POLICY PAPER SERIES

3/2018
November 2018

THE EUROZONE CRISIS AND THE FUTURE OF THE EU

Jeroen Dijsselbloem

CYPRUS CENTER FOR EUROPEAN AND INTERNATIONAL AFFAIRS

UNIVERSITY of NICOSIA

1993-2018 TWENTY FIVE YEARS OF POLICY FORMULATION AND ANALYSIS

3/2018
November 2018

THE EUROZONE CRISIS AND THE FUTURE OF THE EU*

Jeroen Dijsselbloem

* *Keynote Address on the occasion of the completion of 25 years of public service and constructive engagement of the Cyprus Center for European and International Affairs, November 12, 2018.*

THE EUROZONE CRISIS AND THE FUTURE OF THE EU 3/2018

Nicosia, November 2018

Press: Cyprus Center for European and International Affairs, University of Nicosia

Jeroen Dijsselbloem

Jeroen Dijsselbloem was the minister of Finance of the Netherlands from 2012 until 2017. He subsequently was elected as president of the Eurogroup, the Group of Finance ministers of the 19 Eurozone countries, and chair of the board of Governors of the European Stability Mechanism. In July 2015 he was successfully re-elected as Eurogroup-chair for another 2.5 years.

During his five year tenure Jeroen Dijsselbloem turned the Dutch government deficit into a surplus, reduced sovereign debt by one third and helped the Netherlands return to solid economic growth. While maintaining the integrity of the Eurozone, his main accomplishments were the exits from their emergency-programs of Ireland, Spain, Portugal and Cyprus, designing a deal for the third program for Greece and building the Banking Union to put the European banking sector on sustainable footing. All Euro-countries are back into broad-based growth, most of them above potential growth. Since leaving politics this year Jeroen Dijsselbloem is an author (The Eurocrisis; the inside story) and publicist.

Thank you professor Theophanous for the invitation to speak tonight, and for your words of introduction. And congratulations not the 25th anniversary of CCEIA!

Your excellencies, ladies and gentlemen,
Europe has just come out a unprecedented economic crisis and already it is faced with new domestic and geopolitical challenges. Though national governments have a responsibility to address their domestic challenges, the EU has an important role to play in what are now our key issues going forward.

Looking Back

The crisis in Europe took much longer and did more damage than in other economies involved. The reason for that were threefold.

First the financial crisis hit us very hard. European banks had invested heavily in American mortgages. But more importantly the deregulation of the banks, starting in the nineties, created a much bigger risk in Europe than for the US.

For two reasons:
First it happened in the same period the euro was introduced, which lead to a drop in the interest-spreads and an additional credit boom in almost all of our countries. Bank balance sheets doubled, tripled, quadrupled all over Europe.

Second, The European economy was already very much “bank loan dependent”. 80% of the finance to our businesses comes from banks, only 20% from capital markets. (In the US it’s almost the other way around). So when the banks got in trouble, the whole economy got in trouble. On top of that banks took a big stake in the sovereign debt. When government finances were hit, the banks were hit also. Credit dried up and banks were not made or were not able to clean up their balance sheet straight away. It was a negative spiral between ailing banks, governments'fiscal constraints and contraction of the economy.

The second reason why the crisis was so much longer and deeper in Europe was the fact that the financial crisis exposed major weaknesses in the real economy. To mention just a few:

The real estate booms blew up in Ireland, Spain, the Netherlands, and Cyprus.

The sharp increase of wages in the years before 2008, particularly in countries where credit had become cheap since the introduction of the euro. In Greece average household incomes went up by 40% in 6 years, while in Germany due to labor market-reforms wages were frozen for 10 years.

The over-leveraging of the private sector in the years before the crisis.
The pension systems that had expanded future obligations by raising pensions and lowering pension age, had become increasingly unsustainable (and still are in many countries).

The labor markets were showing an ever deeper divide between the ins and the outs, the young and the old, while remaining very inflexible to adjust to economic shocks.

And I could go on. The period before the crisis of 2008 were decades of irresponsible policies with huge consequences in the years that followed.

The third reason the crisis dragged its feet in Europe, was the policy response.

The monetary union was flawed, had no funds, no institutions, no effective common frameworks. Also here the risks had been seriously underestimated. The key principle of the union, solidarity goes hand in hand with responsibility, had been neglected.

In the first phase of the crisis two things happened. All countries improvised, particularly in saving their banks. The way it was done in Europe, took a lot of the fiscal space of governments without forcing banks and bank investors to really take their losses and recapitalize the banks.

On the other hand, in the first years there was a fiscal stimulus coming from governments, to boost the economy. With some success. But the half-hearted approach to the banks, the lack of fiscal space after having saved the banks and the major structural problems in our economies brought on a second crisis, which we have come to know as the sovereign debt crisis.

Europe was late to act. There was no agreement on joint policy actions. There were endless discussions about the no-bail-out principle. The ECB raised interest rates and was very reluctant to expand its operations.

It wasn't until mid 2012 that three important steps were taken.
First of all, after a range of unimpressive temporary measures the ESM (the big bazooka) was set up and finally became effective at the end of 2012. Second, the heads of state and government in the summer of 2012 finally decided to create a banking union, with joint rules, supervision and resolution. And thirdly, Mario Draghi said, at the investors conference in London, we will do whatever it takes to save the euro (and Merkel came out to publicly support him).

It was a turning point. Finally Europe was getting serious.

When I became chair of the Eurogroup at the beginning of 2013, the ground work had been laid, but the ESM hadn't done anything yet, there was no Banking union and Mario Draghi's words had not been followed by expansionary monetary action yet.

There were four programs in place, in Greece, Ireland, Portugal and Spain and one program, for Cyprus was discussed already for a year. And the discussions about the Banking union were stuck. Basically the debate was about who's going to pay the bill for bank-losses? Should it be governments (individually at national or jointly at European level) or should it be the investors and if necessary (dependent on the size of the losses) uninsured deposit holders in banks?

Leaving it up to national governments to bail-out investors had bankrupted a number of our countries. And has raised public anger about saving banks and investors at the expense of the taxpayer, leaving us with austerity. Transferring the bill to Europe wouldn't solve that fundamental issue of unfairness. Politically and economically the sound way to do it, in my mind, was to push back the risks to those who invested the capital and took the returns from the banks in the good years.

In early 2013 as minister of Finance I nationalized SNS bank in the Netherlands bailing in shareholders and bond holders. This was a new approach, also for the Netherlands, since my predecessors saved two major banks with very costly bail-outs. When we had to deal with Cyprus, this bail-in was again my preferred approach. You all know what happened regarding the Cypriot banks and I have described it in detail, from my perspective, in my book on the Eurocrisis, which also came out in Greek a few weeks ago. The bail-in, which is the best approach in a terrible situation, has now become the standard in the resolution framework of the Banking Union and has been applied in Spanish, Italian, Greek and Baltic banks since. Different cases will be dealt with differently. The depth of the bail-in needed, depends on the size of the losses, the size of the depositbase in relation to the capital available in the bank balans sheets, and on the question wether there are public funds available. In Cyprus all these conditions were extremely bad.

Off course, the new capital requirements, the need to have sound risk management, the centralized and much tougher supervision by the ECB-SSM, all of these are crucial in preventing banks going into resolution, and in preventing future bail-in.

Greece was in its second program and was the economy was recovering in 2014 when new elections brought the program to a grinding halt. The new government completely overestimated its negotiating position, made proposals that were far outside the reality of the European treaties and the political reality of other governments.

On top of which the new minister succeeded in alienating everyone that could have been an ally. At the end of the first half of 2015, in which tremendous damage was done to the economy of Greece, we came to an agreement on a third program. A program with more realism, with more commitment from the Greek government, with a bail-in on the banks, and with better terms for the loans (in other words debt relief). It allowed Greece to finally exit the programs this year. The key issue in Greece now is trust, so important when attracting investors to come to Greece. The investment climate must be improved further and politicians must refrain from irresponsible promises to their electorate.

Contrary to Greece, Cyprus came out of the program very quickly, having shown very strong ownership of the problems and implementing reforms to recover effectively. Minister Georgiades has played a crucial role in this. Cyprus is now among the member- states with the highest growth, closely followed by Spain and Portugal. Ireland, another former program country is leading by almost 6% forecasted growth.

Where are we now?

The Eurozone is back in growth, 2017 having been an extremely good year, 2018 showing a drop but still sound figures with growth at about 2%. It is a broad based growth, domestic demand rising, investments up, exports recovered strongly and even public spending contributing to growth again. Unemployment is going down in all countries, sovereign debt is starting to go down yet still very high in a number of Eurozone countries. Most banks have cleaned up their balanced, brought in new capital and credit flows are increasing again.

We are in a much better condition but not yet prepared to face a new economic shock. There are little to no fiscal buffers in too many countries, the ECB still has a fully loaded balance sheet, household debt very often is high, and some banks still have legacy issues such as NPL's.

Many countries need to do more work to become more economically resilient and have long terms sustainability for our social welfare-states. We need to use the current good times to improve our balance sheet and create buffers to deal with trouble ahead.

The biggest challenges are still at national level. Yet the political climate is more challenging then ever. Governments are weak in many European countries, parliaments are deeply divided, the electorates scattered and on the move.

In order to counter that situation we need to create anchors of stability. And the European Union is still a great platform to do exactly that.

What should be done next?

The most important issues for the EU are currently NOT the euro or the economy, but security and migration. And these are issues which require European cooperation.

Here I think we should take the lead of president Macron. The Europeans need to raise their defense spending and work together. Germany will have to accept the fact that is is a large country and therefor has an important role to play. On migration, we made mistakes when we set up the Schengen-zone and in the Dublin treaty. In order to create free movement we took away the inside border controls, without securing the outside borders. And in the Dublin Treaty we said all refugees should return to the initial country of entry and ask for asylum there. But off course most migrants arrive in Europe in Greece, Cyprus, Italy or Spain.

So we need to come to joint protection of the external borders, control migration at the border and share the burden of taking in asylum seekers. All of this is deadlocked because of the issue of quota of refugees. The central-European member states will never accept this. And I think we have to accept that reality. And so a smaller group of member states will have to go for enhanced cooperation in migration policy.

Migration and security are key issues right now, top of the list for electorates in almost all countries now. It is a key driver of populism. The position of the US, China and Russia should increase our sense of urgency. We need an European strategy so the EU is no longer just an economic power but also becomes a geopolitical power.

Having said that, let me return to the Monetary Union. Here my key advice would be: Let’s finish what we started. While clearing out the remaining legacy issues. Let’s complete the Banking union, including a backstop to the resolution fund and a European deposit insurance scheme (EDIS).

We have already harmonized our national insurance schemes with prepaid funds. Once they are fully funded they should merge into EDIS. EDIS is crucial to establish cross border confidence and an truly integrated bank system for the Eurozone, including cross border consolidation of banks.

Let’s also push the Capital markets union. This project was started by the Juncker commission but has lost its drive. Our economic vulnerability, being so dependent on bank finance, is till there.

If we want a more dynamic innovative industry, we need more capital-investments, we need well integrated, deeper capital markets.

The Brexit should increase our sense of urgency on this topic. So let’s finish that Capital Markets Union. Including a fully harmonized single rule book and a single European capital marketsuperivisor. This needs to go hand in hand with improving the investment climates in member-states. Let’s also finish what we started by developing the ESM further.

Allowing them to step in and support member-states in a situation of an adverse economic shock. Of course under the condition of sound policies.

As part of the next round of budget negotiations we will also have to discuss a fiscal capacity for the Eurozone. This is still a pretty thorny issue. It’s not just about finding the funds for it... but also deciding on the purpose, what goals we want to achieve with it, and the governance.

One approach would be to think about having a common unemployment insurance scheme. This would be a way to support member states facing a temporary economic setback.

German Finance Minister Olaf Scholz is working on interesting proposals for a European re-insurance for national unemployment benefits schemes. This would require setting up a prepaid fund to which all member states must contribute and from which countries could be financed when cyclical unemployment rises quickly in a crisis situation.

The member states would jointly decide, after a recommendation from the commission. In Scholz's proposal member states could only draw temporarily from the fund and would have to repay within five years, to make sure it doesn't become the cushion that prevents member-states to progress with necessary economic reforms.

The IMF has made calculations regarding the size of the fund and argues member-states must contribute 0,35% of GHP per year. So for Germany 11 billion annually and for Cyprus 75 million per year. Had we already had such a fund 20 years ago, Germany would have been a net-user in the early 2000's and a net-contributor in the Eurocrisis. In Germany this proposal has been met with quite some skepticism because the general feeling is that European agreements, like the fiscal rules, are too often disrespected.

Also this approach raises the question on how the very different arrangements in our national labor market policies and very different set-ups of the national unemployment insurances would effect such a European reinsurance scheme.

So far the German coalition government unfortunately hasn't come to a joint proposal which could be part of a bigger deal to reform the Eurozone.

I would prefer using the ESM to finance member states facing an economic shock to protect their investments in infrastructure and education or help them finance cyclical costs of unemployment benefits. It would not require prepaid funds and would be under the condition of having respected EU fiscal rules.

There are different models to do it, and we must find middle ground to set up an effective tool in the coming years.

Coming December the heads of state and government will have to come to an agreement on further Eurozone reform. An agreement on parts of Banking union and capital markets union as well as a greater role for the ESM seem feasible. But it is clear that the debate doesn’t stop there.

A gradual evolutionary approach is in my mind the best way forward. While national governments continue their reform drive to improve the investment climate, to make public finance and the welfare states sustainable, providing economic opportunities and social fairness to the many.

To regain trust more is needed. In order to take next steps in strengthening EMU we need trust between memberstates and in our institutions. Trust that solidarity between us, goes hand in hand with responsibility. With governments living up to the commitments made to the Eurozone.

And trust in our common institutions that they will respect what has been agreed and apply it fairly and evenly to all memberstates, large and small. We cannot build a community without all of us also taking responsibility for the interests of the community as a whole.

Blaming Europe for the many flaws in our national economies, legal systems or domestic political governance will bring us nothing but a populist backlash. Expecting Europe, the ECB or a Eurozone budget to come and sort our problems out, is creating expectations which will not be fulfilled and more disappointments ahead. National politicians need to take their responsibilities and that includes sometimes confronting the electorates with the real issues at steak and the difficult choices to be made.

Europe has a major role to play in some issues. Security and migration is certainly one. Dealing with the climate issue is another. Taking the lead in international trade, closing deals around the world, certainly in a time when others don't. Stimulating research and development, public and private, and drastically increasing European funds in this area. But also off course strengthening the Monetary Union.

A lot of work still needs to be done. As the external environment of our union is becoming more and more challenging, the EU will have to lead. As our electorates are becoming more and more impatient, the worst thing to do is to let populism paralyze us. It's time to act; it's time to show results.

Thank you.

CYPRUS CENTER FOR EUROPEAN AND INTERNATIONAL AFFAIRS

UNIVERSITY of NICOSIA

1993-2018 TWENTY FIVE YEARS OF POLICY FORMULATION AND ANALYSIS