EPP Group Study Days | Time for Growth and Recovery

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Speech by the Minister of State and Finance

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Good Morning,

First of all, I would like to thank the EPP group for the kind invitation to participate in this seminar and, in particular, to contribute to this session entitled "Time for Growth and Recovery". This discussion could not be timelier.

As I stated earlier this week in Bilbao – 2014 marks the time for action.

Following several years of reaction – to the financial crisis, to the economic crisis and to the euro area sovereign debt crisis – the time has come to engage in policies aimed at achieving sustainable growth. While the adjustment effort will inevitably prevail in most economies – this is clearly the case of Portugal – the renewed institutional framework in Europe, the ongoing correction of macroeconomic imbalances and the first signs of economic recovery provide the required breathing space to design, prepare and initiate the road to sustainable growth.

We still are in the early stages of this process, but some of the next steps have already been identified. Europe will have to enforce the new rules on enhanced EU economic governance and, at the same time, work towards deeper financial integration. Member States will naturally contribute to these common objectives, but will also have to direct national efforts to the implementation of key structural reforms, so as to build solid foundations for economic growth.

The enhanced EU economic governance creates the adequate framework to preserve the soundness of public finances, which, in turn, is a necessary condition for sustainable growth.

What we have found is that the importance of fiscal discipline was recognised quite early, in the run-up to the Economic and Monetary Union. However, it was never truly enforced. Additionally, as financing conditions remained favourable and the European economy grew, the strength of the rules enshrined in the Stability and Growth Pact faded. Their value would only be acknowledged *ex-post*, when the sovereign debt crisis exposed the vulnerability of public finances especially in peripheral economies.

The naivety of this behaviour had extremely high costs, which in turn gave way to important lessons.

Since the beginning of the crisis, fiscal discipline rules were significantly improved, prevention mechanisms were reinforced and an enforcement mechanism was set up. At the same time, greater coordination between national policies was enacted through the implementation of the European Semester. And the scope of European surveillance – which before was limited to budgetary considerations – was extended, so as to detect potential macroeconomic imbalances as well.

All in all, these solutions seem to be an adequate and direct response to the flaws that existed in the EMU framework. However, the most difficult stage in this process is yet to come: the effective enforcement of the new rules, to confirm that this time is different, that this time any breach of our collective responsibilities will have concrete and immediate consequences. Acknowledging the existing vulnerabilities and correcting them was crucial. But the ultimate goal of this institutional transformation will only be achieved once actual results are produced – in this case, once the existence of enhanced rules actually contributes to the prevention and resolution of economic and fiscal imbalances. Notwithstanding, only in time will we be able to conclude whether the solution is in fact appropriate.

In contrast, the process of achieving deeper financial integration is taking longer. And this delay is already having severe repercussions.

The enhanced EU economic surveillance is essentially a tool for the long run, especially because the economies that were more vulnerable have already started profound adjustment processes. The state of financial fragmentation in the euro area, however, is threatening economic recovery at present – through various channels.

From a broader perspective, financial fragmentation is affecting the monetary policy transmission mechanism itself. This means that one of the fundamental adjustment mechanisms in the euro area is not working properly and, hence, the adjustment is much more difficult. This is especially damaging at a time when several economies are still in the process of correcting imbalances and overcoming additional difficulties that emerged from the financial, economic and sovereign debt crises.

Moreover, financial fragmentation is proving particularly damaging for small and medium-sized enterprises located in peripheral economies, given the existing link between sovereign and banking risk. While this affects all firms in general, it causes higher distress to SMEs because, given their smaller size, they tend to be highly dependent on bank credit. Today, SMEs that are comparable in terms of products, markets, business plans and idiosyncratic risk profiles do not have access to comparable financing conditions – just because they are located in different countries. As these differentials in access to financing linger, the firms' investing capacity declines and so does their growth potential. This is a strong obstacle to the recovery of vulnerable economies, which already have to struggle with the malfunction of the monetary policy transmission mechanism. Subsequently, it also represents a major hindrance to the European recovery and, ultimately, to the development of core economies as well.

For these reasons, financial fragmentation is undoubtedly one of the most substantial challenges for Europe at present. Given its significant and widespread consequences, it can only be successfully overcome with the deepening of financial integration.

This means, first and foremost, the full realization of a truly effective Banking Union, in order to break the link between sovereign and banking risk. However, while the Single Supervisory Mechanism is underway, the Single Resolution Mechanism and the common safety net for deposits are not finalized, and neither is the common backstop for bank resolution, which is a critical element to ensure the credibility of the new framework. Although the establishment of the Banking Union is understandably a long and complex process – and probably the biggest step in European integration since the adoption of the single currency – moving forward is absolutely key to ensure the sustainability of growth in Europe.

In the meantime, it is fundamental to implement short-term solutions to minimize the costs of financial fragmentation. And this essentially means improving financing conditions for SMEs – not only in peripheral economies, but throughout Europe. In 2012, small and medium-sized enterprises represented more than 99% of European firms, provided for two thirds of European jobs on the private non-financial sector and delivered nearly 58% of the gross value added.[1] They are, indisputably, key players in European recovery and in long-term growth.

At present, financial support to SMEs at the European level is made available through two main channels. The first relates to the initiatives of the European Investment Bank Group, whose support to SMEs during 2013 reached maximum levels. It is essential that this enhanced access to finance continues going forward. The second channel corresponds to the attribution of European Funds. While support to SMEs has always been implicit, one of the ten key points of the present EU cohesion policy reform is precisely the encouragement of an increased use of financial instruments to give SMEs more support and access to credit. In fact, the objective will be to double the current support to around 140 billion euro for the period 2014-2020.

Altogether, these are the major European-wide efforts for this new stage of recovery and growth. Nonetheless, they must be complemented by national efforts for the EU economy to reach its potential.

First, Member States have the responsibility to abide by the new EU rules regarding fiscal discipline. While it is the institutions' role to promote coordination and to exercise surveillance, the actual effort of fiscal consolidation must necessarily be done by each Member State, according to its own situation.

[1] Source: *A Recovery on the Horizon? - Annual Report on European SMEs 2012/2013*, available in the European Commission website.

Second, Member States also play an important role in improving SMEs' financing. With a view to promote alternative sources of financing in Portugal, we have simplified our commercial paper regime so as to facilitate the access to SMEs. Additionally, we are also creating a development financial institution in order to simplify and centralize the channelling of EU structural funds to the economy, notably to SMEs.

Third – and most importantly – it is up to the Member States to implement ambitious, widespread structural reforms. Reforms that improve the business environment, strengthen the regulatory framework and boost competitiveness. These represent essential elements for recovery and are necessary conditions for sustainable growth.

The European project is stronger. European economies are rebalancing. Europe is turning the page. We have done a lot so far. But we must recognize a lot still needs to be done.

Thank you very much.