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"Lessons from the euro crisis"

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(Please check against delivery)

Ladies and gentlemen,

It is an honour for me to be here with you in Budapest. Hungary isn't part of the euro area yet. Nonetheless, Hungary has made an important contribution to the single currency project with Alexandre Lamfalussy. In 1949, he fled this country, walking through fields covered in a metre of snow. This adventure paid off well – for all of us. Alexandre became one of the founding fathers of the euro. A fact that only a few people outside this room know. As an adolescent, he witnessed the devastation brought about by the Second World War. And, in his own words, he was horrified by it. It made him decide to help rebuild Europe. And his life has been closely tied to our history ever since.

Alexandre was once asked whether his war experience was the reason for his personal conviction that Europe needed a single currency. His answer was: "Yes, no question, because it was clear that the European Union couldn't exist without monetary union." That vision was paired with the ability to forge a consensus among people who love to disagree and his determination and intellectual power to find workable solutions.

I had the pleasure of working very closely with Alexandre on a few occasions during my years at the European Commission. And when I look at his biography, I see some similarities in certain phases of our lives. He was the head of the European Monetary Institute, the precursor of the European Central Bank. When I read how Alexandre personally knew the first 100 people he hired – first briefly in Basel, then in Frankfurt - I am reminded of my first days at the EFSF in Luxembourg, created in 2010, where we reached a staff of 100 three years later. The EMI, like the EFSF, was an innovative new institution that represented a key step in European integration. And in both cases, there were many who said the institutions wouldn't succeed. But they did. Moreover, both were bodies with a temporary life-span. The EMI's goal was to prepare the ground for the ECB, and then be terminated. Likewise, the EFSF has now been succeeded by the ESM.

There is another story about Alexandre that reminds me of my own experience. He once spoke in a small town in Bavaria. As you know, Germany went through two currency conversions, one after each world war. In both cases, people lost considerable amounts of money. So an elderly man was eager to know if this was going to happen again with the euro. Alexandre convinced the audience it wouldn't. This earned him the praise of Helmut Kohl, who called him up to say: "You really won over those Bavarians, and they are a difficult lot". I also spend a lot of time out on the road telling people about the benefits of the euro. Although I don't think I've convinced each and every Bavarian just yet, like Alexandre, I am deeply convinced that one of the important tasks of policymakers is to explain the benefits of the single currency to citizens.

Ladies and gentlemen, Europe has just come out of the worst crisis since the Great Depression. There were many who said the single currency wouldn't survive. They were wrong. The euro area is emerging from the crisis stronger than before. But there is no room for complacency. The road ahead will require more work, difficult decisions, and above all a clear vision. A vision such as the one Alexandre Lamfalussy had. So, in all humility, let me follow in his footsteps and give you my own vision of the lessons Europe has learned from the crisis.

Let me remind you first that we went through two crises in Europe. The financial and economic crisis was triggered outside Europe in 2007. In the United States, markets had ignored credit risk in subprime mortgage markets. This was aggravated by a lack of financial supervision, which had allowed a proliferation of opaque financial instruments. The behaviour of bankers, supervisors, central bankers, and credit rating agencies all contributed to the crisis. It led to the dramatic bail-out of the U.S. banking system in September 2008. European banks also suffered. Two years later, this was followed by a crisis in the euro area– this time of our own making. Years of irresponsible fiscal policies had caused unsustainable budget deficits and debt burdens in some countries. Others had become uncompetitive, pricing themselves out of international markets with misguided wage policies. Housing bubbles contributed to the imbalances. Institutions for crisis management were lacking. All this finally came to a head between 2010 and 2012, when several countries lost access to bond markets. Sovereign defaults loomed. This was something that had been deemed unthinkable in the currency union. At the height of the crisis, the risk that the euro would break up was real.

That was only six years ago. Since then, policymakers have taken decisive action and their response to the crisis was comprehensive. I believe – like former French economy minister Edmond Alphandéry, who was speaking before me – that this experience has demonstrated once again the ability of Europeans to deal with crisis. The euro area is now more integrated and less vulnerable. Let me mention five lessons one can draw from the crisis.

First, countries should avoid becoming too vulnerable, by keeping debt and fiscal deficits manageable. You can ask yourself why Finland was never attacked by markets, and why it managed to keep its triple-A rating despite a relatively poor economic performance in recent years. The answer is clear: Finnish debt and deficits have remained fairly low.

Fiscal deficits ballooned in a number of countries. However, in the wake of the crisis, all countries have started to reduce their deficits significantly. Across the euro area, fiscal balances have tightened. The aggregate euro area budget gap is now much smaller than in the United States, Japan, or the United Kingdom.

Competitiveness is another area countries have to watch closely. During the first decade of EMU, Greece, Ireland, Portugal ,and Spain lost competitiveness. An excessive divergence in the unit labour costs of these countries, compared to core countries, had developed. Nominal unit labour costs have since converged towards more reasonable levels, and current account imbalances have disappeared.

Reforms produce hardship for citizens. Salaries, pensions, and public expenditure have to be cut. But in a monetary union – where devaluing a national currency is not an option – internal devaluation by reducing unit labour costs is unavoidable to regain competitiveness.

The five programme countries have made the biggest strides in modernising their economies. These programmes are different for each country, but they are always geared at raising competitiveness, employment, and growth.

According to the "Going for Growth" survey of the OECD of 2015, Greece, Ireland, Portugal, and Spain are among the top five of the 34 OECD member states.

It is encouraging that the positive results of this difficult adjustment process are becoming clear. It shows a real willingness in Europe's capitals to continue on the path towards economic convergence.

The second lesson is that national reforms are flanked by a new model of economic governance for the EU. I will not go into details which are well known to you. But I do want to stress that we have created a framework that provides for much tighter economic policy coordination, with much broader surveillance.

With respect to the Stability and Growth Pact, the European Commission was given new powers to enforce this framework. The European Commission also issues country-specific recommendations as part of the European semester; each Member State receives recommendations on where and how to remove obstacles to growth.

Another example are the new powers for Eurostat to check the data it receives from a country. Before the crisis Eurostat did not have that power.

Weaknesses in euro governance – one of the causes of the past crisis – will be eradicated if the Commission uses these new powers, and countries respect the rules they have adopted.

Monetary policy also played a crucial role in fighting the crisis. That is the third lesson. Innovative monetary policy is needed during a crisis, even if monetary policy during normal times should be boring. Back in 2007, the ECB was the first central bank to adopt new so-called unorthodox measures.

Since then, it has initiated a series of measures that were critical in stabilising the situation in the summer of 2012, when the threat of monetary union disintegration was at its peak.

It has engaged in a bond purchasing programme, with a view to avoiding a protracted period of very low inflation that would make the return to sustained growth and the reduction of high debt levels more difficult. Naturally, the aim is to get banks to lend again, to boost investor sentiment, and indirectly to avoid an overvaluation of the exchange rate.

Lesson number four is that we had to make the banking system much safer. Banking Union would have been unthinkable not so long ago. It is another example of what is possible in a crisis and of the progress we've made in enhancing the European framework.

As part of the Banking Union, the Single Supervisory Mechanism oversees the 130 biggest and most important banks at a European level. Banks have hugely increased their shareholder capital. Since

2008, EU banks have added more than €600 billion in new capital. New rules to bail in shareholders and bondholders of a troubled bank became effective at the beginning of this year, and will significantly weaken the link between banks and sovereigns. The Single Resolution Mechanism and the Single Resolution Fund (SRF) are the other key institutions of the Banking Union and will control the new resolution regime.

Over the next eight years, the SRF will slowly build up its funds. At the moment, the ESM provides a financial backstop for countries, should they need to inject money into the SRM. At a later stage, a common financial backstop will be needed. This could be a future role for the ESM. To complete Banking Union, we need a third pillar: the European Deposit Insurance Scheme. The Commission proposed this last year, and it is now under discussion.

The ESM fills another institutional gap in Europe. It is a strong and effective firewall against any future crisis. It was created in 2012 as a permanent institution, and followed on from the EFSF, a temporary solution set up at the height of the euro crisis in 2010. Both institutions have since disbursed a total of €254.5 billion to five countries: Cyprus, Greece, Ireland, Portugal, and Spain.

We have a combined lending capacity of €700 billion. The ESM has paid-in capital of €80 billion, the most of any International Financial Institution worldwide. The EFSF and the ESM have been instrumental in keeping the euro together. That is a huge success. Without the ESM and the EFSF, countries like Greece, Ireland, and Portugal would probably no longer be in the euro area. Europe would be a very different place. Three of the five countries have now exited their programmes. Cyprus will do so in March. Greece was also on the right track, until political upheaval interrupted its progress early last year. Last summer, Greece started on a third programme. The negotiations were tough. But Greece can also be a success story if it fully implements the agreed reform package.

What are the benefits of these new institutions, the EFSF and the ESM? Like I said, no country was forced to leave the euro area – and that makes a big difference for Europe. The five countries have agreed to strict economic reform programmes. In return, they received the financing they could no longer get from private investors. This “cash-for-reform” approach is well known from IMF programmes and we have imported those IMF recipes into Europe. This has been very successful. Our programme countries have become the reform champions of Europe, as I said earlier.

Economic history is quite clear: countries that implement more reforms than others will grow faster after a few years. Spain and Ireland are now among the growth champions in Europe with growth rates of 3 and 6.5% during the first half of 2015. Let me stress here that European taxpayers haven’t spent a cent on the assistance programmes. The ESM does not use its paid-in capital to make loans. Rather, the capital is a guarantee that enables us to borrow money in markets at a very favourable rate. This makes us very different from the IMF, which is refinanced by central banks. We pass on our low funding cost to programme countries, which generates substantial savings for them.

The Greek budget, for instance, saved €8 billion in debt service payments in 2014 alone because of our lending programmes. That’s 4.4% of GDP – and this is repeated every year. If reforms continue, Greece can thus regain sustainability in its public debt. Another benefit of the EFSF/ESM that I want to mention to you is that they contribute to risk sharing within the EMU. Moreover, they are a lender of last resort to governments.

So yes, Europe is much better off with all these new tools, frameworks and policies. Had we already had these new policy tools in place in 2007, the crisis could have been a lot milder. It is interesting to look at that for a moment. The soaring Greek budget deficit – which reached 15.6% – would have been detected much earlier if we had given Eurostat the power to check numbers in Member States earlier. If the European Systemic Risk Board had existed in the last decade, we would have spotted real estate bubbles in Ireland and Spain much earlier, and could have done something about them before they came very big. Large current account imbalances would have been identified earlier, if the new Excessive Imbalances Procedure had been in place. Financial assistance from the EFSF and the ESM could have reached countries faster, if these institutions had already been established.

Problems in banks would have been tackled sooner, if Banking Union had existed. And fiscal rules could have been enforced more strictly if the Stability and Growth Pact had been reformed earlier. Therefore, my tentative conclusion is that we have learned the lessons, that we have adopted many important reforms. We now have a better governance framework, and we have closed institutional gaps. With all that, monetary union will work better after the crisis than before.

Nevertheless, more steps are needed to make the EMU more robust and less vulnerable. The euro enjoys continued popularity. A majority of people support it in virtually every country, despite the many signs of Euroscepticism and populism. This should give politicians a mandate to complete economic and monetary union, to make it more robust and resilient.

The Five Presidents' report offers a good roadmap, and the European Parliament and think tanks have offered other thoughts. The report contains proposals in the areas of economic union, banking and capital markets union, fiscal union, and political union. Many of these are good ideas. Completing banking union is essential, and requires basically just one more step: the European Deposit Insurance Scheme.

Capital markets union is another important step to make the economy more resilient. More financial market integration will lead to greater capital flows, more financial market integration, and promote private sector risk-sharing. This would require harmonising insolvency, taxation, and company law issues. Admittedly, that will not be an easy task.

In the United States, shocks are smoothed out across the 50 states to a much greater degree than across euro zone countries. This happens mainly through market mechanisms. Fiscal transfers appear to play only a limited role. That is not to say that they cannot help smooth cycles and address systemic shocks.

We do use fiscal transfers in Europe. People often don't realize that EU Member States can receive substantial transfers of up to 3% of their GDP from the EU budget. This despite the fact that the EU budget is small – a little over 1% of GDP. These are permanent transfers, not loans, and not related to monetary union, and I do not believe the smooth functioning of the EMU needs bigger transfers than that. The absorption capacity of most countries would not make bigger transfers particularly efficient.

However, a limited fiscal capacity, as suggested in the report, could be useful. Importantly, it could be designed so that it does not lead to permanent transfers or debt mutualisation. There are ways to do this that may not even require changing the EU Treaty. The Five Presidents report also mentions the possibility of a euro area Finance Minister. This could further support policy coordination, external representation, and visibility – and thus the credibility – of the EMU.

Let me conclude here. Monetary Union has come out of the crisis stronger than it was before. A host of measures saved the euro: economic adjustments, greater economic coordination between countries, unorthodox monetary policy, a stronger banking system, and substantial financial solidarity between euro area countries via the EFSF and the ESM.

Further steps would make the monetary union more robust. And when I look at those, I think of Alexandre. If he were still with us, we would simply ask him to start another Lamfalussy process, to move us closer to fiscal and political union. No doubt, he would bring such a mandate to a successful end. Europe's citizens would be the better off for it.