Commissioner Olli Rehn
Welcome address at the ARC 2010
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Key economic policy challenges: learning the lessons, thinking ahead!

1. Introduction

Ladies and Gentlemen, Dear colleagues,

It is a great pleasure to welcome all of you here in Brussels at our annual research conference. As a 'policy entrepreneur' myself, to use Paul Krugman's only slightly pejorative term, I very much appreciate the opportunity to address such a distinguished group of economists from the academic and think-tank community and some even outside them.

The issues to be discussed in this conference could hardly be more pertinent. Finding a new balance between governments and markets, which is the overall theme of the conference, is anything but straightforward. It has never been easy to find such a balance, and the global financial crisis and its fall-out have certainly re-energised the debate about the appropriate role for governments and markets.

To my mind, there is broad consensus that maintaining open markets, sustaining economic and financial stability and ensuring socially inclusive societies in the post-crisis world calls for new and innovative approaches between the extremes of free-market fundamentalism and heavy-handed regulatory interventionism.

Thus, I find it most welcome that the conference will explore new approaches to governance in such areas as the architecture of financial systems, the unwinding of global and EU imbalances, the sustainability of public finances, and the design of modern welfare systems.

2. Repair and redesign of the financial system

The financial system is an evident case in point of the need to revise our policy approach. The crisis has led to a thorough reassessment of the rationality and resilience of modern financial markets, and their ability to mitigate and control risk. In order to save and repair the global financial system, and to reduce the risk of a repeat of such a crisis, we had to act decisively, on all fronts and in a globally co-ordinated manner.

Against this benchmark, we have made important progress after the initial stabilisation of the markets:

We have started to overhaul financial regulation along two main lines:

> (1) to increase the shock resilience of financial institutions by raising the quality and quantity of capital, and to impose business models with lower leverage and higher liquidity, and
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> (2) to increase transparency in financial markets, by for example shifting OTC derivatives' trades to central clearing.

We have also redesigned the supervisory structure in the EU:

- the three new European Supervisory Authorities, overseeing supervision of banks, insurers and securities markets, will help overcoming segmentation and inconsistencies between national supervisors and enhance the overall quality of supervision;
- the European Systemic Risk Board (ESRB) will widen our scope of oversight to the nexus of macroeconomic and financial markets trends at large and be ready to spot and deter the build up of excessive risk at an early stage.

Of course, a lot of work is still needed to make the ESRB fully operational, not least in terms of developing the appropriate analytical tools and the required data base to identify and assess the nature of systemic risks in a way that makes timely decision making feasible.

All these changes to regulation and supervision have been closely co-ordinated with our G-20 partners, most recently in Seoul 10 days ago. The measures, taken or planned, will foster financial stability in Europe.

3***. The state of the global economy***

Ladies and Gentlemen,

Unfortunately, historical evidence suggests that economic recoveries after financial crises tend to be particularly slow and sluggish. And this appears to hold true this time as well. While many emerging economies are steaming ahead again – or still – at a rapid pace of growth, the recovery in the developed countries has been slow and uneven.

For the coming years, we cannot expect but a rather gradual recovery of the world economy. This is to a large extent due to developments in many advanced economies, where households continue to deleverage, while fiscal policy becomes less supportive in the near-term. To make

mattes worse, unemployment remains high in many advanced economies and thus provides little support to private demand, which so far has largely failed to take the baton from the fiscal stimuli.

Downside risks to the global outlook are significant. Among these, the lingering sovereign-debt issues and the by and large weak private demand in advanced economies are the most prominent ones.

Moreover, recent developments suggest that global macroeconomic imbalances have started to widen again. Appropriate macro-economic and structural policies, as well as exchange rate adjustments, should be agreed to facilitate the much needed global rebalancing.

But this requires that countries coordinate effectively at the global level – and not only coordinate, but implement the coordinated decisions. I am reminded of the failure of coordination among the "G4" in the interwar period, brilliantly described by Liaquat Ahamed in his milestone **Lords of Finance**, which tells the story of serious attempts by four central bankers of Germany, France, Great Britain and the United States to avoid macroeconomic imbalances and thus unbearable political turbulence. Quite some lessons to learn and ponder even for today's purposes.

One difficulty of coordination today arises from the fact that among the G20 countries, the needs of economic development and adjustment differ markedly. Fast-growing economies attract investments which push up their exchange rates. Some countries have chosen to intervene in the foreign-exchange markets, others have re-introduced capital controls.

The greatest risk facing the global recovery is that the threat of currency competition prompts unilateral action by individual countries drifting towards retaliation and adopting protectionist measures and beggar-thy-neighbour policies. At the height of the crisis, with the help of the G20,

we managed to avoid such behaviour, and most recently at the G20 Summit in Seoul we reaffirmed this engagement.

However, we must acknowledge that there is growing disquiet with the international monetary and exchange rate system in its present form, aired recently for example by the World Bank's president Robert Zoellick. While his proposal may have been misunderstood as a call for a return to the gold standard, which is a non-starter even if one wouldn't bother to read J.M.Keynes' amusing ***The Economic Consequences of Mr. Churchill***, it nevertheless demonstrates the need to think ahead of new designs for a global exchange rate system. This is certainly also one exciting theme for the research community to provide its contribution.

4. Prospects for the EU economy: a fragile, uneven recovery

Looking now more specifically at Europe, the current economic recovery in the EU, while still fragile and uneven across Member States, is proceeding at a somewhat faster pace than anticipated a in the spring.

Growth has moved towards the upside so far this year and, encouragingly, first signs of a revival in domestic demand, including private consumption and investment, also became evident in the second quarter. Looking ahead, the pace of GDP growth in the EU is set to moderate somewhat until mid-2011, as the global economy goes through a temporary soft patch, dampening EU export growth.

Another factor that is set to weigh on growth prospects in the short to medium term is the fiscal consolidation phase that most Member States embark on in order to put the fiscal situation on a sustainable footing. We have to acknowledge this in the same way as we trusted that large-scale fiscal stimulus was instrumental to stabilize the economy in the aftermath of the of the Lehman shock.

However, despite some inevitable short-run pains, it is essential that fiscal sustainability will be secured with ambitious and detailed plans of medium-term adjustment, complemented by short-term consolidation efforts, and appropriately differentiated across countries. Starting to put the fiscal house in order will not push us back into a double-dip recession; on the contrary, it is the failure to consolidate public finances that could jeopardize the on-going recovery.

I know that many people argue that we should not worry too much about the long run, when – in the famous words – we all will be dead. Unfortunately, it seems to me that markets tend to make the long run quite short, often extending only to next Monday.

The reappearance of tensions in the European sovereign debt markets in the recent weeks underlines the urgency of restoring trust in our public finances. The most tested country is now Ireland.

Yesterday, the Ecofin Council welcomed the request of the Irish Government for financial assistance from the EU. Ministers concur with the Commission and the ECB that providing assistance to Ireland is warranted to safeguard financial stability in the EU and in the euro area.

In the context of a joint programme EU/IMF, the financial assistance package to the Irish state should be financed from the European financial stabilisation mechanism (EFSM) and the European financial stability facility (EFSF), supplemented by bilateral loans to be negotiated by EU Member States. The United Kingdom and Sweden have already indicated today that they stand ready to consider a bilateral loan.

EU and euro-area financial support will be provided under a strong policy programme which will be negotiated with the Irish authorities by the

Commission and the IMF, in liaison with the ECB. The programme will address the fiscal challenges of the Irish economy in a decisive manner. It will build on the fiscal adjustment and structural reforms that will be put forward by the Irish authorities in their four-year fiscal plan next week, providing the details of the Government's commitment to achieve fiscal consolidation of EUR 6 be in 2011, leading to a 3% deficit by 2014.

The programme will also include a contingency capital fund for potential future capital needs of the banking sector. By building on the measures already taken by Ireland to address stress in its banking sector, a comprehensive range of measures – including deleveraging and restructuring – will contribute to ensuring that the banking system performs its role in the functioning of the economy.

Yesterday's decisions are a critical step forward in the joint efforts to stabilise the Irish economy and safeguard financial stability in Europe.

The technical talks on an EU-IMF programme are now well under their way. The negotiations can be concluded by the end of November.

After approval by the Irish Government, the programme will be endorsed by the ECOFIN Council and the Eurogroup, in line with national procedures, on the basis of a Commission and ECB assessment.

4. Developing new governance structures

The large imbalances, which were formed before the crisis, point to weaknesses in the EU system of economic surveillance. Therefore the

EU has embarked on a comprehensive strengthening of economic governance. In September the Commission published a package of legislative proposals which, once implemented, will represent a quantum leap in how the EU countries coordinate their economic policies.

Our proposals are much more than just fiddling with the existing rules. They originate from an analysis of what went wrong in the past and address the weaknesses which the crisis revealed.

Let me start with fiscal surveillance. Regrettably often fiscal policies have lacked prudence and windfall revenues were simply spent. At the same time, the surveillance of fiscal policies has been weak, especially in the area of monitoring and enforcement. Greece is a case in point.

Therefore, the Commission has proposed a significant strengthening of pre-emptive and preventive budgetary surveillance:

- First, the monitoring of public finances will be based on a new concept **prudent fiscal policy-making**. This serves as operational guidance in the preventive part of the SGP. It is based on monitoring expenditure, which can easily be done in real time, and on which the government has more influence than on the deficit.

- **Debt** will be put on an equal footing with deficit in the EDP. This means that the procedure can also be opened on the basis of the debt criterion only. Moreover, the satisfactory pace of debt reduction will be precisely defined.

These changes in the fiscal monitoring are backed up with new set of financial sanctions in case of non-compliance. Sanctions will become more automatic and be triggered at an earlier stage of the policy cycle.

The crisis has also shown that compliance with the fiscal rules alone does not guarantee macro-financial stability. In the years before the crisis, low financial costs fuelled a misallocation of resources, feeding unsustainable levels of consumption, housing bubbles and accumulation of excessive debt. Such imbalances proved highly damaging when the crisis struck. The cases of Ireland and Spain testify to this.

This is why the Commission is proposing to broaden economic surveillance beyond fiscal issues. The surveillance of macro-structural imbalances will have both a preventive and a corrective dimension.

The preventive dimension will consist of a regular assessment of the risk of imbalances, based on a scoreboard of economic and financial indicators. Countries at risk will be subject to an in-depth review in order to detect the underlying problems. Member States where imbalances are considered serious will be placed in an Excessive Imbalances Procedure that would lead to the issuance of detailed policy recommendations and to regular reporting from the concerned Member State.

One important decision on implementing the new governance mechanism has already been taken. As from next year the process of economic surveillance will change considerably with the introduction of the "European Semester". The fiscal, structural and macro economic surveillance will be conducted in parallel in the first half of the year.

Combining these strands of surveillance in the European Semester makes the analytical competence of the Commission even more important than it has been in the past. We have responded to the challenge by increasing DG ECFIN resources and by reorganising the Directorate General.

Equally important in my view is that our in-house expertise is supported by close contacts with the research and policy analysis community outside the Commission. This conference has an important role in fostering such contacts.

5. The sovereign debt and permanent crisis resolution mechanism

Let me come back to the sovereign debt problem that emerged earlier this year and has again been much on the agenda in the recent weeks. Without going into any specifics, let me make a couple points which I think are important in view of the ongoing debate.

In the spring we faced a situation that threatened financial stability in the euro area and beyond. At a moment when the signs of economic recovery were still very hesitant, the consequences of a Greek default would have been devastating. Our assessment on this was shared by all policy-makers in responsible positions, not least by the ECB, the IMF and the US administration. An ad hoc package of financial support conditional of comprehensive adjustment programme was put in place.

When the turmoil resurfaced a few days later, a much bigger precautionary financial stability mechanism was created, broadly on the same grounds and with the same political support.

In the course of the summer, the two arms of this mechanism, namely the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) have been made readily available and operational. With these mechanisms we are now in a much better position to address similar problems that emerged in the spring. For this reason we can now take the necessary measures with regard to the Irish situation promptly and without a need to improvise.

Nevertheless, these currently existing mechanisms are temporary. Their time will be up in the middle of 2013. We now work hard to get the proposed enhanced policy coordination framework fully in place by summer 2011 to minimize the risk of future sovereign debt problems.

While I'm confident that a strong framework will emerge from the legislative process and that will help avert unsustainable fiscal positions in the future, it is nevertheless prudent to prepare for future crises. It's certainly better to be safe than sorry, as we have seen. Therefore, we are in the process of planning a permanent crisis resolution mechanism, effective as of 2013. We indicated already in our May Communication that we would make proposals to that effect, and the October European Council gave us a clear mandate to provide plans by December.

Given the acute tensions in the sovereign debt market, this is obviously not the best possible time to brainstorm on a permanent crisis management mechanism, particularly as such a mechanism has to spell out also how the private sector should be involved in future crisis resolutions. Investors tend to mix what the current policy is with what we plan for the future. Making this distinction is however crucial.

Our current policies are based on the principles we adopted last spring. If the financial stability of the euro area is threatened, the Union and the Member States stand ready to provide financial support conditional on an appropriate adjustment programme, without any sovereign debt restructuring. This applies to all potential cases until 2013.

The future mechanism, on the other hand, will contain an element of private sector involvement to reduce moral hazard and to have a fair burden sharing. That involvement can take many forms, and can be implemented in many ways. I cannot tell yet what we are going to

propose in this regard. The essential thing however is that whatever we will propose has no bearing on the handling of the acute situations.

6. Concluding remarks: Thinking ahead

Ladies and Gentlemen, Dear colleagues,

It is true that the crisis has not enhanced the reputation of economists. The profession did not foresee the by far biggest global financial crisis since the Second World War. While Queen Elisabeth hardly is the only one asking "How come?", I would not dwell into too much of self-pity because of this failure. Predicting truly exceptional events or a dramatic discontinuity that makes a big break in the "normal" trajectory is by definition not among the core strengths of the economics science.

More worrisome is the tendency that economics seems to have drifted towards pretending that it is a science that can explain economic behaviour in the same way as classical physics explains the motion of bodies with a given mass. With all due respect to the profession, I dare – as a trained political scientist with some background in economics and more in economic policy-making – say that this is simply not true.

To understand how the economies consisting of human beings behave, in my view, one needs to incorporate insights at least from history, political science, sociology and psychology.

This does not mean that rigorous analytical thinking or even sophisticated modelling and econometric techniques were useless. If anything, the crisis has revealed the limits of simple extrapolation.

In order to understand how our economies function and how policies can shape them, one has to have a very good understanding of the basic principles of economics and political economy, and the capacity to apply

appropriate analytical tools eclectically. As a policy-maker, I find such advice most useful that combines clear arguments based on economic theory with an understanding of what is called the real world – history, politics and the human mind.

I would thus say that a bit more humility would help the economics profession to retain its influential position in policy making, which for good reasons extends well beyond economic policy in the narrow sense. Professor and FT columnist John Kay has put it well: "Economics is not so much the queen of the social sciences, but the servant".

Against this background, we continuously seek to strengthen in-house knowledge and to enhance the overall quality of work done at ECFIN by improving our connections and interactions with the broader economic research community. Activities such as this conference provide access to ongoing research and exposure to new approaches and insights into issues of great relevance for the DG ECFIN and the whole Commission.

I wish you all the best for your conference and I am looking forward to interesting and stimulating debate during these days.