

# **Completing and Repairing EMU**

**Speech by Vítor Constâncio, Vice-President of the ECB,  
at the Hyman P. Minsky Conference on Financial Instability organised by the Levy  
Economics Institute and ECLA of Bard with support from the Ford Foundation,  
The German Marshall Fund of the United States, and Deutsche Bank AG  
Berlin, 26 November 2012**

Ladies and gentlemen,

It is a great pleasure to be here today to participate at this event organised by the Levy Institute. It is fair to say that, intellectually, the Levy Institute has had a “good crisis”. Building on the post-Keynesian analysis of Minsky’s Financial Instability Hypothesis and Wynne Godley’s theory of sectoral balances and stock-flow consistent models, the work of the Institute’s resident scholars predicted and explained many of the challenges we are facing today.

This serves as a reminder of the importance for policy-makers to keep an open mind in continuously refining our economic thinking. It is today clear to us that conventional macroeconomic models were ill-equipped to capture the key role of financial markets. Our theoretical foundations proved to be misplaced when tested in reality. The way forward therefore has to involve taking the lessons from this empirical test: using the knowledge we have gained so far to better understand the necessary conditions for economic and monetary union to function. What this implies for the euro area will be the subject of my address today.

Shortcomings in EMU’s architecture

EMU was designed with a centralised monetary policy but decentralised fiscal, economic and financial stability policies. Its construction rested on three convictions: first, the synchronisation of business cycles in the euro area; second, a sufficiently flexible and competitive internal market; and third, the existence of sufficient ‘shock-absorbers’ to deal with country specific developments.

Where do these convictions of the EMU designers come from?

Well, the general expectation was that the first two would be supported by the common currency itself. The euro would boost trade and financial market integration within the European Union by eliminating exchange rate risk and lowering cross-border transaction costs. This deeper market integration would lead to greater synchronisation of business cycles, thus making the stance of a single monetary policy appropriate for all Member States.

At the same time, the existence of the euro would strengthen the single market and create greater flexibility, in turn making it easier and faster to rebalance after economic shocks. In this sense, while the euro was ostensibly devised to maximise the benefits of the Single Market, those same benefits would create the conditions to sustain the single currency.

The third conviction – that the ‘shock-absorber’ function can be fully achieved by national fiscal policies – was founded on the belief in sound fiscal positions that would allow the automatic stabilisers to play out in full during downturns. As an additional safeguard for disciplining fiscal policies, a fiscal brake was included in the Treaty to prevent Member States running excessive deficits.

Aside from a single currency and a fiscal brake, EMU's institutional architecture was minimalist: governance of economic and financial policies remained firmly a national competence.

What lay behind these expectations? Of course, political considerations were a dominant factor, insofar as governments had incentives to limit the centralisation of fiscal, economic and financial policies. But to an extent, it also reflected the economic thinking that prevailed at that time.

The rational expectations, perfect foresight paradigm was – and to a large extent still is – dominant. Many of its followers are, of course, aware of its limitations but hope to successfully expand the theory to encompass new aspects of reality. Standard models feature unboundedly rational agents and complete knowledge of all variables' probability distributions in all possible future states of the world. They do not foresee significant credit cycles or irrational asset price bubbles. Moreover, information is fully symmetric and complete state-contingent contracts can be written and enforced.

Default – a situation in which debtors cannot repay due debt in some states of the world – was also ruled out. The optimal lending contracts in such an environment do not even resemble a debt contract. Agents use so-called 'Arrow-Debreu' securities. The set-up allows a different payback for every future eventuality so that borrowers are always able to meet due repayments.

The normative Ramsey model of 1928, devised for a central social planner to decide about the optimal intertemporal path of saving and investment was surprisingly put at the centre of macroeconomics, with the assumption that it could serve as a good descriptive model of the way a capitalist market economy really works. Considered a general equilibrium model of representative agents, the model initially had no money. Money was later inserted back in via the unkeynesian assumption of rigid prices and wages but finance remained completely excluded as if it didn't matter to explain real economy fluctuations.

The crisis has put into question these standard models as good and useful representations of how the economy works. Several researchers, followers of the paradigm, are now working hard to incorporate as many financial frictions as possible into their models. However, other academics belonging to the core paradigm have been raising more fundamental doubts. For instance, Ricardo Caballero wrote: "Rational expectations is a central ingredient of the current core; however, this assumption becomes increasingly untenable as we continue to add the realism of the periphery into the core" [1]. Willem Buiter, questioned the paradigm more acidly: "Most mainstream macroeconomic theoretical innovations since the 1970s ( the New Classical rational expectations revolution ...and the New Keynesian theorizing ...) have turned out to be self-referential, inward-looking distractions at best. Research tended to be motivated by the internal logic, intellectual sunk capital and aesthetic puzzles of established research programmes rather than by a powerful desire to understand how the economy works" [2]

Much earlier, Minsky had already stated the same type of acid test "...for an economic theory to be relevant, what happens in the world must be a possible event in the theory" [3]

Under the ideal imagined conditions of prevailing thinking before the crisis, the market mechanism operates smoothly and since financial frictions are disregarded, financial intermediaries were generally absent from macro models and without leveraged financial intermediaries, financial instability is not an issue. It is true that there some frictions linked to the credit channel had been included in macro models, basically related to the Financial Accelerator developed by Bernanke and Gertler and Gilchrist [4]. This is, however, only a mechanism that could aggravate an on-going crisis,

but was not strong enough to trigger one. Recently, Adrian, Colla and Shin examined which frictions should, at a minimum, be included to be relevant. They concluded from the evidence of the crisis that at least five stylized facts should be reflected in macro-financial models: coexistence of bank and bond finance, substitution from bank to bond financing, increasing credit spreads, stickiness of equity prices and endogenous procyclicality of bank leverage. [5]

In the pre-EMU economic modelling world, therefore, there was no need to counter financial imbalances and financial instability as the financial sector did not play a crucial role from a macroeconomic perspective. Similarly, under the assumption of self-equilibrating markets, there was no need to monitor macroeconomic imbalances and disequilibria on the labour, product or financial markets. With an assumed stable private sector, apart from exogenous shocks, the only source of instability acknowledged were governments and their fiscal profligacy. This supported the decision to elevate only governance of fiscal policies to the European level.

With the benefit of hindsight, it is obvious that this architecture was unstable. Like the neglected build-up of financial imbalances and high indebtedness that led to the crisis, the initial design of the European Monetary Union was a victim of the economic thinking then dominant. A few lessons have to be drawn now.

Lesson number one: the greater integration of euro area financial markets implied that our economies became more prone to contagion. Financial integration ran ahead and European-level financial supervision was non-existing. The financial trilemma of Dirk Schoemaker [6], that states that financial integration, financial stability and national supervision are not compatible, was disregarded and the consequences were significant in terms of the enormous capital inflows channelled by the banks of core countries to banks in the periphery, significantly contribute to the subsequent macroeconomic imbalances. Initially no one thought about banking union.

Lesson number two: the financial and economic shock of the crisis vastly outran the shock absorption capacity at the national level. Nothing was foreseen to deal with liquidity crises that could emerge from contagion and multiple equilibria generated by market perceptions. Only later the EFSF and the ESM were created to address crisis management.

Lesson number three: the existing rules on the fiscal front were insufficient in pre-crisis times, and even more so in crisis times when crisis management was key. Initially, no one talked about fiscal union to introduce more discipline and help with shock absorption.

Lesson number four: the development of macro and external imbalances was significantly driven by private sector indebtedness, proving that the fiscal brake was not enough to guarantee macro stability and excessive heterogeneity among member states. This provided the rationale for the recent creation of a formal Macroeconomic Imbalances Procedure to monitor and promote timely policy measures to avoid the building up of macroeconomic instability in member states.

The deep integration of financial markets led to very large imbalances within the euro area. This was in part because fiscal rules were implemented weakly, not applied rigorously and subsequently watered down. Some countries therefore ran persistent deficits in good times or maintained high levels of debt. But the greater imbalances in fact emerged in the private sector. Looking at the data for EMU's first decade, imbalances in the private sector far exceeded those in the public sector.

Between 1999 and 2007, the ratio of public debt to GDP in EMU declined on average by 5.6 percentage points. But in the same period, the ratio of private sector debt to GDP increased by 26.8 percentage points. For the same period, in the stressed countries, the cumulative increase in the private debt ratio to GDP versus the public debt one, amounted respectively, to 49 and 24 per cent for Portugal, 75 and minus 35 per cent for Spain, 101 and minus 10 per cent for Ireland, 217 and 4 per cent for Greece.

Private debt levels were able to increase so significantly because the integration of national markets allowed for higher borrowing from abroad and increased leverage. For instance, from 2001 to 2006 MFI holdings of cross-border securities issued by non-MFIs increased by almost 44%. And as we now know, these flows were not perfectly optimised by rational private agents. Real estate bubbles in some countries, widening current account deficits and generalised losses in competitiveness. The minimalist institutional construction of the euro area lacked the tools to discourage these developments.

When these bubbles burst, the shock-absorption capacity of EMU was lower than anticipated. Indeed, financial integration acted as a shock-amplifier. Cross-border capital flows rapidly reversed and created contagion. This was in part because private agents realised that there were no mechanisms to ensure the continued solvency of banks and governments in situations of financial distress. Financial assistance at the European level, such that it existed, was reserved only for non-euro area countries. Moreover, there were no federal institutions – like the FDIC in the U.S. – to remove the burden of repairing the financial system from individual Member States.

The official bodies that could – and perhaps should – have intervened to prevent these developments were national supervisors. Yet they lacked the perspective to do so and also the instruments to contain private capital flows that were considered to result from optimizing self-equilibrating markets. Only macro-prudential measures made possible by a consensus at the European level could have dealt with the situation. In other words, there was a mismatch between the degree of integration and the scope of governance.

In retrospect, the euro area was not prepared to deal with the build-up of systemic risks. This was in a large part because it had not equipped itself with the institutions commensurate with a highly financially integrated monetary union. This shortcoming has clearly contributed to the situation we face today. Unwinding its consequences is the key challenge the euro area faces. So let me now discuss how we can address that challenge.

Fixing EMU for the long-term

Unwinding the euro area's imbalances

What is the way out of this situation for the euro area?

First and foremost, the imbalances that accumulated in certain euro area countries have to be remedied by those countries themselves. Under present rules, other member states can only provide some interim financial assistance and have indeed done so via the EFSF/ESM. The indispensable national consolidation effort by the more indebted countries is the implication of a system where fiscal, economic and financial policies are basically decentralised. But despite a difficult start, a significant rebalancing is now happening within the euro area.

Across the euro area, strong budgetary consolidation is taking place. The IMF forecasts that the euro area's primary budgetary position will be almost in balance this year. This is quite an achievement in an international context: Japan, for example, will have a 9% of GDP primary deficit this year, the U.S. 6.5% and U.K. more than 5%. And the euro area is not only performing well on average: each

individual member country will have this year a primary budget deficit lower than those three countries.

Important improvements are also taking place in competitiveness. Member States have now started to undertake structural reforms to facilitate intra-euro area adjustment. There have been determined efforts to address product and labour market rigidities, reform tax and pension systems, and increase the efficiency of judicial systems. And some positive effects are already visible in the data. [7]

For example, the three countries under full EU-IMF programmes have seen unit labour costs improve by around 10% since 2008, relative to the euro area average. This has translated into current account deficits that are on average around 8 percentage points of GDP lower than they were then. At the same time, exports of goods and services in volume since 2009, increased by 22% for Spain, 15% for Ireland, 22% for Portugal, 19 % for Italy, this against an average of 21% for the euro area. [8]

While there are clear cyclical drivers behind these developments, there are also signs of structural improvements. Moreover, drivers of the previously unsustainable domestic demand in some countries, like the housing market, now seem to provide structurally lower contributions to growth, thereby facilitating the way towards a more sustainable growth model.

It is no secret that this necessary process of adjustment, and the reallocation of resources it implies between sectors, is having a negative effect on economic activity. Economic growth is subdued in the euro area, and is expected to remain so for the rest of this year. There is also considerable heterogeneity between euro area countries.

In these circumstances, monetary policy in maintaining price stability on a medium term perspective, contributes also to reduce the output gap, as the literature on flexible inflation targeting has shown long ago [9]. With risks to inflation well-contained, the ECB has lowered its policy interest rate to the historic low level of 0.75% and provided banks with access to unlimited liquidity at this price. However, before September this year, the transmission of our policy rate to the real economy was seriously disrupted across countries.

For instance, when the ECB cut interest rates by 125 basis points between November 2002 and August 2003, lending rates to non-financial corporations across euro area countries responded homogeneously. By contrast, following the 75 basis point cuts implemented between October 2011 and July 2012, the range of bank lending rates across the euro area widened significantly. Indeed, in some countries interest rates for non-financial corporations actually increased.

In an economy like the euro area where more than two thirds of firms' financing comes from banks, a disruption in monetary policy transmission has material effects for investment and employment. But this effect is particularly exaggerated when countries are simultaneously undertaking large fiscal and structural adjustment. Indeed, it was the countries with the greatest adjustment needs that were being most cut off from monetary policy support. They were at risk of entering a vicious circle of rising interest rates, falling growth and deteriorating public finances.

It was against this background that the ECB introduced its programme of Outright Monetary Transactions, or OMTs. It aims to address disruption in monetary policy transmission by tackling one of its root causes: unfounded fears about a break-up of the euro area. By providing a fully effective backstop against disaster scenarios, it sends a clear message to investors that their fears are baseless. This should restore confidence and help normalise the pass-through of interest rates. Indeed, the mere

announcement of the programme approval by the ECB Governing Council led to substantial declines in yields and spreads of stressed countries whose net private capital outflows also decreased significantly since July.

However, countries can only qualify for OMTs if they implement an ESM adjustment programme with strong conditionality. This ensures that they continue to improve their economic fundamentals while the ECB is active. In this way, we aim to set the right incentives for governments and create a framework where the positive effects of our actions are sustainable.

Taken together, these measures will help unwind the euro area's imbalances and stabilise the financial situation over the near term. Member States are correcting the excesses of the last decade in terms of weak public finances, unsustainable credit growth and competitiveness losses. The ECB is taking measures to ensure the proper transmission of its monetary policy and maintain price stability, which buys time for this adjustment to continue.

Completing the euro area's institutional architecture

To stabilise EMU over the long-term, however, requires a more fundamental reform of the institutional architecture. The minimalist approach pursued at Maastricht was found to be inadequate in the context of highly integrated financial markets. In recognition of this, the Presidents of the European Council, Commission, Eurogroup and ECB have been asked to lay out a roadmap to complete EMU over the next decade. They presented their interim report to the European Council in July and will present a final version in December

This Report does not aim to identify what features we would ideally like for the euro area, but rather what features it cannot do without. Having been thoroughly stress-tested over the last three years, we now have a much clearer idea of what rules and institutions are essential for monetary union to function effectively. In the view of the Four Presidents, a stable EMU needs to be built on four pillars: financial union, fiscal union, economic union and political union. Let me explain each in turn.

Financial union

The first and most urgent pillar is financial union or, as it is more commonly known, banking union. Bearing in mind what we have learned about the importance of financial markets in a highly integrated monetary union, taking measures to ensure a stable and well-ordered financial system in the euro area has to be our first priority.

What does this imply in practical terms?

First of all, a single supervisory mechanism for banks. As I outlined above, a single financial market combined with national supervision is not sustainable. Before the crisis, it led to a lack of oversight of cross-border activity. Since then, it has facilitated a retrenchment of bank lending behind national borders. A single system of supervision can reduce these risks by allowing for an aggregated view of the euro area financial market; by providing a safeguard against regulatory capture; and by ensuring that national interests are not put ahead of the European interest.

With this in mind, the Commission has presented a proposal for the establishment of a Single Supervisory Mechanism, entrusting the ECB with specific supervisory tasks. This is a welcome development and the ECB is ready to assume these tasks. However, it is essential for the credibility of supervision, and for the ECB's reputation, that the legal framework allows us to implement these tasks in an effective and rigorous way. Another necessary principle, as I have argued elsewhere [10], implies

that "there should be a clear organizational separation between monetary policy and supervision. This can be realized at all organisational layers, from the analytical and informational level to the decision-making level". The Commission's proposal includes the creation of a Supervisory Board in the ECB composed basically by the Heads of Supervision of the participant countries and that Board will be the vital component of the Single Supervisory Mechanism (SSM). This can also open the door to the participation of countries that are not members of the euro as they could have equal treatment in the Supervisory Board.

But supervision is only one leg of a genuine financial union. It also requires an effective tool to deal with bank failures without triggering financial instability, without long squabbles about burden-sharing, and without dragging sovereigns into a deadly embrace with their domestic banks. In the view of the Four Presidents, this requires elevating resolution responsibilities to European level, and putting them in the hands of an independent European Resolution Authority (ERA). There are three main reasons for this.

First, an ERA would ensure more effective decision-making when cross-border banks run into difficulties. Centralising decision-making would bypass many of the current obstacles to effective resolution such as the need for cooperation and coordination between multiple authorities. This would in turn lead to quicker decisions and reduce resolution costs, as early action would help to maintain the economic value of the bank in question.

Second, an ERA would be more effective in minimising the cost for taxpayers of bank failures. A bank may be "too expensive", "too complex", or even "too well-connected" to resolve at the national level, making bail-out the preferred strategy. An ERA, on the other hand, would have the financial, legal and administrative capability as well as the necessary independence to carry out effective resolution. By imposing burden-sharing on shareholders and creditors and by financing residual costs through a European Resolution Fund financed ex ante by all the banks, the ERA could ensure that the private sector bears the primary burden of bank resolution costs. European resolution, similar to what the FDIC does in the US, is not about bail-out of banks by state recapitalisation efforts, but the use of wide bail-in powers to resolve banks with little use of tax-payers money.

Third, an ERA is a necessary complement to the single supervisory mechanism. A system where supervision is European but resolution is national creates frictions. The single supervisor may assess that a bank needs to be resolved, but the relevant Member State may be unable to bear the resolution costs or unwilling to resolve a favoured national firm. Hence, the country would likely turn the table on the ECB, and push for generous liquidity support or supervisory forbearance.

From the ECB's perspective, an effective financial union is a key complement to the single monetary policy. To the extent that it restores the flow of savings between euro area countries, it will support the normalisation of monetary policy transmission and allow us to exit our exceptional measures. But more fundamentally, without integrated capital markets and a well-functioning banking sector, there cannot be a single monetary policy – and this means we cannot fulfil our mandate.

Fiscal union

The second pillar, fiscal union, is necessary to ensure that fiscal policies are fully commensurate with the requirements of the common currency. The crisis provided prima facie evidence of the sizeable negative spillovers associated with fiscal crises within monetary union. Moreover, it showed the importance of sound fiscal policies for allowing governments to perform their essential functions: countries with weak budgets lose their ability to perform cyclical stabilisation during a crisis.

Measures that guarantee solid fiscal policies are therefore a public good – both for individual Member States and for the whole euro area. For domestic citizens, they ensure that the automatic stabilisers will be able to play out in full during a downturn and smooth the economic cycle. For citizens elsewhere in the euro area, they provide protection against contagion emanating from budgetary decisions over which they have no democratic control.

The recent reforms to strengthen the euro area fiscal framework – the so-called six-pack and the fiscal compact – are welcome and go in the right direction. But they remain within the logic of the Maastricht Treaty where responsibility for fiscal policies is exclusively in national hands. This creates an inherent credibility problem, as for fiscal frameworks to be fully credible, they have to be enforceable. This is impossible without a further and deeper sharing of budgetary sovereignty.

This could be achieved by giving European institutions greater competence to effectively compel euro area Member States – in a graduated manner if and when the situation deteriorates – to take the necessary fiscal policy decisions.

This would correspond to a further sharing of national sovereignty. But for both weaker and stronger countries, it is in fact an opportunity to regain substantive sovereignty as opposed to formal sovereignty. For the weaker countries, measures that put the soundness of their fiscal policies beyond doubt will allow them to be fully sovereign, in the sense that they can use fiscal policy in its vital economic stabilisation role and take free decisions about taxes or types of expenditure without fear of excessive discipline from financial markets.

For the latter, sharing sovereignty at the European level will allow them to effectively protect their domestic economies from spillovers from the rest of the euro area. Moreover, they will no longer be placed into situations where they are de facto forced into taking decisions to avert imminent catastrophe.

The sharing of sovereignty is also the pre-condition for any risk-sharing mechanisms at the euro area level. The recent Report by the Four Presidents mentioned the gradual development of a fiscal capacity for the EMU – that is, a common budget for the euro area distinct from the EU budget. It identified two possible functions of such fiscal capacity: first, facilitating the adjustment to country-specific shocks; and, second, providing financial incentives for structural reforms.

Reflections on this are at a very early stage and the pros and cons need to be carefully weighed but it is a very important component of a fiscal union. There is a long debate going back to the Werner Report in 1971 or to the preparation of the Maastricht Treaty on the degree of fiscal integration that is necessary to sustain a monetary union. In my view the key question on taking detailed decisions remains that of efficiency, being necessary to assess whether there are economic benefits in excess of costs in moving some expenditure to the euro area level.

Economic union

The third pillar, economic union, is necessary to ensure the conditions for prosperity within a monetary union and thereby prevent countries from becoming a burden on others. Without the possibility for exchange rate adjustment, countries have to remain sufficiently flexible to adjust through other channels as underlined by the theory of Optimal Currency Areas. This is particularly important in the euro area – as opposed to, say, the United States – because fiscal transfers go only

through the EU budget to compensate regions that lose competitiveness and become permanently depressed.

The bedrock of economic union is completing the Single Market to allow for higher factor mobility. To a certain extent, the failure of markets to self-equilibrate before the crisis was because markets were incomplete. For instance, the single market in services remains unfinished, despite the fact that the areas covered by the Services Directive account for more than 45% of EU GDP. There are also significant remaining barriers to labour mobility, for example linked to the portability of pensions and national insurance contributions.

However, it is clear that competitiveness is a more complex issue than solely factor mobility. It depends on national traditions and economic structures. What role can the centre therefore play in ensuring competitiveness? For some fundamental issues linked to adjustment within monetary union – like flexibility of wage formation – we could envisage best practices established through guidelines for all countries set at the euro area level. But there are also dangers in over-harmonisation. We are seeing currently that system competition can play an important role in stimulating structural reform.

A more nuanced way forward may be to strengthen the framework for encouraging country-specific reforms. The Four President's Report has suggested that Member States could enter into bilateral Reform Contracts with the Commission, whereby they would make legally binding commitments to implement structural and institutional reforms. In return, they would receive funding to facilitate the transition process and finance transition costs – perhaps, for worker reallocation programmes. This could be one function of a fiscal capacity.

There is still a lot of thinking to be done in this area. And we have to get the balance right. The most efficient way to ensure adjustment is to let market forces operate in the many protected sectors that still exist in the euro area. But we also know from the first decade of EMU that markets do not always self-regulate and that interventions from the centre to ensure competitiveness may be needed. The key challenge is to articulate the appropriate role for the European level, the state and the market in the euro area.

Political union

The fourth pillar, political union, is needed to ensure that the other pillars have sufficient democratic legitimacy. I will not dwell long on this issue, as it is fundamentally a matter for the Member States and European citizens. Suffice it to say that the crisis has shown the limits of applying a national mind-set in a deeply integrated monetary union. Citizens are affected by what happens across borders and their political arrangements need to reflect this. In this sense, political union is not about moving forward, but about catching up with the depth of economic and financial integration that already exists.

What is at stake refers basically to democratic accountability and legitimacy. An important element of legitimacy has been provided in the past, in the European Union and other democracies, by what Fritz Scharpf called output legitimacy (or government for the people) [11], that is, by the effectiveness of the system in ensuring the continuous improvement of the citizens' quality of life. All advanced democratic countries and consequently the European Union will face challenges in this front stemming from the prolonged period of slow economic growth that has now just started. This is the consequence of two types of processes. First, the adjustment to the form of balance-sheet recession that the crisis represented and the workings of mechanisms of the associated debt deflation. Second, by the structural problems created by ageing populations, globalisation, energy and environmental risks and decreasing returns of technological progress recently underlined by Robert Gordon [12]. To

strengthen output legitimacy, the Euro Area has to improve the effectiveness of its decision-making institutions to overcome the present situation of crisis. The decisions and reforms I have highlighted in this talk have precisely that objective. The transfer of some functions to the European level is necessary as I argued here. We should not hide, however, the difficulty in explaining these reforms to the European public opinion to get their support in the present environment.

This means that it gains accrued importance the attention that will have to be given to the other form of political legitimacy referred by Scharpf the input legitimacy (government by the people) – that is, increasing citizens' participation in European decisions. In some ways this may appear as contradictory with the search for effectiveness linked with the first form of legitimacy that requires now stronger central deciding bodies. To understand the great difficulty in addressing this issue, we have only to think about the analogy we could establish with the political trilemma of the world economy recently enunciated by Dani Rodrik [13]: "we cannot simultaneously pursue democracy, national determination and economic globalization" I will not enter into such complications. I will recall, however, that in this context, we should never forget that Europe is not a Nation or a State. Political life and legitimacy continues to occur mostly at the level of nation-states. This implies that to foster legitimacy we have to act on the two levels the European and the national by giving for instance, the European Parliament a stronger euro area dimension and engaging national parliaments more in euro area discussions. I wanted to highlight the importance of these issues but as I said I will not dwell upon them further.

#### Conclusion

Let me then conclude.

The euro area was designed in the 1990s and we should not be too critical of the fact that its architecture was influenced by the prevailing economic theory. However, we now have more than a decade of practical experience of sharing a single currency in Europe. It is unacceptable if we do not learn the lessons of that experience.

The most important lesson is that, to maximise its benefits, the single currency needs strong common institutions. Strong institutions to supervise and stabilise the single financial market. Strong institutions to guide fiscal policies and preserve budgetary sovereignty. Strong institutions to guarantee competitiveness and encourage sustainable growth. And strong institutions to engage citizens more closely in the European project.

In this effort the European and national dimensions of legitimacy must be balanced. Nevertheless, we must also recall that Nations are a construct of man, not a natural reality, meaning that our consciousness and our knowledge are socially constituted. A form of civic community among strangers was somehow created to shape several European nation-states only as late as the XIX century. That explains why we belong to two societies, our own and the European one as the essential cultural background for our universal- aspiring values. In this sense, Europe is a memory, a key to understanding our own past. However, the EU, and even more so the EA, are political projects and what we want now is to pursue the project of completing and deepening the integration of European nations in a unique community of destiny that is neither a nation nor a State. It is a powerful vision of preserving and defending national identities and interests in a globalized and very challenging world. If we would fail, as Helmut Schmidt said: " For us, European citizens, that decadence would be a tragedy, meaning the loss of our self-determination". [14]

We can only hope that our past and community of culture will help us to be successful in our endeavour.

Thank you for your attention.

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European Central Bank  
Directorate Communications  
Press and Information Division  
Kaiserstrasse 29, D-60311 Frankfurt am Main  
Tel.: +49 69 1344 7455, Fax: +49 69 1344 7404  
Internet: <http://www.ecb.europa.eu>

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