

THE BROOKINGS INSTITUTION

IS THE EURO SAVED FOR GOOD?  
AN OVERVIEW OF THE ECONOMIC SITUATION  
IN EUROPE AND THE WORLD

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## P R O C E E D I N G S

MR. VAISSE: Hi, everybody. My name is Justin Vaisse. I'm the director of Research for the Center on the U.S. and Europe, and it's my pleasure to welcome all of you at Brookings this morning. I'm very happy you could join us for a conversation with Olli Rehn, the EU Commissioner for Economic and Financial Affairs.

The discussion this morning is held in the context of our partnerships with our friends at the Heinrich Böll Foundation. Together in the past few months we've been discussing the issue of the euro. We've held a number of workshops and roundtable in the euro zone situation, and we have also worked in tandem with the EU delegation here on K Street, and I would like to extend a special welcome to Ambassador Vadidel Madow, who's joining us today.

We only have an hour and a half, and even less than that, so I'll be very brief in my introduction. In Commissioner Olli Rehn we have a very distinguished official who's been at the heart of the European projects for the past seven years in the two Barroso Commissions, enlargement and then a currency in the economy. So first he was a commissioner for enlargement at the crucial moment when the EU expanded dramatically and also conducted difficult negotiation with candidate countries.

Then starting a bit more than a year ago in February 2010, he was commissioner for Economic and Financial Affairs amidst one of

the worst global financial crisis ever at the time when the euro was rumored to be gravely imperiled and threatening to take the whole European integration project down with it. So that was I guess a pretty brutal beginning. But I guess Commissioner Rehn was well armed because before assuming his functions in the Barroso Commission, and even briefly in the Prodi Commission, Olli Rehn had been an accomplished -- had an accomplished political career both in Finland and in the EU institutions as a member of the European Parliament in the 1990s and as head of the cabinet of the Finnish commissioner.

He also had experience in the private sector and in the academic world, briefly running the Center for European Studies at the University of Helsinki. So we not only have the best person to tell us about the euro zone and Europe's position in the world economy but also someone who has really been a key witness at a central position in the past 10 or 15 years.

As for the context, it is well known to all of you, I'm sure. On March 11, an extraordinary summit of the Euro Group reached what was called a "grand bargain," setting up a permanent fund for the assistance of ailing countries struck by a sovereign debt crisis, strengthening fiscal economic coordination as well as European governance. This decision was confirmed by a later summit by the entire European Union in late March, less than a month ago, and provided both quick relief to the

tensions on the euro and the long-term solution for future debt crisis.

But, of course, the question is, will this be sufficient? And we have at least two problems on the horizon. I shouldn't say on the horizon for Portugal because a week ago Portugal asked the help of the European financial stability facility to face its debt problem. So, and the situation of some countries in the periphery still is a cause for great concern.

And, second, we know that the bank crisis had become a sovereign debt crisis which, of course, officials are working on. But the bank situation is still not sold with a round of stress tests ahead of us in Europe and that is certainly another issue of concern, and at stake, of course, is not only the future of the euro but the broader question of the tensions generated by the situation on the European Project, and, of course, the interaction between Europe and the rest of the world.

In the recent IMF world economic outlook, some concern with Europe and in particular with the euro zone was expressed, and so that's one of the points that I'm sure Olli Rehn will be able to discuss. And he will also address the sort of more broad question of the global recovery and Europe's role and part in the global recovery in the recent month and in the years ahead.

After Commissioner Rehn has presented his preliminary remarks, I will ask Dan Hamilton, whom it's a pleasure to welcome this

morning at Brookings, who's one of the most eminent specialist transatlantic relations on this side of the Atlantic, and on the other side of the street I would say Dan Hamilton is the executive director of the Center for Transatlantic Relations, which is just across the street at Johns Hopkins University, and he's the executive director of the American Consortium of EU on EU Studies.

He has recently authored -- and I should say recently because he's authoring them at a very rapid pace, and it's hard to keep the resume -- has recently authored two important studies. One is one you probably know very well which is *The Transatlantic Economy*, the version -- the 2011 edition. And another one is a book that Commissioner Rehn presented a couple of weeks ago along with Dan, *Europe 2020: Competitive or Complacent?*, and you'll find sort of mini versions of these books on the table outside.

So I will Dan to provide a discussion and comments after Commissioner Rehn has spoken. So once again, Commissioner Rehn, it's really a pleasure to welcome you at Brookings, and we look forward to your remarks.

COMMISSIONER REHN: Thank you, Justin. Dan, ladies and gentlemen, let me first thank you for your very kind invitation to give a talk here at Brookings on a topic that has kept me very busy over the past year. In fact, as Justin said, it was a brutal start a year ago. It is true that I

have to hit the ground landing, and I started in this post about -- what is it? -- 14 months ago.

And I recall a discussion about a year ago with Jose Manuel Barroso, the president of the European Commission. He said -- we had a small meeting, and we discussed the situation in Greece and the euro area and the crisis that was then folding and emerging. President Barroso asked me that, you know, Olli, what's wrong with your -- when you started in this Economic Monetary Affairs portfolio, things started to be extremely turbulent, and we immediately faced a turmoil in the financial market center, the euro zone. And I reflected a little and I said, yes, you are right. But, on the other hand, now we have an extreme karma in the field of enlargement. (Laughter) So at least life is not boring, and it is a very meaningful job to try to work out strategies to overcome this current crisis.

The financial crisis has served as a very severe stress test for the euro area economy. Many commentators have claimed that our single currency has failed and have predicted a breakup of the euro zone. It is certainly true that we have lived through a period of serious stress, but the euro's critics are wrong to claim that this will lead with failure or breakup. The euro area will not only survive but is coming out of the crisis stronger than before once we have completed the ongoing reforms, completed our firefighting work, and built a new economic and financial architecture with this work that is currently going on.

These, my key message today, I'm glad to discuss this once we move to the Q&A. And my key message is supported by five main arguments:

First, we have shown our capacity to act and to contain the financial turbulence and have created effective financial stability mechanisms.

Second, we are implementing a very systematic program of fiscal consolidation and undertaking, in fact, unprecedented structural reforms in Europe.

Third, we have identified the key weaknesses of EU economic governance. There are weaknesses we are fully aware of that we have identified these, and we are addressing them in a way that will profoundly change the policymaking landscape in the European Union.

And fourth, we are already seeing results in terms of economic recovery and increasing confidence. You have on the screens, you have some figures about the economic sentiment indicator which shows that we are, in fact, now clearly back to the pre-crisis level of economic confidence both in the euro area and the EU as a whole. And in terms of economic sentiment and recovery, we have clearly rebounded in the course of the past year, and this rebound is now continued.

And fifth, the benefits and value of the euro for Europe are far larger and more significant than often appreciated by at least some of

the euro's critics. So let me elaborate these five arguments and provide you some empirical evidence that this indeed is the case.

Less than 12 months ago, Greece was about to default. We discovered that the country's public finances were in much worse state than earlier known or assumed. While we took some time to reorganize what was necessary and to get our act together, we did so decisively. The euro area together with the IMF approved a 100 billion euro conditional rescue packets for Greece in early May last year.

Only one week later, we created a three-year financial stability mechanism with a community arm called the European Financial Stability Mechanism and an intergovernmental arm called The European Financial Stability Facility, all in all with 500 billion euros of resources in terms of guarantees backing these mechanisms.

Then last November, Ireland's banking sector was about to implode and that would have had devastating consequences for its public finances. In that moment, we were able to activate the new mechanism very swiftly. And last week, Portugal requested EU IMF financial assistance, and we can expect a support program to emerge in a matter of a few weeks. Our teams from the Commission ECB and the IMF have just arrived to Lisbon earlier this week, and the negotiations on political conditionality will start with full effect as of next Monday when it votes.

Of course, the turbulence in the sovereign debt markets is



not over yet, and this slide provides you figures about developments in the sovereign debt markets from January 2007 until the recent date set. And we are quite confident that with the Portuguese program we should be able to contain the problem, (inaudible) the problem to the most vulnerable countries. It is not worth the -- Portuguese request did not affect spreads in the neighboring Spain and, indeed, as you can see from this chart, indeed it has been almost universally recognized now, latest by the IMF yesterday in today's papers, that Spain has decoupled from the other three countries.

While I cannot say mission accomplished, by no means, yet I am increasingly confident that we are entering into the end game of the crisis management phase. The European Financial Stability Mechanism and Facility are in force until 2013, mid-2013. After that, they will be replaced by a permanent European Stability Mechanism, ESM, which will safeguard financial stability in the euro area and contain three elements: first, of course, financial assistance; second, always a conditional program of fiscal assessment and structural reforms; and third, a possibility for private sector involvement. And all this based on an analysis of debt sustainability conducted together by the EU and the IMF.

What has been achieved with these arrangements by providing conditional financial assistance to soon three EU member states, we have prevented financial chaos in Europe which could have led

potentially -- which could have had potentially serious global repercussions as well.

Presenting a European (inaudible) has not been a simple task with 27 fiscal authorities and 11 central banks in the European Union. You know, we never had the genius of Alexander Hamilton to draw on like you did, unless you count Jack Delora also for that purpose. But nevertheless, the task has been accomplished.

It is essential to note that it is not just financial assistance that is involved. The assistance is strictly conditional. A member state which makes a request has to put its public finances in order and take very difficult but equally necessary and often overdue statutory reforms in the labor markets, financial systems, competition policy and many other areas. The assistance packages are, in fact, instruments for reforming some of the weakest and more vulnerable EU economics.

This takes me to my second point. Europe is now arresting its challenges of public finances with rigor and vigor led by the most vulnerable countries, and I'm glad to note that there is a similar end of war starting also in the United States based on the speech of President Obama yesterday at George Washington University. The crisis has increased government debt in the euro area by some 20 percentage points to close to 90 percent over GDP by 2012, next year, whenever it's -- this is somewhat lower than the comparable figure for the United States

which would include states and local governments. But we strongly believe that immediate action is needed to put debt on a declining path, not only on average, but in every single member state.

And that is precisely what we are doing now. This year every EU member state will reduce its budget deficit until the consolidation is set to continue for years to come. Similarly, structural reforms are not being implemented with a new sense of urgency. This is key for unleashing higher potential growth in the long term and for raising employment prospects.

Perhaps the best example is Spain, where the labor market depends on the system, and the banking system, especially the savings banks sector, are now being reformed with previously unseen determination which has been appropriately recognized by the market and the investors. And, by the way, also by the Chinese, Russian, and Norwegian sovereign debt funds that have recently returned Spain to the list of countries where they continue to invest in their -- in the bonds.

Ladies and gentlemen, yet from the euro area perspective, the most significant thing that the crisis brought about is a complete overhaul of European economic policy governance. It is based on the following analyses of the problems or systemic weaknesses we experienced in the economic and monetary union over the past decade. Even if the EU has had what we call the stability and growth factor to

guard against imprudent fiscal policies of individual member states, the path has not been sufficiently effective or strict enough; it has allowed countries to run high debt levels, thus making them vulnerable to adverse shocks. Greece, of course, is the most acute example of this kind of fiscal imprudence.

Also, we paid very little, if any, attention in our policy coordination to broader macroeconomic imbalances such as weak competitiveness, high current account deficits, or credit and asset price bubbles. Nevertheless we should not forget that these can cause severe problems not only for the member state in question, but also for the rest of the euro area or the Union as a whole. Ireland and Spain are cases in point of this kind of macroeconomic imbalances.

And finally, when even rules have existed, they have not been enforced with rigor, which was one of the fundamental weaknesses of the EMU Act 1 in the past decade.

Now all this is changing. We are about to put in place a comprehensive reform over economic governance in this summer. What will it mean to have two pillars and one foundation and one framework, which are illustrated on this slide? And the first of the two pillars is that in order to avoid the buildup of excessive deficits and debt, we will strengthen stability and growth factor by making the adjustment towards a medium-term mastery objective operational and binding. And we will also revive

the neglected debt criterion of the pact and focus much more on debt sustainability of all the member states.

Second, we will broaden economic surveillance to identify and address macroeconomic imbalances and divergencies in (inaudible). When unsustainable developments are identified on the basis of a scoreboard of indicators, in-depth country analysis and country-specific recommendations will follow, intersected by the Commission and decided by the Council.

There is, by the way, plenty of resemblance with our new mechanism and the currently planned mechanism for G20 in tackling global imbalances with the important distinction that we have more bite, and we have an enforcement mechanism, also, for this identification in addressing macroeconomic imbalances in the European Union.

Third, to prevent unsustainable economic policies by member states, we will introduce stronger incentives and sanctions which will kick in at an earlier stage of the surveillance process and which will be gradually tightened unless corrective action is taken by the member state concerned.

Equally important, we want to make the consequences of irresponsible fiscal behavior more automatic. We call this semi-automaticity, and that's less subject to political deliberation, i.e., political wheeling and dealing.

One very important change has already been implemented from this year on -- from this January onwards: the process of EU economic surveillance is conducted in the first half of the year through the so-called European semester. It will enable consistent policy guidance to member states early enough so that it can be taken into account by member states in the formulation of their national budgets for the following year. Right now, from April to June, we are in the process of doing this for the budget over next year, 2012.

With these changes, we are recasting our policymaking in an essential way, particularly in the euro area, but also more broadly in the EU. Economic policymaking will become much more rules-based and will take much better into account the spillover effects to other member states. Neither the European Union nor the euro area will become a federal system, but they will be much more than a sum of its member states through deeper economic policy integration and reinforced economic governance.

By the way, many Americans, I recall, think that EMU -- and you can find this often in the economics or political economy textbooks also -- many seem to think that EMU stands for European Monetary Union. That's not precisely correct. In fact, it means Economic and Monetary Union, and what we are doing with this reform is that we are not finally creating a true and functional economic union to supplement the

already strong monetary union.

In other words, what we are doing in Europe now is strengthening our economic pillar and in the EMU feeling "E" with the life, and I guess, indeed, high time to do so.

Ladies and gentlemen, before concluding, let me now still say a few words about the specific role of the euro. It often tends to be forgotten in the daily commentary of the financial media. The economic rationale of the euro was, on the one hand, to enhance the functioning of the markets in a very integrated economic system and, on the other hand, to provide economic and monetary stability.

It has done both. The euro has substantially helped cross-border trade in both goods and services in Europe. It has also been a stabilizing factor and prevented the all-too-familiar currency crisis with sky-high interest rates as well as eventual devaluations of the fixed but adjustable systems like the European monetary system in the past. With the types of shocks we have experienced since August 2007, an EMS system would have been highly destabilizing and would have most likely broken down.

I have some personal experience of this because I worked as a young member of parliament as a chief of staff of the Finnish Prime Minister Esko Aho in the early 1990s, and we have to face the crisis, clean up the mess that the previous government created and face the crisis of

the 1991-93, which was as very deep economic recession in the country I know best. And then the Finnish currency markka was brought down by several factors, including George Soros who put down not only the bounce sterling but also the Finnish markka. And it was not his fault, but in the end we faced unemployment of almost 20 percent and had to go through a very deep structural change. And that's a typical lesson of a small state in Europe.

Now in this crisis, the euro has served as a protective shield, and we are now rebounding without having to go so deep as we went in the course of the 1990s. And that experience is very deep among the policymakers in the smaller states and why not larger states in Europe? And I think it is important to take this into account and not underestimate this experience, because we feel that with the euro we have a protective shield, and it has greatly stabilized our economy in Europe.

Of course, the single currency made it easier for some member states to end up in an unsustainable credit booms and unsustainable private and public debt levels. Similarly, the adjustment after the bursting of the bubble is probably more demanding in the absence of exchange rate flexibility. But one should not exaggerate these aspects.

The United Kingdom and many so-called new member states managed to create much bigger credit bubbles, banking crises, and



public finance problems than many prudent euro area member states. And if you look at the speed at which Irish unit level costs have adjusted, the exchange rate adjustment alone does not seem to be decisive, and by the Finnish example it also has quite significant economic and social costs.

While the reform service I have briefly described benefit the Union as a whole, they are especially important for the euro area. Therefore, the coordination must be clear among these countries than the rest. And, for instance, the sanctions for that behavior must be tougher for the euro area member states.

So, ladies and gentlemen, to conclude, macroeconomic developments over the past year have produced rather strong evidence that our policies are working in spite of a very difficult starting point. A recovery is underway; it has taken hold and is progressing now. While it has been export-led up to now, domestic demand has started to contribute increasingly; moreover, the labor market is gradually improving.

No doubt Europe still faces significant economic genesis. Global competition has not diminished in the years of economic crisis, rather the opposite. Unemployment is still unacceptably high in many parts of Europe. Our populations are aging rapidly, and we face the challenge of securing our energy supplies in a safe and environmentally sustainable manner.

But let me be clear. The euro is not on the list of problems. Instead it is an essential part of the solution. It contributes to growth by enhancing cross-border economic activity and competition, and it is essential for macroeconomic and monetary stability.

Lastly, let me recall that the euro is not just a technical monetary arrangement but rather the core political project of the European Union. As such, it is a symbol of our political will and determination to work together for our common good. And that is a further reason why it is worth taking Europe seriously when we say that we are ready to do whatever it takes to defend the euro and financial stability in Europe.

Thank you very much for your attention. (Applause)

MR. HAMILTON: So, good morning. I was asked just to give a brief comment and maybe help facilitate the discussion, so let me do that.

I think all these comments I would just make one sort of basic point which I think the debate about the euro is important to understand that the issues of the euro, it seems to me at least, are more reflection of Europe's broader economic challenges than their cause. And I think often the focus on the euro, per se, doesn't, you know, get to the more fundamental points. The euro is going to reflect how Europe deals with its economic challenges, not just the construction of the euro itself.

And so if you think, if you step back a moment and reflect on

how Europe has been doing, I mean it still brings considerable strengths to the world economy and to its own competitive position. Justin mentioned the books we've just done, I mean if you compare the EU as a region with other world regions, say, North America or Latin America or Africa or Asia, you know, the EU is still the number one trader in the world; it's the number one destination for foreign-directed investment of the world, it's the number one source of foreign-directed investment of the world. It is a major provider of capital not only to the United States but to lots of regions around the world. It brings considerable strengths; it's in a better position, I think, than often the media and political debates give it.

I think one striking development of importance to the United States is that over the last 15 years the EU has maintained its share of global exports at about 19 percent whereas the United States' share has gone down 6 percentage points to only about 12 percent. And Japan's share has gone down equally about 6 percentage points to only about 8 percent.

So the EU, on balance, has withstood this global competition better than the other major advanced economies. And if you look at sort of what the EU is exporting, it does tend to be many goods that the rising powers want. So I think there's a challenge here the EU is presenting to actually other major advanced economies in terms of their export possibilities.

The President, as you know, pitched the idea we have to double our exports, and that's a good goal, but at the moment it's not where the U.S. is heading. And so the EU provides, I think, some benchmark of competition in comparison, also, with us.

The last strength it seems striking from the last survey we did is that last year, back to the point about rebounding, American companies earned \$186 billion in Europe. That was a historic high, not just a rebound. It's the all-time high in terms of profits by U.S. companies in Europe. So somebody thinks Europe's worth investing in and is actually making a lot of money. And I should say the European companies in the United States last year also did rather well.

So if you look at some of those leading indicators, they say there's some confidence in what's happening in moving on. But clearly there are some very severe challenges that Europe has to face, and I think to get back to the point about the euro reflecting that challenge, Olli was talking about how the firefighters are doing with the euro crisis, and that this permanent stability mechanism is in place and on its way in 2013.

But, if I may, that seems to me a bit like, you know, the fire is raging right now, and down the street around the corner, downtown somewhere, you're building a really good glitzy new fire truck that'll put out the fire as soon as it can get there, but it's going to take a while -- well, if the fire is still going. And I think this is sort of the current

challenge of Europe, that Portugal now again having a challenge, and the sort of the case-by-case management of the unfolding crisis hasn't really, I think, convinced the markets that European leaders, you know, have got their hands around this crisis.

So I think 2013 sounds good, but getting from here to there is going to be a challenge. So I'm afraid Olli's still going to have a lot of work to do between now and then. I'm not sure you're at the end point. I can -- Greece and Ireland are still actually in some trouble. The question will be after these bailouts, what is the next possibility dealing with these countries if they have to come back again for further support even though the bailout packages have been put in place?

So I think there's still a challenge there. It underscores his main point that you have a common currency area without a common economic policy. And that discrepancy in the end helps to drive Europe apart. And many of the euro's challenges are because the underlying competitive differences with among your EU member states is pulling and tearing at that sense of commonness. It seems to be shorthand that you have sort of the northern tier countries, you know, I would say courier up north, Northern Europe, doing pretty well, actually, having gotten out of the recession and moving forward, Poland almost even in that class.

But then you have that peripheral countries for very different reasons, each of them have their own problems not making the curve in

terms of not only the crisis but looking to their competitive position for the future.

And then you have besides Poland the other sort of Eastern countries that had emerged out of communism were on a pretty good track until the recession hit. And now the question is whether the model they had been on is relevant now to the future they are facing. And what does that mean, then, for the solidarity that is supposed to be behind the European Union? What does that imply? How do you manage the competitive dispersion, and I think that's going to be a major challenge for the euro but also for the European Union.

And that leads to a different issue I did not mention, but I do believe as a serious issue facing Europe today, and that's the demographic challenges. Olli mentioned it briefly, but I just want to underscore it. Europe is aging and shrinking. If you look at the projections of population and the kinds of workers and so on, it has a serious problem maintaining in its competitive position. It would have to double its current immigration to halt its population decline. It would have to triple its current immigration to simply maintain the working population that it has. And it would have to quintuple -- five times -- its immigration rates to maintain the worker elderly ratios it has today.

This is a severe challenge at a time when Europe still is the main source or destination of all, well, migrants in the world, but they tend

to be the unskilled migrants. So Europe at a time when it needs people is getting people, but it's getting unskilled people, and it doesn't have in place, then, a pan-Europe talent strategy that would encourage skills, high-skill migrants first of all, training those that do come training them up, training its own population and maintain its competitiveness. There is a human capacity issue in Europe that I think will start that is already affecting lots of other elements of competitiveness.

So I just want to put that out as this is not a problem of the euro, but it's a problem that will affect the euro and many other institutions of Europe over time.

So finally the question is, what does that mean for the EU, per se? And the Commission, you know, and member states have put forward this Europe 2020 strategy. The question is if the EU is going to be a value added, then it is more than the sum of its parts. That means  $2 + 2 = 5$ , if the EU is a success.

Right now I think it would be hard to argue that  $2 + 2 = 5$  in Europe today. The Commission has put forward this important 2020 strategy. It has many interesting good elements in it, but the last strategy, the Lisbon strategy, foundered not on the good goals but the fact they couldn't be implemented by the member states, who either refused or were unable to do the real work that would make that real.

So my 20/20 and the book that we have is not the

Commission strategy. I believe it's Europe's closing window. I believe if you project the trends that I've discussed, Europe has about a decade to reposition itself for the global economy it's facing. And if it doesn't get that right, it's going to face some really severe competitive pressures that could further accelerate this pulling apart among its member states.

So it has to get the recovery right. I think Olli's working very hard to do that. It has to improve its productivity which is really not where it should be. It has to tap the full single market. The single market is the bedrock of Europe's competitive position in a world of continental-sized players, and so it's trying. I know that the Single Market Act has been advanced, but it really has to do this. It provides European companies with a base by which they can compete in this type of world.

It has to unleash what we call the sleeping giant of the services economy. Europe and the United States are really the only big services economies in the world. Europe has considerable strengths there but is embroiled in debates about that that are hampering it from unleashing its full potential that could create a lot of jobs. All of the net job growth in the EU in the last 15 years are in the services area, all of it. All of it. So not addressing that is not a job creation strategy.

I mentioned the talent strategy. That relates to innovation as knowledge economy. Someone coming from Finland would know that better than many. That is, you know, ultimately, where Europe's



competitive advantage will rest. so the innovation union that's proposed is very important, but people are the ones who innovate, so I end where I tried to stress that the human challenge for Europe is quite severe. And how Europe deals with that I think will start to address lots of other issues that it faces as well.

So there you are, and, hopefully, you will have a good discussion. Thank you. (Applause)

MR. VAISSE: Thank you very much, Dan, for these great remarks. I think I'm going to abuse the privilege of being the chair to ask a question, and maybe it would be a follow-up on one Don said in the beginning of his remarks, the firefighter analogy. So the question of the medium-term strategy, we know something definitive and great is coming for 2013, but what are we doing in the meantime? That was more or less Dan's question, and I would add my own question more on the very short term which is could you tell us about one of the key questions of this crisis which is the situation of the banks, of European banks?

We had a round of stress tests a year and a half ago which were considered not to be very conclusive or actually, at least, which didn't convince the markets. Could you tell us about the current round of its state and it's likely and, you know, what we hope to achieve through them?

COMMISSIONER REHN: Thank you. With pleasure and, in

fact, as you refer to this, say, short-term versus long-term, or short-term firefighting versus long-term growth in governance's use, it is perhaps true that we will have the permanent European stability mechanism only from mid-2013 onwards. That will be kind of a brand new fire brigade car while we still have for the moment also a fire brigade maybe that's kind of a pre-owned car of fire brigade. But we have to make best out with that, and it's worked in the Irish case, and I have no doubt that we can make it to work also in the Portuguese case.

As across the banking sector, you are right that this is really the second key dimension of the crisis, the current states of the crisis in a sense, that I think we have already for some time been in a phase of the crisis which is kind of a severely intertwined combination of a sovereign debt crisis and banking sector fragilities. And you cannot solve one without solving the other; you have to tackle both. And that's why the current amount of bank stress tests is so critical and crucial for enforcing confidence in the European economy.

The round has started and it is now conducted under the auspices, under the guidance of the brand new European banking authority which started its work in January. So one big difference this time around will be that while last year, in the latest round of the stress tests, the national authorities had the sole right of implementation of the tests. Now we have -- and there was a very loose coordination only among the

27. Now we have a European supervisory authority which has a significant possibility of significant power of oversight and guidance of the process.

And I trust that the implementation of the stress tests this time will be more uniform and more rigorous, which was the handicap last time. Even if 24 or 22 of the many states did it right with full rigor, we had some weaknesses, the biggest of them Ireland, and that eroded the credibility of all the stress tests.

One final point still in this context. It is absolutely essential that all those member states who have a reason to assume that they have needs of restructuring, and especially recapitalization of some of the vulnerable banks when the results are revealed, they should now already prepare credible backstops, national backstops, to prepare for possible recapitalization in the case that such kind of vulnerable banks are bumped.

MR. VAISSE: Mm-hmm.

COMMISSIONER REHN: And this process is now going on, and we are going to have a discussion on this in a few weeks in the (inaudible) Council of Finance Ministers where we should peer review how things are done in different member states in this regard.

MR. VAISSE: Thanks. And now open to the floor. We have a bit more than half an hour, and so we'll take the questions by rounds of

three. So please identify yourself when you ask the question and make sure it's as question.

Sir?

MR. THOMAS: Yes, my name is Javit Thomas. Javit Thomas. I'm a consultant to the World Bank. I have a question.

You mentioned that there will be better enforcement, and you mentioned the word "sanctions" for those who do not follow the rules. Can you elaborate a little bit on what kind of sanctions, and how do you make those sanctions effective, please? Thank you.

MR. VAISSE: Thanks. Sanjean, here?

MS. CHOY: Good morning. My name's Sanjean Choy. Commissioner, could I follow your comment on Spain? And I read an IMF report, also, this morning after you mentioned Spain is (inaudible) with the three countries. It is true. However, what I'm not sure about on the savings bank. And, yes, the savings bank in Madrid is okay, but Katarina is not the same case.

And B, unemployment in Spain is quite high. And C, and Spanish stock market was the worst performing stock market in the world with debt. I'm not sure. I'll be interested in your views on debt issues.

And with regard to Portugal, with the departure of (inaudible) now, ECB has my liveries while we await to continue the purchase of sovereign bonds. (inaudible) ECB will play more important role in

upcoming Portuguese negotiations? Thank you.

MR. VAISSE: Thanks. And so the gentleman in the blue tie.

MR. ODIE: Thanks. Yes, my name is Antony Odie. I'm also a freelance consultant connected to the World Bank.

Commissioner, building on what was just said about the stress tests, obviously in some of the countries unsound banking practices, weak banking regulation are a major part of the story. Beyond the stress test, what does Brussels have in mind for leveling upwards standards of regulation of the banks in the countries? That's the softball question.

Just to put a little spin on it, you hear people saying that the bailout for Greece is really designed to give German and other banks enough time to prepare for default which people say is going to come anyway. Would you like to give us your comment on that?

MR. VAISSE: Thanks. Olli, why don't you answer these three questions, and, Dan, if you have something to add, you will be welcome to do so.

COMMISSIONER REHN: Thank you. First as regards the new sanctions regime, the point here is that -- and the key point, really -- is that we will have to have sanctions at our disposal at much earlier states in the policymaking cycle than in the past. In the past, one reason why the sanctions were not effective was that they would have been

triggered only when the damage was already done, and then it would not make too much sense to have a financial sanctions.

Now, instead of only having the sanctions in at the very late states, we are bringing them forward to the preventive arm of the stability and cost factor. I mean there are still sanctions in the so-called corrective arm, but we are bringing them to the preventive arm, implying that once we can identify or once we face the situation where a member state is deviating from the path of prudent fiscal policymaking, deviating also from the pact, then it is our responsibility as the Commission to propose to the Council to take sanctions against a member state which would, in fact, be tightened gradually so that first you would have to pay a interest-bearing deposit. It could turn into a non-interest-bearing deposit, and finally to a fine in case a member state is not taking corrective action.

And in a way, this is designed less for the cases like Greece when it was already in the crisis, rather for, say, cases like Finland or Luxembourg, if they would start deviating from responsible fiscal policy. For instance, if after the elections, parliamentary elections in the country I know best in the coming weeks, there will be a new government which would propose a budget for next year of, say, 5 percent fiscal deficit instead of 1 percent fiscal deficit. I would have to propose sanctions through the Commission to the Council which Finland could avoid if it would -- if it were to take corrective action and realize its budget for next

year.

So the whole point is that it has to trigger early enough, and it has to be gradual so that the country can avoid these sanctions taking place. Of course, it's not only the financial sanction. I mean it's relatively -- a relatively more or less some significant, but will not turn any member state to bankruptcy or default. But it's also a signal to the markets, to the investors, and it is also a political and reputational sanction if this were to happen.

I certainly hope that the country I know best will avoid this fate, but that's up to the (inaudible) talks and the new government to avoid it.

Concerning Spain, you are right that Spain has significant challenges. There is very high unemployment and that's why the labor market reform is particularly important and it is now moving forward, and I trust that it will have an impact on the very high unemployment in Spain.

One of the problems in Spain has been really a dualistic labor market, and Spain should be able to reduce this dualism and improve the employability of its labor markets.

As to the savings banks, there is a very determined restructuring going on. For instance, the number of savings banks is reduced from 46 to around 15 through mergers, and there is a clear remedial plan of recapitalization through the so-called "froba", which is the

Spanish national backstop, and this plan is now being implemented by the Spanish authorities.

Concerning the financial sector regulation, we are working together with our international partners in G20, and we have agreed on the new Basel III capital requirements, capital adequacy requirements. And my colleague, Mr. Barnier, is shortly translating these Basal III standards into the form of legislation, and then the Commission will in the coming weeks or months make a proposal to the member states how we translate the G20 Basel III standards into the European legislation.

We will play by the G20 rules, and we will implement this in due course and in the time frame that is foreseen in the commitments undertaken in this international context.

Here I want to say that we have already done one major reform which has been implemented to which I referred already indirectly. In other words, we have informed the system of financial supervision, in fact, both microprudential supervision and created an entity for macroprudential supervision. January, this January, three supervisory authorities at the European level started one for banks, another one for insurance, and a third one for securities.

And on top of that we created what's called the European system at risk board, which is presided by or chaired by President Jean-Claude Trichet of the ECB, which combines the forces of this European



regulators, national regulators, and central banks, the Commission, and which has a task of assessing preventively, preemptively assessing risks to macro finance sustainability in Europe. I'm a member of that board, and I find that its creation very important, and it will significantly supplement the work the Commission is doing in order to identify macroeconomic imbalances.

So in the past we have no system of kind of preemptively identifying macroeconomic imbalances or macrofinancial stability risks. Now we have tasked both the Commission and the view of their system at risk in order to do this. I'm sure that we will be able to do better in terms of crisis prevention in the future because of this new instruments.

Finally, on Greece I'm aware of the public debate and recent statements as regards the debt sustainability of Greece. We do not see debt restructuring as an option. Instead we are engaged into a revised and updated debt sustainability analysis, which we will do profoundly with the IMF and we will present it in due course to the member states of European Union, and I guess Dominique Strauss-Kahn to be the IMF board. That is a regular exercise, and we want to -- of course, in the context of the reviewing of the program which we do every quarter, so we want to assess now next time around in May the growth prospects of Greece as well as tax revenues, and we will in that context also assess the overall implementation of the program. It, so far at least, has been on

track, and in that context, as I said, we will also do a debt sustainability analysis of Greece.

MR. VAISSE: Thanks. We'll take another round of questions right here next to you.

MR. BRUTER: This is Alex Bruter with the German TV, N24. To follow up on your last remarks just to understand, with the permanent mechanism in place after 2013, is it your view then possible haircuts in the case of Greece or others is more likely after 2013? And also going back to the German question, how deep do you think is the German banking crisis or the German bank -- banks' weaknesses? And how do you think particularly the exposure to sovereign debt in the so-called pegs countries has played a role in handling the current crisis?

MR. VAISSE: Thanks. At the back over there?

MR. FLANAGAN: Thank you. Good morning, Commissioner, and my name is Patrick Flanagan. I'm a student at Seitz, Johns Hopkins University. And on Monday, the IMF announced that Ireland's GDP growth this year will be cut in half.

COMMISSIONER REHN: Can you speak a little bit louder, please, so we can --

MR. FLANAGAN: Sorry. On Monday, the IMF announced that Ireland's GDP growth would be cut in half, and then on Tuesday, the expectations in Ireland's meeting it's debt to GDP rates for this year, it's

unexpected that Ireland will meet its tests and agreements. Do you expect greater austerity measures in Ireland in the coming year? And, secondly, are you optimistic about the interest rates on Irish debts being lowered by the EU?

MR. VAISSE: Thanks. Sir?

MR. BEERY: Brian Beery from Europolitics. I just wanted to follow up on your remark that regarding Greece we don't see debt restructuring as an option. Why is that not an option? Could you just elaborate, and not just for Greece but for Ireland as well? Why is the Commission being so adamant that debt restructuring cannot happen?

MR. VAISSE: Thanks. We have three questions.  
Commissioner Rehn?

COMMISSIONER REHN: Thank you. So the small talk is over. (Laughter) So we start with Ireland, in fact, because these two others are interrelated, more interrelated. And concerning Ireland, it was known when the program was designed, the EU IMF program, which is based on the economic recovery program of Ireland itself, that there will be in the beginning a negative impact on economic growth before it starts to rebound and gain strength again.

Now it is essential that the Irish government will stick to the program as it was agreed with its European international partners in order to achieve the fiscal deficit -- or reduce the fiscal deficit to 3 percent by

2015. And we have analyzed and calculated very carefully the part of Irish, Irish fiscal part of adjustment and taking into account that there also are some positive signs in terms of export growth and industrial production. I'm confident that Ireland will be able to overcome its challenges.

In this regard, the recent conduct of bank stress tests is a very important milestone. It was done properly and profoundly. The Irish authorities worked very closely with the Commission, ECB, and the IMF, and we agreed on the strategy forward, and this stress tests, as you probably know, revealed weaknesses of or needs of recapitalization of 24 billion euros, The program for -- EU IMF program for Ireland was designed so that it has the maximum capacity of 35 billion euros to accommodate the problems of the banking sector. Twenty-four billion is clearly within the frame of the program, and in fact it is very close to the central scenario on which the growth and fiscal focus of the program was designed. In other words, that was based on the needs of recapitalization of 25 billion euros.

The fact that the result of 24 billion euros is close to 25 billion euros, the central scenario is accidental. It was not designed to be so (inaudible) on the basis of very careful bottom up empirical work. But in any case the result is in the frame of the program and in fact is relatively close to the central scenario of the program which was designed last

November.

So in that sense, the Irish program is on track and at least initially the results of the stress tests and the study of restructuring and recapitalization of the banking sector has been relatively well received by the markets as well.

Concerning the discussion on debt restructuring over Greece or any other countries, we see that in a still fragile situation in the European economy, it is a high risk that debt restructuring would cause a chain reaction through the banking sector, and thus having a serious negative impact on the capacity of lending of the banks and other financial institutions which would, of course, have negative ramifications to the channel of credit to enterprises, households, and individual citizens, and could thus endanger the ongoing economic recovery.

Moreover, nobody should underestimate the risk of contagion effect to other sovereigns. I recall one day a minister saying that those who continuously speak about debt restructuring in public are causing damage to my country, the minister who has done very determined and important work in order to reform that country.

Concerning Greece as regards your question related to haircuts more likely, or before or after 2013, I would not want to, want to enter into that discussion. I just say that in the current EUSF private sector involvement, it's not foreseen, not included, while in the future

permanent EUSM private sector involvement is introduced as a possibility, not automatic, but as a possibility, it will be, if needed, done according to the IMF force and practices.

The German banking sector is recovering and is, of course, benefitting from the overall strong recovery of the German economy which we all welcome. However, there are well-known vulnerable elements in the German banking sector, and it is very important that Germany, like other member states, will ensure that it will have the national resolution or recapitalization regimes in place in order to ensure that it can convincingly handle the situation once the results of the stress tests will be published in June.

There are also some important stated cases which my colleague Hautiel Monyas is dealing with, including with one of the chairmen of Landesbank in the near future.

MR. VAISSE: Thanks. We have time to take a last round of three questions. We'll start it in the back.

MR. NEHRING: I'm Klaus Nehring from UC-Davis. If that restructuring is such a dangerous option, what is in the medium or long term? What's the model for holding government debt? Who's supposed to hold government debt? If it is -- right now it's concentrated in, by many European banks, and, if that's going to be the case in the future, then isn't that continuously going to be the danger of contagion and, basically, isn't

there continues to be then the implicit expectation of the financial markets that the holder of this debt will be paid out and the impending moral havoc.

MR. VAISSE: Thanks. Here in the middle.

MR. CHASTAIN: Yes, Ken Chastain from DoD. I have a question. There a growing public backlash against the very austere reforms that have been the conditions for these bailouts. What do you do if a government comes back to you and says, our government will fall unless we renegotiate these very stringent conditions? That is a possibility with Greece at the very least.

MR. VAISSE: Just the gentleman behind.

MR. KIMBALL: Thank you. My name is Patrick Kimball from Boston College. Sir, of all the questions to that is the political will from the political elites is obviously there to continue the euro project, but the politicians are in the end answerable to their citizens and the people. So what is the popular will throughout Europe, do you think, for considering the euro project? Thank you.

MR. VAISSE: Okay, since it's the last one of questions, we'll take one very last. The gentleman in the back.

MR. STANCILL: Ben Stancill of the Carnegie Endowment. Commissioner, you pointed to Ireland as an example of a country that's successfully making this competitive adjustment that's needed. But that's

occurred at a time when Irish domestic demand has fallen by nearly 20 percent. Clearly this can't be the goal of other countries that need to make a similar adjustment which their adjustment so far hasn't kept pace with that of Germany, or has basically maintained the same competitive stability to Germany.

So what do you suggest that these countries do, especially at a time when the ECB is raising interest rates?

MR. VAISSE: Thanks. I think we have the last three questions were very clear, and in terms of their theme and then the first question about the debt restructuring. So the floor is yours for the last round of answers.

COMMISSIONER REHN: Thank you. As regards debt restructuring or who will be willing to hold government debt, I can say that I can see private sector involvement under certain circumstances morally justified and economically reasonable. But not in such a fractured situation as we are still currently in in Europe. And that's why we have made a very clear distinction between the future ESM starting from mid-2013 which will include the possibility of private sector involvement under certain conditions with clear rules and based on the debt sustainability analysis. And the current arrangements and the current stock of debt where we do not want to open this possibility. There's a very clear distinction in that regard.



If we were in a vacuum and I could have an academic debate on this, I would have no problem seeing the importance of having some kind of arrangement for orderly restructuring, but we are not in a vacuum. We live in a very real world with all its sensitivities and fragilities and, therefore, I voluntarily limit my academic freedom in this context.

As regards public backlash and reactions to the EU IMF programs, it's clear that the European Union is based on a very fundamental belief in democracy and, therefore, we have to respect that we have 27 national debates, national democratic debates, and elections often change the color of the government and often have an impact on the policy priorities of different governance.

And that's, of course, causing, then -- having some consequences on some countries that are either negotiating or are in the EU IMF program. For instance, if you take Ireland in the Irish program which covers three years from 2011 to 2013, the first year, this year, is fixed because the budget for this year had to be voted and decided. The elections took place some time ago, as you know, and there is now a relatively recent -- or a lot of a new government in Ireland.

There is room of maneuver in the out of years to some extent, but still we expect that the current government respects the program and implements the memorandum of understanding that has been agreed between the European Union and the Republic of Ireland

and between the IMF and Republic of Ireland.

We have no doubt a challenging political situation in Portugal which is preparing for elections in early June. And we should negotiate an EU IMF program with Portugal in the meantime. In fact, I should present it to the Euro Group finance ministers, (inaudible) finance ministers mid-May, the 16th of May. And, therefore, we are now working so that we are negotiating in the first place with the Portuguese government which our former counterpart, while at the same time we are closely consulting and talking with the main opposition parties so that we would, from our side, facilitate a cross-party agreement endorsing the program in the middle of May.

There may have to be some adjustment after the 5th and before the 15th of June because the 15th of June is the critical deadline of new financing of Portugal, and the program has to be both in force, and we have had to go to the markets to get funding in order to have that money flowing to Portugal in time. And they have some impact, but it's essential now that the part of this political force system service can agree and prepare a cross-party agreement to endorse a program for Portugal. And I have appealed, also President Barroso has appealed to the responsibility of all Portuguese political forces to overcome this challenge and I agree that's kind of a cross-party agreement.

There is the question of political realities, of course, very

fundamental concerning the euro. If you look at the opinion surveys in the euro area member states, even during the crisis and during the difficult period there is relatively strong support for the euro. But, of course, in the end it's a matter of having sufficient and sustained political will for the euro, and in that sense I don't underestimate the challenges. We have a certain divergence of political debates in Europe, not so much on the euro, but rather on how to handle the economic challenges in Europe for the moment.

I go very often to the national parliaments in the member states from Greece to Greenland and from Ireland to Germany, and I feel that schizophrenia in my body and soul because sometimes these national debates are diametrically opposed. That's the further reason why we have to build bridge and we have to all those who are responsible and who see the European growth as valuable, it is our task that we build bridges between these different national debates.

On Ireland, I said that Ireland has, in general terms, been able to reduce its unit labor costs based on under -- please don't misunderstand me. I do not underestimate the challenges of Ireland nor the hardship the Irish people have had to face and will have to face for some times still. But, at the same time, it is also a result of accumulated imbalances in the past decade and is one further reason why we have to reform the European economic governance, and it is one further reason

why it is important that Ireland itself has both fiscal prudence and also -- and shows that it's current account and macroeconomic policies are in tune with balancing its growth and ensuring sustainable economic development. Thank you.

MR. VAISSE: Thank you very much for these very personal, I would say, insights, but also for the broader overview that you gave. Please join me in thanking Commission Rehn and have a good day.  
(Applause)

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/s/Carleton J. Anderson, III

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