governance", Frankfurt, 19 December 2019.

– and, as such, these do not represent mere ad hoc measures or some form of legal and economic "bricolage", but, somehow, the beginning of a fundamental change in the design of EMU.

5 – Tentative Conclusions: Evolution or Transformation of the two initial policy principles of EMU?

5.1 – Keeping the extremely succinct nature of this analysis, as aforementioned, I purport at this point to reach some tentative conclusions, coming back to the two initial policy principles of EMU I have underlined at the beginning (infra, 3.1.), and trying to put into perspective their evolution and transformation.

As regards (i) the separation of monetary and fiscal authorities, pressing requirements of financial stability have led to a new interplay between those domains and to, I would daresay, a reinterpretation of the key monetary policy goal of price stability, based on its extensive reading.

This development and this extensive reading have been challenged in courts, especially at the German Constitutional Court, leading to fundamental rulings of the ECJ, namely the "Gauweiler" ruling[21](on the OMT program of the ECB) and the December 2018 "Weiss" ruling[22] on the ECB Public Sector Purchasing Program (which, differently from OMT program, has actually been implemented).

Again, the very limited purview of this analysis does not allow me here to go into the details of this last ruling but one passage of it deserves quoting. I refer here to paragraph 60 of the "Weiss" ruling, where the ECJ states unequivocally, referring to articles 127, 119, 130 TFEU, that (direct quote) "the authors of the Treaties did not intend to make an absolute separation between economic and monetary policies ( )."

We cannot be sure, at this stage, that the ECJ "Weiss" ruling will be the last chapter in this string of judicial challenges since, for instance, recently a group of German academics has tried to reopen Hearings in the Pending German Constitutional Court case, concerning the ECB Public Sector Purchasing Program, due to the recent ECB decision of resuming bond purchases for an indefinite period as from 1 November 2019 (procedurally anyhow this specific claim has been rejected by the Court). Anyhow, we have to wait for the final decision on this case by the German Constitutional Court[23], and, even this, in all probability, will not close the string of judicial controversies in Germany on this most sensitive domain.

5.2 - As regards the other initial policy principle of (ii) a distinction or separation between central or supranational monetary policy and financial supervision (and related functions) essentially at national level, such distinction has been blurred with a movement towards the supranational level – here not through extensive interpretation of legal goals, but through normative developments,

[21] "Gauweiler" ruling of the ECJ, of 16 June 2015, case C-62/14.

[22] "Weiss" ruling of the ECJ, of 11 December 2018, case C-493/17.

[23] I refer here to the pending ruling of the Bundesvertassungsgericht in the proceedings "Expanded Asset Purchase Programme of the European Central Bank", Reference: 2 BvR 859/15, 2 BvR 1651/15, 2 BvR 2006/15, 2 BvR 980/16, based on the oral hearing of 30 and 31 July 2019 - Second Senate of the Federal Constitutional Court (Bundesvertassungsgericht). As aforementioned, as per the date of its completion, this text considers developments occurring until 31 December 2019.

to the extent these have been allowed without Treaty Change, somehow overcoming the traditional *Meroni* doctrine or using, to the fullest extent, the normative bases consented by the Treaties, e.g., as regards the possibility originally envisaged to attribute prudential banking supervision functions to the ECB or the possibility of new international Treaties that do not conflict as such with the EMU provisions of the TFEU, as envisaged in the Pringle jurisprudence of the ECJ.

The key problems here are not so much judicial challenges, as it has been happening with non-conventional monetary policy measures (although there exists also relevant judicial developments in Germany[24]), but how to address issues of democratic legitimacy of the new institutional building of the Banking Union and related developments.

These developments imply the transfer to the EU of banking and resolution competences which were before close to the core of national fiscal sovereignty and subject, as such, to high standards of democratic accountability. This is a problem very much related with popular support of integration referred by President Trichet during this conference, but raising here other complex institutional and even constitutional *lato sensu* issues, which would require an extensive, dedicated *ex professo* analysis.

Another conference of Banco de Portugal, as timely as the one which originated this brief analysis in connection with the twentieth anniversary of the Euro, may well provide the opportunity for that much needed critical debate, focusing on the democratic accountability, or lack thereof, of the institutions that support both the Banking Union and the gradual building and consolidation of a much needed financial stabilization function of EMU.

[24] Notably with the 30 July 2019 ruling of the *Bundesvertassungsgericht* on the transfer of supervisory tasks to the ECB/SSM, which will not be specifically covered here.

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1 – Introduction

Good afternoon. First of all, I would like to thank Banco de Portugal, in the person of its Governor and of its Vice-Governor, who invited me to be here today. My warm greetings, of course, to all participants, my fellow panellists and the moderator, and to the distinguished guests.

This session is about the fundamental principles of the Monetary Union, in a conference that is celebrating the first twenty years of life of the euro. It is a celebration moment, yet we have heard quite a lot of complaining about many things; but I'm actually quite happy with the euro twenty years after. So perhaps I'm a bit more positive. I do acknowledge what's coming in the future, but we are alive, and these kinds of economic and financial crises are supposed to exist, and it could all be much worse, right? And this speech of "it could all be much worse", is something that we all have to keep in mind. And it´s difficult but it's why you are all here, to try to help. I'm here in the quality of a reasonably well-educated person, I believe; I'm not a macroeconomist but I do have some responsibility in education, and I think that's another aspect we should be discussing here today, together with the topic of the session.

Before I actually start, let me just say that my slides are a bit different from the other ones I've seen so far. I am doing something different, I am sharing with you a couple of pictures that I took with my students when we travelled to Frankfurt, to a place where they actually met the institutions in which important decisions are taken for all of us. That's something that's actually concerning in our society, which is the disconnection between the new generation and everything that's institutional. It's something we should think about in the future. And it's important, at some point, to promote some positive speech about the European project again and the construction we are making, despite the hiccups that we go through. They are normal, right? It's like the growing up pains; and, actually try to bring those people together and put them in a position in which they support the euro somehow. They are people from Europe and all kinds of nationalities that you can imagine. Just to explain that the slides won't really have any economic content except for the support for Europe.

To give you some guidance as to what I'll present, I will focus on the topic of the session and mix it with the general theme of the conference, which I have summarised as "The fundamental principles of the European Monetary Union 20 years on: The debut, the present and aspirations for the future".

Let's think about our twenty year journey chronologically and let's start with the debut.

[25] Transcript of the intervention. The supporting presentation is available at: https://www.bportugal.pt/sites/default/files/0202_sessao_2_clara_raposo.pdf

2 – The Debut

From the debut, the euro was never an easy currency to launch. This is mostly due to the heterogeneity that is present in the European Union countries and in the building of a monetary union without a fiscal or political equivalent.

In fact, we are far today still from discussing the feasibility of the completion of the monetary union that would also be complemented by a single fiscal policy, mutualisation of debt, establishment of a single labour market, and the creation of a political union that could provide accountability for those who would conduct such European policies.

From the start, then.

The European Economic and Monetary Union (EMU) is set around a set of principles, which were included in the Maastricht Treaty, interpreted by the European Union Court of Justice and by national courts. The core principles are well known, headed by price stability as the primary objective, the prohibition of monetary financing, the no bailout clause and the principle of independence of central banks that has been repeated again and again this morning, of the euro area Member States.

I do actually find it interesting (and I'm sorry if I bore you a little bit with this) to try to understand how the design of the monetary union was influenced by the developments of economic theory. Thinking about the early literature on optimal currency areas (OCA), we go back to Mundell's 1961 seminar paper, with the analysis of labour mobility and flexible wages and prices, and then cover many extensions on the degree of openness (McKinnon), fiscal integration (Kennen), and even political integration was already brought to the discussion in the literature in the 1970s (Tower and Willet). After the early days, many more contributions have been added with general equilibrium model efforts in the 1990s and with the analysis of asymmetric shocks and the identification of core countries (as in Bayouni and Eichengreen, 1992, among others).

So, the numerous papers produced in the 1990s revealed the richness of the topic and the different perspectives of analysis. And, despite dispersion of results, there seems to be sufficient evidence supporting the creation of a monetary union in Europe, with the aim of making it simpler and more efficient to develop the common market for goods, services, capital and financial assets. A political union project of peace, of course, has always been in the background.

It is also relevant to remind ourselves of the trends in macroeconomics in the 1980s, with the development of the new classical school, strengthening the relevance of inflation compared to output stabilisation in a setting of fully rational expectations. So, there was the belief that the Philips curve would be vertical in the long run and monetary policy would not have permanent effects on output, and the same would apply to nominal flexible exchange rates in terms of their effectiveness. Monetary policies could be effective in targeting inflation, though.

This vision had clear influence in the construction of the European monetary union with, what I would call, a minimalist design.

And we know today that this design has weaknesses. This became clear to all in the more recent crisis. Our union was designed without a mechanism that is triggered when a crisis arrives. There was no answer to liquidity squeezes and "sudden stops" in the sovereign debt market. There was no macro stabilisation function in place to deal with recessionary shocks and there was no union level macroprudential policy, nor micro supervision of the banking system.

We are nowadays much more aware of the relevance of the financial side of the economy, including the issues related to the existence of national sovereign debts that don't have national currencies and with largely exposed banking systems. These aspects have not been properly considered by the OCA theory, nor in the construction of the EMU, despite Goodhart's warnings in 1998.

This brings us to recent years and to the present.

3 – The Present

Knowing that the euro area in 1999 was far from being an OCA, many economists (and others) anticipated that the worst would happen as soon as the first asymmetric shock came.

Twenty years after, and against all odds, the euro proved to be more resistant than expected. And, indeed, asymmetric shocks came, and it has not been easy to address them. But we are still here, and the euro is still here.

Today, besides the original twelve members, the euro is the currency of seven more recent EU members, as well of the currency of the City of Vatican, Kosovo, Monaco, Montenegro and San Marino.

But, for the monetary union to overcome the acid test of the past decade crisis, many changes and reinterpretations have been made.

In 2011 and 2012, economists like De Grauwe (2011) and Buiter (2012) launched the appeal for the creation of a lender of last resort, in what they called a fragile euro area.

So, indeed during the recent crisis, the ECB resorted to less conventional policies, acting like a "normal central bank", intervening in open market operations. And only then signs of improvement in the economies really came.

Perhaps due to my background in financial economics I may tend to favour those who establish the connection between the depth of the crisis and a "financial shocks explanation", more so than due to competitiveness issues or excessive fiscal burdens, which I also understand play their roles. For example, looking at the ratios of public debt to GDP from 1999 to 2007, not all peripheral countries most hit by the crisis shared the same evolution of the levels of public debt (from as high as 107 percent in Greece to as low as 25 percent in Ireland, in 2007). Quite a few of these countries had actually experienced a reduction in the weight of public sector debt in their GDPs (like Ireland, Italy and Spain, and the euro area as a whole). And, contrary to this, actually, regarding private debt the increase was generalised (we had on average a 26.8 percent increase in private debt in the euro area in that period) – and banks in all countries exposed.

The monetary union has played a role also in the increase in private debt, with the lowering of interest rates early on in countries used to having high inflation and with the flows of credit from banks of core countries to banks in the periphery. This is free flows of capital and absence of banking regulation directly controlling credit, and then the sudden stop came in 2008.

Despite ECB's provision of liquidity after the credit crunch of 2009, both supply and demand for credit did not recover in the recession and Europe experience the double-dip of growth, that we also saw this morning, in the years 2012-2013. And the situation in Greece and how long it was taking to make decisions, as well as the fiscal consolidation all countries were trying to follow at the same time, both contributed to this outcome.

But, at the time, it was not so easy to assess the extent of the recession and perhaps the quantitative easing measures took longer than ideal to start. But it was all new territory.

And when we really think about it, in a way, our monetary union was born imperfect but has been able to adapt. If survival is a measure of success, then, on balance, the monetary union and the euro have been a success story so far, according to this definition.

But past performance, which finance professors like me well know, is no guarantee of future success. So, it is never too soon to think on what about comes next.

4 – Aspirations for the Future

Turning to the future, the euro's status of stable currency of reference is well established and redenomination risk is not mentioned around every corner. So, the euro has reached some degree of sustainability and adulthood.

Yet, the current circumstances we are living in raise special concerns that must be addressed. Let me enumerate the two challenges which we face nowadays that I find more pressing, not being a specialist in monetary policy:

- The climate of political instability associated with a revival of the danger of populist nationalism is something that we should be really concerned with. And this is actually, to me, surprising, in a union in which price stability has been the central objective of the ECB's mandate, also due to the historic memory of high inflation periods with the rise of populism (and ultimately war, which would be something that I would be much more concerned with than a financial crisis).
- The second concern that we have is the high indebtedness of some European countries, associated with the limited instruments that we have in macroeconomic policy, when many expect a possible downturn in the economy coming reasonably soon.

Such uncertain times, and before they become tougher, should be used for reforms in order to build the conditions for the creation of a stronger monetary union in which redenomination risk is only rarely discussed. So, what can the future bring then? I shall mention three priorities, like everyone else has:

a) Number one, I would say the priority is the completion of a banking union.

   It is essential to explore the creation of the European Deposit Insurance Scheme (EDIS) with its own backstop – and compared to the recent past, we have today, perhaps, a more optimistic outlook, after the German Finance Minister's declarations to the Financial Times last week. This scheme should be coupled with a public credit line to the single resolution fund, and the creation of some kind of European Safe Assets. I think we should discuss this. A Eurobond does not seem feasible, but maybe a tranched synthetic security based on national sovereign debt is. A European safe asset may well be the best solution for the home bias of national banks on their sovereign debts. Imposing limits of this kind of exposure to banks, as an alternative, could potentially create undesirable instability in the sovereign debt markets, too soon after the recent recovery.

   Of course, a European Deposit Insurance Scheme implies a transfer (or redistribution), and some countries fear that others could abuse. Yet, achieving banking stability should compensate for these eventual costs. And at the same time, banks in all countries are now subject to the same rules regarding supervision and resolution; and, finally, this would not necessarily have implications on a more general fiscal control in the EU or in the euro area.

   The existence of a safe asset in Europe could also contribute to development of the project of a Capital Markets Union. This, of course, would have stronger requirements than "just" a safe asset, such as convergence of corporate legislation, a single rule book on regulation of markets, and harmonisation of taxation on financial assets. Perhaps this capital markets union is still too far from our horizon, but needs to be discussed and could, in the end, lead to a Single European Securities Market Supervisor. The interest in such a strengthening of integration would lie in the potential for higher scale and liquidity in equity and debt markets, which could perhaps better foster economic growth and be a better exit for private equity or venture capital.

b) A second priority has to do with the concern we have with the weakness of national sovereign debts that lack their own currencies.

Politically, it seems unfeasible both to implement a solution like Euro bonds or a fiscal union that leads to some sort of political union. An alternative is having the ECB playing the role of a "normal central bank" (as defined by Eichengreen, 2018). In such a case, the central bank is allowed to pursue flexible inflation targeting and backstop financial markets, preventing self-fulfilling crises.

The fact that the European Court of Justice accepted the ECB's intervention as lender of last resort to banks and markets, opens way for future adoption of a similar policy. The ECB seems to be allowed to intervene in the sovereign bonds market.

In any case, clearer legal rules on this matter by euro area member countries would be helpful.

c) The third priority is the creation of a European level fiscal capacity, like we saw this morning, to complement the current existing policy instruments.

   This central fiscal policy capacity can only be useful if there is a mechanism for coordination of national fiscal policies, combining them with the Euro area fiscal policy, I'll say direction, not to say stance. A European level stabilization fund requires also our focus and an appropriate design that would ensure its effectiveness in periods of negative shocks so that public spending could generate higher multipliers when needed. Of course, concerns regarding moral hazard and asymmetries of usage across countries are unavoidable; yet, the system could be designed in a way to try to minimize such concerns by imposing rules of access based on country level fiscal discipline performance for example.

So, to conclude this point on aspirations for the future, a final word regarding the Growth and Stability Pact, on which there is a reasonable consensus on the need for a revision. In my view, though – at first sight, a revision to further densify rules is not welcome. In fact, most countries that had higher imbalances during the crisis period are now in the 3 percent budget deficit and with primary surplus. Another aspect to consider when revisiting the Stability and Growth Pact is the impact these rules have on political tensions, as we have seen in the case of Italy, which may support an argument towards attributing countries more responsibility for their fiscal policies as well.

I would like to conclude by acknowledging the many interesting and lively conversations I´ve had with a couple of colleagues, mainly the chairman of my school's board, Professor Vítor Constâncio and my colleague, Margarida Abreu, with whom I share this passion about the future of Europe and its unique project of peace and development.

5 – Concluding remarks

I hope and I believe Europe can move forward and actively contribute to a more sustainable strategy for us all and for the new generations, but demographics are probably the greatest challenge right now. The old continent needs the scale to still be influential and set the bar high for the humans of the twenty-second century. And, in the same way that Constâncio tends to end his interventions on this theme, my concluding words will also be Robert Mundell's from 1973, when I was still a child and Portugal a dictatorship, still far from the European community, and I cite:

"Can there be a transformation of attitudes in Europe? A shift away from the concept of competitive national interest and rivalry so destructive in the past?   It is time for Europe to wake up"

Thank you for your time.

Session 3: The geopolitical dimension of the euro

From left to right: Wolfgang Münchau, Carlos Moedas, Paul De Grauwe and Francisco Seixas da Costa.

Chair

- Francisco Seixas da Costa, Ambassador

Speakers

- Paul De Grauwe, European Institute, LSE
- Carlos Moedas, Former Commissioner Research, Science and Innovation, European Commission
- Wolfgang Münchau, Financial Times

Topics for the session

In the context of escalating trade policy tensions the global economy has become increasingly fragmented across institutional and economic dimensions. As a result the global outlook has become increasingly fragile and uncertain, undermining confidence and investment and weighing heavily on long-term growth. These frictions go beyond trade and seem to be also related with control over technology, energy sources and physical and digital connectivity. This session aims to discuss the role of EU and EMU as a world power and influencer over the last two decades and what should we aspire for the future.

Amongst the questions that may be addressed in the session we would suggest the following:

i) A lot of hope was placed in the political role and influence of the EU in the world when the Maastricht Treaty was signed. How do we assess the influence of EU as a major international player over the last 20 years?

ii) The EU is the most open trading bloc in the world. What are the risks that EU faces amid these China-US confrontation?

iii) What is the perspective of the evolution of the economic and political relations with Russia?

iv) Can the EU play a leading role in a world in search of a new anchor? How and in which dimensions (trade, defence, climate change, migration, social equity)?

v) Does EMU have the internal cohesiveness and conditions needed to support an increased geopolitical leading role? What are the conditions needed?

vi) What are the prospects for further political integration in EMU in the next decades? What are the conditions and triggers for further political integration?

Paul De Grauwe[26]

John Paulson Chairperson in European Political Economy, European Institute, London School of Economics and Political Science (LSE)

I would like to talk about the geopolitical dimension of the euro. So, let me start with observing that there was a striking contrast between the EU as a trading power and the EU as a monetary power.

The EU is a trading power, but not a monetary power, and what I want to do is to analyse why is this so and, what can be done about it?

Let me first focus on the EU as a trading power, why is that?

The EU sets rules and standards within the internal EU market and these rules are also applied in large parts of the world, many companies elsewhere want to take over these rules. They do this because the internal market is one of the largest markets in the world, so it's in the interest of these companies to do so. And in addition, there has been a full transfer of sovereignty of the power to make trade deals with the rest of the world, from member countries to the European Commission.

So, as a trading nation, we really speak with one voice. And so, it's a combination of these two things: size and one decision making power. This theme, we'll come back in my talk.

It has given the European Commissioner powerful and credible instruments to pursue the interests of the EU Member States and this power includes the power to retaliate against nations that harm the trade interest of the EU.

And let me give the example of the trade war today with the US. The Trump administration has started a trade war by bullying the EU, thinking that this would be sufficient to bring us down, and he's found out that bullying is not enough, and that the EU has strong and credible instrument of retaliation that will harm the US, and Trump politically. And he will probably retreat, as he has already done so with China. Because this is a war that he cannot win against an adversary who is strong, equally strong as the US in the trade field.

So, that is that is key. What about the euro?

There we have a big contrast, but the question is, can the euro be used as an instrument of European power? And what I'm going to do is to identify the conditions under which this can happen and I will distinguish between objective conditions that determine the capabilities to use power and then the political conditions that lead to the effective use of that power.

So, these are two different things that we have to keep in mind, we have to create capabilities to use power, and then we also have to effectively use that power. That does two things that I want to do. So, let me talk about this objective conditions and they relate to size.

[26] Transcript of the intervention. The supporting presentation is available at: https://www.bportugal.pt/sites/default/files/0301_sessao_3_paul_de_grauwe.pdf

Like in the case of trade, they relate to size. You have to be big, if you are not big, you are not taken seriously in the world. And here the EU in terms of size, when you look at GDP, it is also among the big countries. But that's not the case for financial sizes, Wolfgang also stressed this.

Financial size remains relatively small and lacks full integration. Just a few statistics, about outstanding equities and bonds. You find that the US, certainly in terms of the size of the bond market size of the equity market is significantly bigger than the euro area. Also, the use of the euro as international reserve, although significant, remains relatively small compared to the US. Here I show you the evolution of the use of the euro in global foreign exchange reserves. The US has gone down a little, but it's still significantly larger than the euro. So, what we find is that the euro is not used as a major medium of exchange outside the Eurozone.

I'm really talking about something different that is a payment system. What is lacking is a euro payment system outside the eurozone and that is not there precisely because the financial area of the eurozone remains relatively small and heterogeneous, which contrasts with the dollar which is backed by a huge financial area that has made it possible to create a dollar based worldwide payment system. So we have here a big difference, which is the financial side, the integration of finance that has made it possible to create a payment system outside the US. These objective factors are missing, so the capabilities to exert power are not there. The euro stick is a small one. You know what Roosevelt said about using sticks? "Speak softly and carry a big stick", so our stick is small. The euro stick is a small one compared to the dollar stick, which can be used by America as an instrument of power.

But now, what I'm going to do, is to ask the following questions. Suppose these objective factors were there. We had the capabilities. Suppose we had moved forward in terms of financial integration. Could the euro be used as an instrument of world power by Europe? I now arrive at the political dimension.

Even if the euro was a big stick, it could not be used as an instrument of world power, mainly because of the absence of a common foreign policy, as Wolfgang also has already mentioned. Foreign policy remains firmly in the hands of Member States. There has been very little transfer of sovereignty in that area and Member States have their own foreign policy objectives. So, the euro cannot be used easily to exert power in the rest of the world because there is an absence off a common objective. What would be the use of the euro on the world scene?

Well, the French, the Germans, the Italians would give a different answer to that question and therefore it would not be used. Contrast again with the US, where these two conditions of capabilities and a unified decision making process are present. As a result, there is a capacity to use that power, as was shown recently, when the US excluded some countries from the use of its payment system quite a significant use of the monetary power.

I conclude from this that the Eurozone lacks the financial size that creates the capabilities to exert power in the world. But it also lacks the political unity needed to formulate a common foreign policy objective.

So, to conclude I'm asking the question, what has to happen to change this or to put differently, how to create the world money in the sense of a medium of exchange that you can use as an instrument of power?

And again, the two same factors arise here: size, that determines capabilities and, political unity that allows to pursue common foreign policies. To increase financial, what matters is to integrate capital markets; a capital markets union. Banking union is also key, and all this is very much unfinished. In banking union, we have made steps forward, but it's still unfinished business.

There also has to be a perception that euro is here to stay indefinitely. This has been given a serious dent when the sovereign debt crisis erupted. Here let me add something that I don't think is truly solved.

There is the existential question of the euro: will it be there in 50 years? It's not evident. You can take it that US will still be there in 50 years, but will, the euro be there in 50 years? Well, we don't have the same kind of certainty about this, of course, you're never certain about what's going to happen in 50 years. Some tail risks might arise, so that even the whole planet somehow is destroyed, but I don't want to go into these issues here.

But it has to do with the fact that the euro area remains fragile. We have unified money, but not a union of budgets. And, as a result, with each serious recession, investors will look around into these bond markets and try to identify the weak chain, move out the capital from one country to be invested elsewhere, thereby creating a crisis as we have seen in the past. And are we ready to deal with that? That is still a problem that creates some uncertainty and that we have to keep in mind and be sure that we can solve this.

One issue that I was thinking about is the following: Why is it that we have not been willing to create the conditions to achieve a large and unified financial area, banking union, capital market union, in the same way as we have been willing to do that in the trade area?

It would have been possible to create a financial size necessary to create a euro that has geopolitical clout. And so, the reason why we haven't done that, it's a little bit puzzling for me. We have done it in the trade field, but not in finance. Probably this has something to do with the fact that the benefits of creating a unified financial area, are not perceived as strong enough compared to the benefits of a common trade policy.

When you ask an economist about what are the benefits of trade, there will be almost unanimity that free trade will increase welfare. When you ask them: is financial integration going to increase welfare? There is not the same kind of consensus. Let me tell you why. Think of the capital markets union; it's clear that capital markets union has a potential to create great benefits, Mr Trichet mentioned it and I don't have to go into detail. It is a potential to create a lot of benefits: firms will have access to better finance, also there will be a better insurance mechanism against asymmetric shocks.

But, at the same time, a capital market union in times of crisis actually may increase the fragility of the system because it will make it possible for capital to flow even faster and in larger size from one country to the other. If we don't deal with these issues that I was talking about earlier, that is if we maintain national sovereignties in the field of budgetary policies, imposing a capital market union may actually destabilise the Eurozone in times of crisis. This is something that we have to be aware. It may also explain why we have not been willing to go all the way towards unification as we have done with trade policy.

There's another little paradox here that I want to mention, and that has to do with what Giscard d'Estaing, called "le privilège exorbitant" of the dollar. The paradox is that we have been complaining about this exorbitant privilege that US dollar has, and we have not pursued policies that would create an exorbitant privilege for the euro.

Why didn't we do it? I guess it has to do with what I mentioned earlier. There is no consensus about the welfare gains of financial integration as compared to the consensus about the welfare gains of trade integration. This might have been the reason why we have not created the capabilities. The only way to do so is to integrate further.

What about the political condition? Here again, the key point that I mentioned earlier is the absence of a common foreign policy, and this can only be achieved in the context of political union. This implies the creation of an EMU government embedded in a parliamentary system that has to give legitimacy to this government. That is going to be key if we want to have a euro as a geopolitical instrument. I think you have to add here that the capacity to pursue a common foreign policy is linked to the capacity to exert military power. Without military power, you cannot exert a foreign policy.

Soft power is limited. Therefore, for the euro to become an instrument of power, we will have to create a vehicle of EMU power that is absent today.

To do that, we will need massive transfer of sovereignty from nation states to the European level. We did manage to transfer sovereignty to the European Commission to pursue a common trade agenda.

Why this difference again? I think that in the trade area, as I said earlier, it was this perception that this would create strong welfare gains. We were willing to transfer sovereignty because there was a perception we would be better off doing this. Also, there was a perception that this was a technical matter. Of course, there's a political dimension to this, but it was much more seen as a technical matter; a contract that governments have with the European Commission and that can ultimately be revoked. That's the key fact, because the sovereign nations remain there. They've made a contract with the European Commission: please go out and make trade deals in the world but understand that this contract could be revoked.

Contrast that with the transfer of sovereignty in the field of foreign policy and military affairs. Such a transfer touches upon the existence of the nation state itself. It's much more part of the nation state, and it has also a permanent feature. Once you transfer your military power, say, from France to a European institution: there you are, France you have lost your sovereignty permanently.

That's not the case with trade policy, where you can always say, "The hell, we do it on our own". Once you have transferred the military power, it's finished because then Europe can actually invade France if they don't want to obey the order. This kind of transfer of sovereignty is much more intrusive, and explains why we have not been able to move forward.

Conclusion: It will take a long time for the euro to become an instrument of European power on the world scene. But nothing is impossible. And as Jean-Claude reminded us this morning, it took the US 200 years to achieve its unity which made it possible to exert monetary and other power in the world.

Thank you for your attention.

Carlos Moedas[27]

Former Commissioner Research, Science and Innovation, European Commission

Thank you for the invitation. Thank you so much Governor.

You know, it's very rare to have two commissioners in the same room and almost impossible to have two from the same nationality. But today that is exactly the case. Elisa: I'm very happy to be with you here today, and of course with this great panel.

I thought about making three points in this introduction about the geopolitics of the euro.

And, in the first one, I want to be a little bit provocative for people that love economics like we do. The Euro is a political project. It is not about economics or finance. Economists look at the flaws as if the project was about economics. There are flaws because it's a political project.

President Draghi on his farewell speech, basically said the euro found its economic justification in the eighties with a poor state of the economy. The poor state of the economy was the justification needed for an amazing political project. In reality, if you want to have a single market you need a single currency and politicians at the time understood that very well. The only way was to create a single currency.

For the single market to work you need a currency, if not, you would be in constant competitive devaluations. And we know where those competitive devaluation get us. But some could say that we could avoid a single currency by creating a fixed exchange rate. But reality is that it doesn't work because capital is mobile across borders.

So, I think that sometimes when people criticize the euro and criticized the project, they go on to the angle of the fact that is about economics and it is not, is really political.

The second point that I wanted to make is much more on my field of engineering. If you think about the digital world of today, what are the two most important words?

I think they are speed and scale. And my question is how could we, as Europeans, achieve that speed and scale without a single currency? I think that we can achieve scale without a single currency, but the speed of achieving that would be totally different and by the way, being myself in the intersection of engineering and economics, I think one of the worst enemies of innovation is competitive devaluation.

That's what always happened in this country, right? In the eighties and nineties. You would get in a problem, you just devalue and you don't need to be more competitive. So, you basically have this enemy of innovation, which is competitive devaluation.

And so, I think that if you look into the future, that future would be very difficult in a scenario that we're not together. Especially when you look at the scale of Europe. Today we're 7% of the population. I mean, we are really small. Look at Germany: what is Germany in the scope of the whole world? It is nothing, it's a very small country.

[27] Transcript of the intervention.

And third, more on a personal experience of mine during these five years, one of things I really liked to do was to talk to people that want to criticize Europe. If not, you really go into the bubble of Brussels and everybody's pro-European and that's great, but it's not challenging. So, I went into different places to talk to people that are anti-Europeans.

I remember being in Singapore, and we went into the car of the European Commission. It was at the end of the mission. So, I was about to go to the airport, and decided to visit one of their beautiful museums. That was very nice but we met at the entrance five or six Dutch people there and, when they saw the little flag of the European Union they came to me and said: "You're spending our money. You're spending the money of Europe" I said: "Look, I've been working for 48 hours nonstop and I'm going to the airport. But let me tell you why your country is big because of Europe. You come from a country small in size. Let me tell you how a world where the Netherlands would be alone would not allow you to be here on vacation. Let me tell you why they accept euros here at the museum but would never accept a local currency of a country the size of yours". And they said: "We don't like Europe but we love the euro."

And I think that the euro was the Project. It's something that people really love. And when you look at the past five years, makes me think when we started with Mr Tsipras in Greece, he went into the elections. He won the election, then he went into the referendum and did a U-turn, a huge U-turn after the referendum.

And you ask why? Is it because it changed his idea?

And if you're going to the historical side of it and we look at the polls at the time, it was interesting to see that 75% of the Greeks, at the time, wanted to stay in the euro. Whatever it takes.

And so, Mr Tsipras understood that he had 75% of the people in the country that actually were upset with the austerity. They were upset with the European Project but not with the Euro. I'm not saying they were not upset, but they were definitely not willing to leave the euro.

So, my message to you today is political. The Euro has been a great success.

Wolfgang Münchau[28]

Associate Editor, Financial Times

I would like to talk about an aspect which I think might be different from what my co-discussants are going to focus on and, it is the foreign policy aspects of the euro.

The idea of using a currency as a foreign policy instrument is quite new. The Americans, more than anyone, have used economic power to levy sanctions and that had a mixed record, there were some successes. Sanctions against Iran have very long records dating back through the 1970's with Jimmy Carter, and later Ronald Reagan, Clinton.

The Bush administration then reverted to very classic diplomacy, but it was not until Obama that they discovered that they could actively use the dollar as an instrument. The realization wasn't that it happened before, it was that the foreign policy folk realised that that all dollar transactions, whether it takes place in America or abroad, all clears through the American system. They all clear in the territory of the United States and that gave them the idea that they could impose sanctions, including secondary sanctions, on financial institutions they were doing business with. So, they had an instrument not only to stop American companies from exporting certain instruments, but they also had instruments to stop a European bank from funding operations that America found undesirable. That was a new instrument that they suddenly discovered.

Now, the Obama administration, from a European perspective, was very responsible in the way they used the instrument. If we looked at the long negotiations leading to the Iran nuclear deal the Americans, the Obama administration, had imposed sanctions on Iran in 2010 and the Europeans had imposed sanctions, there were long negotiations taking place in 2014 and 2015 culminating in the deal. Obama and the Congress then renounced the sanctions in 2016 together with the Europeans. If you look at Russia's annexation of Ukraine, we've had a very similar synchronized attempt. There were differences and nuances between the American and European positions, but we moved in tandem.

Now it wasn't until the Trump Administration that these sanctions were used against Europeans for the first time. When America pulled out of the Iran nuclear deal it resulted in post-secondary sanctions on European companies, and it was quite interesting to watch how unprepared the Europeans were.

I remember the German foreign minister immediately saying "We're going to use the SWIFT system to block this" and not realizing that the SWIFT, even though it was based on a European country, was not under the orders of any European government. Then the next step in the European response was to set up a special purpose vehicle to fund European companies that were doing business with Iran. I was thinking of the kind of companies that would use it and the only type of company that I could come up with were carpet traders, carpet importers, who didn't do business in America but who were doing business with Iran and only in euros.

That was the only one. But still, to my knowledge, no money has been given to this thing. But one has to say it's a new instrument and the EU is ideally placed for it because the EU is unlikely to be a hard power foreign policy actor. We are not, we're trying to improve our defence cooperation but it's a long way down the road until we are effective. But we have those instruments, we have

[28] Transcript of the intervention.

the Euro, we have competition policy, we have trade policies, these are instruments that could be used in a soft power diplomacy and that could be hardened.

Now, what is lacking to turn the euro into a foreign policy instrument? Why are we not there yet and why are the Americans ahead of us? There are basically two reasons. One is the mentality of foreign policy people. I used to attend a seminar many years ago called the "Königswinter conference", where British and Germans always meet once a year and it set a very typical thing of what is going wrong there.

There were two groups, one was a foreign policy group and the other was an economics group. The foreign policy people went into one room and the economists went into the other room. They would then talk among them about problems. The economists talked about various economic issues mostly about the euro as an economic thing and the foreign policy people talked about the bigger things. And then, they would then come together with a reporter and they had to talk with each other, and they would all pretend to be interested and then they walked away. There was virtually no overlap in the interest, they were completely separate, and that is still the case today.

In the last decade, the Council of Foreign Relations, a big American think tank, established an economics job. There was somebody, an economist who was actually thinking about how to use economics in the foreign policy setting. When the European set up its equivalent, the European Council of Foreign Relations, of which I'm a member, I suggested that they do the same thing, but there was no interest in that at all, not in the beginning. Later, they recruited some economists, and there was some economic thinking, but not anywhere near to the same degree of trying to develop some sort of foreign policy strategy based on the currency. To this day, that still hasn't happened.

So, the first thing we need to do is educate foreign policy diplomats in the use of economic instruments and that hasn't happened yet. The second thing that is missing, and perhaps the more serious thing, is the following: we need a capital markets union and a legal framework behind it, because in America the President has the right to basically ban companies from acting, we don't. Who would actually make that decision in Europe? We don't have a set up for this. It's clearly not the job of the central bank, the ECOFIN would also not be right. The European Council could potentially do this but even they don't have the legal instruments to do this and we haven't got the political readiness to say to an American company that unless you follow our policy, you will not be able to transact in Europe, which is what Americans do to us.

So, we haven't got the level of confidence yet that the Americans with the Trump administration have developed. But from a technical point of view, a deeply integrated capital market is absolutely essential. Now it is essential for so many other things as well. We've looked at a fiscal union, Mario Draghi was talking about the fiscal union with a debt instrument with macroeconomic stabilization function, it is important for financial stability, for economic well-being, for welfare. It is not quite sufficient, but it is essential.

Capital markets union is absolutely essential for this to happen and as a reform, that would be my suggestion as a first step. It's a long way until we get to this point, but there is a real opportunity for the Europeans to do this because we've got the stuff, we can do this, and the world is kind of moving into our favour. We're moving away from a period where we confront each other militarily, but we use sophisticated economic tools and industrial policies. If you look at China, haven't discussed China at this point, but here is another case of how do we use our powers or whether we'll allow the other party to play us off against each other, which the Chinese seem to be doing now.

Closing Remarks

Luís Máximo dos Santos

Vice-Governor, Banco de Portugal

Luís Máximo dos Santos, Vice-Governor, Banco de Portugal

I. Twenty years ago we launched an unprecedented, historic experiment. Eleven free and sovereign nations, including Portugal, democratically decided – after checking compliance with the criteria set out in the Maastricht Treaty – to share monetary sovereignty, and exercise it jointly.

It is true that history has witnessed several monetary integration processes (and also some disintegration processes, by the way). But none have been quite like the creation of the euro, given its nature and complexity. Indeed, never before has such a vast and heterogeneous group of nations, in terms of both economic and social development and their history and institutions, decided willingly and in peacetime to live together under a monetary union.

The step taken 20 years ago, pursuant to the provisions set out in the Maastricht Treaty, stemmed from the political ability to seize on the historical opportunity which then arose and was fully consistent with the need to complete the internal market and affirm Europe's position in the face of globalisation.

But this was not at all an impulse driven by circumstance. On the contrary, it fulfilled a long-sought (but not always explicit) goal of the European integration process and was the result of a long journey, full of breakthroughs and setbacks, which continued a gradual monetary integration process. The clearest example of this is the European Monetary System, created in 1979.

Regardless of how we assess its rationale and results, it is appropriate to state that the creation of the euro was one of the boldest acts of economic and political proactivity ever performed and, for that very reason, has led us, to some extent, into uncharted territory. This gives us a precise idea of how fundamental it is to take the necessary measures to ensure that the European monetary unification is successful in the long term.

II. Despite structural shortcomings in the Economic and Monetary Union (EMU) project, which were far more serious in its initial version (and which have been discussed here today in part), it is important to emphasise 20 years on that:

i) The number of euro area member countries has increased from the 11 founding members to the current 19 members;

ii) Despite all these challenges, we have managed to overcome the existential threat hovering over the euro area in the wake of the global financial crisis, particularly from 2010 onwards;

iii) We managed to enhance the coordination of the Member States' economic and fiscal policies;

iv) We managed to establish the Banking Union, although it is still incomplete;

v) We are working towards a capital market union;

vi) Data for the June 2019 Eurobarometer indicate that 76% of euro area citizens support the single currency, which, as Jean-Claude Trichet, former President of the ECB, has told us, has not been sufficiently highlighted.

As such, we now undeniably have a more consistent overall operating framework for the EMU.

However, as several speakers at this Conference have already noted, the progress we have made so far, although impressive, is still not enough.

Approximately 20 years ago, I wrote that:

"the debut of the euro went very well, but a happy ending is yet to be secured".

In my opinion, this statement remains valid.

In fact, a great deal of progress in the EMU is still needed to achieve adequate robustness, particularly against a backdrop of serious economic crisis.

Most notably, it is key that we complete the Banking Union, given that a common deposit guarantee scheme will bring it some much needed coherence, which is a prerequisite for benefiting fully from its advantages.

This, however, is still not enough on its own. In my view, is even more important to equip the European Union with a budgetary tool enabling it to deal with asymmetric shocks that uses the automatic stabiliser approach. As pointed out earlier here today, it is also necessary to better reconcile centralised monetary policy with the Member States' fiscal policies.

The EMU is not an end in itself, but rather one of the means used by the European Union to achieve, pursuant to Article 3(3) of the Treaty on European Union, the "sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment".

Deepening the EMU is no longer an option: it is an imperative.
Future generations will not think well of us if, after launching such a pivotal process, it becomes apparent that we were not competent and brave enough to take the necessary measures to make it viable in the long term and to optimise its advantages.

In fact, despite its positive developments, albeit too slow and not always consistent, a sense of distrust still permeates the European integration process, of which the EMU is a cornerstone.

The causes of this phenomenon extend well beyond economics, into a political and cultural domain of great complexity, which is too large to explore here.

But it will always be said that 20 years ago the European ideal was pushing forward, and the EMU project, inherently novel and bold, had the charm and vitality of a benevolent utopia.

As time went by, due to of developments anchored in very heterogeneous factors, it turned inwards, became self-satisfied with real and imaginary feats, became somewhat narrow in its outlook, was unable to convince people of its true merits, turned a deaf ear to relevant criticism, and set itself adrift from the public.

However, this path is being inverted.

The European Monetary Union has proved itself able to withstand all this (although, at great cost, it is true to say), because the underlying vision is sound, its failure would bring unimaginable costs, and it has still been possible to a degree to reform its mechanisms.

The EMU's success is vital for Europe in the context of globalisation, and only with the euro can we aspire to succeed both at domestic and global level.

It has become commonplace to state that Mario Draghi, as President of the ECB, declared in 2012 that "the ECB is ready to do whatever it takes to preserve the euro", and added that this would be enough.

However, it has been less emphasised that this statement, which is generally considered to have been a key determinant for the subsequent course of events, was not issued by the president of one the classical EU institutions but that of a still recent institution, albeit one with particular responsibilities in this field and effective tools to act. It should also be noted that it was not issued by a political leader of one of the most powerful EU Member States, which also provides food for thought.

In his famous speech in 1962, the President of the USA, John F. Kennedy, said that we chose to go to the Moon "not because [it is] easy, but because [it is] hard". Successfully deepening the EMU is not quite as hard as going to the Moon, but it undoubtedly takes courage and clear-mindedness to take difficult and necessary decisions.

III. 2019 has seen many significant anniversaries: this includes, for instance, the 100th anniversary of the International Labour Organization, the 75th anniversary of the Bretton Woods Conference, the 25th anniversary of the end of the Uruguay Round negotiations, which led to the creation of the World Trade Organization and, of course, the 20th anniversary of the euro, the theme of today.

These are all very different events, but with one common feature: the idea that cooperation and international economic integration are positive tools to further the well-being of the population, and the firm belief that an international order where law prevails over brute force is invaluable to peaceful coexistence.

> By marking the 20th anniversary of the euro with this Conference, Banco de Portugal, an active player in the EMU creation process from its very beginning, wanted to use a key date for us collectively to encourage a no-taboos debate, to assess how far we have come and the challenges which lie ahead.

The first panel focused on the difficult, crucial issue of interconnecting a centralised monetary policy with merely harmonised fiscal policies.

The second panel revisited the core principles established in the Treaties and how they were implemented.

The third panel highlighted the geopolitical consequences of the euro, which is in line with one of key goals behind its creation to "build a European monetary identity", most notably by lessening dependence on the US dollar.

The consequences of the creation of the euro extend well beyond the European Union's borders. Whichever perspective one takes, this is a major event of world history, first and foremost due to its repercussions in international monetary and economic relations as well as in geopolitical terms and, for this very reason, we have decided to assess the past 20 years also from that standpoint.

As this event is now coming to a close, I think it is fair to say that we have fully achieved the purposes of this Conference.

Annex

Curriculum vitaes

Carlos da Silva Costa

Governor

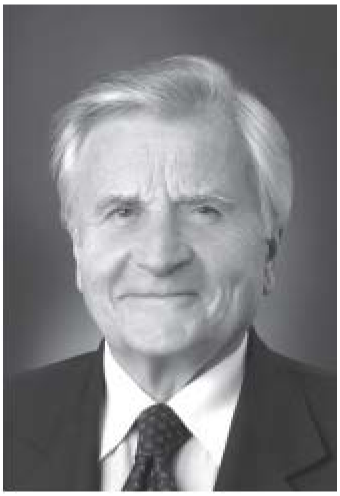
Governor since 7 June 2010.

He is a member of the Governing Council and of the General Council of the European Central Bank, of the General Board of the European Systemic Risk Board and of the Financial Stability Board Regional Consultative Group for Europe. He is the Chairman of the National Council of Financial Supervisors.

From October 2006 to May 2010 he was Vice-President of the European Investment Bank (EIB), with responsibility for EIB funding and for EIB financing operations in Portugal, Spain, Belgium, Luxembourg, Latin America and Asia.

From 2000-2006, he was Executive Director of Caixa Geral de Depósitos (2004-2006) and General Manager of Millennium BCP (2000-2004).

From 1993 to 1999 he was Head of Cabinet of European Commissioner João de Deus Pinheiro, with responsibility in "Communication, Culture and Audiovisual" policies (1993-1994) and the EU cooperation policy with Africa, the Caribbean and the Pacific (1995-1999). He was Coordinator of the Economic and Financial Affairs Department in the Portuguese Permanent Representation to the European Union and member of the EU Economic Policy Committee (1986-1992).



Jean-Claude Trichet

Keynote lecture

Jean-Claude Trichet is presently Chairman of the Board of Directors of Bruegel Institute (Brussels) and European Chairman of the Trilateral Commission.

Jean-Claude Trichet is a member of the "Institut de France" (Académie des Sciences Morales et Politiques). He is honorary chairman of the Group of Thirty (Washington). He was a member of the Eminent Persons Group on Global Financial Governance (EPG), set up in 2017 by the G20 Finance Ministers and Governors, which published its report in 2018.

Jean-Claude Trichet was President of the European Central Bank (2003-2011). He was Governor of Banque de France (1993-2003) and Undersecretary of the French Treasury (1987- 1993). He was President of the Paris Club (debt rescheduling) (1985-1993), President of the European Monetary Committee (1992-1993), President of the Group of 10 Central Banks Governors and President of the Global economy meeting in Basel (2002-2011). He was President of SOGEPA (Société de Gestion des Participations Aéronautiques) (2012-2013) and Director of Airbus Group (2012-2018). He was named "Person of the Year" by the Financial Times in 2007 and n° 5 of the "World Most Powerful" in the Newsweek list (2008).

Mr. Trichet is a graduate of the Ecole nationale supérieure des Mines de Nancy, of the Institut d'Études Politiques de Paris, of the Université de Paris (in Economics) and of the École Nationale d'Administration. Jean-Claude Trichet has been awarded honorary doctorates by several universities.

Nuno Alves

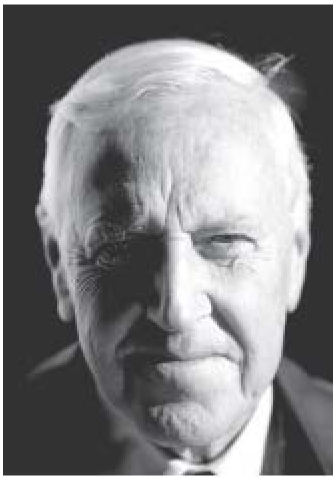
Chair Session 1

Nuno Alves is Head of the Economics and Research Department at Banco de Portugal.

He has been an economist at Banco de Portugal since 1995. He was Head of the Monetary Policy Division in 2005. From 2006 to 2018 he was Deputy Head of the Economics and Research Department. He was appointed Head of the Economics and Research Department in October 2018. He has been a member of the Monetary Policy Committee of the Eurosystem since 2006.

Nuno Alves has an Economics Degree from the School of Economics and Management of the University of Porto and holds a PhD in Economics from Nova School of Business and Economics. He has been an Assistant Professor at Católica Lisbon School of Business & Economics since 2014.

He has publications in journals such as Journal of Macroeconomics, Applied Economics and Applied Economics Letters. His research interests are monetary policy, inequality and poverty.



Niels Thygesen

Panellist Session 1

Niels Thygesen is Professor Emeritus of International Economics at the University of Copenhagen. After working for the Danish Government, Harvard University (as Advisor to the Treasury of Malaysia), and the OECD as Head of Monetary Studies, in Paris. Former adviser to the Governor of Denmark's Nationalbank until 1983 and Joint Chairman of the Danish Economic Council. He chaired the Danish Economic Society 1974-9 and is now Honorary Fellow.

Most of his research over the past five decades has been in the area of European monetary and financial integration. He participated in a number of European Working Groups in the 1970s and 80s. Mr Thygesen was nominated by the European Council as the only independent academic member of the so-called Delors Committee, which prepared the first full outline of Economic and Monetary Union in Europe in 1988-89.

He advised the governments of Denmark and Sweden on crisis policies in the 1990s and was nominated by the International Monetary Fund (IMF) Executive Board as member of a panel of independent experts to evaluate the effectiveness of IMF surveillance in the Asian crisis in 1998-9. Over 2000-9 he chaired the Economic and Development Review Committee (EDRC) of the OECD. Since 2016 he has been Chair of the European Fiscal Board, with a mandate to advise the European Commission (until 2022).

Niels Thygesen was President of Société Universitaire Européenne de Recherches Financières (SUERF) 1988-91; he was a Founder member of the European Shadow Financial Regulatory Committee (ESFRC), of the Euro50 Group (Paris, since 1999), and a member of the Advisory Board for the Official Monetary and Financial Institutions Forum (London, since 2010). He has been Advisor to the President of the Institute for New Economic Thinking (INET) and Chair of the INET Center, University of Copenhagen.

Nazaré da Costa Cabral

Panellist Session 1

Graduated in Law (1994) from the Faculty of Law of Universidade de Lisboa and in Economics (2015) from Nova SBE - School of Business & Economics. She has a master's degree (1998) and a PhD (2007) in Law also from the Faculty of Law of Universidade de Lisboa. She has been a teacher at several Portuguese and foreign universities, working as a researcher with several articles and books published, mainly in the areas of public finance, public budgeting and social security.

Between 1997 and 2002 and between 2005 and 2007, she worked as a legal advisor and consultant for government offices in the areas of Labour and Social Security. During this period, she was also a member of several working groups that revised legal diplomas in the field of social security. In 2015 and 2016, she was part of the project "National feasibility assessment of the different European unemployment benefit schemes options", of the consortium led by the Centre for European Policy Studies (CEPS), in charge of assessing the conditions and feasibility of creating a European-wide unemployment subsidy. More recently, in 2018, she was a member of the High Level Group of experts on pensions and an expert on the European MoveS project (a network of independent experts in the fields of free movement of workers (FMW)) and social security coordination), in a consortium led by EFTHEIA with the European Commission.

Eduardo Paz Ferreira

Panellist Session 1

Eduardo Paz Ferreira holds a PhD in Law and is a Professor at the Faculty of Law of Universidade de Lisboa and the dean of his scientific group.

He is a Member of the Scientific Committee of the Faculty and of the General Council of Universidade de Lisboa.

He chairs the Institute for Economic, Financial and Tax Law and the European Institute of the Faculty of Law of the University of Lisbon (IDEFF); he also coordinates the Centre for Research in European, Economic, Financial and Tax Law (CIDEEFF) and is the editor of the magazine Revista de Finanças Públicas e Direito Financeiro.

Eduardo Paz Ferreira was awarded a Jean Monnet Chair in EU economics by the European Commission.

He is a member of the Academia de Ciências and chaired the Associação Fiscal Portuguesa for two terms. He chaired the Audit Board of Caixa Geral de Depósitos (CGD) and was non-executive member of the Board of Directors. A committed Europeanist, despite his criticism of several decisions, he accompanied Portugal's application for accession to the European Community in 1977.

Eduardo Paz Ferreira has published multiple works and organised various conferences. Among his books, are: União Económica e Monetária - Um Guia de Estudo, Quid Juris, 1999; Valores e Interesses - Desenvolvimento Económico e Política Comunitária de Cooperação, Almedina, 2004. 25 Anos na União Europeia, 125 Reflexões, Almedina, 2011; Crónicas de Anos de Chumbo 2008-2013, Edições 70, 2013; Da Europa de Schuman à Não Europa de Merkel, Quetzal, 2014; União Europeia. Reforma ou Declínio, Nova Vega, 2016; Por uma Sociedade Decente, Marcador, 2016; Os Anos Trump. O Mundo em Transe, Gradiva, 2018; Integração e Direito Económico Europeu, AAFDL, 2018.

Pedro Machado

Chair Session 2

Pedro Machado is Head of Legal Services and Chief Legal Counsel at Banco de Portugal.

He has been working for more than 18 years in financial regulation and supervision. From August 2001 to August 2006 he worked as Principal Legal Counsel at the European Central Bank, and from September 2006 to June 2011 at Banco de Portugal, where he was appointed member of the Legal Committee of the European System of Central Banks (LEGCO). From July 2011 to June 2013, he was Chief of Staff of the Minister of Finance. From July 2013 to December 2014, he was Deputy Head of the Prudential Supervision Department of Banco de Portugal. From January 2015 to August 2017, he became Financial Services Risk & Regulation at PwC Portugal. Upon his return to Banco de Portugal in September 2017, he was appointed Head of Legal Services and Chief Legal Counsel.

From 2012 to 2015, Pedro Machado served as a non-resident member of the Board of Directors of the European Investment Bank.

Pedro Machado holds a Law Degree from the Faculty of Law of Universidade de Lisboa and undertook post-graduate studies in European Law at the European University Institute (Florence).

Peter Praet

Panellist Session 2

Peter Praet joined the European Central Bank (ECB) as Member of the Executive Board in 2011 and retired in June 2019. He was responsible for the Directorate General Economics.

Mr Praet gained a PhD. in Economics from the Université Libre de Bruxelles in 1980. He was an Economist at the International Monetary Fund (IMF) from 1978 to 1980, Professor of Economics at the Université Libre de Bruxelles from 1980 to 1987, Chief Economist of Générale de Banque and Fortis Bank from 1988 to 1999 and Chief of staff for the Belgian Minister of Finance from 1999 to 2000.

Before joining the ECB, he was Executive Director of the Nationale Bank van België/ Banque Nationale de Belgique from 2000 to 2011. Mr Praet was responsible for International Cooperation, Financial Stability and Oversight of Financial Infrastructures and Payments Systems. Between 2002 and 2011 he was also a member of the Management Committee of the Belgian Banking, Financial and Insurance Commission, where he was responsible for prudential policy for banking and insurance.

Mr Praet served on several high-level international bodies, including the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the Committee on the Global Financial System and the European Banking Authority. He was First Alternate of the Board of Directors of the Bank for International Settlements from 2000 to 2011.

Luís Silva Morais

Panellist Session 2

Luís Silva Morais is Associate (tenured) Professor at the University of Lisbon School of Law (FDL). Founder and Chairman of the Research Centre on Regulation and Supervision of the Financial Sector (CIRSF), in association with his Jean Monnet Chair and Jean Monnet Programs, which he coordinates in scientific partnership with Banco de Portugal, the Portuguese Securities Market Commission (CMVM), the Portuguese Insurance and Pension Funds Supervisory Authority (ASF), and also with the European Banking Institute in Frankfurt.

Mr Silva Morais is Vice-Chair of the Appeal Panel of the Single Resolution Board and Chairman of the Supervisory Committee of the Portuguese Insurance and Pension Funds Supervisory Authority (ASF). Attorney-at-law and founding partner of Luís Silva Morais/Sérgio Gonçalves do Cabo & Associados, rl, Sociedade de Advogados, specialising in EU law, financial sector regulation, competition law, economic law and economic regulation in general.

He has represented the Portuguese Republic in several proceedings before the Court of Justice of the European Union (Luxembourg). Among other institutional and professional affiliations, he was an executive member of the Management Board of the Portuguese Insurance and Pension Funds Supervisory Authority (at the time, Instituto de Seguros de Portugal) from 1998 to 2001); Member of the Economic and Financial Council of the Ministry of Finance from 2001 to 2011 (as Vice-President of the Special Unit for Privatisation of State-Owned Companies) and Chief of Staff of the Secretary of State for Treasury and Finance (XIII Constitutional Government of Portugal – 1996-1998).

He regularly publishes on financial regulation, European law and competition law. Mr Silva Morais's page on the Social Science Research Network (SSRN) is available at http://ssrn.com/author=1644131.

Clara Raposo

Panellist Session 2

Clara Raposo is an economist and holds a PhD in Finance. She is the dean of ISEG Lisbon School of Economics and Management of Universidade de Lisboa, where she works as full professor of Finance in the Business Management Department since 2010. She was in charge of the Finance scientific area of the Business Management Department, and coordinated the Masters in Finance and the Post-Graduate Degree in Financial Analysis.

She was Associate Senior Professor of Finance, Associate Professor and Adjunct Professor at ISCTE – Instituto Universitário de Lisboa, University Lecturer of Finance at the University of Oxford Saïd Business School, Tutorial Fellow of Management at the University of Oxford's St. Edmund Hall, and Junior Teaching Assistant at Nova SBE - School of Business & Economics. She completed a Finance PhD at the London Business School, an Economics MSc at Queen Mary University of London Westfield College, and an undergraduate degree in Economics at Nova School of Business and Economics. Her areas of expertise are business finance and corporate governance.

She is the lead researcher in a project looking into SMEs' certification and their relationship with the banking system, funded by Fundação para a Ciência e a Tecnologia (FCT), the Portuguese funding agency for science, research and technology, and by Fundação Francisco Manuel dos Santos.

Clara Raposo chairs the Economics and Management Panel of FCT that awards PhD studentships and renews post-doctoral fellowships. She is an independent non-executive member of the Managing Board of Interbolsa and board member of IPCG in the 2019-2021 term of office. She was elected correspondent member of Lisbon Academy of Sciences on 30 May 2019.

Francisco Seixas da Costa

Chair Session 3

Francisco Seixas da Costa is a retired diplomat currently working as strategic consultant and member of the board of several international companies. He is a member of the Consultative Council of Calouste Gulbenkian Foundation and a member of the Independent General Council of the Portuguese public service broadcaster RTP. He is also columnist in newspapers.

Ambassador Seixas da Costa was Secretary of State of European Affairs in the Portuguese government, executive director of the North-South Centre of the Council of Europe and guest professor in Portuguese universities. As a diplomat, after being posted in Oslo, Luanda and London, he was permanent representative to the UN, OSCE and UNESCO and ambassador to Brazil and France.

He has a degree in Political Sciences and published books on European and International Affairs.

Paul De Grauwe

Panellist Session 3

Paul De Grauwe is John Paulson Chair in European Political Economy at the London School of Economics (LSE). He is also a Research Fellow at the Centre for European Policy Studies (CEPS), in Brussels, and at Centre for Economic Policy Research (CEPR), in London.

Paul De Grauwe was member of the Belgian Federal Parliament between 1991 and 2003. He was also a member of the Group of Economic Policy Analysis advising the European Commission President, José Manuel Durão Barroso.

His research activity focuses on international monetary economics, monetary integration, exchange rate economics and open-economy macroeconomics. His extensive list of publications includes articles available at the Centre for European Policy Studies (CEPS), Centre for Economic Policy Research (CEPR) and other think tanks' websites. He has published many books including: "The Economics of Monetary Union", Oxford; "International Money. Post-war Trends and Theories", Oxford; "The exchange rate in a behavioral finance framework", Princeton, 2006 and "Lectures on Behavioral Macroeconomics", 2012.

Carlos Moedas

Panellist Session 3

Carlos Moedas graduated as civil engineer from Instituto Superior Técnico, Lisbon. He was one of the first Erasmus Students in Portugal and attended the École Nationale des Ponts et Chaussées in Paris. He started his career as a civil engineer working for the French conglomerate Suez Lyonnaise des Eaux in France.

In 1998 he graduated with a Master in Business Administration from the Harvard Business School. After his graduation from Harvard he worked for Goldman Sachs in their Investment Banking division in London.

He returned to Portugal in 2014 and became head of Aguirre Newman, and also a member of the executive board in Spain. In 2008 he created his own investment management company.

Mr Moedas headed the Social-Democrat Party's (PSD) economic team in 2011 and was part of the negotiations on Portugal's 2011 Public Budget. That same year he was elected a Member of Parliament and appointed under-Secretary of State to the Prime Minister of the XIX Constitutional Government of Portugal, tasked with coordinating the adjustment programme.

In 2014 he was nominated the European Commissioner responsible for Research, Science and Innovation.

Carlos Moedas co-authored a series of publications in the fields of science and innovation. Among these articles, one stands out: 'Open Innovation: Research, Practices and Policies' published in the California Management Review, co-signed by Henry Chesbrough, who is known for coining the term 'Open Innovation'.

He became the youngest member to be elected to the Portuguese Academy of Engineering in 2014. He is an honorary fellow of the African Academy of Sciences, was awarded an Honorary Doctorate in Laws by the University of Cork in Ireland and an Honorary Doctorate in Management from the ESCP Europe (École Supérieure de Commerce de Paris).

Wolfgang Münchau

Panellist Session 3

Wolfgang Münchau is director and co-founder of Eurointelligence, a service that provides daily information about the euro area, targeted at investors, academics and policy makers. He is also the European economic columnist of the Financial Times and a member of the European Council on Foreign Relations.

Wolfgang was one of the founding members of Financial Times Deutschland, and editor-in-chief from 2001 until 2003. From 2010-2015 he was also a columnist for Spiegel.

Previous appointments included correspondent posts for the Financial Times and the Times of London in Washington, Brussels and Frankfurt. He was awarded the Wincott Young Financial Journalist of the Year award in 1989 and the 2012 SABEW award for best international columnist.

Wolfgang has published three German-language books. His book Vorbeben from 2006, predicted the financial crisis and received the prestigious getAbstract business book award in 2008. A US version was later published by McGraw Hill under the title Meltdown Years.

Luís Máximo dos Santos

Vice-Governor

Member of the Board of Directors of Banco de Portugal since June 2016 and appointed Vice-Governor in September 2017.

He was Chairman of the Board of Directors of Banco Espírito Santo, S.A. (2014-16), nominated by Banco de Portugal, and Chairman of the Liquidation Commission of Banco Privado Português, S. A. (2010-16), appointed by Tribunal do Comércio de Lisboa (Lisbon Commercial Court), at Banco de Portugal's proposal.

Master's degree and graduate in Law (Legal-Economic Sciences) by the University of Lisbon School of Law (FDL). He lectured at the Faculty of Law of the University of Lisbon and also lectured in the post-graduate programmes in European Studies and Financial Markets at the European Institute and the Institute for Economic, Financial and Tax Law, respectively, both of University of Lisbon School of Law.

He participated in various working groups under the auspices of the Ministry of Finance: chaired the Working Group for the Re-evaluation of Tax Benefits (2005), Member of the Working Group for the Revision of the Local Finances Law (2005-2006), of the Coordination Structure for Tax Reform (2000-2001) and the Commission Studying the Taxation of Financial Institutions and Products (1997-1998).

He was a member of the Supreme Judicial Council (2000-09) and the Supreme Council of the Administrative and Tax Courts (1997-99). Furthermore, he was a lawyer for the Portuguese Republic and represented the Portuguese Government in various proceedings at the Court of Justice of the European Union.

He joined the editorial boards of several scientific publications.

Author of several works (articles and monographs) published in areas of his expertise.

Distinguished with an award granted by the German Foundation, Alfred Toepfer Stiftung, Hamburg, awarding works related to European Integration, on the occasion of granting of the Robert Schuman Prize to His Excellency the President of the Portuguese Republic, in 1987.