SPEECH/10/632

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Reinforcing EU Economic Governance: relevance for Ireland

Institute for International and European Affairs

Dublin, 9 November 2010

Ladies and Gentlemen,

Let me first thank you for the invitation to discuss the reinforcement of EU economic governance with you today. During my visit in Dublin I have already met with the political leaders, social partners and the Central Bank and have listened to their views. I am honoured to round off my visit here by extending the dialogue to the civil society through the Institute of International and European Affairs.

This visit to Dublin is very important for me. Of course I meet Finance Minister Brian Lenihan regularly in Brussels and spend a lot of time talking to Irish colleagues over the phone. But I thought it important to meet here, to listen to the views of political leaders and social partners on tackling Ireland's economic and social challenges. I also want to use the opportunity to explain how the Commission supports the Irish economy and Irish citizens to face the current economic challenges.

On a personal note, I want to say that for a Finn it is particularly easy and natural to associate with the Irish people. We both have a similar history; we became independent almost exactly at the same time; we are both Republics with a capital R; and we are both staunch and smart proponents of small states' rights and the Community method in the European Union.

Ladies and Gentlemen,

As we all are painfully aware, Ireland has suffered a sharp fall in economic output over the last three years and is now undergoing an important structural adjustment.

The Irish economy became over-reliant on construction and an oversized financial sector. The fall-off in activity hit the labour market hard. The knock-on effects on other parts of the economy have also been felt, and the scale of the crisis in Ireland has left no one untouched.

We all know that adjustment takes time. It also takes determined and sometimes painful decisions: it requires political courage and political and social dialogue.

It is by now clear that much of the economic instability in Europe is not only due to budgetary indiscipline. In the run-up to the crisis many unsustainable imbalances emerged in the private sector as well.

In the case of Ireland in particular, we need to recall that sovereign debt has not been at the origin of the crisis. Rather, private debt has become public debt. The financial sector has misallocated resources in the economy and then stopped working. It needs reform.

Indeed, earlier and better surveillance of these imbalances right across the EU could have helped to avoid the worst excesses. However, many of the private sector imbalances, such as excessive credit growth and large current account imbalances, were not at the core of the scrutiny framework used under the EU's existing surveillance arrangements.

The Stability and Growth Pact was created to ensure that no country would pursue fiscal policy that would endanger the financial and economic stability of the other member states and the euro area as a whole. It has not done that, mainly for two reasons.

First, because it was not applied as rigorously as intended. Second, because the Stability and Growth Pact was not broad enough in scope, as it left non-fiscal economic imbalances outside the scope of surveillance. Ireland and Spain are unfortunate examples of this.

It is indeed important to keep in mind why we have undertaken the exercise of reinforcing economic governance. It is because our policy framework failed to prevent unsustainable fiscal and economic developments in many member states, with devastating consequences for their economies, and the risk of a financial and economic meltdown of the euro area as a whole. Containing the crisis has been a huge and politically delicate challenge, which has required extraordinary actions by the EU, its member states, the ECB and the IMF.

The reform of EU economic governance must address these shortcomings. But new rules alone will not be enough. At the same time, the Member State governments must commit to prudent fiscal policy making – and accept that if they deviate from such path, there will be consequences. This is necessary, if we are serious about containing the risks to financial and economic stability in the euro area – and we are very serious about this.

Reform of economic governance is also a priority on the international scene, notably in the G20 context.

Dear Friends,

Let me next explain the core elements of our proposals. I will then try to put them into the Irish context.

First, we propose to reinforce the Stability and Growth Pact. We want to introduce a concept of "prudent fiscal policy making" to make the adjustment towards a medium term budget objective more operational and binding. Debt sustainability will be monitored more closely by setting a numerical benchmark for a satisfactory pace of debt reduction.

This means that Member States should not increase government expenditure at a rate that exceeds a cautious assumption about their medium-term growth potential, unless they introduce revenue policy measures that would fund it. And any unexpected revenue surprises would automatically be allocated to debt reduction.

Second element of our proposal is to broaden economic surveillance to identify and redress macroeconomic imbalances and divergences in competitiveness.

The countries with the largest current account deficits and credit growth prior to the crisis have had the worst falls in economic activity and the sharpest budgetary deterioration. To rectify this deficiency in the surveillance framework, and supplement the existing budgetary surveillance framework, the second pillar of the Commission's reform package aims to prevent and correct harmful macroeconomic imbalances that could work against the proper functioning of EMU, or damage economic activity in a Member State itself.

This will be based on a scoreboard of economic and financial indicators. When unsustainable developments are identified, we will carry out in-depth country analysis and issue country-specific recommendations. This work should of course be closely intertwined with the work of the European Systemic Risk Board which will start work next January.

Third, we need to effectively enforce economic surveillance through the use of appropriate incentives and sanctions to strengthen the credibility of the EU fiscal framework. These would kick in at an earlier stage and be gradually tightened, unless corrective action is taken by the member state concerned. Very importantly, we also want to make the consequences of bad behaviour more automatic – i.e. semi-automatic – and thus less subject to political deliberation.

In principle, there would be an alternative to policy action based on clear rules. It is market discipline. Unfortunately, market discipline alone is not very effective, and can come at very high costs. As we have seen, markets typically have not restrained excessive borrowing by the governments or the private sectors until it has been too late. And when the markets have reacted, the reaction may have been excessive.

Ladies and Gentlemen,

I welcome the Irish government's announcement last Thursday of a multi-annual consolidation strategy that confirmed the commitment to bringing the deficit below 3% of the GDP by 2014. I look forward to the greater degree of detail of consolidation measures which the government intends to provide shortly. These medium-term budgetary objectives and their concrete implementation with expenditure ceilings should become a permanent feature of fiscal policy making in Ireland.

There are clear social and economic benefits to better medium-term planning. Detail on the scale of future fiscal plans gives the private sector more information to make investment decisions. It allows public spending bodies to make better plans, as they can be more certain of future funding. Greater clarity boosts the credibility of the fiscal stance.

Ireland kept debt levels well below the 60% of GDP threshold in the first ten years of EMU. This provided some room for manoeuvre at the beginning of the crisis. By contrast, some other Member States ended a long period of benign economic conditions with much higher levels of government debt. This has contributed to the perception of vulnerability since then.

The most pertinent novelty of our new proposals on economic governance from the Irish perspective is their focus on addressing cumulative and detrimental macroeconomic imbalances.

The huge growth in private sector credit and house prices in Ireland would have required pre-emptive and preventive policy action. As we have witnessed, the unwinding of these imbalances has brought an additional burden of adjustment both here in Ireland and elsewhere.

Earlier recommendations by the EU to curb these imbalances could have helped to reduce the worst of the excesses before they occurred. Not only that, it would have called for large financial and budgetary buffers to deal with the fall-off in construction-related activity when it occurred.

Ladies and Gentlemen,

Before concluding, let me recall one central feature of the Irish economy: the economic dynamism and relevance of the private sector. In the case of Ireland the principal economic driver continues to be the private sector, particularly exports.

The contribution of the private sector to the Irish GDP is no less than 77.5% (or 124 billion euros) in 2009. Ireland has strong economic fundamentals which have delivered economic successes. Taking the necessary structural measures to support fiscal adjustments will pay off in the medium and long term for both sustainable growth and job creation.

Ladies and Gentlemen,

I believe that the Irish and the Finns share a rather similar proverb that was used back home during the 1990s recession which hit Finland particularly hard. "Even the longest night will be followed by a new dawn", the Finnish Prime Minister Esko Aho used to say at the time. I'm told that the Irish version says "the darkest hour is just before the dawn".

It might feel a small consolation at times like these, but I have no doubt that Ireland too will overcome this crisis. You are smart and stubborn people. Time and again you have proved you can overcome adversity. And this time you do not face the challenges alone. Europe stands by you.

Thank you for your attention, and I am ready to take your questions.