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Thoughts on Europe and Its Future Outlook and Challenges Facing the Banking Sector in Europe

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Opening greetings.

A little over a year ago a majority of UK voters chose to leave the Union, a decision that made many Anglophiles in Europe sad. This decision and its follow-up (the start of difficult negotiations and uncertainties about the future relationship) has prompted fresh reflections on both sides of the Channel about Europe's identity, about the reasons for disaffection – which go beyond Britain, though it alone has taken the ultimate step of leaving – and about the strengths and weaknesses of the Union's institutional setup.

Your invitation to share some thoughts on the outlook for Europe is surely part of this growing debate, and I take it as a sign of your belief that both a Britain-less Europe and a Europe-less Britain will continue to need to understand each other as much as they can.

Disaffection with Europe, while having its own distinctive motives, is part of a broader trend of surging anti-establishment sentiment across the Western world; it cannot be properly analysed without reference to this broader trend. This in turn is a very complex subject and has multiple causes; any explanation based only on economic disillusionment and rising inequality would, in my view, be at best incomplete. It would be impossible to discuss its multi-faceted nature here in any meaningful detail.

So let me leave this discussion for another day and just say that a rising demand for protection, driven by many factors (including economic insecurity, reduced trust in traditional parties, migration and the threat of terrorism), has been met by a political offer of insular policies, often making scapegoats of outsiders, such as migrants or poor labourers in developing countries who are an easy target for polarising and channelling grievances, providing a simple answer to complex issues. Both casual observation and structured research have shown that links exist between anti-establishment attitudes and the rise of Euroscepticism.

I would like to point out that in this context the remarkable achievements of the EU are often forgotten, or too easily taken for granted: seventy years of uninterrupted peace among nations that had fought each other for centuries;

an understanding that decisions in the common interest must be taken together, with due process, and that conflicts need to be resolved based on rules and institutions (including, yes, a codified right to leave peacefully should a member country decide to do so); rules to protect and promote the benefits of liberal democratic institutions and a market economy, and an ability to make those benefits felt beyond our own borders, notably in countries undergoing constant waves of transition. And I do not need to mention here the benefits of a single, large and diversified market.

But to go back to disaffection: while much of it seems due to common trends in Western societies, in Europe part of it seems related to a more specific perception that European institutions do not serve European citizens as well as they could. This perception takes different hues, depending (among other things) on nationalities and political persuasions; however, over-intrusive rules, an inability to respond effectively to new challenges and to tackle emergencies, together with unresponsiveness to the ordinary person's needs appear to be recurring themes.

Because of this, and given the terms of your kind invitation to speak, I shall henceforth concentrate on institutional aspects. First, I have a few thoughts on European institutional design; second, a more detailed discussion of two areas where European Union institutions have a particularly prominent role, namely public finance and financial supervision; and third, a brief reflection on the prospect of Brexit and how it may affect all this.[1] I'll be candid; it must be understood that these are my personal thoughts and do not in any way represent the Bank of Italy's views.

Unanswered questions in EU institutional design

Critics of the Union's institutional setup often point to a lack of democratic legitimacy in European institutions. Two claims are usually made: first, the lack of a European 'demos', or body of citizen-voters who share a political identity and take part in a common debate on political choices; second, the lack of truly representative institutions. While there may be some truth to both, I believe that the reality is subtler than is usually assumed.

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[1] The sections on institutions and public finance draw heavily from a previous speech (Moncalieri, 19 December 2016).

I shan't linger too long on the 'demos' issue. Let me just refer you to what I find to be a rather convincing discussion of the topic in a book by M. Monti and S. Goulard.[2] I would summarise their discussion by saying that the 'demos' and democratic institutions are the chicken and egg of the body politic. It is impossible to specify a rigid sequencing. While the latter cannot properly function without the former, the former does not usually even exist without the latter. (The two authors even claim, based on historical evidence, that there was no 'demos' in 5th century BCE Athens before the establishment of democratic, city-wide institutions). I would add that the ever-increasing ease of communication and exchange across national borders is generating more and more cross-border debate, and may well be assisting in the emergence of a pan-European political arena. Time will tell.

Therefore, the more important discussion, in my view, is about European institutions and their claimed lack of representativeness. My perspective on this is the following. If one looks carefully at the architecture of the European Union, one will note that it resembles 'normal', democratic constitutions as far as parliament and the judiciary are concerned, but not at all for the executive branch. Let me clarify this point, which I think is rarely noticed explicitly.

Today the EU has an elected Parliament that, while less venerable than the one where we are holding our conversation today, has a central role; it co-decides on legislation, mostly on a par with the Council; has budgetary and control powers; in short, though perhaps within a narrower mandate, it has a status, composition and powers that are broadly comparable to those of parliaments in many democratic polities. European voters may not have fully noticed it yet (the 'demos' will follow!), but this is a fact.

The Union also has a judicial system that ensures the uniform interpretation and application of EU law. While the make-up of its component courts is somewhat unique, and while its rulings are obviously confined to matters that the Treaties assign to the Union, the characteristics and actual functioning of the European Court of Justice are akin to those of an ultimate court of appeals or a constitutional court in many democracies.

The executive function, to the extent that this concept can be applied to Europe, is more unusual. The EU is in the unique position of having two institutional branches with powers of political direction, the Council and

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2 *De la démocratie en Europe*, Flammarion.

the Commission, with very different compositions and sources of legitimacy. Besides, each branch also exercises functions beyond those typical of a government.

The European Council, made up of the heads of government of the member states, provides 'impetus' and sets the policy agenda in a rather vaguely defined but practically important way. It has maximum influence in foreign and security matters. At the same time, national governments, represented at a lower level in the Council of the EU, also play a key role in the legislative process.

The European Commission, on the other hand, nowadays resembles in many ways a government in a parliamentary system. The Commission's President is proposed by the Council but he or she must survive a vote in Parliament; Commission members need Parliament's consent. This is not merely pro forma: after the 2014 elections, Parliament made it clear that it would vote down any nominee except the *Spitzenkandidat* of the party that got the most votes. Like a normal government, the Commission manages and implements EU policies and the budget, and represents the Union outside Europe. But it lacks a clear ultimate power of direction.

At the same time, in certain fields and in its general function of 'custodian of the Treaties', the Commission has functions that would typically fall in the domain of independent, quasi-judicial regulatory authorities: for instance, it has a mandate to enforce competition rules. As an executive body, it is essentially political; as a technical authority, it is bound by objectivity and independence. The two do not square well: making discretionary policy choices and impartially enforcing technical rules seem to require rather different institutional frameworks.

The lack of a conventional executive branch is paralleled by the lack of some of the instruments that are typically available to a government. On the eve of the single currency, Tommaso Padoa-Schioppa noted that the Union's 'capability for macroeconomic policy is, with the exception of the monetary field, embryonic and unbalanced: it can avoid harm (excessive deficits) but it cannot do good (a proper fiscal policy). (…) It is thus right – he concluded – not only to applaud yesterday's step but also to underline its unfinished nature, the risks and the rashness'.[3]

3 *Corriere della Sera*, 3 May, 1998.

In the absence of a clear institutional framework for discretionary political action, European economic governance has largely been based on rules: budget rules, the ban on rescues between member countries, rules on bank supervision and resolution and so on.

In sum, it is the balance between rules and government action in the way the Union runs its affairs, rather than a lack of representativeness, that is in my view the most unusual feature of European institutional arrangements.

This is largely intentional: national governments want to retain a say, and may not be prepared to see the emergence of a rival centre of discretionary action. However, given the massive amount of responsibility already transferred to European institutions in some fields, their scope of action in those fields is restricted by European rules anyway. The result is not a lot of discretion at the national level, but little discretion anywhere in the system.

Whatever the optimal balance might be, I think most would agree that rules are necessary, but there are limits as to what they can achieve. You cannot run a large, advanced, diverse economy on autopilot, a fact that became even more apparent with the crisis.

The crisis showed the limits on what individual member states could achieve on their own, and it pointed to the need for coherent action, given, among other things, significant spillovers across member countries, especially within the monetary union.

The areas that underwent the greatest centralisation of responsibilities were public finance and the financial sector. After the sovereign debt crisis erupted, emergency measures have been progressively accompanied by reforms of European Union governance and more specifically the euro area, starting with enhanced public finance rules and macroeconomic surveillance. In 2012, the ‘Four Presidents’ Report’ envisaged complementing or replacing national intervention tools with common instruments. For banks, the report proposed transferring supervisory responsibility in the euro area to an area-level institution, and establishing joint crisis resolution and deposit guarantee mechanisms, to be supported by public funds through the European Stability Mechanism (ESM). As to public finance, in addition to implementing the reforms already approved (the Six-Pack and the Fiscal Compact), it proposed gradual steps towards the creation of a euro-area budget and the issuance of common debt. Most of these proposals were taken up again in subsequent documents, including the “Five Presidents’ Report” of June 2015. They are still the backbone of the recent Commission’s reflection paper on the future of the EMU.

The restrictions on the use of national mechanisms were put in place quickly, but the introduction of European instruments has been partial, and virtually non-existent on the fiscal side. Member states are now constrained by many rules that say what *cannot* be done, while the EU has gained neither the powers to decide what *should* be done, nor the tools or institutional framework to implement the needed policies.

Whether one is a true believer in European integration or not, this is a point that appears to deserve attention. When many key matters are in European hands, one can scarcely leave them to be governed (only) by an uneasy mix of quid pro quo deals and technocratic fiat.

Fiscal policy

Let me now consider one of those key areas, fiscal policy, in some detail.

Fiscal rules are necessary in a monetary union. They serve as a coordination mechanism, ensuring that all national fiscal policies contribute to maintaining financial stability in the area. Poor compliance with fiscal rules in the period preceding the crisis justified their being strengthened.

Coming from a country with a high public debt, I am especially aware of this. Lest I be misunderstood, let me be absolutely clear. The Bank of Italy has constantly reminded the Italian authorities of the importance of fiscal discipline. The Governor of the Bank of Italy has repeatedly made this point on public occasions. Personally, at Parliamentary hearings on budget plans I have never failed to underline the strategic nature of the objective of debt reduction. In a recent speech, I pointed out that, thanks to an improved cyclical outlook, now is the time to act.

That the sustainability of the debt in the long run must be ensured is dictated by common sense (and the markets), regardless of any rules. Rules are useful, however, in order to ensure that no member state poses a risk to others through irresponsible behaviour, and to provide a framework, a benchmark and a cue for public policy debate within countries.

The issue, therefore, is not about whether rules are needed, but what you can realistically hope to achieve by applying them. Very simple fiscal rules, by themselves, do not work well in practice. It would be unreasonable to take decisions on the fiscal stance without accounting for the cyclical position of the economy, for instance, or for exceptional circumstances. Without a substantial EU budget, some flexibility in the rules constraining national budgets is unavoidable.

Thus realism has required the introduction of more and more elements of flexibility in the system of European fiscal rules, and these in turn have required more safeguards to fend off abuses. With exceptions and counter-exceptions, over time the fiscal rulebook and its application have become so complex that it now takes a specialist to navigate the various definitions of objectives and constraints in the Stability and Growth Pact. Certain concepts, like the 'structural' budget, rely on statistics that are open to interpretation and debate: there are many possible measures of the output gap, for instance. Waivers for exceptional circumstances imply, by definition, a discretionary assessment. The system is too intricate to be transparent to the public, yet it is inherently incomplete; there can be in fact (as every economist in this room will acknowledge) no 'complete contract' in the real world.

This is one case where the ambivalence between the Commission's political and technical roles is apparent. There is tension between the impartial, technical, rule-based assessment that it is called on to perform, and the multitude of complex and unexpected real-life circumstances that it will actually face. Discussions often become very heated politically and the Commission is sometimes subject to accusations of arbitrariness.

The absence of a substantial European budget and the complications of the Stability and Growth Pact are linked. If there were some fiscal capacity at the European level, the constraints on national budgets could be simpler.

The Commission's recent focus on an appropriate fiscal stance for the euro area as a whole and its attempt to quantify it for the first time are welcome developments. My point here is not to discuss whether their quantitative assessment is correct, which is a subject of intense debate. My point is to underline that in our current decentralized policy setting, implementing whatever aggregate fiscal stance one thinks appropriate is difficult anyway.

Automatic stabilizers embedded in a common budget, on which the discussion has mostly focused so far, would partially free national budgets from the pressures arising from adverse cyclical conditions. A common budget, however, could also be used to adopt discretionary measures. Ultimately, both theory and experience suggest that some fiscal-policy counterpart to the single monetary policy would be a natural thing to have.

Discretion does not mean total freedom from constraints: constitutional limits on spending or deficits can be set at the European level just as they already exist at the national level in many countries. It only means recognizing that it is impossible to govern public finances by rules alone; that no complete contract exists in public finance that can allow a democracy to dispense with open, transparent debate on budget decisions; and that, to the extent that spillovers and the common good require significant constraints on national budgets, some fiscal space must be found at the European level.

Just to avoid another possible source of misunderstanding, let me clarify that a common budget for the future does not imply a mutualisation of past debt. That is an entirely different debate. Furthermore, I am not advocating permanent transfers across member states. Not only would this be politically unfeasible. My own experience with regional differences in Italy tells me that structural fiscal compensation of economic disparities does not put an end to them: it entrenches them. So, for instance, any EU-wide automatic stabilisers should be designed to be geographically neutral in the long run.

Banking union

You might be interested in a discussion about how this line of reasoning applies to another field where considerable responsibilities have been transferred from EU member states to the European level: banking.

I have four points to make on this matter. 1) Banking union is a very good idea that needs to be completed. 2) In this case a considerable amount of discretionary power *has* been transferred to the centre, predominantly to independent, i.e. non-political, authorities, and within a complex structure, which again poses the issue of optimal rules, accountability and coordination. 3) Despite the incompleteness and complexity, and the sheer novelty of the arrangements, it has worked reasonably well, indeed given all circumstances remarkably well, when put to the test. 4). Some streamlining remains necessary in order to reduce uncertainty further and increase the effectiveness of the system. Let me expand briefly on each point.

I do not think I need to say much to convince this audience of the benefits of a single European market in banking. Let me just point out that the crisis made it dramatically evident how easily markets could fragment along national lines when a very bad event hits. In an emergency, it is everyone for themselves. It is not just an issue of markets fragmenting spontaneously. Understandably, even legitimately, national authorities, acting on the basis of national law and answerable to national institutions and the national public, will instinctively want to 'raise the drawbridge'. However, this is an obvious collective action failure. Efficiency will suffer; the risks to stability itself will increase. (Think of what happens if you erect barriers during a liquidity freeze: every agent, every segment of the market might feel more secure by holding on to its own cash, but if everyone does so then the market is bound to stay frozen). Thus, while the single market can be expected to be good for the economy at all times, it is doubly so in difficult times.

The single market in banking requires a single supervisor, and much more besides. The original design also included a single resolution mechanism, with pooled resources and the determination to use them when needed; a common deposit insurance; and a European public financial backstop. All this was meant to provide effective European resources and decision-making power, so that institutions can act swiftly, boldly and freely when necessary. It is also gradually being recognised that a banking union cannot fully function without further harmonisation in various areas of law, above all in bankruptcy law (work on this has just started and there is much to do).

The Single Supervisory Mechanism (SSM) has been operational since end-2014. The Single Resolution Mechanism (SRM) has been in place since January 2016; while it has already taken on considerable responsibilities, many elements are still under construction. The BRRD has introduced new tools that had to be set up almost from scratch (like resolution plans and a minimum level of eligible liabilities or the MREL requirement); the process is underway. The Single Resolution Fund (SRF) is being built up gradually, and the conditions for using it are quite stringent. No common backstop (the third line of defence, after private involvement and the SRF) is as yet in place. Finally, the European Deposit Insurance Scheme is still at the proposal stage; negotiations are at a standstill.

The pursuit of financial stability involves many tasks (rule-making, supervision, resolution/liquidation and macro-prudential action); the design of the supervisory architecture needs to consider a trade-off between the prevention of conflicts of interests and the need for coordination and information exchange. Concerns about the former (a bit overdone, in my view) have prevailed in the European case, so that each task is entrusted to a different authority. However, there are many potential areas of overlap, with duplication, lack of coordination and conflicts always a danger. Furthermore, the most sensitive task of all, namely resolution/liquidation, often involves decisions about the use of public money, which in many other jurisdictions sees a democratically accountable government as the ultimate decision maker. In Europe the role of rules (again) and independent, technical authorities is greater, because of a reluctance of member states to commit to possible transfers outside, ideally, a rigidly pre-determined framework.

How has this worked in practice? As I said before, my answer would be: on the whole rather well, given the circumstances and constraints. However, it is unfinished business and it does need streamlining and reinforcing.

I shan't comment on the SSM, except to point out that it has gone a long way towards fulfilling one of its most important aims, namely, guarding against the fragmentation of the European market. This is, I think, a worthy achievement in itself. May I just add that, more generally speaking, establishing a central structure and bringing together different, long-standing supervisory cultures and practices was an enormous task and the rapid progress achieved in just two and a half years is quite remarkable. The SSM works like a system, with common rules, lively discussion at the decision-making level and a great deal of operational integration. (This does not mean that we always agree on everything; but we do agree on most things, and when there is disagreement, the decision rules are clear, and we move on).

The resolution / liquidation part has received a lot of attention in the past few weeks, in relation to the handling of the crises of one Spanish and two Italian banks. Let me concentrate on the latter and draw some conclusions from the experience.

This is obviously not the place to go over the matter in detail. Governor Visco focused on these cases in a recent speech; we have also published a set of Q&As on the Banca d'Italia website. to which you may refer for a fuller picture. I just want to make four brief points.

The solutions that have been put in place by Italian and European authorities are entirely in line with the EU framework for bank crisis management (BRRD and State aid rules). They represent a pragmatic European response to the need to deal effectively with banking crises in the transition towards the new framework, without putting financial stability at risk.

Pragmatism is no circumvention. While State aid was authorised to avoid a threat to stability, avoiding bail-in has only been possible because the two banks were put into liquidation and exited the market. This is not only a matter of the old legal entities losing their banking licences. The approval of the deal by the European competition authorities has been conditional on a radical downsizing of residual operations in terms of staff and branches. What is left was put to tender in an open, competitive procedure. This point may have mostly escaped the public's perception, but it is crucial. The rules are clear: in such conditions, when an entity is liquidated, bail-in is not required. This is both justified in principle (with exit, there is no distortion of competition) and wise in practice. Rules are there to prevent financial instability and bolster the public's confidence, not the other way round.

The sale of assets to another bank has taken place, as I already mentioned, through an open, transparent procedure. Again, no mere formality, despite the limited timeframe: the procedure was genuinely open and involved six entities, including an insurance company and two non-Italian banks. In the end only one tendered a sufficiently comprehensive offer.

Public support is temporary and of a limited amount, once again in line with European rules. The credit of around €5 billion that the State holds vis-à-vis the two banks is backed by the assets to be liquidated and stands a fair chance of being recovered, given enough time.

This deal, together with the solution of the Monte dei Paschi case, removed uncertainty from the market and boosted confidence, thanks also to an improved general economic outlook. The markets reacted very positively.

So is everything fine? Not quite. Ex post, I think the process was handled successfully and the outcome was eminently reasonable (there is no 'first best' when a bank fails). But the process itself was much more complicated than is optimal, involving many authorities at the national and European level. Negotiations were complex at times. Coordination is always resource-intense.

Some streamlining is in order. The involvement of private investors' money in resolving banks will be easier and more readily accepted when banks are able to issue explicitly bail-inable debt whose risk is understood from the beginning. (Making the bail-in rule retroactive was a mistake).

More generally, the banking union project remains lopsided. Restrictive rules are in place, but common backstops are not. The discretionary decision to declare a 'public interest' when a bank is 'failing or likely to fail' is left to a technical body, which is an unusual arrangement and may lead to a restrictive bias, a situation whose consequences for financial confidence must be thoroughly evaluated.

An incomplete banking union is a risk in itself; if allowed to persist for too long, it becomes an additional source of uncertainty for investors and banks.

The 'Brexit test'

The UK notified the European Council of its intention to withdraw from the European Union on 29th March. In May the EU Council gave the Commission a mandate to negotiate the withdrawal. Negotiations started in June. The agreement needs to be finalised by March, 2019.

According to the Treaty, there are two separate but related negotiations. One concerns the exit agreement, which should cover, among other things, the rights of people and firms currently enjoying the EU's freedom of movement who, after Brexit, will find themselves on the 'wrong' side after Brexit; and the UK's financial obligations towards the EU. The second negotiation concerns the relations between the UK and the EU after withdrawal, including any trade agreements.

Negotiations will follow the sequencing proposed by the European Council: the terms of withdrawal must be discussed first and 'preliminary and preparatory discussions' for a trade agreement will only start after 'sufficient progress' has been made towards achieving an orderly withdrawal.

For post-Brexit trade relations between the UK and the EU, two options are realistically on the table: i) a bilateral trade agreement or ii) no agreement at all, in which case trade relations would be governed by WTO rules and the

Most Favoured Nation clause would apply. Two other options are theoretically available, i.e. accession to the European Economic Area or participation in the EU customs union, but they appear unlikely at this stage, given the UK's well-known red lines on immigration and the jurisdiction of the ECJ.

So far, the negative effects on the UK's economy that many expected immediately after the referendum have failed to materialize. However, the economic impact of Brexit in the longer term remains highly uncertain, and much depends on the future trade agreement between the EU and the UK. It is difficult for an economist to believe that barriers won't have any detrimental effect on economic welfare.

In the long run, trade between the EU and the UK would be hampered by the imposition of tariffs and customs controls, if no trade agreement is reached. The cost to the UK economy also depends on to what extent less openness to trade, immigration and foreign investment will affect innovative capacity, competitiveness, and productivity growth. Brexit spillovers to the EU are expected to be negative but modest.[4]

An issue that will be close to the heart of many in this audience is the loss of the 'single financial passport'. If there is no specific agreement, after Brexit UK-based banks will be treated just like those from any other third-country in the EU. The European Commission has recently proposed that third-country systemically important banks would have to set up an 'intermediate parent undertaking' (IPU) within the EU, subject to supervision and crisis management under EU rules and by EU authorities. At present, many non-EU banks have their European legal and operational headquarters in the City; some of them may be required to set up an IPU. Whatever the final arrangements, effective supervision of activities performed in the EU will have to be ensured.

Another issue is the fate of euro-denominated derivatives clearing. Much of it happens through central counterparties (CCPs) established in London. Last June, the European Commission proposed that CCPs clearing 'super systemic' amounts of financial instruments denominated in European currencies be subject to location requirements, especially the euro.

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[4] M. Pisani and F. Vergara Caffarelli, *What will Brexit mean for the UK and euro area economies? A model-based assessment of trade regimes*, Banca d'Italia, Temi di discussione (Working Papers), forthcoming.

Conclusions

Increased disaffection, certain deficiencies in its institutional set-up and the incompleteness of the banking union are significant challenges that the EU must take.

Brexit, meanwhile, is a challenge for both sides. How has it affected the EU's own development?

It has not, so far at least, sparked imitation. On the contrary, European leaders seem to be increasingly aware of the need to act together and to act boldly to preserve and further develop what has been achieved in the past sixty years.

Some tentatively positive signs have come lately also from sentiment indicators and from electoral results. The Eurobarometer, which had been signalling growing disillusionment with the Union for years, saw a slight rebound in pro-EU attitudes. Elections in several European countries failed to confirm a surge in anti-EU forces. Surely the improved economic climate has helped.

Just as surely, there is no room for Euro-complacency. While personal attitudes towards Europe vary, the concrete functioning of institutions, their ability to be seen as responsive and to deliver functional results, is what ultimately matters. Pragmatism is usually there and is essential; but, looking forward, it is not sufficient.

Whatever one thinks of any further moves toward full political union, the amount of sovereignty that has already been pooled at the EU level, especially in economic and financial matters, is substantial. When Europe was mostly about things like fishing quotas and agricultural prices, important as these matters are, one could more or less live with a suboptimal arrangement. Now that it has a key role in certain issues that go to the heart of the political debate in any country, such as budget balances and financial stability, this is no longer the case.

Building the capacity to act at the European level, and not just rules to constrain national action, requires much mutual trust and institutional foresight. Many would say that the current circumstances make such steps politically difficult. There can be no question of trying to forge ahead with advances that many citizens are not prepared to accept. Still, I find it useful to point frankly to issues regarding the functioning of European institutions that experience and reflection tell me are important.

I believe a strong European Union is also in the interest of those who have decided to leave it.

Let me now close by saying that, personally, after 2019 I shall miss my UK colleagues in EU institutions very much, and not just because of the loss of their consistently admirable competence. Over the years I have always appreciated the open, anti-bureaucratic, market-friendly attitude that they have invariably brought with them. Much as I regret Brexit, I do hope that four decades of working together will have taught each side how to learn from the best qualities of the other.

Thank you.

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