

**Pioneer Investments
European Colloquia
Corte Franca,
14 September 2011**

07.09.2011

Opening address:

"The political economy of EU frictions"

**Marco Buti
Director General
DG ECFIN
European Commission**

1. Introduction

It is a pleasure and honour to stand here today and address this illustrious round of academics and practitioners of financial markets. The timing seems particularly appropriate. The major financial crisis continues to haunt us; it is mutating and rotating between financial markets and the public sector. The European sovereign debt crisis has not only put into question the role and viability of states but also achievements in European political and economic integration over many decades.

How could it have happened and what happens next?

In my view, the answer is not straightforward. A meaningful response must build on an honest description of what happened.

I would like to spend some minutes on such assessment. In my view, the crisis must be understood as the compound effect of three kinds of interlinked "frictions" (to use the somewhat benign term used in the title of these Colloquia):

1. the economic frictions posed by the financial and sovereign crisis,
2. political frictions due to a crisis-hit population questioning the historical consensus in Europe, and
3. institutional frictions in the EU that demonstrated its lack of readiness to take on these challenges.

I hope that thereby I can usefully contribute to this Colloquium's proceedings that promise, at least during this morning session, to develop along the red line of imbalances and frictions. I will try to bring together economic, political and institutional frictions. This is obviously a tall order, but without such an integrated view, we cannot derive the appropriate answers to current woes.

2. Classic and new frictions

2.1. *Economic frictions*

Foremost, and obviously, Europe has gone through a series of major economic and financial challenges. I do not have to spend too much time in this audience about the details. You are certainly all only too well aware of these.

What is important is that we apply the right reading and the proper conclusions from these turbulences. The financial crisis starting in 2007, the rescue of financial institutions by governments around the globe and the ensuing fiscal strain in many countries seems to suggest some clear trends. Let me mention a few:

- The crisis has left the *banking sector in many countries in a rather weak position.*
- The crisis has also strained *government accounts*: lower tax revenues, funds deployed for bank bailouts as well as higher risk and liquidity premia on government debt.
- Banks have weakened the government accounts and, in a *feedback loop*, sovereign crises have reverberated onto banks' balance sheets and funding possibilities via weaker collateral and write-downs.

- *Growth dynamics around the globe have been affected.* Many advanced economies, including the US and parts of the EU Member States, face softer labour markets and aggregate demand. Risk premia, both sovereign and corporate, will remain well above levels prevailing in the pre-Lehman markets. They have stabilised, well above pre-crisis levels, in the corporate world but have further widened for sovereign issuers.
- More fundamentally, the *growth models of the last decade have shown their limits.* They used to be based on strong growth of financial deepening and fuelled by forms of economic activity that were particularly relying on credit. It seems clear that in many countries debt has been accumulated well beyond long-term sustainable levels. Just one figure on this: from a fundamental economic point of view it is hard to understand why the total debt of non-financial enterprises and households should have risen in the EU from around 110% of GDP in 1999 to nearly 160% in 2009, and for some countries levels and dynamics are much higher than this EU-wide average. The correction has started, but it is slow and so far rather a levelling off than a true reversal.

- Also against this background, what can be expected is a *muted recovery* reflecting the need of deleveraging across sectors. The renewed signs of weakness of the global upturn confirm this diagnosis.

- Importantly, not only risk premia but also actual levels of *counterparty risk*, on aggregate, might remain fairly elevated over the medium terms. This may well cause the prevalence of procyclical feedback loops between risk premia, actual risk of corporate and sovereign issuers and debt levels. Such dynamics will be a mirror-image of what many debtors enjoyed in the past decade. The sovereign crisis in the euro area is a prime example of this unfolding adjustment pain. That trend towards higher risk premia will be reinforced by the widespread re-evaluation of traditionally risk-free assets in global financial markets.

- And *economic integration and globalisation imply that economic and financial frictions are not and cannot be geographically isolated*. This is even more so the case in Europe with its much higher degree of economic interaction across borders. And at the same time, slower credit growth and catching up of emerging economies might alter the features of global economic interaction and might very well slow down further globalisation.

2.2. *Political frictions*

The economic crisis and with it the strains of the European model of welfare state had their predictable effects on the political landscape.

The long period prior to the financial crisis was blessed with low inflation - the "great moderation" - and globally low risk premia. In the Euro area, the elimination of the exchange rate risk coupled with the view that sovereign debt was a risk free asset, led to very low interest rates also in countries with traditionally higher rates. Nonetheless, this blessing was mixed: together with a benign global economic setting, it greatly diluted the political incentives for reform in Member States. Yielding a quasi "anaesthetic" effect", it lured societies and their political leaders into denial and refusal of necessary adjustments.

This large-scale rigidity prevented diverging, and partly destabilising, national preferences from converging more broadly towards patterns that are more compatible. This failure paved the way for the crisis.

In turn, the crisis brought, across the EU, to the fore EU-sceptical voters, parties and governments: taking a critical or destructive role seemed to pay for politicians. And it was also the EU that was blamed for the loss of stability and welfare as a consequence of the crisis, in Finland or Germany as in Greece or Ireland, on the specific line of reasoning differed.

This backlash is in my view to some degree a cyclical pattern: economic crises are fertile ground for such trends. But if these become too large, become self-perpetuating or mutually reinforce across borders, it bears the risk of becoming structural in nature.

One of the immediate effects of this shift in the political landscape has been that the fairly high consensus on resolving the banking crisis has broken down in resolving the sovereign crisis: on the surface the disputes and publicly led debates had all the classical features of a multidimensional distributional fight between different groups within countries and between countries.

2.3. Institutional frictions

The EU, since its inception, has always been both: the European institutions and the founding Member States. Both are meant to pursue their interests and mandates, but play their role in a constructive setting. In particular, European institutions are meant to be the sufficient counterweight against Member States' particular interests.

When it comes to economic and fiscal policy, the Union had to always reckon with the particular attachment of Member States to their competences when it comes to the budget. This is also reflected in the distribution of powers between the EU and Member States: although there are clear Treaty obligations on fiscal conduct, the enforcement mechanisms are much less straightforward than for normal EU obligations of a Member State.

The recent economic and political frictions across the continent have further strained and partly broken this balance within the Union. At least on the surface, the Union has been sliding back into a loose intergovernmental setting. The level of discord has accordingly risen, also due to the veto power by individual Member States that tends to be the norm under intergovernmental arrangements. Moreover, that intergovernmental governance has become even more top-heavy: Heads of State or Government have taken control from their subordinate ministerial, and therefore more technical and business-like, formations. The Union seems having lost its sense of purpose.

Yet, I might note that simple appearances of historical trends might be misleading. We should not necessarily expect institutional and political progress to be anything close to linear. On the contrary, our long experience in building the European Union and the euro area has demonstrated that advancement can seem quite bumpy or dialectic.

Allow me to illustrate this with an example: the 1992-1993 crisis of the Exchange Rate Mechanism caused its swift breakdown and it led to a looser successor instrument, the so-called ERM-II with much wider fluctuation bands. However, this very crisis, in parallel and seemingly paradoxically, impelled the project of the single currency.

This resurgence of national interests and intergovernmental decision-making has made our crisis management not exactly easier. The systemic nature of the crisis required an EU-wide strong and swift reply. Yet, once again, the EU has shown political and limits to its ability to carry out effective crisis management: length, distribution of tasks, dispersion of views, voting rules, communication.

And these limits to effective EU crisis governance were most pressing and most visible at one of the conceptual fault lines of the EU: at the interaction of an integrated monetary area and still highly decentralised fiscal prerogatives of Member States.

It is not lack of institutions or rules in the area of EU economic policy making or a lack of grasping the seriousness of the crisis. Rather, it has been a repeated failure to generate decision and solutions commensurate to the speed and depth of the challenges.

3. The current response

That does not mean that the European Union has been idle. That was simply not an option. Against this setting of a deep economic and fiscal crisis and EU centrifugal forces, the EU has walked along a cliff over the past year. The margin of error has been small and the territory has been uncharted.

Despite the odds against making meaningful progress, the EU has in the midst of the unfolding crisis been able to adopt some landmark changes to its functioning and institutions. We have worked towards improving the crisis resiliencies of the EU from various angles:

1. The Euro area summit on 21 July marked the current end point of building a systemic response to a systemic crisis, namely:
 - A thorough *overhaul of financial sector regulation and establishing a new architecture of supervision* in Europe for banks, insurance and securities markets, with the emphasis on higher shock resilience and higher transparency.
 - The *creation the European Systemic Risk Board* with the task to spot and defuse potential future risk in financial stability.

- The *setting up of the European Financial Stability Facility*, with a large overall envelope, a broad range of instruments and lending rates geared to securing fiscal sustainability of beneficiary countries.

- *Agreement on the European Stability Mechanism*, the ESM, as successor to the EFSF, a proper, strong and permanent international organisation for the euro area.

- The *legislative package* of measures to improve economic and fiscal governance in the Union and a start into monitoring and guiding its underlying factors, namely, what we call excessive imbalances.

- The establishment of the so-called "European Semester" according to which national policy choices and budgets are first discussed at the EU level before being implemented at national level.

2. In parallel, we have been in an active crisis management mode, as in the middle of a crisis, prevention is obviously not enough:

- Member States advanced necessary and sometimes overdue fiscal consolidation and reforms to render their economy more competitive and dynamic.
- Together with the IMF, the EU set up large-scale and policy-relevant assistance programmes for six Member States, three of them members of the euro area.
- We organized Europe-wide stress tests of systemic banks and insurance companies and helped ensuring a proper follow up to their results where needed.

In short, the Union has made substantial progress in strengthening our economies, stabilizing the financial sector and government accounts. Equally importantly, it has made strides in reducing the likelihood and impact of a future crisis, be it financial or fiscal in its root.

In the area of crisis management, we have engineered true innovations in the architecture of Europe's governance and institutions, and that in a short span of time. Nothing existed still 18 months ago, except some forms of support to countries other than the euro area; no concept, no legal or institutional basis, and in the beginning not even the political will.

These achievements did ultimately come quite fast, but often in a counterintuitive and sometimes painful incremental mode. This was chiefly because disagreement between Member States reflected the difficult interplay between solidarity and systemic reasons on the one hand and incentive compatibility and moral hazard on the other hand.

To find an operational synthesis, Member States had to get ready for this sea change, had to be ready to cross previous red lines or enter traditional no-go areas. And so they did. In this fragile economic, political and institutional setting the achievement was quite remarkable and will become clearer as time moves on.

Please do not misunderstand me. I am the first one to admit and to point to all the shortcomings in the process European decision making over the past year and the inability of the decision-making process to be ahead of the curve. The process was by no means smooth, orderly or always constructive. In addition, the Union was often painfully late and seemed driven by day-to-day market pressure only. Having to prove so innovative, reinventing the Union by defining its role in the management of crises in the very middle of a crisis, did not come easy. And all the frictions that I talked about before did not facilitate the process either.

The public took ample notice of this and understandably even more so than of the actual achievements. In that sense, we did a poor job in calming and steering markets when this was needed most.

4. A new synthesis

Nevertheless, the story does not end here. The crisis is further unfolding and mutating. Our crisis response so far has been a gradualist extension of our general Community approach. However, the success of this response has so far been mixed at best.

What are the contours for a credible solution?

- We need *closer fiscal integration*: it properly reflects the ever stronger effects of fiscal conduct in any Member State on its partners; and, at the same time, it is indispensable in a setting where fiscal solidarity between Member States becomes a key feature of the Union;
- we must define and implement a *new growth strategy for the Union* in a situation in which the classical macroeconomic tools of fiscal and monetary policy are fading;
- *further financial integration* within the European Union must be possible without weakening the shock resilience of Europe's financial sector; or, in other words, we must avoid some of the mistakes made in the last decade and match integration of markets with proper integration of policies, regulation and supervision;
- and, critically, we must quickly learn from the current sovereign crisis and sharpen our *tools for effectively combating systemic crisis* hitting one or more of our Member States.

Living up to these huge tasks requires rules and institutions at the central level rather than loose coordination between Member States. Under the new realities, it is not reassuring if we have only one institution, the ECB, being able to respond quickly.

We must build consensus about this vision of Europe's destination. For the sake of the challenges on road ahead, this consensus must be broad and robust. That can only be achieved as a result of an open, wide and, if necessary, controversial debate. "Integration by stealth" is not an option, less so than ever. That debate might finally allow the EU to find back its purpose and drive under radically changed auspices.

There are of course some who contest this vision, and for various reasons. What we are often told is that the EU's system of decision-making and co-operation is essentially just a blueprint for fair-weather conditions. Conversely, it would fail, and necessarily so, in adverse conditions.

The so-called "Monnet method" of progressively integrating Europe has been recently called into question, for example by the *Economist* earlier this month. Its main drawbacks would be a voters' backlash, resenting the shift of power to the European level and the ineffective decision-making process.

I do not deny any of these two observations: public opinion has shifted in some Member States to more Euro-sceptic territory. Moreover, our way of reaching decisions is ineffective process, particularly when time is of essence. Yet, I consider the conclusion drawn from these facts fundamentally flawed, and outright dangerous for the long-term welfare of Europe. Let me mention two of the most celebrated quotes of Jean Monnet:

- "Europe will be forged in crises, and it will be the sum of the solutions adopted for those crises", and
- "Nothing is possible without men and women, but nothing is lasting without institutions".

This applies today more than ever. Europe is built on stable institutions that allow durable responses to the vast and systemic crisis on our continent. One thing is amply clear: intergovernmentalism, or any kind of a more ad-hoc form of co-operation among our countries, does not properly function over time. Our own history has shown that fact repeatedly.

This obviously does not mean conservatism: the sum of the responses to the crises cannot be a stratification of ad hoc responses: I have argued that we need a new synthesis. Equally, institutions cannot remain unmovable: the new architecture for economic governance and financial supervision shows that Europe is on the move.

5. Conclusion

Let me allow summing up. The crisis has polarized the likely future of Europe. If we do not succeed in building a stronger Europe, ready to take on the challenges of the global economy, we will slide back in to national turf policy, and the achievements over the last five decades will be at risk.

A clear and rational mind will have no difficulty to identify the right way forward. I count on the financial sector as an ally in this struggle to define our future: over the entire history of the EU, financial industry has consistently been at the vanguard of integration. This has been no coincidence: financial institutions thrive on open markets and stability across the globe. The EU is a key pillar in this process, and even more so than ever, when geopolitical structures are rapidly redefined.

In conclusion, our shared interest in preserving and advancing a vital, stable and open Europe seems overwhelming.

Also for this reason, I truly enjoyed the privilege of having been able to address you today and thank you very much for your attention.
