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The Political Economy of Banking
Union and Finance in Europe

Lucas Papademos

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ALBERT H. GORDON LECTURE

FEATURING
LUCAS PAPADEMOS

MODERATED BY
DEAN DAVID T. ELLWOOD
SCOTT M. BLACK PROFESSOR OF POLITICAL ECONOMY

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Harvard Kennedy School
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ALBERT H. GORDON LECTURE

THE POLITICAL ECONOMY OF BANKING UNION AND FINANCE IN EUROPE

LUCAS PAPADEMOS

Prime Minister of Greece (2011–2012)

Vice President, European Central Bank (2002–2010)

Governor, Bank of Greece (1994–2002)

The Albert H. Gordon Lecture (est. 1987) focuses on the fields of finance and public policy with special attention to the internationalization of finance.

I. INTRODUCTION

Thank you Dean Elwood for your generous introduction. I am happy to be back in Cambridge to give this year's Albert H. Gordon Lecture at the Harvard Kennedy School.

It has been a privilege for me and a rewarding experience to join the Kennedy School faculty after two intense periods in my professional life that involved dealing with extraordinary crises: the global financial turmoil and the first phase of the eurozone crisis, as a central banker, and the Greek debt and economic crisis, as a technocrat turned politician.

A distinctive feature of the Kennedy School is that it provides a unique environment for teaching, research and debate by people with expertise and experience in all the disciplines that are relevant to public policy and essential for the effective functioning of government. I have learned from and enjoyed my interaction with faculty and students of different professional backgrounds and interests.

Winston Churchill allegedly once confided that he never

began a speech with the phrase “It gives me a great deal of pleasure” because speaking was not one of the things from which he derived great pleasure, presumably because it involved hard work to prepare and considerable effort to deliver. Even though I see some truth in that, it will not prevent me from saying: It is really a great pleasure and an honor to address you this evening. I am glad to see friends and colleagues who have joined this event. I am also honored to give the 2013 Gordon Lecture in this prestigious series.

In choosing the theme of my speech, I opted for a topic in line with the purpose of the lectures established by the philanthropist and legendary financier Albert H. Gordon: a topic focused on issues in finance and the role of public policy.

Specifically, I will examine and assess the historic undertaking of creating a banking union in Europe to complement and reinforce the monetary union and to complete the single market for financial services, which is an essential condition for resolving the eurozone crisis and supporting economic growth.

In so doing, I will emphasize the role of politics and economics – as well as their interaction – in designing and implementing an effective and efficient banking union that can help achieve Europe’s stability and growth objectives and can be a decisive further step towards an “even closer” European Union.

When I left the central bank boardroom and the university classroom to join the government “war room”, I expected that politics would inevitably influence decisions on economic policy, both at national and European levels. This expectation was fully confirmed by experience in various ways and on several occasions.

That politics influences economics – economic policies and developments – is certainly understandable and appropriate. The views of the people and of their elected representatives on economic policy goals and on the means of achieving them are an important and integral part of the democratic process. Over the past few years, however, we have also witnessed in many

countries, in Europe and elsewhere, some rather troubling developments: narrow minded politics – influenced by short-termism, populism, and party antagonism – have had profound and adverse effects on economic policy formulation and implementation. Pertinent examples are the fiscal and debt-ceiling problems in the United States, and the debt and economic crisis in the eurozone.

In Europe, the interplay of economics and politics has influenced economic policy and developments both at the national level and at the European level. In some countries, political wrangling and political risk have increased the uncertainty faced by business and households, have reduced the effectiveness of the policies being pursued, and have therefore adversely affected economic performance.

Moreover, tensions and perceived trade-offs between national interests and agreed European Union objectives have shaped the adopted approach to tackle the eurozone crisis and the chosen roadmap to European integration.

Looking ahead, a growing concern is how politics will affect economic policy choices, financial market developments, and economic performance in the European Union.

In my remarks, I will focus on the following issues:

First, the role of economics and politics in causing the eurozone crisis, in explaining its severity and persistence, and in defining the path followed so far towards resolving it;

Second, the economic and political significance of the establishment of a banking union and the completion of the single market in financial services;

Third, the current blueprint for a European banking union which is characterized by many positive features but may pose policy challenges;

Fourth, the implications of the apparently growing divergence between public attitudes about European economic integration and the political leaders’ commitment to establish a closer European Union; and

Finally, the interdependence between political, economic

and financial risks in Europe, which underscores the crucial importance of mitigating financial fragmentation and boosting economic growth in the eurozone.

II. THE ROLE OF ECONOMICS AND POLITICS IN THE EUROZONE CRISIS

Let me start by briefly looking back in time and discussing the role of economic and political factors in causing the eurozone crisis, in explaining its severity and persistence, and in determining the policies adopted to resolve it.

There is a broad consensus about the economic causes of the eurozone crisis, with some differences as to their relative importance. Excessive government deficits resulting in the accumulation of high public debt, a significant erosion of cost competitiveness and an associated widening of external deficits, weaknesses in national banking systems and housing price bubbles were the main culprits, although their relative significance differed across eurozone countries.

Underlying almost all of these economic causes of the crisis were political factors. First, in several countries imprudent fiscal policies and excessive government debt reflected shortsighted politics influenced by electoral cycles and the propensity to postpone the necessary adjustments until they became inevitable. Second, persistent and sizeable competitiveness losses were allowed and not corrected partly because of nonappreciation of their longer-term consequences for real incomes and employment in countries that were members of a monetary union and partly because of the inclination to avoid corrective policies and practices that would be politically unpopular in the short run. And, third, the risks of excessive bank credit expansion to the private sector and of progressively unsustainable housing price increases were known but greatly underestimated by supervisory authorities and effectively ignored by governments influenced by political considerations. All in all, public policy had been diverted from addressing key challenges in an environment of myopic euphoria that was also encouraged by the absence

of market discipline. This last point is relevant to the present situation as market discipline has weakened again.

After the eurozone crisis broke out in May 2010, ambivalence or hesitation in a number of member states about the implementation of appropriate policy measures, especially the introduction of structural reforms, partly reflecting “political considerations” and partly the influence of vested interests, contributed to the prolongation and severity of the crisis.

At the European level, when the single currency was launched, political conditions were not ripe for the establishment of a more complete and balanced Economic and Monetary Union (EMU). The economic pillar was weak, essentially comprised the Stability and Growth Pact, that is a set of rules aimed at preventing excessive budget deficits in eurozone member states and at promptly correcting them if they materialized. Actually, politics led to and allowed the violation of the rules. Indeed, in 2004 the Pact was amended; it became more flexible in principle and was less adhered to in practice. Therefore, individually and collectively the eurozone countries permitted the build-up of excessive and eventually unsustainable fiscal imbalances, while they chose to ignore the ECB’s continuous warnings about diverging competitiveness trends and the need to reverse them.

During the three and a half years since the onset of the crisis, European political leaders and institutions took, slowly but surely, an unprecedented number of actions to resolve the crisis and prevent the recurrence of similar episodes in the future. In particular, let me point out (i) the sizeable financial support provided to five member states, (ii) the creation of the European Stability Mechanism (ESM), (iii) the adoption of a new Intergovernmental Treaty to ensure balanced budgets in member states, (iv) the introduction of a reinforced economic governance framework, and (v) the decision of European leaders to take further steps towards establishing a genuine EMU, starting with the creation of a banking union in 2014. These actions were unthinkable three years ago, when the crisis erupted in May 2010, but were decided because of the eurozone countries’ political

commitment to preserve the single currency and the single European market.

The eurozone crisis has significantly abated during the past year or so, but it is not over yet. Critics have argued (i) that the measures taken so far are not sufficient for effectively resolving the crisis and ensuring the smooth functioning of EMU, and (ii) that they were taken very slowly and in a step-by-step manner that prolonged the crisis unnecessarily and made it more severe than it would have been if a bolder and more comprehensive approach had been adopted earlier. There are elements of truth in these arguments. However, it has to be realized that the reason for the approach adopted is that the required decisions were difficult and profoundly political. These decisions had to take into account sometimes diverging views among member states on the way forward, as well as constraints imposed by national politics. So, political factors largely explain the step-by-step approach that may have contributed to the severity and duration of the crisis. But ultimately – and this is the positive conclusion or lesson I want to draw from recent experience – the economics of EMU and the political views that eventually prevailed, which reflected the single currency’s economic and political benefits, led to the adoption of appropriate actions for resolving the crisis and building a stronger monetary union.

III. THE ECONOMIC AND POLITICAL SIGNIFICANCE OF EUROPEAN BANKING UNION

Looking ahead, the pertinent question is whether politics will support or hinder (i) the implementation of the necessary fiscal consolidation policies and structural reforms in member states and (ii) the completion of the European integration process, which are necessary to ensure that monetary union will be effective and durable.

Let me address these points by focusing on what I consider to be the crucial and pressing issue for resolving the crisis and improving the economic growth performance in the eurozone. This is the establishment of a fully-fledged banking union and

an appropriate fiscal burden-sharing scheme requiring a higher, though limited, degree of fiscal integration among member states.

In the summer of 2012, European political leaders and institutions reached a consensus on a fundamental issue: the need to complete the architecture of monetary union, in other words to establish a “genuine Economic and Monetary Union (EMU)”, comprising four parts: a banking union, an economic union, a fiscal union and a political union.

I should clarify at the outset two points. First, the establishment of a genuine EMU – a fundamentally political objective – does not imply the creation of a single federal state, or a federation of states. This is not necessary for ensuring the viability of monetary union, and it is not a politically realistic, or even desirable, option at this stage. Second, the concept of a union varies depending on the type of union being considered. It is reasonably well defined in the case of a banking union, while it remains vague and has not been articulated in the case of a political union. What is meant by political union is a framework that will provide democratic legitimacy and ensure the required political cooperation for the effective functioning of the three other types of union being considered.

The political commitment of European leaders to move towards the establishment of a genuine EMU and thus a closer Union should not be underestimated, despite delays in implementation and uncertainties about the overall blueprint and the timeframe for achieving the goal. This commitment is embodied in the European leaders’ endorsement of the reports prepared by the presidents of four EU bodies and institutions,¹ which reflects the conviction that the ongoing crisis would be effectively resolved and the viability of the euro would be secured only if the systemic dimensions of the crisis were addressed by tackling the fundamental weaknesses of the existing institutional architecture and economic governance of EMU.

Although the elaboration of parts of the “grand plan” for a genuine EMU has been postponed for the unspecified future, it is especially significant that agreement was reached on the creation

of a banking union and on taking concrete steps to establish its first component, the Single Supervisory Mechanism (SSM), with the ECB acquiring supervisory responsibilities in the eurozone. It is also important that legislation has been proposed and will be soon adopted for the creation of a mechanism for the resolution of failing banks.

Why is the establishment of a banking union in the eurozone so essential both for the resolution of the still ongoing crisis and for boosting economic growth and employment over the medium and longer run? There are two main reasons. The first reason, which is particularly important for the medium term, is that a banking union should break the “adverse feedback”, the “vicious circle” between public finances and bank balance sheets that has made the crisis so severe and has been inhibiting its resolution. This adverse feedback still exists in all program or stressed countries, independently of whether the origin of the crisis was mainly due to unsustainable sovereign debt, as in the case of Greece, or to poor bank asset quality, as in the case of Ireland. The adverse interaction between banks and sovereigns became more severe as recession deepened and it delayed economic recovery. It has resulted in the fragmentation of the eurozone financial system with bank lending rates and credit availability diverging substantially across eurozone countries.²

Indeed, a major casualty of the global financial crisis and the eurozone crisis has been the significant retrenchment in international financial integration particularly within Europe. Financial globalization, as measured by the international financial integration (IFI) ratio – the sum of foreign assets and foreign liabilities relative to GDP – rose impressively in advanced economies over the thirty years before the global financial crisis. The increase in financial globalization was very sharp during the pre-crisis period 2003-2006. The steep rise in the IFI ratio during those four years was fostered by exceptionally low policy interest rates for an extended period and by financial innovations that led to an international credit boom.³

In Europe, the increase in international financial integration before the crisis was even more pronounced than in the

United States or Japan.⁴ This increase captures two parallel developments: first, stronger intra-European financial linkages, especially cross-border bank-related debt flows, which grew substantially within the eurozone before the crisis⁵; second, large acquisitions of foreign assets and raising of foreign liabilities by Europeans vis-à-vis the rest of the world.

The situation today is dramatically different. Financial integration within the eurozone has gone into reverse since 2010. Cross-border capital flows, especially bank-related debt flows, have fallen sharply.⁶ The funding costs of banks and bank lending rates have diverged significantly. In program or stressed countries, bank lending rates have been 2 to 6 percentage points higher than the corresponding lending rates in core member states, depending on the country and the type of loan. Some commentators have described the continuing financial market fragmentation in the eurozone as the “renationalization of European finance.” As a result, the very accommodative monetary policy stance of the ECB is not transmitted homogeneously across all eurozone member states. In countries under economic programs or under market stress, the much tighter financing conditions and limited access to cross-border funding at sustainable rates are contributing to a credit crunch. This has been a major inhibiting factor to economic recovery in these countries, which collectively account for about 40 percent of the eurozone’s GDP.

To be sure, the higher bank lending rates and lower credit availability in some eurozone countries reflect the higher credit risk stemming from weak macroeconomic conditions and uncertainties about the quality of bank balance sheets. There is evidence, however, that the higher funding costs of banks and the constraints they face in raising funds also reflect concerns about their country of origin, that is about sovereign risk. A banking union should help reduce risk premia that mirror differences in the banking systems because of fragmentation along national borders. A common supervisory and resolution framework would result in a uniform standard of oversight and confidence and help contain systemic risks stemming from concentrated

exposures to certain risks.

The second reason why the establishment of a banking union is vital for stability and growth in the eurozone is that it will ultimately ensure the full substitutability of bank deposits between banks in all eurozone countries, it will foster the completion of the single market for financial services and, more generally, it will support the efficient functioning of the single market for all goods and services by strengthening competition in credit markets.

IV. THE CURRENT BLUEPRINT FOR A EUROPEAN BANKING UNION

Let me now focus on the current blueprint for the European banking union and the timeframe for its establishment.⁷ The key question is whether the decisions already taken and being implemented concerning the supervision of systemic banks and the proposals being considered about the other elements of a banking union will be sufficient to achieve stability and growth objectives in an effective and timely manner.

My answer is broadly positive, but there are policy challenges to be addressed and uncertainties lie ahead. The final outcome depends on political decisions to be taken in the future and is conditional on the views that will eventually prevail with respect to certain aspects of Europe's banking union and its fiscal underpinnings.

Before elaborating on this general assessment, I would like to make two preliminary observations.

First, regarding the concept, a fully-fledged banking union requires a single regulatory and supervisory framework, a single resolution regime for failing banks, and a single deposit insurance scheme. Moreover, to break the negative feedback loop between bank risks and sovereign risks, a banking union should include a credible public backstop at the European level.

Second, on the question of timing, it has been decided that the banking union will be established in stages, starting with the Single Supervisory Mechanism (SSM) that has been entrusted to

the ECB. It is envisaged that the Single Resolution Mechanism (SRM) will become operational by January 1, 2015.

The good news is that the Single Supervisory Mechanism (SSM), which was formally approved by the European Council in October 2013, will be fully operational in November 2014. The ECB, in cooperation with the national supervisors and existing European supervisory authorities, has been taking all necessary substantive and organizational steps to ensure this. A key prerequisite for the functioning of the SSM and the performance of the supervisory tasks of the ECB is (i) an asset quality review (AQR) of 128 systemically important European banks, which account for about 85% of the banking system in the eurozone, and (ii) a stress test of these banks that will be carried out over the coming year. The planned AQR and the stress test are of crucial importance for the effective and credible functioning of the SSM. At the same time, they underscore the urgent need to proceed with the establishment of a single resolution mechanism and a single deposit insurance scheme.

Conceptually, the case for and the urgency of creating a full banking union are clear. If the ECB – the new single European supervisor – reaches the conclusion, on the basis of the AQR and the stress test, that a bank has to be recapitalized and the national fiscal authority does not have the capacity to support the insolvent bank because the sovereign is highly indebted, then the stability of the banking system would be threatened and the credibility of the banking union would be jeopardised. It is also clear that if a highly indebted government could muster the resources to support a failing institution, the latter's rescue would intensify the adverse feedback between public finances and bank balance sheets and thus complicate the resolution of the crisis.

Moreover, in the case of a highly indebted sovereign, which may face the risk of insolvency, a national deposit insurance scheme cannot inspire confidence in a domestic banking system threatened by a systemic crisis. In such a situation, a deposit insurance scheme with backstop funding at the European level is needed to prevent a system-wide bank run. Hence, a credible

supervisory framework – the planned SSM – is necessary to maintain public confidence in the banking system and to allow a European deposit insurance scheme to function. But it is not sufficient to prevent systemic threats stemming from a widespread erosion of confidence, such as that experienced in some eurozone countries.

What seems conceptually desirable in principle, may not be economically and politically feasible in practice, at least over the policy-relevant medium term. Over the past few months, alternative views have been expressed about the Single Resolution Mechanism, which reflect different assessments about relevant risks, funding requirements, and legal constraints.

There have been different views about the real need to establish the other two components of the banking union right away, as well as about the features of the resolution mechanism and the nature of the resolution authority, partly because of differences in risk assessments, prevailing financial conditions and banking structures, and the influence of local politics.

There have also been concerns about the cross-border distribution of risks related to failing banks and the implied fiscal burden-sharing should such risks materialize. As it is considered likely that relatively more problem banks will be found in stressed countries, distributional issues have dominated the public debate. Moreover, it has been argued that introducing a fully-fledged banking union to deal with the legacy of bad loans is unacceptable, because it is equivalent to introducing insurance after the accident has occurred.

In addition, it has been claimed that the establishment of a single bank resolution authority and fund at European level requires a Treaty change, which leads to additional political uncertainties, because a new Treaty has to be ratified by all 28 member states and, in some cases, by referendums.

Nevertheless, the decisions taken so far and the regulations proposed by the European Commission regarding the recapitalization and resolution of frail banks fulfill key

requirements and have positive features. However, the envisaged Single Resolution Mechanism (SRM) also includes some rules that may pose serious policy challenges during episodes of severe financial stress.

Let me be specific on three features of the recapitalization instruments of the SRM that have been decided or have been formally proposed.

First, the direct bank recapitalization instrument established at the European Stability Mechanism (ESM) has relatively limited resources for performing this task, up to €60 billion out of the ESM's total capital of €500 billion.⁸ The ESM can directly increase the capital of a bank only after a member state first offers a specified amount of capital support⁹ and provided that it makes a capital contribution alongside the ESM equivalent to 20 percent of the total amount of the public contribution. Moreover, ESM direct recapitalization would be subject to strict conditionality on the supported institution and possibly on the country's economic policies.

Second, the proposed by the European Commission¹⁰ recovery and resolution rules on the way bank losses are to be borne – by shareholders, by bailing in unsecured senior bonds, by injection of public capital or by bailing in other unsecured debt and non guaranteed deposits before resort to ESM direct recapitalization is possible – are reasonable in principle but may prove to be too constraining in practice and could have undesirable side-effects. These rules are being discussed and the final text of the directive is expected to be formally approved in the coming months.

Third, the SRM proposed by the European Commission involves a single resolution authority and a single bank resolution fund rather than a network of national resolution authorities and funds whose actions would have to be coordinated by a board.¹¹ This is a positive feature because experience suggests that coordination between national resolution authorities would most likely prove to be ineffective and would not result in timely and

cost-efficient resolution decisions.

Overall, the proposed European banking union blueprint is characterized by a symmetric and balanced structure. It includes a Single Supervisory Mechanism with a transfer of supervisory powers to a single authority, the ECB, over all systemically important institutions that should significantly reduce the probability of a bank failure.¹² It is envisaged to contain a Single Resolution Mechanism that appropriately involves a single resolution authority and a single backstop public fund. However, the relatively limited direct recapitalization to be provided by the ESM as a last resort and the rules on the absorption of losses by equity holders, creditors and unsecured depositors, with emphasis on bail-in tools, imply a limited sharing of risks. Although these rules have the great merit that they reduce the potential burden on taxpayers, they entail certain risks that should not be underestimated.

The envisaged European banking union framework fundamentally reflects the prevailing view about the appropriate way to deal with the trade-off between, on the one hand, taking action to protect financial stability by bailing out troubled financial institutions and, on the other hand, addressing the risk of moral hazard at the country level and at the bank level by minimizing the financial support provided by governments and ultimately taxpayers, with the help of rules that bail in creditors and depositors, in addition to shareholders, so as to absorb the losses and thus share the cost of recovery. Whether the choice made is optimal will have to be assessed in the light of the framework that will be finally adopted and of future circumstances and events.

The Lehman episode suggests that decisions taken to prevent moral hazard can have undesirable and unexpected consequences in terms of the overall cost to the economy and the taxpayers. While carefully designed and implemented bailouts can help safeguard financial stability and may result in gains or small net costs for the respective governments.¹³ However, it is not straightforward to reach a conclusion *ex ante* on the appropriate course of action. This will have to be based on the assessment of

risks and costs that are dependent on the particular situation and events to be encountered.

Will the current design of a banking union eliminate financial fragmentation and foster the creation of a single market for banking products and services?

A full banking union as defined earlier should achieve both objectives over time. But the currently envisaged set up may not contribute to the attainment of both these goals over the medium term.

It has been argued that the limited direct recapitalization of banks by the ESM in overindebted countries, the emphasis on bail-in rules, certain features and modalities of the proposed resolution mechanism, and the implied relatively limited risk-sharing are not likely to encourage cross-border banking integration and the creation of a single market in financial services.¹⁴

Moreover, although the Single Supervisory Mechanism should mitigate financial fragmentation, the currently envisaged sequencing of establishing the other banking union components implies that the positive effects will probably prove modest over the short and medium term.

Of course, this assessment, and other policy challenges related to the functioning and stability of the banking union that may have to be addressed, depend on the outcome of the asset quality review and the stress test to be carried out in 2014. If bank recapitalization needs are modest and are not concentrated on banks in overindebted sovereigns, financial fragmentation will be mitigated. If this is not the case, the adverse interaction between bank costs and sovereign costs is likely to intensify.

Over a longer time horizon, the effective functioning of the European banking union and, more generally, of EMU, is likely to require more risk-sharing and a higher degree of fiscal integration. Taking that extra step requires decisions that are fundamentally political. One relevant question is what is the minimum transfer of fiscal sovereignty to the European level that can help improve the stabilization capacity of the eurozone and ensure the effective functioning of the banking union. Some

recent research suggests that the necessary transfer of sovereignty is relatively small.¹⁵ But clearly much more work is required in this area. Another relevant and political question is whether further steps towards greater European integration are at present considered by political leaders feasible and desirable in the light of the apparently declining public support for the European project and the EU. This second question brings me to the next part of my remarks.

V. POLITICAL RISKS TO EUROPEAN FINANCIAL AND ECONOMIC INTEGRATION

Over the past year and a half, there have been many positive developments and encouraging signs regarding the prospects of resolving the eurozone crisis. The progress made in program and stressed countries towards reducing fiscal imbalances and restoring competitiveness has been significant. Financial market conditions and sentiment have greatly improved, partly as a result of the policies being implemented at the national level, partly due to the decisions taken by European leaders, and partly – indeed mainly – because of the actions and words of the ECB. The announcement of the Outright Monetary Transactions (OMTs) scheme and Mario Draghi's declaration that the Bank "will do whatever it takes" to save the euro have had a game-changing impact on financial markets. As a consequence of these policies and certain other factors most forecasts – official and private – point to economic recovery in the eurozone next year after six quarters of recession.

At the same time, there have been a number of unsatisfactory economic developments and troubling indications of rising political risk. The unemployment rate in the eurozone as a whole is at a record level of 12.1 percent on average over 2013, and in some countries it has reached dangerously high levels, about 27 percent in Spain and Greece. The expected economic recovery is likely to be weak, uneven across member states and may turn out to be fragile. The projected anaemic growth will not suffice

to reduce the unemployment rate which is expected to remain at very high levels, around 12 percent in the eurozone, over the next two years. These facts and projections suggest that social tensions may increase and there is a serious risk of political backlash against the fiscal austerity policies and structural reforms being implemented.

Economic adjustment costs in the periphery have been accompanied by bailout fatigue in eurozone creditor countries. Although, ultimately, creditor countries provided financial support to their European partners, having been convinced that such solidarity was also in their national interest, it cannot be taken for granted that relaxation of the adjustment efforts in the periphery, or political events that would trigger a resurgence of financial market tensions, would be addressed by a new bout of financial support.

These observations are consistent with the findings of various surveys indicating a significant decline in public support for European economic integration and the European Union. According to the survey conducted by the Pew Research Center in eight EU countries, a median of only 28% of the respondents believed that economic integration strengthened the economy, down from 34% in 2012, and favorable views of the EU had fallen from a median of 60% in 2012 to 45% in 2013.¹⁶

Moreover, the eurozone crisis has created a great divide between periphery and core countries in the EU. In Spain, Italy, Portugal, Ireland and Greece, which have suffered a lot during the economic recession, public sentiment about economic conditions and prospects is particularly bleak and public attitudes about European economic integration and the EU have become very unfavorable. Not surprisingly, the lack of employment opportunities is considered a huge problem, the first challenge governments should address, in seven of the eight countries surveyed.¹⁷

The latest Eurobarometer survey, conducted in November 2013, confirms the previous findings and points to potentially stormy weather ahead.¹⁸ The public does not seem to share

the view of political leaders that the approach and the policies adopted were the best for resolving the crisis.

Before reaching a pessimistic conclusion from these survey results about the future of the eurozone and the EU, let me present one optimistic survey finding which is fairly robust over time and across eurozone countries. Despite the steep rise of euroscepticism on the Continent, support for the euro remains strong.¹⁹

- About 60% of those living in the eurozone regard the euro as a good thing for their country, and
- Just over two thirds of those living in the eurozone say that the euro is a good thing for the EU.

Apparently, the public values the long-term benefits of the single currency more than the short-term adjustment cost of fiscal austerity.

There are two other encouraging and relevant findings. There is strong public support for fiscal consolidation based on public expenditure reduction,²⁰ and most citizens have a very positive attitude to economic reforms. Almost eight of ten of those living in the eurozone agree that there is a need for significant reform to improve economic performance and almost three quarters think that economic reforms would be more effective if they were implemented in a coordinated way at the EU level.²¹

Nevertheless, despite these encouraging results, the declining support about the European project, opposition to fiscal authority and persisting high unemployment can influence national politics and threaten the completion of the fiscal consolidation and reform efforts under way, thereby leading to renewed tensions in sovereign debt markets and adversely affecting European integration.

Regarding the creditor countries, the German coalition agreement confirms earlier expectations that the approach to European integration will remain broadly the same and the policies to be pursued will not be dramatically different than

in the past. The agreement includes general statements about solidarity and support, but it also adheres to the principle of non-mutualization of risks and there is no reference to European fiscal capacity. Overall, Germany is strongly committed to the preservation of the euro and further European integration, while it will aim at promoting the political and governance structure in Europe that it considers appropriate.

To sum up, the political climate in the eurozone countries remains complex. There are political risks to resolving the crisis and to implementing the agenda of creating a closer union. The pertinent question is what can be done to prevent these political risks from materializing. There are several avenues to this end. But the main one should be based on the fact that in Europe political risks mainly reflect the economic situation in member states and the eurozone as a whole, and that they are highly correlated with economic risks. This observation brings me to the last part of my remarks.

VI. REDUCING POLITICAL RISK BY IMPROVING ECONOMIC GROWTH PERFORMANCE

There is always a strong relationship between economic risk and political risk. But the causation between the two is not always easy to identify and may change over time. In assessing the outcome of national elections, it has often been said: “it is the economy stupid”. It may also be true, however, that in assessing the economic growth performance of countries or of the eurozone as a whole, it may be justified to say: “it is the politics idiot”.

Looking ahead, the most effective way to address political risk, at both the national level and the European level, is to improve economic growth performance and contain the downside risks to economic recovery in an effective manner and as an urgent and top priority.

Compared with previous years, the nature and relative significance of risks to growth have changed. The risk of a

eurozone break-up has effectively been eliminated. But social tensions and political uncertainties persist and in some countries may have risen. National politics are becoming polarized and may hinder fiscal consolidation and structural reform. Moreover, there are two types of risk stemming from financial markets. The improved financial market conditions and sentiment – in bond and equity markets – may foster complacency and delays in implementing structural reforms. At the same time, persisting fragmentation in the availability and cost of bank credit in some countries poses a risk to economic recovery.

The overriding economic policy priority should be to raise actual and potential growth; that is, to strengthen the incipient recovery over the medium term and increase potential growth over the long term. Related to this objective is the urgent need to reduce the high unemployment rate, which, if it persists, threatens to seriously undermine long-term growth performance and social cohesion and jeopardize the completion of the economic adjustment process.

To foster a stronger and more durable economic recovery, the economic policies adopted and being implemented should be strengthened and complemented by pursuing rigorously and effectively four intermediate objectives in a systematic, pragmatic and concerted manner. Pursuing these objectives should not be accompanied by a reversal of the progress made in fiscal consolidation and an unraveling of the ongoing efforts to reduce government debt-ratios to sustainable levels. The policy challenge is to reconcile further fiscal consolidation with a stronger revival of economic growth.

First, it is vital to place greater emphasis on and accelerate the implementation of structural reforms to improve market efficiency and international competitiveness. This is the main lever for raising growth over the medium and longer term and reducing the structural component of unemployment. We all agree about this. But implementation is inadequate and lagging behind plans. Extraordinary monetary accommodation will not last forever and, in any event, it cannot strengthen the economy's

capacity to generate long-term growth.

Reforms are essential for strengthening economic activity and increasing employment in a sustained manner. But because their positive effects on growth take time to materialize, there is an urgent need to complement reforms with other policies that can have an immediate and significant positive impact on employment and can help catalyse a stronger economic recovery.

Second, it is crucially important to increase credit provision to the private sector in the eurozone as a whole and to mitigate the fragmentation in the availability and cost of credit in program and stressed countries. The data released by the ECB last week underscore the need for action on this front.

To be sure, the establishment of a banking union will eventually address the problem of financial fragmentation, and, more generally, it will have positive effects on the growth performance of the eurozone over the longer run. But it is not clear by how much and how quickly this will happen. Hence, an important public policy priority is to mitigate financial fragmentation significantly over the short and medium run thereby supporting economic recovery.

A third, and related aim, should be to improve and diversify the financing of small and medium-sized firms (SMEs) that are facing serious funding problems in many countries. In all countries – large and small – SMEs account for 80 to about 95 percent of total production, two thirds of employment across Europe and are key drivers of growth and job creation. So, improving their funding conditions is essential for strengthening the eurozone's recovery and longer-term growth performance.²²

Finally, and in parallel to the above, there is an urgent need to implement rigorously the whole range of measures agreed by European political leaders that aim to reduce actual and structural unemployment. To this end, it would be helpful to establish a monitoring mechanism that will assess frequently – say every quarter – the progress made in implementing these measures, as well as the other growth-enhancing policy actions summarised in Summit conclusions, and make proposals on how

to overcome delays and implementation gaps.

If greater efforts and simultaneous progress are made on these fronts, their positive effects on economic activity will be mutually reinforcing. The risks and uncertainties surrounding the economic outlook will be reduced, consumer and business confidence will be boosted, and hence, recovery will become stronger and durable.

The sense of urgency in implementing the appropriate policies should not be lost. If unemployment is not reduced in a timely manner and economic recovery is not strengthened, the positive developments over the past year and a half in many countries may prove short-lived and political risks are likely to materialize.

VII. CONCLUSION

In conclusion, I would like to make a few remarks of a more general nature.

It is a fact that in recent years economic policy uncertainty in advanced economies, partly related to political events, has increased and is greater than during some war periods. This development does not bode well for the real economy and financial markets. Academic studies have shown that increases in policy-related uncertainty, associated with elections, domestic political conflicts or policy activism, foreshadow declines in investment, output and employment.²³

Two disturbing features of politics in recent years are that populism and short-termism are flourishing, adversely affecting economic policy-making, and that polarization of political views and extremism are increasing in several countries and are threatening the effective functioning of our democracies.

At the same time, it is encouraging that at crucial moments when our economies were on the brink, when the danger of economic collapse or financial meltdown became too big and came too close, reason prevailed and political leaders took the right decisions.

Looking ahead over a longer-term horizon, in my view the baseline scenario about the resolution of the eurozone crisis and the outlook for the establishment of the European banking union and for further progress towards European integration is a positive one. Of course, like any prediction about the future, it is surrounded by uncertainty and is subject to risks. And I previously pointed to several economic and political risks. There is also uncertainty about the timing of the resolution of the crisis and the completion of the banking union. But both will take place.

The fundamental reason for being optimistic about the future of the eurozone is that its member states have a strong common interest – economic and political – in overcoming the crisis and preserving the credibility of the euro. And they will act accordingly, although they are likely to pursue a step by step approach at a pace that will be influenced by financial market developments and national – even local – political considerations.

Tip O’Neill, the former U.S. Speaker of the House, famously said that “All politics are local” and I would add “and often shortsighted”. At this critical juncture, what we need in Europe and in other parts of the world is the political vision and resolve to pursue and implement policies that are broad-based and farsighted.

Financial markets that are forward-looking have encouraged and rewarded the adoption of economic policies that serve the long-term public interest.

Thank you for your attention.

NOTES

¹The presidents of the European Council, the European Commission, the Eurogroup and the European Central Bank. See European Council (2012a, 2012b, 2012c).

²See “Box I.2: Financial fragmentation and SMEs’ financing conditions” in European Commission (2013b), and the article in European Central Bank (2013) on the transmission of policy interest rates to bank lending rates at times

of financial fragmentation.

³See Philip Lane (2013b, 2013c).

⁴See Philip Lane (2013a, 2013c).

⁵The significant increase in financial integration within the eurozone before the crisis was a consequence of several factors: the lifting of capital controls, the freedom of establishment provided by the Treaty, the harmonization of financial regulations and the introduction of the euro in 1999.

⁶Globally, cross-border capital flows declined sharply in 2008 and remain more than 60 percent below their pre-crisis peak. The retrenchment has been larger in the eurozone, where banks reduced cross-border lending and other claims by 3.7 trillion dollars since 2007 Q4 with about 3/4 of that reduction (2.8 trillion dollars) related to intra-European claims. See J. Cohen-Setton (2013) and the McKinsey Global Institute report cited in that article. The effects of the crisis on financial globalization and on capital flows in the eurozone are discussed by, among others, Philip Lane (2013a, 2013c).

⁷Beck (2012), Goyal et al. (2013), Pisani-Ferry et al. (2012) and Ubide (2013) examine and assess the design and effects of European banking union.

⁸Of which €80 billion is paid in and €420 billion is callable capital. The ex ante limit for the amount of financial assistance available for the ESM direct recapitalization instrument can be reviewed by the ESM Board of Governors if deemed necessary.

⁹A member state has first to recapitalize the bank so that its Common Equity Tier 1 (CET 1) ratio reaches 4.5 percent under a sufficiently prudent scenario of a stress test. The ESM may directly recapitalize a bank only if the requesting member state is unable to provide financial assistance to the bank in full without very adverse effects on its own fiscal sustainability and provided that the bank is unable to attract sufficient capital from private investors. The main features of the ESM direct recapitalization instrument were agreed by the Eurogroup Council of Ministers in June 2013.

¹⁰See European Commission (2012).

¹¹See European Commission (2013a).

¹²The SSM will harmonize supervisory rules and practices; it will provide a common and credible assessment of the quality of assets and the soundness of the European banking system; and will determine the capital needs of systemic banks to withstand conditions of stress.

¹³The experiences of the US and Sweden support this assessment.

¹⁴This point has been stressed by Ubide (2013).

¹⁵See, for example, Caudal et al. (2013).

¹⁶See Pew Research (2013). Only in Germany at least 50% of the public stated both in 2012 and 2013 that economic integration strengthened the economy and were favorable of the EU.

¹⁷In particular, more than nine-in-ten Italians, Spanish and Greeks think that unemployment is a very big problem. See Pew Research (2013), p. 6.

¹⁸It showed that 28% of the European population had a fairly negative or very negative view of the EU, compared with 15%-17% in the pre-crisis period, and only 31% still have a positive view of the EU, down from almost 50%

before the crisis.

¹⁹See the Flash Eurobarometer 386, The Euro Area, November 2013.

According to the Pew Research survey previously cited, more than 60% of the people want to keep the euro as their currency in Greece, Spain and Italy, as well as in Germany and France.

²⁰See Pew Research (2013), p. 7.

²¹See Flash Eurobarometer 386 (2013), Summary, p. 13.

²²There are three pertinent significant initiatives to address the SMEs' funding difficulties: (i) the cooperative activities of the European Commission and the European Investment Bank (EIB) aimed at restoring lending to the economy, with emphasis on SMEs, by developing and implementing risk-sharing instruments, which leverage funds from the EU budget with EIB lending (see European Commission and EIB (2013)); (ii) the joint work of the European Commission, the EIB and the ECB to enhance funding to SMEs by revitalizing the securitization markets; and (iii) the study undertaken by the Institute of International Finance (IIF) and Bain & Company (2013), which assesses the relevant issues on the basis of a survey and makes suggestions on how to build a growing SME sector supported by a diversified financial structure.

²³See Baker, Bloom and Davis (2013).

LUCAS PAPADEMOS served as prime minister of Greece from 2011 to 2012, leading a government of national unity during the most difficult phase of the Greek debt and economic crisis. Previously, he was vice president of the European Central Bank (2002–2010) and governor of the Bank of Greece (1994–2002). He played an instrumental role as central bank governor in bringing Greece into the Eurozone and as prime minister in keeping the country in it. Papademos, who is currently professor of economics at the University of Athens and senior fellow at the Center for Financial Studies of Goethe University Frankfurt, held several senior positions at the Bank of Greece, including that of chief economist (1985–1993). Earlier, he served as a senior economist at the Federal Reserve Bank of Boston. He has been a member of numerous councils, boards, and committees, including the executive board and the governing council of the ECB, the financial stability board, the EU economic and financial committee, and the Trilateral Commission. Papademos has been on the faculty of Columbia University (1975–1984), the University of Athens (1988–1993) and, most recently, Harvard Kennedy School as visiting professor of public policy. He earned a MS in physics, an MS in electrical engineering, and a PhD in economics, all from the Massachusetts Institute of Technology.