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Lessons from the euro crisis
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Ladies and gentlemen,

Many thanks for inviting me to this conference. I was asked to talk about lessons from the crisis. Let me start right away with one of the key lessons: We need better communication about Europe! Every time a problem emerges or there is a political risk out there, you hear that the euro area is failing. What we need is a realistic picture of Europe, pointing out the achievements, clarifying the to-dos, and dispelling prophecies of doom. This is what I want to do today.

I will look at growth, but also at how equally wealth is spread through society. A second point that I will make is to refute a notion that Europe – and the monetary union in particular – is a permanent construction site. It is true that there are still issues that we need to fix – overcoming the legacies of a crisis as we have experienced it simply requires persistence. But these are fairly limited steps compared to what has already been achieved. Finally, I will argue against the populist and protectionist sentiments in Europe questioning the very basis of our progress over decades.

Europe has staged a sustained recovery after the euro area debt crisis of 2010-2012. Unlike the United States, Europe was hit by a double crisis. First, there was the subprime mortgage crisis, the largest crisis since the end of World War II. It originated in the States but understandably also damaged European banks. Europe then entered a crisis of its own making, the euro area debt crisis. With a delay, financial markets had identified flaws in countries' economic policies and the institutional set-up of the monetary union, and started testing policymakers' resolve. Soon, countries such as Greece and Ireland lost the ability to finance themselves in the market, and were heading towards default. This was something that had been deemed unthinkable when the Maastricht Treaty was signed and it rapidly became clear that extraordinary action was needed. We kept the euro together through a number of steps.

First and foremost, countries did their homework. They implemented reform programmes that were often painful for the population, parts of whom came to dread these years of "austerity". The ECB did its part to support the economy with its unorthodox policy measures. At the supranational level, Europe now has tighter economic policy coordination with greater surveillance powers for the European Commission. The new Macroeconomic Imbalances Procedure is an example of that, Eurostat's new mandate to verify national statistics another.

Europe also set up a far more effective system of bank supervision, which means that the responsibility for overseeing the largest banks is no longer in national hands. Banks have become better capitalised and we have a path towards resolution that avoids vicious cycles between banks

and sovereigns. The ESM is another important innovation. It is a lender of last resort for sovereigns, a function that did not exist in the euro area before the crisis.

As a result, the euro area has staged a robust recovery over the past years. Euro area growth increased by 1.7% last year and is expected to reach 1.6% in 2017. That is above the potential growth rate and bodes well for future job creation. It is true that growth rates are lower than they were before the crisis, when we had years of 3% growth. But the crisis has shown that such elevated growth rates were probably unsustainable, fed by bubbles and imbalances in some countries.

And let's not forget that euro area growth last year was actually slightly above that of the U.S. From a per capita perspective economic growth in the euro area is now back in line again with the US, just like it was before the crisis.

Another point is that the distribution of income is far more equitable in Europe than in the US. It is not a straightforward exercise to get the data, but what there is clearly points to the fact that top income earners in the US have benefited more from growth in the economy than the lowest income earners over the last decade, while income growth has been distributed more equitably in big euro area countries. Needless to say, such disparities feed into a sense that globalisation has failed to fulfil its promise of greater wealth – at least not for everybody. And this is likely an important driver of the rise of populism across the Western world.

Let me also give you some evidence to show that the euro area's macroeconomic position is now much more balanced than at the start of the crisis. Budget gaps have tightened to more sustainable levels across the euro area, and are well below the US in the aggregate. Even Greece had a large primary surplus last year. Equally important, competitiveness has returned in countries that needed ESM programmes and current account deficits have largely disappeared. In the past, some euro area economies had priced themselves out of export markets through years of overly generous – and in the end unsustainable – wage increases. Many did not believe that an economy could rebalance itself through adjustment programmes such as those of the ESM. Evidence shows the contrary. And equally, what happened in programme countries refutes the notion that structural reforms are “slow burners” that only yield benefits many years down the road. The countries which exited from the programmes – Cyprus, Ireland, Portugal, and Spain – show that this is not true. The results of addressing the country's imbalances showed more rapidly than general wisdom would have had it.

Past reforms also worked in the labour market. In past crises, economic rigidities stood in the way of people finding jobs and many workers were driven out of the labour market, mostly into retirement. This time was different, because of the reforms introduced in Europe prior to the crisis. Participation and employment rates in Europe are higher today than in the year 2000. That means that a higher percentage of the population actually has a job today compared to 15 years ago, despite the high unemployment rate. In the US, the participation rate has decreased significantly.

At the same time, we need persistence to improve growth and address the legacies of the crisis. Labour markets are the first area where this holds. The unemployment rate is declining, but it is still higher than before the crisis for the euro area as a whole. And while some countries like Germany are moving to a situation of full employment and a labour shortage in some sectors, others still face very high unemployment rates. We cannot afford for young people to suffer most with unemployment rates reaching the current excessive levels. Young people should have access to work

and gain the experience and expertise that will drive their growth – and that of the economy – in the years to come.

Second, investment activity still hovers below pre-crisis levels. A much-needed investment rebound is critical not only for economic recovery but also for long-term growth prospects. While the decline in the investment ratio was much larger in the private sector, public investment can play an important role in closing the investment gap. At the same time, a stable and business-friendly economic and political environment and openness to cross-border investments are the best way to stimulate private investment activity.

Let me also say a few words about the health of the euro area banking system. Banks are much better capitalised than before the crisis, and have added more than €600 billion in equity capital. It is true that non-performing loans are still too high, and they are one reason why bank profitability is low. In countries such as Cyprus, Greece, Italy, Ireland, Portugal, Slovenia, and Spain they are close to or even exceed 10% of total gross loans, which is clearly too high. It means high direct costs, because of impairment charges. But there are also elevated indirect costs, because bad loans eat up management and staff time, and are a burden on funding and capital. Bad loans have started to drop in Europe, and banks are also well provisioned, 52% on average. However, more needs to be done to support the improvement. The SSM has set targets for NPL reduction and deals with the issue in a homogenous way at the European level. We need efficient insolvency procedures. Aligning these procedures across Europe would help create a European market of distressed assets. One could even build a common trading platform, which does not entail a transfer of assets or mutualisation. And we need financial regulation to create an open and competitive market for servicing companies to manage these loans.

Tackling legacies will help to raise growth, but more can be done to increase the resilience of the euro area. In my view, the European Monetary Union does not need a full fiscal union to function properly, nor a full political union. But certain additional measures would be useful.

First we need to complete Banking Union, which would strengthen financial integration and risk-sharing via markets. Banking Union lacks a common backstop for the Single Resolution Fund. Setting up such a backstop would make the SRF more credible.

The other important step to completing Banking Union would be some form of European deposit insurance. Obviously, before this can happen, the legacies at banks mentioned before need to be resolved. We need to de-risk first, because no country with a healthy banking system should have to pay for past mistakes by its neighbours. Consequently, it will take a while before a European deposit insurance exists. But the advantages would be considerable.

Capital Markets Union would also strengthen financial integration and make the euro area more robust. By harmonising corporate, tax, and insolvency laws, European countries would lower barriers for equity flows and other investments across borders. This would facilitate equity investments from one country into another and help reduce Europe's excessive reliance on bank funding.

Another step that would make EMU more robust would be a limited fiscal capacity to tackle asymmetric shocks. Examples in the US show how this can be done without debt mutualisation or

permanent budget transfers. US states can draw on a rainy day fund, or supplementary unemployment schemes to help them through tough times, and then refund the money later.

Any of these steps would enhance economic risk-sharing, which is the biggest remaining challenge in the EMU. Risk-sharing refers to the sum of mechanisms through which a shock – positive or negative – to one country’s economy is shared by others. This can take place through fiscal mechanisms and through capital markets. Together, they help smooth consumption, demand, and business cycles and make national economies more resilient. Risk-sharing is underdeveloped in the euro area – and the capital markets channel in particular. This is the case not only when compared to the US, but also compared with large European economies. In the US, and within Germany, as much as 80% of an asymmetric shock is evened out. In the EMU, it is below 40%. This is where Europe needs to catch up.

Let me finish by recapping the economic and political arguments of why the populists – who want to leave the euro, build walls between countries, and stop trading – are wrong. There are many arguments to show this, but I’d like to focus on the lessons from the crisis.

First, I showed that those saying that the euro area is underperforming are neglecting important achievements. Euro area countries are among the richest in the world, with living conditions superior to other areas, according to many studies, and with more equitable growth. We have recovered from the crisis, overcome imbalances, and reduced vulnerabilities in our financial system.

Second, I disagree with those who disregard the successes of the euro area response to the crisis. The euro area came out of the crisis with a substantially stronger architecture and more resilient economically. Despite all the internal political constraints, the euro area has managed to deliver a policy response overcoming many of the institutional weaknesses. This includes establishing completely new institutions, such as a European crisis resolution mechanism and European financial supervision. It is sometimes not sufficiently acknowledged that all this has been achieved jointly by a coordinated effort of all member states – a historically unprecedented example of international cooperation.

Third, it is said that the euro area *per se* is flawed and at the heart of a deficient economic policy structure that cannot work. In economic parlance, the euro area is not an “optimal currency area”. The crisis has shown that it is not diversity in income levels or economic structure that matters but a balanced growth path. Economic imbalances breed financial instability. The adjustment experience of programme countries shows that a clear reform path can redress such imbalances even within a monetary union. This is a fact which many would have contested before the crisis.

Fourth, the idea that some euro area countries would do better if they exited the euro is false. There would be large and immediate costs for the economy because the country would have to redenominate its currency, which would depreciate immediately if the economic fundamentals were not solid enough. In other words, leaving the euro because your economy is doing poorly is not a real solution. Rather, it would make the population much poorer.

What makes me confident and optimistic about the future of the euro area, is that wide swathes of the population seem to understand the argument that I just made. In the Eurobarometer poll, the popularity of the EU and of the euro is consistently high. Let me give you a few numbers. When

asked whether the EU is a place of stability, 66 percent of the people agree. To the question whether they support the four freedoms – goods, services, capital and labour – a full 80 percent agree. And the euro is supported by 70 percent of the inhabitants of the euro area. This is a ringing endorsement of the work the EU has done over the past decades. It also gives policymakers a sound mandate to continue to make the monetary union more robust and its economy more resilient. People understand that this is in the interest of their own prosperity.