European Stability Mechanism

“Lessons from the crisis and the next steps for EMU”

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Ladies and gentlemen,

I am very happy to be back in Helsinki. Being here in December – when days are short – is a reminder that the year is almost over. So now is a good time to look back. A year ago, I thought we would have a quiet time in 2016. Quieter at least than 2015, when we negotiated the third Greek programme. But of course, we didn’t.

Brexit and the US election were big shocks that happened in 2016. It was an unusually eventful year. Even this week, Austria held an important presidential election, and we are still watching politics play out in Italy. Fortunately, markets don’t seem too bothered about the No-vote there. Next year, there is more uncertainty, with elections in France, Germany and the Netherlands.

Undeniably, populism is on the rise in the West. It is a force that questions globalisation, cross-border cooperation, and international trade. It is a force that debates some of the cornerstones of the European Union, and of the economic and monetary union. And it is a force that pushes Europe on to a crossroads, where it needs to decide which way to go. Finland is one example where this is the case - but your country also shows how a populist party can join a government and be cooperative.

I see it as my duty to bring rational and balanced arguments to this debate. We need to explain that globalisation has reduced world poverty, and raised living standards. If Europe wants to remain a meaningful economic power in the world, we have to act together, not country-by-country. Integration has brought many tangible benefits to Europe’s citizens. Too often, we’ve failed to mention that. On the other hand, we should not ignore problems, and we should be honest about the challenges we still face. I know there is a fair amount of scepticism in Finland. Like in other countries, people no longer automatically trust what the experts tell them. And it is true that Europe has just come out of one of the worst crises in its existence. But this has made Europe stronger than it was before – not weaker. Let me give you my arguments why I think that this is the case in the next half hour, and then we can discuss them.

Often, the euro is described as a purely political project. But that is not correct. The single currency has brought real economic advantages, and enables countries to fully enjoy the benefits of the single market. Companies are saving foreign exchange costs of €20 to 25 billion per year. Cross-border trade between euro area countries has received a boost of up to 10%. Transaction costs have fallen sharply. Price transparency has increased, leading to greater competition, which, as we know from economic theory, results in larger productivity gains, and higher growth.

The single currency has also solved a problem of monetary policy in Europe. Before the euro, Bundesbank decisions dictated monetary conditions in many countries outside Germany. Yet because of its mandate, the Buba could only take the economic situation in Germany into account. This often led to suboptimal monetary conditions in the other countries. Finland itself experienced long periods of foreign exchange instability before the euro was introduced. It is quite similar to what we see globally nowadays. Emerging markets like India and Mexico are heavily impacted by the monetary policy of the Federal Reserve. But the Fed cannot take this into account, at least not directly. And not only was it difficult for smaller European countries unable to influence decisions of the Bundesbank. Quite often, it was also hard for Germany, which itself suffered repeatedly from currency turmoil in Europe. The Tequila crisis in 1995, for instance, triggered a massive appreciation of the Deutschmark against other European currencies. It rose 20% against the Italian lira, for instance. German exports suffered, and this cost the country one percentage point of growth that year.

With the advent of the euro, this problem no longer exists in Europe. The ECB's policy decisions take the whole of the euro zone into account - a major advantage for the countries that use the euro. Some argue monetary conditions cannot be appropriate for individual countries, because they are based on the economic situation in the entire area. But they forget that the situation was worse before the introduction of the euro.

So there is plenty of evidence that monetary union has made a real difference in the economic well-being of Europe's citizens. People recognize that. Two-thirds of euro area citizens support the euro, and more than half in each euro area country. In Finland, 76% of the respondents said that they were in favour of the single currency in the latest survey. Such strong support gives politicians a mandate to defend and improve EMU further. I will say a bit more about how they can do that in a minute. But let me first go back to the crisis.

Europe had to deal with a double crisis. First, starting in 2008, banks were hit by the subprime crisis, which started in the United States. This was followed by the sovereign debt crisis, which was of our own making. Years of irresponsible fiscal policies had caused unsustainable budget deficits and debt burdens in several countries. Others had become uncompetitive, pricing themselves out of markets with misguided wage policies. Housing bubbles contributed to the imbalances in some countries, endangering the banking system when they burst.

The loss of market access for a country that had joined EMU had been considered unthinkable when the Maastricht Treaty was signed. That meant there was no mechanism to deal with it. So when it did happen, and countries like Ireland, Portugal and Greece lost market access, many predicted the euro would break up. That this didn't happen is only thanks to the decisive action from national governments and European institutions.

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Firstly, countries did their homework. They put their fiscal house in order, and adjusted macroeconomic policies. Budget gaps have now tightened to more sustainable levels across the euro zone, and are well below the US in the aggregate. Even Greece will have a fiscal deficit of only 2.5% of GDP this year, about the same as Finland.

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Equally important, competitiveness has returned in countries that needed ESM programmes, while current account deficits have largely disappeared.

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Programme countries implemented more structural reforms than any other country in the world, according to the OECD and the World Bank. On top of these national efforts, there is stronger and broader policy coordination at the European level. In this respect, the new Macroeconomic Imbalances Procedure is an important new tool.

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Secondly, the two institutions I manage, the European Stability Mechanism, and its predecessor the EFSF, filled a gap in the institutional framework of EMU. We are a lender of last resort to sovereigns, a function that did not exist before the crisis. The two institutions have provided assistance to five countries: Greece, Ireland, Portugal, Spain and Cyprus. We have a total of €247 billion in loans outstanding, three times as much as the IMF globally.

Our loans are a form of financial solidarity between euro area countries, because they constitute substantial budgetary savings for programme countries. This is because our lending rates are very favourable: only one-third of what the IMF charges. And obviously well below what a country in distress would pay in the market. We have calculated that this saves the Greek budget €8 billion each year, or 4.5% of GDP. And yet, this comes at no cost to the euro area taxpayer. We fund ourselves in markets by issuing bonds and bills. The reason that we can do this so cheaply is because of our strong credit rating which is based – in the case of the ESM – on the €80 billion in capital our member states have paid in.

The third significant institutional innovation that was needed to fight the crisis is Banking Union, which saw the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism.

In short, Europe's answer to the crisis was not to give up. Europe knows how to take decisive and comprehensive action when needed. In doing so, we took a balanced approach. On the one hand, Europe has shown a willingness to provide financial solidarity. But countries can only get ESM money on strict conditions. They have to go through a process of often painful economic reforms. It is not something any government takes lightly. But this bitter medicine works. Four countries have successfully exited their programmes and are now success stories. Ireland, Spain and Cyprus are among the countries with the highest growth rates in Europe.

And even Greece was beginning to show signs of recovery during the second programme with the EFSF in 2014. That process was brutally interrupted early last year when the newly elected government changed course and started moving backwards in the process. The country lost much time and money during that period. Fortunately, Greece is now back on track, and I expect it to be able to return to the bond market well before the end of the programme in August 2018, provided that it implements the necessary reforms. In this context, the announcements made last night by the Greek Prime Minister without consultation with the institutions raise a number of questions.

The short-term measures to make its debt more sustainable, which the Eurogroup agreed to adopt on Monday, should be an additional help. To sum it up in one sentence: Greece is no bottomless pit.

Another sign of Europe's effective response to the crisis is the fact that the economy is doing fairly well overall. This is not sufficiently recognized. Growth in Europe is above potential, so the output gap is closing. It is true that potential output growth seems low. But in per-capita terms, economic growth in Europe is similar again to that in the US, just like it was for decades until 2009. This is important because it measures the average rise in standards of living, taking out differences in population growth.

What's more: benefits from growth are spread more equally in Europe than in America. In Europe, 80 percent of the population has seen real income growth in the last 15 to 20 years. In the US, that was the case for only 10 to 20 percent. Last but not least, participation and employment rates in Europe are higher today than in the year 2000, as a result of the Lisbon strategy. 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.

I know you rarely find these arguments in the media – and yet they are underpinned by the facts. Many of the negative headlines about Europe are painting a picture that does not agree with reality. The truth is, Europe isn't doing bad at all. That doesn't mean there are no challenges. But they are less daunting than what was at stake in 2010, and I am confident Europe can handle them.

Many people have identified challenges that remain for EMU, and with ways to deal with them. Last year's plan by the five presidents of the European Council, Commission, Eurogroup, ECB and the Parliament contained many useful ideas. There were also plans from other politicians, parliamentarians and several think tanks. Some ideas are mutually exclusive, others will take considerable time. If the recent rise in populism has made one thing clear, it is that now is not the time for an unmitigated call for more Europe. Any proposals to deepen European integration and to develop the institutional framework of EMU needs to have clearly identifiable benefits.

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From my perspective as an economist, the biggest remaining challenge in the EMU is the lack of economic risk-sharing. 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 United States, but also compared with large European economies. In the US, and within Germany, as much as 80 percent of an asymmetric shock is evened out. In the EMU, it is below 40 percent. In my view, this is where Europe needs to catch up most.

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Like I said, risk sharing inside the monetary union could be enhanced through markets or through fiscal mechanisms. Let's look at markets first. There we see that economic risk sharing is closely related to financial integration, or the degree to which banks and financial markets operate across borders. Data show that monetary union gradually promoted financial integration during the first 10 years of its existence. Fragmentation then dramatically returned during the crisis, through a combination of a drop in confidence and the return of country-specific risk premia. But also under pressure from regulators and through demergers of cross-border banking groups. Then - more recently - financial integration resumed, though it has remained well below its peaks. One reason for this slow recovery is probably the low profitability at European banks. The large amounts of new capital banks had to raise because of new regulation has rendered them much safer. While that was an intended outcome of the new regulation, it also means that profitability has come down.

Non-performing loans are another reason why profitability is low. I don't see bad loans as a systemic issue, because they are starting to drop, and they are well provisioned – 52% on average. But in countries such as Cyprus, Greece, Italy, Ireland and Spain they exceed 10% of total gross loans, and that's clearly too high.

It is understandable that financial integration is not on top of the agenda of an industry in the middle of a process of restructuring and catching up. Nevertheless, it is an important issue for the functioning of EMU and the development of the real economy. But there are some ideas to promote financial integration.

First of all, banks need to aggressively reduce Non-Performing Loans. They also need to cut costs, reduce the number of branches – at least in some countries - embrace digital solutions and consolidate the sector. On the policy side, Banking Union should be completed by creating a single rulebook, through a financial backstop for the Single Resolution Fund, and eventually through some form of common deposit insurance, after legacy problems have been sorted out. Finally, Europe needs to implement Capital Markets Union.

As far as risk-sharing through the fiscal channel is concerned, let me say that the EU budget has for decades provided transfers to low-income countries in the EU to promote real convergence in living standards. While the EU budget is small – a little over 1 percent of GDP - poorer countries can get support of up to 3 percent of their GDP, which is substantial. Monetary union does not need fiscal transfers in addition to that. However, it could be worth to set up an additional fiscal capacity for the euro area for risk-sharing purposes. Importantly, this could be done without creating additional permanent transfers and without additional debt mutualisation.

One idea for such a capacity is a rainy day fund, something that exists in most US states. Countries would get support from such a fund in bad times, and they would pay the money back once they recover. Another option is a centrally managed US-style unemployment fund countries would pay into and draw on during a recession.

Ladies and gentlemen, I have covered a lot of ground and I look forward to hearing what you have to say, and to discuss some of these ideas with you. So let me briefly conclude.

There is a lot of headline noise around Europe, whether it is on Brexit, Italian banks, the next referendum or the rise of populist parties. But we should not be distracted by that, and try to discern the underlying developments objectively.

I see more reasons to be optimistic about Europe than to be pessimistic. The EMU has just overcome the greatest existential threat in its history: the debt crisis between 2010 and 2012. Many people at the time predicted the end of the euro. And they would have been right, if no action had been taken. But Europe did take action, and proved its naysayers wrong. As a result, the EMU is now on a more stable footing than before the crisis.

The challenges that remain are far smaller than the ones we faced back then. We do not need a fundamental overhaul of the monetary union. We do not need a full fiscal union, nor a full political union.

But we can strengthen monetary union further, which would bring sizeable economic benefits to Europe's citizens. EMU can be made more robust, and its economy more resilient. The steps I have mentioned today offer a pragmatic way forward to this end, by increasing fiscal and financial integration and thus risk sharing.

I know that some of you hold a degree of healthy scepticism towards the EU and the euro. But I also know that Finland – a small and open economy – understands the arguments that I just laid out very well.

I thank you for your attention, and I look forward to our discussion.