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Panel II: Which institutions are needed?

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It is a real pleasure for me to be in Lisbon again. I would like to thank Finance Minister Maria Luis Albuquerque for her kind invitation to this conference. Portugal is a special country for me and the EFSF. We have provided financial assistance to support the country's recovery during the recent crisis. Portugal's successful implementation of the economic policy conditions linked to our assistance show how committed the country is to the euro.

The city of Lisbon is the namesake for important reform and integration steps in Europe as the 'Lisbon Agenda' and 'Lisbon Treaty' demonstrate. So I can hardly think of a better place than Portugal and particularly Lisbon to discuss how Economic and Monetary Union (EMU) should develop in order to deepen the ties among its members further and to make it even more robust and sustainable than it is already.

Fortunately, we aren't starting from scratch:

- With the EFSF and the ESM the euro area has built an impressive firewall of € 700 billion that was able to contain and overcome a crisis that threatened five Member States and that seemed to put in peril the very existence of the currency union.
- There were courageous reforms at the national level, particularly in countries with EFSF or ESM programmes like Portugal.
- The European economic policy framework was strengthened. We tightened the rules and gave the Commission more power to enforce them.
- We also laid the groundwork for a full Banking Union with harmonised rules and centralised supervision for systemic banks. We are building instruments for bank resolution.
- And the ECB provided critical support with its determination to live up to its mandate.

The result of all these measures is an EMU that is more robust and less vulnerable than before the crisis. Markets are acknowledging this. Despite recent uncertainties about

Greece, market reactions are limited to Greece. There is no spill-over to other euro area Member States.

Nevertheless, I see no reason for self-congratulation. There are imperfections. Our fiscal rules have become too complex. And further steps can be taken that would support our claim that EMU is irrevocable. Therefore the Heads of State and Governments have tasked the presidents of the Commission, the European Council, the Eurogroup and the ECB to produce by June a follow-up to their 2012 report called *Towards a genuine Economic and Monetary Union*.

I was asked to talk about which institutions are needed in EMU. In order to avoid overlaps I will not stray into governance issues which were discussed in the previous panel. I will make my remarks from the perspective of a pragmatic policy maker, one who is heading the only dedicated euro institution and who is constantly in contact with investors throughout the world. And I will focus on things we can do without changing the EU Treaty and only briefly touch upon ideas that would require such a change.

Let me start with an obvious observation: the euro area is not a state. We do not have a central budget and we do not have a common finance minister as the US does, for example. But there are some things that the euro area does have and that do work when we think about 'fiscal capacity' and 'risk sharing'. There are several important elements of risk-sharing in the euro area and the EU already now that are often forgotten: the EFSF and the ESM, of course, but also the European Investment Bank (EIB) and the Single Resolution Fund (SRF). We do have an EU budget that provides for sizeable permanent transfers for countries with a lower standard of living. In the case of Greece, for example, the transfers from the EU budget are equivalent to about 3% of the Greek GDP every year. Furthermore, there is some private sector cross border risk sharing and the bankruptcy laws can also be mentioned in this context. The Bank Recovery and Resolution Directive (BRRD) enforces risk sharing with the private sector when banks fail.

But finding ways to strengthen risk sharing even further would improve the functioning of the monetary union. Some ideas that have been floated are possible without an EU Treaty change. It is a reality that a full EU Treaty change would consume a tremendous amount of time and political energy. For many governments this is therefore not an option. But we can accomplish a lot under the current legal framework.

In general, a limited fiscal capacity to compensate uneven national business cycles, asymmetric shocks, or pro-cyclical effects of monetary policy could help avoid excessive economic hardship. What could a limited fiscal capacity look like?

- One idea is a so-called 'Rainy Day Fund'. Member States would accumulate common buffers during good times to smooth adjustments during a recession. Such countercyclical budget planning would contribute to sound fiscal policy, and enhance credible surveillance by centralising the buffers.
- A limited unemployment scheme would also be an option of risk-sharing. Pooled common funds to finance short-term unemployment could promote cohesion. But such a scheme would need to be conditional on compliance with sound budgetary policy and avoid so-called moral hazard issues.
- Another possible tool is a targeted fiscal capacity that would reward the structural reform efforts of individual Member States. This idea builds on our experience at the EFSF and ESM where we have seen that linking economic conditions to financial assistance provides a powerful incentive to implement painful but necessary reforms. This is particularly important because the lack of structural reforms in individual countries can create negative spill-over effects for the entire currency union.

Let me stress that all these ideas can be organised in ways that avoid permanent transfers and debt mutualisation among Member State over an entire economic cycle. These are essential preconditions for the political acceptance of such proposals.

Risk-sharing can also be strengthened through financial markets, for example through the development of the Capital Markets Union. There are many individual modules under this heading: One of them would be a harmonisation of national insolvency procedures which would contribute to the emergence of EU-wide equity and debt markets and to new risk-sharing opportunities.

Harmonising and consolidating deposit insurance could also be an important element to further cement confidence in the euro area banking system. This would also be the final step to a full Banking Union and could again be done in a way that avoids debt mutualisation.

As I said: these initiatives can be put in place without an EU Treaty change. A possible way forward would be the so-called enhanced cooperation within the EU Treaty framework if the topic falls under an EU competence. The alternative would be deeper integration through intergovernmental agreements between the euro area Member States. I am well aware of the dilemma this creates. Opting for the latter implies achieving more integration outside the EU framework and community instruments. This may be a price worth paying temporarily provided these measures strengthen and deepen EMU. The creation of the ESM, which is also based on an intergovernmental agreement outside the EU Treaty, is the best example of this logic. But enhanced cooperation should be seriously considered where possible.

In the long run, however, I am in favour of incorporating temporary intergovernmental agreements into the EU Treaty. I am a firm believer in the community framework with strong community institutions like the European Commission and the European Parliament. An EU Treaty change could transform the Commission into the central political body within the European governance framework. In the view of some, such a role could eventually lead to further changes. There are concerns that a strong political role for the Commission is not compatible with tasks such as the authority over competition issues. There may be arguments for delegating this task to a separate and independent EU body. Another issue in that context could be whether the SSM should remain within the ECB. An independent SSM would attenuate risks of potential conflicts of interest between monetary policy and supervision.

I am often asked whether an EU Treaty change should be the opportunity to transform the ESM into a European Monetary Fund modelled on the IMF. This question overlooks the fact that we already have the equivalent of a European Monetary Fund. The difference with the Washington-based institution is that in Europe we spread over several institutions what the IMF does on its own globally. The ESM is responsible for organising and disbursing loans to the programme countries. For the economic analysis of the programme countries and for defining the economic policy conditionality the Commission is in the driver seat. This shared responsibility has worked very well in the past years. An EU Treaty change could eventually alter this arrangement. But given the successful status quo I see no urgency to rush for change.

(1460 words)