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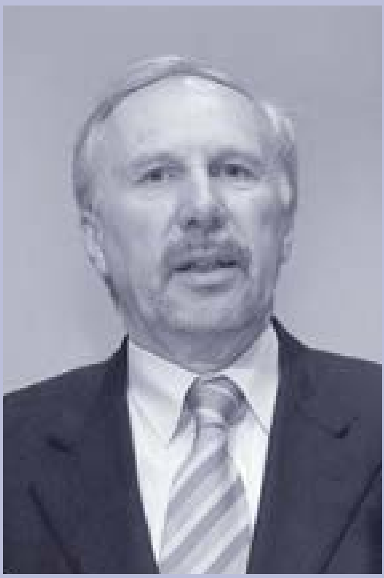

Opening Remarks

Ladies and gentlemen,
Let me warmly welcome you to the 40th Economics Conference of the Oesterreichische Nationalbank.

In particular, I would like to welcome Austrian Federal Chancellor *Werner Faymann* and this year's keynote speakers, *Peter Praet*, Member of the Executive Board and Chief Economist at the European Central Bank, and *Klaus Regling*, CEO of the European Financial Stability Facility. And it is a great pleasure to welcome all other high-level speakers, representing the European economic and financial architecture, academia and European institutions.

Over the past four decades this conference has offered a platform for discussion between policymakers and economists with an institutional and academic background. It has played a useful role in creating new ideas and stimulating political reactions to ever-changing economic environments.

This year's conference, entitled *European Monetary Union: Lessons from the Debt Crisis* focuses on economic developments in Europe and the corresponding policy reactions from 2007 until today. Recent developments in international bond markets indicate that unfortunately, the fiscal problems in the euro area cannot be considered to be completely solved yet. The aim of the conference is to identify possible further policy responses to the crisis and to offer a forum for discussion on how to tackle future challenges.

From a historical perspective, sovereign debt crises are clearly recurrent phenomena. Going back to the pre-World War II period, various European states ran into difficulties servicing their debt and some of them defaulted (Reinhart and Rogoff, 2008)[1].

Since World War II, however, there have been no cases of sovereign default in Western Europe.

Rather, sovereign default became a phenomenon typical of emerging and developing countries. Due to their high dependency on international lending and their high responsiveness to changes in the monetary policy of creditor countries, fluctuations in exchange rates and commodity prices, many of these – mostly African or Latin American – countries encountered severe financing problems. Hence, debt restructuring in Latin American countries has been the topic of numerous economic publications.

Thus, it was quite an unhappy innovation when, in the aftermath of the financial market turmoil, which had resulted in a severe recession, a sovereign debt crisis emerged in several – by international standards comparatively wealthy – EU Member States from spring 2010 on.

In early 2010, Greece's increasing financing problems marked the beginning of a previously "unthinkable" development, a sovereign debt crisis of a

[1] *Reinhart C. M. and K. S. Rogoff. 2008. This Time is Different: A Panoramic View of Eight Centuries of Financial Crises. NBER Working Paper 13882. March.*

euro area country. Financial market players started to reconsider the "habit" of demanding undifferentiated risk premiums for the sovereign bonds issued by different euro area Member States. By the way, this lack of differentiation is not stipulated in the EU Treaty, which includes several provisions to enhance *market discipline* in public finances, such as the prohibition of monetary financing, the prohibition of privileged access of public finances to financial institutions, and the no-bail-out rule. But as we know with the benefit of hindsight, for a long time market forces did not perform the desired function of signalling concerns about fiscal sustainability to borrowing governments at an early point. But once sustainability was doubted, markets – as usual – reacted collectively and very abruptly, driving up risk premiums and the financing costs in the countries considered as vulnerable.

As a result, the Greek debt crisis quickly spread to other euro area Member States. This happened through various channels, including trade links, cross-border financial exposures, but also fire sales, flight to quality, emergency reform-induced political instability and expectation effects. By the end of 2010, Ireland (on November 21, 2010) and, shortly afterwards, Portugal (May 17, 2011) required emergency lending, which was provided by financial assistance packages negotiated by the IMF, the EU and the ECB. By mid-2011, the confidence crisis spilled over to Spain and Italy. Their sovereign yields rose to pre-EMU levels. Prior to EMU, in the 1980s and early 1990s, exchange rate expectations were the major drivers of interest rate spreads between EU Member States, and both inflation and real GDP growth tended to be higher in Southern Europe. In the current crisis, by contrast, the assessment of a country's political reform capacity and stability as well as perceived sovereign default probabilities were drivers of yield spreads.

While before 2009 the market underestimated the importance of heterogeneous developments within the euro area, since the onset of the EU debt crisis, markets have tended to exaggerate and amplify their importance. The lack of confidence in the sustainability of public finances led to a situation where short-term developments or negative economic surprises caused strong market reactions. From a medium-term to long-term perspective, the size and intensity of the reactions appear to be – in part –unjustified. Recent sovereign bond auctions that led to negative interest rates on German short-term bonds (the same development can be observed for Austrian government bonds with very short maturities) are market distortions triggered by a massive flight to quality. The strong reactions to the political developments in Italy during the summer of 2011 highlighted the new regime of extremely nervous financial markets.

In such a sensitive environment, both policy reactions and the absence of such reactions may lead to severe consequences. During the different stages of the crisis, a great variety of economic policy measures were implemented.

Confronted with a global economic downturn in 2008, European governments took massive expansionary fiscal policies to stimulate economic growth. While the discretionary measures were of significant magnitude, a large part of the following deterioration in public finances was caused by automatic stabilizers. Corporate tax revenues collapsed throughout Europe. Countries which had experienced significant property bubbles before the crisis were also faced with a strong decline in tax revenues related to property (such as transaction taxes, capital gains taxes, VAT on newly-built houses, etc.). Both factors revealed the reliance on large windfall revenues before the crisis, which were previously mistakenly judged as structural. This development was exacerbated by a strong increase in unemployment, which in turn reduced revenues from income taxes and social contributions and at the same time raised expenditures on social transfers. Unfortunately, especially in the most affected countries, these strong increases in unemployment and the implied deterioration in public finances via automatic stabilizers have persisted until now, and the growth prospects for many euro area economies have been revised downward substantially (implying also a deterioration in governments' revenue prospects). Furthermore, governments throughout Europe had to tackle problems in the financial sector by providing capital and taking over bad assets (via "bad banks"); in several countries, this also contributed substantially to growing government debt (and deficit) figures and further weakened the sustainability of public finances.

As a reaction to the lack of compliance with existing rules in the past, and in order to tackle substantial macroeconomic imbalances and heterogeneous economic developments within the EU, the economic governance framework was substantially revised in 2011. The so-called "Six Pack" introduced stricter rules for public finances and addressed structural heterogeneities via a new scoreboard evaluating structural developments and emerging imbalances. The fiscal compact signed by all EU Member States with the exception of the UK and the Czech Republic went one step further, requiring the structural balance and debt rules to be incorporated into national law "of binding force and permanent character," preferably constitutional.

The unfolding of the economic and sovereign debt crisis and, in particular, the limitations experienced in stopping the spillovers to other EU Member States have sparked criticism of the ef-

ficiency and effectiveness of the euro area's and the EU's economic governance and the decisions taken over the past three years. However, an adequate assessment must consider the constraints and limitations that the decision-making bodies were faced with.

At the recent IMF meeting, there was an intense debate, the bottom line of which the press described in the following – overly simplified – way:

- IMF and the U.S.A. promote a growth strategy
- EU and the ECB advocate austerity

In fact, the discussion as such was and is more differentiated in Washington; and I expect that we will see a similar debate also at this conference.

As to fiscal consolidation, a first and basic aspect refers to meeting refinancing needs:

- Sovereign rollover needs (Q2 – Q4 2012) in the euro area: EUR 912 billion
- Sovereign rollover needs (Q1 – Q4 2013) in the euro area: about EUR 880 billion

In “normal times” markets would be able to refinance even such impressive amounts. In “nervous” times, as we are experiencing now, much depends on the credibility of borrowers in the eyes of private lenders.

However, *credibility* is a difficult concept, based on many ingredients. One element, clearly, is the trust of investors in the political stability of a country and its preparedness to undertake the necessary reforms. Another aspect concerns the credibility of fiscal consolidation programs. This is not only a political challenge, but also an economic issue. Fiscal consolidation is not just an accounting procedure, it has to be seen in the context of macroeconomic developments and potential repercussions. If consolidation programs have to be revised because of overly ambitious timetables or the failure to take into account macroeconomic effects, investor confidence may dwindle. One lesson that had to be learned the hard way is that consolidation programs must be seen in the context of growth prospects.

As to economic growth:
It is true that some fiscal consolidation measures may have negative effects on economic growth in the short term, but positive ones in the long term. Still, it is important to have a clear idea of what constitutes a “short term”, because if this implies too long a period, there may be lasting negative effects on potential output growth via hysteresis effects, the aging of capital stock, etc.

In any case, there is a growing consensus that successful stabilization programs will need not only an *austerity part* but also a *growth part*. The latter may encompass *structural reforms* with regard to the labor and the goods and services markets or/and special measures to fight youth unemployment, e.g. by enhancing vocational training or launching special job programs. Experience shows that in emerging or “quasi-emerging” economies foreign direct investment may play a special role as a vehicle for export-led growth, obviously implying the need for competitive unit labour costs and a well-functioning physical and institutional infrastructure.

Summing up, it is possible and necessary to combine consolidation and growth strategies. But one has to be aware that there may be different time lags as to when the different strategies are showing effects. This could create *credibility gaps*. To overcome these gaps is the role of external policy intervention, e.g. by the European Systemic Risk Board (ESRB). But it is important, as has been underlined frequently, also by ECB President Mario Draghi, that strategies to restore confidence and to ensure refinancing are consistent, oriented toward the long term and based on a reliable political support by the country concerned.

As to politics:
Financial assistance packages that include guarantees and the provision of funding through the European rescue facilities impose a financial burden or at least a financial risk on the citizens of the guarantee-providing or creditor

countries. Obviously, it is not always easy to find a majority of voters (taxpayers) willing to shoulder the financial liabilities of another country. It seems that the citizens in the EU still do not identify themselves strongly enough with the – still relatively young – project of European integration to fully support unlimited supranational financial assistance to individual Member States. In the end, we are still dealing with sovereign democracies in the EU and in the euro area. The heterogeneity of income levels within the euro area creates additional obstacles. Solidarity among EU nations continues to be limited.

As a result, in contrast to interregional transfers that we see in a number of fiscally federal countries, the EU seeks to overcome the present divergences in the euro area by providing loans subject to strict and controlled conditions, which supplement the general system of EU regional and structural funds.

To the recipient countries this might seem to be an infringement of important aspects of their political independence. However, I do not see a credible alternative to the procedures developed in the context of specific aid programs. But this leads us to the broader problem of the political legitimacy of EU and euro area action during the crisis, e.g. with regard to the role of external control of fiscal policy decisions by national parliaments or decisions regarding the operational structure of instruments like the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM).

Of course, all these problems are part of the age-old question of how to combine relatively short-term election cycles with the need to ensure sustainable long-term economic growth. One traditional way of dealing with this problem is, for instance, requiring a two-third majority for certain decisions. In the EU, this is the case by including certain provisions in the EU Treaty that are extremely difficult to change. In this context the ECB can be seen as the most independent central bank in the world, as its independence is enshrined in the EU Treaties.

However, in the current institutional structure of the EU it is still unclear as to who has the mandate – and obligation – to take binding decisions in economically difficult times like the ones we are currently experiencing. The current crisis has shown the need for close cooperation within the EU, but also a tendency of re-nationalization of important aspects of crisis management, where a number of actions are based on intergovernmental arrangements rather than Community law.

This is not the place to discuss these problems in more detail. But to me it is obvious that the process of European integration has reached a crossroads where the future form and degree of European cooperation are up for decision.

The current debt crisis heralds a new era for the European economic and political architecture. The difficulties are hard to overcome but certainly also imply enormous potential.

The strong interdependence of markets within the euro area facilitates financial contagion and spillovers. To safeguard the financial and macroeconomic stability of the euro area the problems of individual countries have to be tackled by common supranational political and economic initiatives. An important lesson to be learned from recent developments is that a currency union in the end also amounts to some form of political union. This understanding has led to a revision of the

European economic governance framework. Stricter rules and the more immediate threats of financial sanctions were formulated to prevent unsustainable public finances and macroeconomic imbalances in the future. While such rules have the ability to give guidance and to deliver benchmarks, it will never be possible to force countries to fully comply with them as long as the countries involved are sovereign nations. In the end, what it all boils down to is that a political union needs more than a tight set of rules and restrictions, namely central decisions-making in fiscal policy, or, at least a strong say for Community institutions in recipient countries' budget policies. The developments over the past two or three years indicate that even in the face of a severe sovereign debt crisis with potentially devastating consequences for the euro area as a whole, the time is not (yet?) ripe for such a far-reaching change in governance and sovereignty.

Let me in this context also briefly touch on the often raised call for "solidarity." In the context of the EU debt crisis, for most people the picture that comes to mind is "rich" European countries paying for transfers to the troubled "poor" countries. However, this is only one side of the coin.

Solidarity also implies the willingness of the recipients of transfers to take maximum effort to improve their own financial situation.

Whatever decisions governments make, it is vital that the majority of voters ultimately support these decisions. This applies both to recipient and to creditor countries. Rescue packages or intergovernmental transfers that do not have public support certainly lead to unsustainable political developments, which in turn have the potential to trigger a new confidence crisis. The potential of the current crisis lies in the momentum for change. The crisis could be used to overcome the dominance of national interests and create an even more strongly integrated EU.

The debt crisis also reminds us of the importance of maintaining financial stability. Banking crises have a strong potential for seriously harming the real economy. In order to reflect their probability and, if they occur, their negative real impact, the provision of sufficient liquidity and an adequate capitalization of the banking sector as well as mechanisms to facilitate the liquidation of insolvent banks are key. The first requirement has to be met through backstop facilities by the central bank while the second and the third issues have to be addressed through financial market regulation and supervision.

Ladies and gentlemen,
I have certainly not been able to cover all aspects relevant in the context of the debt crisis or to do justice to the complexity of the issue at hand. But this is the very reason why we need this conference. I am confident that the broad diversity of speakers – ranging from representatives of academia and international institutions to policy advisors and decision-makers – will be able to provide a broad picture of the relevant issues, possible trade-offs and options for solutions.