

Olli Rehn

Commissioner for Economic and Monetary Affairs
European Commission



Keynote Address

Sehr geehrter Herr Gouverneur, meine Damen und Herren!

Ganz herzlichen Dank für die Einladung zu Ihnen zu sprechen.

In the past decades I have been a frequent visitor to Vienna, in particular when I was responsible for Enlargement, and I am again honoured to speak to such a distinguished and international audience.

Vienna has always been a hub between East and West. While the economic transformation in Austria's neighbouring countries has been a fascinating process, it is equally remarkable how well the Austrian economy was able to adjust to it and to turn it into an East-West success story.

Let me however start with one of the Austrian founding fathers of modern economics, Joseph Schumpeter. In his book "Das Wesen des Geldes"¹ – and if I read my German correctly, "Wesen" has a double meaning, first "system" but second "being" – he wrote: "Der Zustand des Geldwesens eines Volkes ist ein Symptom aller seiner Zustände." ("The condition of the monetary system of a nation is a symptom of all its conditions.") And Schumpeter went on to relate this to human condition: "Nichts sagt so deutlich, aus welchem Holz ein Volk geschnitzt ist, wie das, was es währungspolitisch tut." ("Nothing shows as clearly what kind of wood a nation is cut from, than what it does in monetary policy.")

More than 80 years later in our economic and monetary union, you may ask from what kind of fabric Europe is cut. Across Europe, we are seeing a support fatigue on the one side and a reform fatigue on the other. Many ask: "Will this crisis never end, are the support measures necessary, are the re-

forms too demanding – is the European response on the right track?"

Yes, we are on the right track. It has been necessary to take immediate action of financial support and equally of reform and adjustment in the countries facing a sovereign default or a banking meltdown. We must be firm in requiring full implementation of the measures, but also be patient, as some measures may require time to show effect.

To understand our response, let us take a look back in time in the euro area. Over the last decades, the European economy has grown together. Our product and financial markets integrated. The Southern enlargement first and the Eastern enlargement later on implied that the economies in the



South and in the East were catching up, which in turn required economic adjustment in the so-called old Member States.

The introduction of the euro provided further benefits. For the catching-up economies, the euro allowed better access to international capital markets, while for the trade-oriented economies it reduced the transaction costs.

¹ Schumpeter, J. A. 2008. (New Edition). *Das Wesen des Geldes*. Ed. Mann, F. K. Göttingen: Vandenhoeck & Ruprecht.

In the pre-crisis period, the euro area as a whole enjoyed macroeconomic stability with stable inflation and some improvement in fiscal policy. However, inside the euro area, macroeconomic imbalances were built up over the last decade.

Our integrated financial market channelled the savings from countries with slow growth in domestic demand to countries with current account deficits, where domestic demand was thriving. In some cases, credit flowed into housing and other real estate, resulting in unsustainable leverage and asset prices. Also wages increased faster than productivity, thus weakening the cost competitiveness of some economies.

By 2007–08, the unravelling of the subprime risks triggered the current crisis. At that time, those imbalances in the EU were at their peak. The financial sector in the EU Member States could not absorb the risks it had taken. Subsequently, the public sector stepped in. All parts of the economy benefitted from the public response, because this did not only involve aid to banks, but also to SMEs and to workers, for instance by subsidising shorter working hours. The fiscal stimulus measures were coordinated in the European Economic Recovery Plan.

Our fresh economic forecast confirms that this powerful response has paid and has produced results. The economic recovery of Europe is maintaining its momentum despite turbulence and tensions in financial markets. Its base is broadening from exports to domestic demand, implying that growth is becoming more balanced. In 2012, we will reach the pre-crisis level of production in the EU.

The policy measures made the euro area labour market remarkably resilient during the recession, with employment

declining clearly less than output. But it also implies the recovery in production will now be somewhat faster than employment growth.

Ladies and Gentlemen,
Most economists agree that it is the role of the public sector to step in when so-called tail risks materialise, i.e. risks that are very rare but very large. In fact, only the public sector has that capacity. To do so, the public sector needs to be in a healthy condition itself. However, this was not the case in all euro area or EU Member States. The crisis exposed those countries where imbalances were large, where public finances were not in a good shape, and where there was a lack of structural reform.

Therefore, it is not correct to speak of a crisis of the euro and the monetary union. It is a crisis of certain Member States, with the potential of severe economic ramifications for the rest of the euro area.

First, the value of the euro has not changed over the past year; the effective euro exchange rate was last Friday almost precisely the same as in the beginning of May 2010. Second, we have contained the crisis into the three countries in programmes. This is evident both from the sovereign bond spreads and the overall economic recovery in Europe.

While counterfactual scenarios are always difficult to construct, there is in my view no doubt that, without the EMU, the global financial crisis would have unleashed a series of devastating currency crises in Europe. The euro has saved us from that by serving as a protective shield. This has also been the case for Austria.

With the example of Lehman, we have seen what devastating consequences a default can cause, not only for direct creditors but – what is im-

portant – also for third parties who could be hit by spill-over effects in our integrated economy.

Precisely to prevent another downward financial spiral getting out of control, we needed to prevent Greece from defaulting in May last year. The ad-hoc financial assistance package was tied to strong conditionality of reforms and of debt reduction. But we also needed to prevent contagion. A week later, we created the temporary financial backstops – the EFSM and EFSF – to manage any further sovereign financing problems which could threaten financial stability in Europe. Later last year, we also decided on the principles of a permanent stability mechanism, which will replace the temporary ones in 2013.

In December last year, the temporary facilities were brought into action when we needed to grant conditional financial assistance to Ireland. On 16 of May, a similar decision was made on a programme for Portugal.

The decisions, together with the very substantial reform measures taken in programme and in many non-programme countries – particularly on fiscal consolidation – and the very responsible policy approach taken by the ECB, have allowed us to contain the sovereign debt crisis into the three countries.

Some worry that this is not without risks for the creditor countries. But we need to see the vastly greater risk of inaction: if we had not given the comprehensive policy response, devastating risks would have materialised immediately. This is my response to those weary of support: The rationale of our strategy is to prevent the great risk of a financial meltdown. We have contained but not banned that risk yet.

And my response to those weary of reform in the programme countries is

that reducing the excessive level of public debt does indeed require major efforts on several fronts to reach the necessary primary fiscal surplus for an extended period of time.



We have relevant and positive examples that reforms can be done. Belgium in the 1990s was able to maintain a large primary surplus for an extended period of time. Take Latvia and Romania. Both receive financial assistance tied to a programme of conditionality under a Treaty provision.

Latvia faced a collapsing economy after the burst of the construction and financial sectors, an oversized public administration, ballooning deficits, and quickly increasing debt and unemployment. In spite of fiscal consolidation measures amounting to over 15% of GDP since end-2008, growth has picked up in mid-2010, exports are booming and unemployment is quickly decreasing, though it still remains very high.

Romania has for example implemented a far-reaching pension reform. The old system would have led to a gradually increasing fiscal deficit of the pension system that would have grown from 1.3% of GDP in 2009 to 7.6% of

GDP by 2035. The reform, in place since January, stabilizes the fiscal position of the pension system.

Romania has meanwhile been able to access financial markets. For Latvia, we expect this to happen in the second half of this year, ahead of schedule. In view of the engagement of the Austrian banks in Eastern Europe, these are very encouraging developments, and I am glad to add that the banks have contributed to this with their responsible behaviour, especially through the Vienna Initiative.

It is the obligation of the recipients of financial assistance to do their utmost to deliver on their programme. It is clear that Greece has to seriously reinforce the implementation of budgetary savings and the economic reforms before any new steps may be taken. Likewise it needs to implement its privatisation programme. This is a matter of urgency, and I expect new measures to be announced shortly.

It is also clear that financial assis-



tance is a measure only needed when other measures have failed. Its use implies that policies have not been appropriate for a long time before. This has to be addressed and it is being addressed.

It sounds simple but is still essential to recall that prevention is always bet-

ter than correction – not to speak of crisis management.

That is why we are in the process of reforming economic governance in Europe. Last September, the Commission introduced a legislative package consisting of three main elements:

1. to strengthen the Stability and Growth Pact in order to prevent unsustainable fiscal positions emerging, and to correct such positions promptly, should they nevertheless emerge,
2. to introduce surveillance of macroeconomic imbalances and divergences in competitiveness, with corrective actions recommended if excessive imbalances are identified, and
3. to create a more effective enforcement mechanism, with earlier and more automatic sanctions in the case of violation of the rules.

Many people doubt that much will change. I have to disagree. I am fully confident that we will finally end up with tough fiscal rules and with a new emphasis on high debt levels, backed up by a much stronger sanctions mechanism than up until now, and also by an effective framework to deal with broader macroeconomic imbalances.

I trust that the Council and European Parliament can agree on the package in June, so that we will have the new rules in place shortly.

Strong national fiscal frameworks are also a necessary element of the governance reform. Austria provides a good example on this with its national stability pact created in 1999 and improved over time.

Ladies and Gentlemen,

It has also been clear for long already that the current stage of the crisis is a severely intertwined combination of a sovereign debt crisis and banking sector fragilities. It is clear as well that we cannot solve one without solving the

other. We need to resolve both in parallel.

That is what we have been doing. To conclude, let me summarise this:

First, we have prevented a financial meltdown.

Second, we have contained the sovereign debt crisis into three countries, whose public finances, banking sectors and growth policies are being totally revamped.

Third, we embarked on fiscal consolidation process across Europe to reduce fiscal deficits and to put the debt ratios on a downward path. Moreover, many Member States are implementing growth enhancing structural reforms that were considered impossible just a year ago.

Fourth, we have created a new architecture of financial regulation and supervision, with tough rules and competent supervisory authorities.

Fifth, we are about to conclude a major reform of economic governance,

in order to prevent imprudent fiscal policies and detrimental macroeconomic imbalances in the EU.

We are not there yet, the work goes on. The coming weeks before the summer recess will be crucial in terms of completing our crisis response, concerning the bank stress tests, the stability mechanism and Greece.

There will difficult decisions ahead. But we are making significant progress. The most telling evidence of progress is the economic recovery that we are now witnessing in the great majority of the Member States, Austria included. I have no doubt that, with perseverance and determination, we will overcome also the remaining challenges.

Hence, my response to Joseph Schumpeter's question "what Europe is made of" is the following:

„Europa ist aus hartem Holz geschnitzt.“ (“Europe is cut from tough wood.”)

Vielen Dank!