The Financial Reconstruction of Europe: Enhancing European Governance

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• A sequence of events …
  o global financial crisis and recession (2007-09)
  o public finance crisis in Greece (2009-10)
  o spreading of tensions to weaker euro-area countries (excessive public/private debt, foreign trade deficit, poor competitiveness, low economic growth; 2010-11)
  o announcement of Greek PSI (2011)

• … leading to a crisis of confidence in the survival of the euro
• Yield spreads between government bonds in the euro area reflect two factors
  - National: weaknesses of some countries’ economies and public finances (sustainability risk)
  - European: incompleteness of European construction and fears of a euro break-up (redenomination risk)

• The (2010-12) response has thus been two-pronged
  - prudent budgetary policies and structural reforms to support competitiveness at the national level
  - a process of far-reaching reform of EU economic governance (since 2010) and political commitment to strengthen the Union (June 2012)
The reform of European governance

• The reform is part of a process aiming at rebuilding trust among member states
  • commitments on public finance were reinforced (ex ante coherence checks on objectives and policies and more automatism of sanctions; rules recognized in national legislation)
  • new surveillance procedure on macroeconomic imbalances
  • tools for financial management of sovereign crises (EFSF/ESM: total lending capacity €700 bln)

• Not all elements of the reform have been tested yet
The role of the ECB

- Implementation of complex reforms requires time
- Persistent market distortions and fragmentation can undermine monetary policy transmission and jeopardize the entire process
- ECB’s unconventional measures were introduced to counter such distortions
- OMTs, announced in the summer of 2012, provided a “bridge” over the implementation of reforms
- Conditionality is a key feature
- The announcement produced immediate benefits
• The crisis confirmed the enormous risks arising from the incompleteness of the European construction

• Lack of political union and a federal budget resulted in
  o exacerbated market demands for fiscal consolidation in individual member states
  o impossibility to smooth their contractionary effects and impact on citizens’ welfare

• Progress made so far must now be followed by a further, deeper reinforcement of EMU, building on a renovated mutual trust and a longer-term vision
• The process has been set in motion

• Building an effective Banking Union will be the first test of our resolve …
  
  o all its components (not just the single supervision) are necessary to sever the link between sovereigns and banks
  
  o the rules of the game for the forthcoming comprehensive assessment of banks must be based on analytical rigour and equal treatment of all banks across countries
  
  o we must apply wisely the rules on bail-in and State aid

• … but success requires that discussions on fiscal and political union are soon followed by concrete actions