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"Beyond the crisis: lessons for the future of the eurozone"

Speech delivered by President Herman Van Rompuy at the London School of Economics

It is an honour and a privilege to speak here at the LSE today. Bringing together, as this University does, economics and political science, is highly valuable.

When I studied economics myself, more than forty years ago, I was much taken by Ralf Dahrendorf -- who later was a famous LSE director and played so many roles in British, German and European society. His brand of political economics was fascinating reading. I studied at another venerable institution, with an even older history than LSE: the University of Leuven... One of my professors belonged to the Werner group which developed the first real Plan for a European monetary union. My brother wrote a PhD about "Britain and the E.M.U." -- in 1975! That's how I discovered the work of Robert Mundell on the optimal currency area -- the Nobel Prize winner of 1999, who still defends the euro.

To the academic and purely theoretical thinking of the 1970s we can now add the political experience of more than 12 years of a single European currency.

Most urgent is to draw the lessons from the recent crisis -- from the global roller-coaster which started 4 years ago, and reached a decisive turn in Europe in early 2010 when the Greek problem exploded upon the stage.

But, let me start with some expectation management. As some of you may know, six weeks ago I was asked by the 17 Heads of State or Government of the Eurozone to "propose improvements to crisis management in the euro area by October". It could be tempting to share some of my ideas with you as of today. However, -- unlike some of the other players --, I do not practice "megaphone diplomacy" via the media. I prefer "quiet diplomacy". It is more discrete, but also more efficient.

P R E S S

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And, since the interplay between politics, the media, and the markets, is a rich and promising field of academic study in itself…, I am sure you will understand!

The main points I want to share with you are these: overall, the euro and the single market have been a help not a hindrance. Important work has been done to prevent similar crises, and to deal with the current one, with further steps in the months ahead. The political implications of these developments are not fully crystallised yet.

Let us start with some positives. Although obvious, they should not be taken for granted.

Europe was hit three years ago by the biggest economic tsunami since the Great Depression. Yet we avoided most of the mistakes that we made in the 1930s:

- We avoided protectionism -- in no small part thanks to the single European market and the legislation that backs it up.
- We largely avoided competitive currency devaluations -- in no small part thanks to the euro. Just imagine for one moment what would have happened three years ago if we had still had the Franc, the Peseta, the Mark, the Guilder, and so on: there would have been turmoil on the currency markets, upsetting import and export expectations, in addition to the turmoil we already had. It would have shaken, if not destroyed, the Internal Market. Even now, at the global level, we must take care that exchange rates reflect the economic fundamentals rather than being an element of protectionism.

Let us not forget, the euro remains fundamentally solid as a currency.

It has strengthened in value on international monetary markets (unlike the pound and the dollar).
It has throughout its existence maintained a low and stable inflation rate.
The balance of payments of the Eurozone is in broad equilibrium.
Public debt levels are on average lower (yes, lower!) than in the USA or Japan.
And the euro is being held across the world as an alternative reserve currency.
Economic growth has returned to the Eurozone as a whole rapidly after the financial crisis. Higher than expected last year and in the beginning of the year, though less than expected this semester.

So, we did some things right. But as we all know, there were also a number of problems.

Some are long-term and structural, not least our insufficient economic growth rate in ageing societies. The Europe 2020 strategy is intended to respond to this, and we must return to it. We must further develop the Single Market, our great asset, and we will do so. Growth and jobs remain priorities. Job creation is currently the major issue in the United States and in many EU Member States too.

It is essential that we identify how and where the Europeans of today and tomorrow can earn their money. This is about seizing opportunities, about education, about technological and social innovation, about future perspectives. The issue touches every citizen. And the political world must provide some of the answers. Nevertheless, what has dominated the headlines and our attention is the issue of sovereign debt.

Excessive debt is a problem that has hit a number of countries across the world, not only in Europe. But its existence in some Eurozone countries has had an impact right across the Eurozone and indeed the single market. We have discovered that three countries representing about 6% of the GDP of the euro area, could threaten the financial stability of the Eurozone, as well as the stability of the banking sectors in all Member States. Lack of financial oversight played its role. But clearly, the financial and monetary interdependence had been hugely underestimated. Without the fiscal irresponsibility in some countries, there would never have been a crisis in the Eurozone. It is as simple as that.

It may be useful to remind you that when the crisis erupted, we had to start from scratch. There was a complete absence of appropriate instruments. There was even an interdiction to take certain types of action (no bail-out clause). Politically, it was also difficult to act, both in the debtor countries, which had to accept reform programs with strict conditionality, and in the creditor countries, who guarantee the loans.

Nevertheless, since May 2010, we did establish a completely new economic governance framework, including a support mechanism for countries in difficulty. (Recently we made the latter more flexible, while assuring the right conditionality.)

What we have put in place is a multifaceted reform. People who only focus on one or another aspect, and rush to denounce them as insufficient, miss the overall picture and the interactions between the elements.

It is the overall combination of institutional pressure, peer pressure and market pressure that will help to avoid getting into such difficulties again. All three have been enhanced:

- Institutional pressure has been strengthened thanks to a set of reforms. In particular, a strengthening of the budgetary surveillance (improved Stability and Growth Pact making it easier to sanction a Member State) and the establishment of macroeconomic surveillance (which did not exist before). We will together look not only at deficits and debt levels, but also at risks of asset bubbles or trade imbalances.

- Peer pressure has also been enhanced. For instance through the so-called "European Semester", where all Member States will compare notes on their national budgets and where budgetary and economic policies are evaluated. But also through the new Euro-Plus-Pact, under which 23 out of the 27 countries have committed to structural reforms, for instance on pensions or the labour market. What's more, today's governments realise acutely how the economic situation of others affects their own, and vice versa. Phone calls between European political leaders on their respective debts are now almost daily bread: a very concrete translation of the abstract notion of "interdependence"!

- And thirdly, market pressure will complement the above in a way in which it did not in the past. In the first decade of the euro, the markets were asleep. Now they are awake -- and even if they are sometimes overreacting, they will not go back to sleep again. Market signals were not being transmitted in an early and more gradual way to states whose debt levels rose dangerously high or whose current account deficits were unsustainable.

The interplay between these types of pressure should not be underestimated. Take the peer pressure. Some fear that governments will water down Commission recommendations, as happened in the past. They forget a new element at play, a major incentive to keep an eye on one's peers: the billions involved in the rescue mechanisms. If, after a Commission warning, ministers for some reason let a

colleague off the hook, and if at a later stage the country in question asks for emergency loans their public opinion would want to know: "How could you let this happen?". Markets, too, would react to such events more speedily than in the past.

I personally am convinced that still more needs to be done. I will make a number of proposals in October. I will not disclose them here in detail. A word, though, on the emerging consensus around the idea that the Eurozone be strengthened institutionally. It is natural. The crisis of the last three years has proven that the big decisions, the long-term orientations to safeguard the Eurozone's financial stability, can only be taken at the highest level. In order to deal with the banking crisis of 2008, a first meeting of Eurozone Heads of State and Government was organised by the then European Council President, Nicolas Sarkozy. (By the way, Gordon Brown was a special guest.) I have chaired four such meetings in 2010 and 2011 -- each time in exceptional circumstances. It is a good idea to meet more regularly, and not only in periods of tension. *Gouverner, c'est prévoir.* To govern, is to foresee.

At the same time, we must keep the link between the 17 of the Eurozone and the 27 of the Union. The euro affects the single market, and vice versa. The euro affects the financial sector all over Europe. Moreover, many will join the Eurozone in the future.

All these measures will help in the long run to improve the Eurozone's economic performance. But of course there remains the short term problem. How do we turn the corner on the existing cases of excessive debt?

In recent weeks and months, the focus has been on Greece. Here too, there is a danger that commentators focus on one or another measure, deeming it to be insufficient, while in fact it is on the whole panoply of measures that we must evaluate what has been decided.

At the Eurozone Summit of 21 July, we agreed three things to help Greece reduce its debt.

First, to provide additional funding to support the Greek programme up to 2014.

Second, we supported -- for Greece and for Greece only -- the voluntary involvement of private bondholders. It will reduce the Greek debt burden by more than 10 pct.

Third, we lowered the interest rates on the loans for Greece and, even more importantly, we extended the maturities to up to 30 years. This significantly lifts the burden of repayments. It gives them time. We also reduced the interest rates for Portugal and Ireland.

When I became budget minister of Belgium in the early 1990s, my country had a debt burden of over 130% of GDP. In the 1980s, interest payments on the public debt amounted to 10 pct. of GDP in Belgium. Compare this with the 6 pct. of Greece today. Yet we turned the corner: in 2007, our debt burden had reduced to 85%. A more recent example is that of Latvia. So it can be done, provided that time is given.

The priority now is for all countries to implement what we have decided. This is true for Greece and for others, for each individually and for our collective decisions. Implementing rather than unpicking what we have agreed is vital.

This brings my to my concluding remarks. When taking these decisions, several countries have gone far beyond their traditional positions and red lines for the simple reason that the euro and their own economies were at stake. Of course, one may have wished to take these steps earlier. But these decisions represent deep changes, triggering important and legitimate political debates.

There is a debate about the tension between the time of democracy and the time of the markets -- between the weeks, months, years of legislative procedures in a parliament; and the days, minutes, or even the seconds of a mouse-click which determine the rhythm of the trading floor. Something for you at LSE to reflect upon!

There also is the debate about the political direction in which the Eurozone is heading. Then sometimes terms like "political union" or "fiscal union" are used, which give easily rise to enthusiasms, fears or misunderstanding. Let us be clear what such terms are about and what they are not about.

On "political union" I can be short. For some it is a future nightmare, for others a profound aspiration. I belong to another, pragmatic school of thought. The Eurozone and the European Union are deeply political. It started as a political project with one aim: keeping the peace in Western Europe. And look at ourselves today: we are a club of 27 states, with common institutions, dealing with foreign policy, security, key economic questions, some aspects of migration, the environment. In what way is this union not already political? The euro itself was launched to create irreversible ties between the participants, triggering further integration.

The second term, "fiscal union", gives rise to even more interpretations. Of course we have had since the Maastricht Treaty a joint commitment of Member States to avoid excessive deficit and debt levels (so all working in the same direction as regards fiscal policy) but some people imply there is somewhat more to "fiscal union". However, we should keep a sense of proportion, as most other scenarios which the term covers are highly improbable.

For instance, "fiscal union" does not mean transferring a substantial amount of taxation and spending to the European level. At present, 98% of public spending is national (or sub-national) -- only 2% goes through the EU budget. This situation is most unlikely to change drastically, if at all.

Nor will fiscal union mean fixing common tax rates for everything. The current argument about common tax rates only applies to certain limited and defined fields (like VAT). It is anyway primarily about fair competition in the single market, and not about overall macroeconomic stances. We do need more tax coordination, certainly in the field of corporate taxes, knowing that decisions in this field require unanimity.

'Fiscal union' could of course mean increases in transfers from richer to poorer member states. But Member States have already indicated their reluctance to radically increase the level of "structural funds". Those funds, which have been of great benefit, express the key-value of solidarity in our Union and can of course be more focussed to better underpin economic reform.

Finally, we are challenged by the markets concerning the discrepancy between the perceived weak degree of fiscal policy integration and the high level of monetary/financial interdependence – the discrepancy between a common currency and divergent policies. We have taken major steps to address this: on the one hand strengthening fiscal responsibility at national level, on the other hand developing loan-facilities for countries facing difficulties. We could consider further steps over the medium term and this is more and more part of the public debate. In my view, fiscal and financial integration in this respect has to go hand in hand with fiscal discipline. Without the latter, we would

be making the same mistake as when the euro was launched: a too weak policy infrastructure. By all means, it will require careful deliberation about the political conditions. In that respect, drawing the lessons from this crisis is a work in progress.

I have spoken about the challenges at European level and within the Eurozone. This of course is not to forget that many of the challenges we face must be addressed at world level. The G20 remains the most promising vehicle for doing so, but it is not without its problems. Domestic concerns hinder a deepening of global cooperation, but all main players have to do their homework: from the American and Japanese debt problem to Chinese inflation and its undervalued exchange rate – both phenomena are linked. The upcoming G20 Summit in Cannes is an opportunity to be seized to enhance global governance. Of course, the international agenda is blocked: the Doha Round on trade, the Climate Conference, the international monetary reform. Not to mention purely political issues, such as the Middle East Peace Process.

In the Eurozone and in the European Union and we are taking decisions which are often unpopular -- in an era of populism. The European Union will do what it takes. Step by step, in the right direction.

The current generation of leaders will not destroy the work of the Founding Fathers of 60 years ago; nor the efforts of successive governments of Six, Nine, Twelve.. and now Twenty-Seven member states. The political and economic costs of going back are mind-boggling.

Seen in the light of history, the European Union is too precious an achievement to be put in jeopardy! I say this in a calm and determined way: this generation in politics will do, what must be done.