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"THE EURO'S CONTRIBUTION TO ECONOMIC STABILITY IN CENTRAL, EASTERN AND SOUTHEASTERN EUROPE"

Keynote lecture 1:

THE EURO'S ROLE ON THE WORLD STAGE

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Governor Nowotny, dear Ewald,

Ladies and gentlemen,

It is a great pleasure for me to address this distinguished audience at the conference on European Economic Integration. Let me also congratulate the Austrian National Bank and its Governor for their laudable initiative.

The topic of this conference – The Euro's Contribution to Economic Stability in Central and South-eastern Europe – could not have been more pertinent. During the crisis, the euro effectively shielded Members of the EMU from the turbulences that proved so costly in times of stress in the past. But at the same time, we must recognise that the single currency is not a solution to all economic woes. The opportunity to learn from the lessons of this crisis and prepare a strategy that will strengthen Europe's response to any future adverse economic shocks is of utmost importance for all of us, and in particular for the New Member States, as many of them still face the challenge of adopting the single currency.

1. The global economic crisis

But before refering to the Central and Eastern European region, let me first turn to the impact of the crisis and the measures we have already taken to counter its devastating effects.

Financial markets were at the epicentre of the crisis. The EU and the euro area were not spared, with some large financial institutions on the verge of default. The risk of a collapse of the entire European financial system was no longer abstract – it had become a real danger.

The european reaction did not linger. The Commission and the Council quickly developed principles and objectives for a coordinated approach. For its part, the ECB was the first major central bank to address market tensions via enhanced liquidity provision to the banking system. Member States allocated sizeable public means to banking rescue packages. Since October 2008, the Commission approved a total of over 3½ trillion (almost one-third of the GDP) of State aid measures to financial institutions. So far, EUR 1½ trillion have been effectively used under the four main headings of debt guarantees, recapitalisation, liquidity support, and treatment of impaired assets.

Credit restraint and sagging confidence hit business investment and household demand, notably for consumer durables and housing. The cross-border transmission was extremely rapid with the spectre of a new Great Depression looming large. Projections for economic growth were revised downward at a record pace.

The contraction now seems to have bottomed out. Still, GDP is projected to fall by about 4% in the EU and the euro area in 2009. The cumulative output loss amounts to some 5% of GDP since the recession started in the second quarter of 2008. In order to give you a sense of magnitude, this is about three times more than the average loss in the previous three recessions. Having said this, the situation would undoubtedly have been much more serious, had central banks, governments and supra-national authorities, in Europe and elsewhere, not responded forcefully.

The EU's response to the downturn has been swift and decisive. The overall fiscal stimulus, including the effects of automatic stabilisers, amounts to about 5% of GDP in the EU in 2009 and 2010.

There are reasons to be optimistic about the near-term outlook. Financial conditions have improved over the summer, with several financial indicators returning to pre-crisis levels. Business and consumer confidence indicators have also improved in recent months. World trade has stabilised, and there are indications that the destocking cycle is bottoming out. The relative resilience of consumption has proved to be a stabilising factor during the recession, as disinflation and relief measures included in fiscal stimulus packages have supported household incomes.

According to our latest forecasts, which were published at the beginning of the month, the EU and the euro-area economy are emerging from recession in the second half of this year. In the EU and the euro area, annual growth rates are expected to be 0.7% in 2010 and gathering pace, at around 1.5% in 2011.

However, I should stress that uncertainty about the strength and sustainability of the recovery remains. Banks are in the process of strengthening their solvency ratios, helped by the accommodative stance of monetary policy and rescue packages. But the stabilisation in financial markets has yet to yield concrete outcomes for credit distribution to the economy. Moreover, deteriorating employment prospects are a huge source of concern which we need to address.

2. The role of the euro

Ten years after the inception of the euro, the crisis has put the single currency to a major test. But far from withering, the euro has weathered the storm well.

First, and most importantly, the euro prevented exchange rate and interest rate turbulences among the euro-area Member States. We know

from experience how damaging such intra-European currency turmoil can be for the functioning of the Single Market.

Second, the euro area's stability-oriented macroeconomic framework has reduced the level and fluctuation of inflation and interest rates and kept expectations well anchored. It has also played a valuable role as an anchor of sound macroeconomic policies for Member States actively pursuing the adoption of the euro, or whose currencies are linked to the euro.

Third, since the start of the financial turmoil, the European Central Bank has skilfully managed liquidity and aggressively lowered interest to record low levels. This has helped to ease conditions in the interbank market and to anchor inflation expectations throughout this period of uncertainty.

Finally, but not of least importance, the governance structure of EMU, - again, far from being perfect - facilitated the coordination of policy action across the euro area and the European Union as a whole.

Imagine for a moment, how the crisis could have unfolded without the euro. The coordination problems would have multiplied. 16 European central banks would have had to struggle for a coordinated liquidity provision while trying to keep exchange rates and inflation expectations in check, or engage in negotiations about currency swaps.

Why then, after ten years of successful EMU, did the crisis hit so hard the euro area? The single currency in itself is no panacea. The crisis has highlighted the unfinished business in the euro area. As argued by the Commission in our Report on EMU@10 last year, unfinished business relates in particular to (i) the accumulation of intra euro-area imbalances;

(ii) the lack of a pan-European cross-border financial supervision and crisis management framework, and (iii) euro-area governance. Let me take a few minutes to go through these three challenges.

Because of important macroeconomic imbalances accumulated over time, some euro-area countries have been hit particularly hard. One group of countries have been running very large and persistent current account deficits and have registered a sharp deterioration in their net foreign asset positions. These external deficits reflect the strength of private domestic demand compounded by losses in price competitiveness due to an inappropriate response of wages to productivity growth. At the same time private sector debt has increased rapidly and external funding has tended to be channelled excessively into housing and consumption, contributing to the emergence of housing bubbles.

How to correct these imbalances? Taking measures to downsize and adjust oversized sectors, including in particular housing, is part of the answer. It is also necessary to reduce high private sector debt and adjust unsustainable intra-euro area current account imbalances. Countries with entrenched current account deficits should restore competitiveness.

Conversely, other euro-area Member States have been running large current account surpluses. These Member States have benefited from a strong export performance prior to the crisis, sometimes underpinned by robust gains in price competitiveness. However, to various degrees, their large current account surpluses also reflect comparatively weak domestic demand. They became particularly vulnerable to sudden reversal in global trade. As the global economy seems to be rebalancing,

this group of countries also face formidable adjustment needs in terms of strengthening domestic demand.

The crisis put the spotlight on unfinished business also in terms of integrated financial supervision. I would not claim that better arrangements in this domain would have prevented the crisis. But the fact that progress in financial integration in the euro area was not matched by a parallel strengthening of supervisory arrangements certainly hampered the euro area's capacity to respond to the crisis. Our supervisory framework remains fragmented along national lines despite the creation of a European single market. Existing supervisory arrangements failed to promote a common supervisory culture.

The comprehensive packages of legislative measures proposed by the Commission, building on the De Larosière report, aims to significantly strengthen the supervision of the financial sector in Europe. This package represents the rapid and robust response to the shortcomings in European financial supervision and should help prevent future financial crises.

Finally, the crisis showed that the established mechanism of policy coordination within the euro area was not working sufficiently well. Indeed, if co-ordination had started earlier and had been more comprehensive, the aggregate impact of the euro-area economic policy response could have been stronger. Co-ordination matters for the EU as a whole, but it is particularly important for euro-area Member States. More than ever, the euro area should exert leadership in these testing times.

3. The need for coordinated exit strategies

Last Friday, Eurostat published the flash estimate for the third quarter of 2009, posting 0.4% GDP growth in the euro area and 0.2% in the EU. This is in line with our autumn forecast and confirms positive momentum for 2010 and 2011. While 2010 will post a modest recovery still policy-induced, 2011 should see self-sustained growth. Therefore, it is imperative to continue implementing the agreed stimulus measures in 2010 and start withdrawing them in 2011 as these unprecedented stimulus measures in combination with automatic stabilisers and the sharp reversal of revenues have led to a significant deterioration of public finances.

The fiscal costs of the crisis and of projected demographic development compound each other and make fiscal sustainability an acute challenge. The Commission highlights in its recent report on fiscal sustainability the risks if no ambitious efforts to implement structural reforms and to consolidate government accounts are taken. If no fiscal consolidation measures are taken beyond the automatic withdrawal of the stimulus measures, the report projects that by 2015 the average debt ratio would be at around 100% of GDP both in the EU and the euro area. It would continue to increase to around 120% of GDP in 2020.

In the light of these fiscal sustainability challenges the time is ripe to start articulating a comprehensive exit strategy from the crisis.

Do not get me wrong!

It is still too early to start exit now. But in order to manage market expectations wisely in this uncertain environment, we need to prepare it now and to communicate clearly on it. By doing so credibly, monetary conditions could remain accommodative, which would avoid pushing up borrowing costs and making the fiscal consolidation longer and more

painful than it would otherwise be. The Ecofin agreed in October that, beyond the withdrawal of the stimulus measures, substantial fiscal consolidation was required in order to halt and eventually reverse the increase in debt and restore sound fiscal positions. Provided that the Commission forecasts continue to indicate that the recovery is strengthening and becomes self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest. Timing and pace of the consolidation need to take account of country specific situations, which also implies that a number of countries need to consolidate before then.

I want to stress the importance of coordinated exit strategies across countries in the framework of a consistent implementation of the Stability and Growth Pact. In line with this, the Commission decided in October to initiate the excessive deficit procedure (EDP) for nine EU Member States on the basis of projected budget deficits above 3% in 2009, and to adapt the EDP's launched six months ago for another four countries.

The timing, intensity and sequencing of policy withdrawal require our attention. To be successful in this process, close co-ordination among all actors will be needed to ensure optimal cross-country differentiation but also cross-policy consistency.

In the euro area, coordination requirements are particularly strong, given growth spill-overs between countries and the single monetary policy. But at the same time, the need for coordination extends beyond the EU scope. The global nature of the crisis calls for coordination of policies at a global level. At the St Andrews meeting of 6 and 7 November, G-20 Finance Ministers and Central Bank Governors committed to the further development of strategies for managing the withdrawal from the

extraordinary macroeconomic and financial support measures. We agreed to cooperate and coordinate, accordingly.

3. CEE (Central and Eastern Europe) and SEE (South Eastern Europe) countries and the crisis

New Member States (NMS) from Central and Eastern Europe (CEE) were badly hit by the crisis, following a sharp decline of global demand and retrenchment of capital inflows.

Many of them fell into sharp recessions and their fiscal positions deteriorated markedly. However, the recession and financial strains were and remain stronger in those countries which already at the onset of the crisis had been suffering from major imbalances or policy weaknesses.

In the Baltic states, for example, several years of rapid catching up had been accompanied by accumulated imbalances. These imbalances, reinforced by the global financial crisis and the fading away of external demand, ultimately led to a sharp reversal of the cycle. Estimated GDP falls for 2009 in the Baltics are in double digit figures.

High external and fiscal imbalances also increased exposure to the global economic downturn in some New Member States with floating currencies, notably Hungary and Romania. By contrast, other CEE countries have been more resilient to the global crisis.

The EU did rapidly showed its solidarity with its members in difficulty. In October 2008, Hungary asked for international financial support by the EU and IMF to counter pressures on its balance of payments and financial markets. This led to the activation of the EU medium-term assistance facility for the first time in 15 years. Since then, two more programmes,in Latvia and Romania, have been launched, bringing the

total commitments under the facility to 14.6 billion euro. In view of the increasing needs, the ceiling of available EU assistance has been raised in two steps from 12 to 50 billion euro. This assistance is provided in the context of broader international support packages, implying an unprecedented degree of co-operation with the IMF and the close involvement of other actors (MDBs, bilaterals).

In conjunction with the accompanying policy programmes, the international assistance has contributed to stabilising market expectations and underpinning confidence. BoP assistance has given the three countries breathing room to implement reforms necessary to restore access to private external financing and, ultimately, to honour their external debt obligations. Assistance also contributed to prevent a larger recession in the three countries. By providing significant financing to the budget, the programmes have allowed greater operation of automatic stabilisers than would have been possible otherwise. This has helped limit the social effects of the crisis. Importantly, the assistance is providing an opportunity to adopt long-due structural reforms in the countries concerned.

EU BoP assistance to non-euro area Member States is embedded in the broader policy framework set by the Treaty. Its elements include regular economic surveillance (particularly on fiscal and structural policies), support through structural funds, the single market framework and the euro adoption process. This broader institutional dimension is a crucial difference between EU Member States and other emerging economies affected by the crisis.

The private sector has been involved in the crisis resolution efforts as well. Parent banks have so far provided the necessary funding to their

affiliates in the new EU Member States, and a significant deterioration of conditions in the substantially foreign-owned banking sectors in these countries has been avoided. In the context of the European banking co-ordination initiative –the so-called Vienna initiative- parent banks have committed to maintain exposure to these countries and recapitalize their affiliates, if necessary.

More recently, the financial market situation in the NMS has improved. However, we should not have illusions on the pace of recovery. Even assuming continued forceful policy actions, the recovery is expected to be gradual. Some economies in the region are constrained in the use of fiscal stimulus. The scope for CEE countries to benefit from an export-led recovery is limited. Potential growth in the region is also unlikely to return to pre-crisis trends in the short term.

Policy challenges for the CEE countries remain significant. What is of key importance in the short term is to maintain resilience in view of persistent macro-financial vulnerabilities. Banking sectors continue to face important risks given the ongoing deterioration of asset quality. From a medium-term perspective, it is important to address further accumulated imbalances and re-establish a robust and sustainable growth and convergence path. This will require continued efforts particularly in the fiscal and structural fields.

New Member States, in their efforts to accelerate the catching-up process, have acquired over the years an important capacity to adjust . I am confident that in the face of the current challenge this capacity to adjust will prove invaluable.

Before concluding, let me say a few words about the situation in candidate and potential candidate countries, where the crisis has so far been felt to different extents.

Some of those countries, particularly the most integrated in international trade and capital flows, felt the impact of the crisis more quickly and more severely and will post negative growth this year. Let me note that the banking sector in pre-accession countries has weathered the crisis remarkably well, thanks to its high degree of capitalisation and liquidity, and – in the case of Turkey – due to a strong round of previous reforms. Only one ailing bank needed to be rescued, in Montenegro.

However, and in spite of fiscal adjustment measures taken in these countries, my main concern over the short- and medium-term relates to the continued deterioration of the fiscal situation.

The EU stands ready to help candidate and potential candidate countries in difficulty. EU macro-financial assistance can be provided, in conjunction with IMF programmes, to support them through the worst of the crisis. Earlier this year Serbia and Bosnia and Herzegovina agreed programmes with the IMF. This in turn played an important role in enabling EU-based parent banks maintain their financial exposure to these two countries. The EU will also contribute to these efforts. The Commission recently proposed two macro-financial assistance loans in favour of Serbia, and Bosnia and Herzegovina, of EUR 200 and 100 million respectively. These loans remain to be approved by the Council and the Parliament. Serbia also benefits in this context from exceptional EC budget support assistance expected to be released this year and in 2010.

4. Euro attractiveness

Ladies and gentlemen, let me conclude on the EU members that are not yet integrated in the euro area.

The fall-out of the crisis – including the reappraisal of risk, tighter financing and liquidity conditions, and exchange rate volatility – has brought euro-area membership to the forefront. The exit strategy will serve these countries in their preparation for euro adoption.

Among countries with pegged exchange rate regimes, the crisis has reinforced the prevailing euro-adoption strategies. Euro-area membership is perceived as a credible exit strategy propping up confidence (by residents and non-residents alike) in the pegs. Euro adoption is seen as offering a relief to liquidity constraints and eliminating exchange rate mismatches while not imposing additional challenges to economic policies.

For countries with floating exchange rates, the crisis has highlighted the vulnerabilities coming from large fiscal deficits against the background of tighter global conditions.

Euro adoption should not be seen as a quick fix to economic vulnerabilities. It should rather be part of a broader long-term policy strategy. As the crisis has amply demonstrated, membership in the euro area enhances resilience, but it does not eliminate the need to work out underlying imbalances that have been built up over the last years. Also, new entrants need to prepare thoroughly to cope with life under an irrevocably fixed exchange rate in order to successfully perform within the euro area.

The challenges of euro preparation should not be underestimated. For the recent new euro area entrants, preparation has involved the need to improve the state of public finances, in some cases changes to the exchange rate regime, and structural reforms to strengthen domestic adjustment capacity. In this respect, the crisis might serve to galvanise public and political support for the measures that are necessary to proceed with convergence and move closer to the goal of euro adoption.

Euro adoption remains a key anchor for medium-term policies and expectations for NMS. However, an accelerated euro area enlargement that would require a waiver or a loosening of the entry criteria specified by the Treaty is not an option. Without sustainable convergence, euro adoption may turn out to be a suboptimal strategy for the country concerned. And by heightening economic divergences and adjustment problems, it would also make the management of EMU more difficult.

Compliance with the convergence criteria in a sustainable manner is in the interest of both the prospective and existing members of the euro area. It signals the commitment and the ability to ensure a stable macroeconomic environment after irrevocably giving up the national exchange rate and monetary policy. It thus contributes in the best way to the smooth functioning and the stability of the euro area.

Thank you for your attention.