I have spent the last days at IMF meetings here in Washington. The growth forecasts for the United States have been revised down. The same was done to Europe mainly due to the sovereign debt crisis. The US and Lehman were the center of the crisis in 2008, now it is more about Europe and sovereign debt.

Europe must be seen in a global context. The present problems in Europe are nobody else’s fault, but Europe is dependent on what happens in the rest of the world. That was seen in 2008–2009, and it is visible now. The global economic situation is today a matter of clearly more serious concern than it was a few months ago.

One need not even refer to the published macroeconomic forecasts to see this. It is visible in the confidence indicators of businesses and households. It is also demonstrated in the financial markets, where stock market indices have plummeted and long term interest rates have decreased since last spring. Significantly, the decrease in yields can also be observed in the market for inflation-indexed debt, which suggests that it is really a question of weakening of growth prospects – rather than expectations of deflation, for example.

But it is not the only the forecaster’s baseline that has changed. Also the downside risks to economic performance have increased. This greater uncertainty can be seen in many places. It shows up in the gold price which has soared, as you know; and much more importantly, it shows up as flight to (perceived) quality in the financial markets.

The flight to quality is a predictable consequence of current financial conditions: the fragility of some countries and banks, combined with the heightened uncertainty regarding the future. Investors react by trying to move funds from more indebted countries to “safe havens”. At the same time, banks are increasingly cautious and selective about lending to their peers – to the detriment to the operation of the interbank markets. Banks prefer dealing with the Central Banks instead. In short, liquidity preference has again started to dominate the markets.

As I said, Europe in general and the euro area in particular has become the centre of attention of the financial markets. This is not so because of the average condition of the European economy: indeed, judging by several objective criteria, Europe is not worse off economically than the other comparable economic areas.

In 2011, the public deficit of the euro area should be around 4.5% of GDP, while in the United States or Japan it will be about 10% of GDP. As we know, the accumulated government debt is much lower in the euro area than in Japan, and of the same order of magnitude as in the U.S.

Moreover, the currency is solid. The euro is a credible currency which over the last 12 years has kept its value in terms of price stability in a remarkable way in comparison with its preceding national currencies in the previous decades. The stability of the currency itself is not disputed and there is no evidence of distrust in it, be it in the long-term yields on euro denominated AAA rated bonds, or in inflation expectation surveys, or in the exchange rate itself, which is stronger vis-a-vis the dollar now than when the single European currency was launched in 1999.

But of course, there are urgent problems in the euro area today. But they are not predominantly aggregate problems; rather, they are problems of divergence within the area, and structural deficits in several individual member countries. These came to the surface at the time of eruption of the global crisis in 2008, when the yield differentials on euro area government bonds started to widen. The problems of divergence and deficits have revealed
serious weaknesses in the economic and fiscal governance of the euro area which are now in the process of being corrected.

This summer has witnessed renewed problems as markets have worried about the effects of a possible new global economic slowdown on Europe, at a time when European leaders were slow to demonstrate their determination to deal with the problems of debt, deficits and divergence.

In order to restore credibility and to weather even less favorable global economic conditions, Europe must move forward on three main fronts at the same time. These are the fronts of

1) fiscal correction,
2) bank capitalization, and
3) economic governance.

The necessity of convincing action in these areas has been well recognized in principle and work is under way.

For instance, in their meeting on July 21, this year, the heads of state or government of the euro area countries made a number of important decisions which, when implemented, will take Europe a long way towards dealing with the present problems.

Also, the EU finance ministers reached just over a week ago (in their meeting in Wroclaw, Poland) an agreement on strengthening the economic governance procedures of the euro area. The European Parliament votes on the governance package – the so called six pack – this week and I expect it to be in force as of beginning of 2012.

The political process in Europe is sometimes painfully slow. It is also very complicated and can be confusing to an outside observer. This is because of the very nature of our Union. EU is an entity with a lot of jointly legislated and mutually binding norms. But a common executive is really operative in certain limited areas only, such as trade, competition and agricultural policies – and in monetary policy, in the form of the ECB. In most areas, however, EU does not operate by a common executive agency; it operates by common rules. In these areas, the competence of the EU executive – the commission – works through the regulation and surveillance of the national governments' actions.

The structure of several national executives, operating under Union treaties and directives, and the complicated process of making these norms, explains why EU works differently from the U.S., which has a unitary executive at the federal level, vested in the President. The way the EU is operates often stretches the patience of the financial markets, who would like to see quick and clear-cut decisions instead of slow negotiations by large committees and councils.

A rule-based system of coordination works best if the rules are good, if they are followed and enforced, and if the world is stable. Under conditions of large and surprising shocks, like the recent great recession, and soft enforcement of the common rules, the EU's economic governance has not worked effectively enough, and this is a major underlying reason for the present problems.

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I return now to the three fronts on which advance is necessary to restore stability. The first of the fronts, fiscal correction, means that countries having a fragile fiscal position now must correct it, as they have indeed committed to do. These countries fall into three categories.

The first is Greece, which is actually deemed a special case now. The new EU/IMF adjustment program for Greece is crucial to foster sustainable economic growth and stabilize public finances. Strict and rigorous implementation of this program is absolutely necessary. Besides fiscal consolidation, the privatization measures and structural reforms agreed in the program are essential for revitalizing the Greek economy and to create growth over time.
In the summit of July 21, 2011, the heads of state and government made a number of important decisions which pertain also to the Greek situation and its impact on the European financial markets. First of all, they agreed to support the new program for Greece. There was also a decision for enhanced flexibility in the use of the EFSF, including intervention in the secondary markets, if warranted by exceptional financial market circumstances and risks to financial stability.

The approach to private sector involvement in the euro area was also clarified. It was recognized that Greece is in an exceptional situation and that for that reason it requires exceptional and unique solutions. A part of that is a voluntary bond exchange program for the private investors. At the same time, all euro area member countries reaffirmed their determination to honor fully their own individual sovereign signature. The ECB has been outspoken in this matter. It has made clear that it was advising that any contribution asked of the private sector should be voluntary, as is the case.

Nevertheless, and despite all financial support, which is given in the form of loans, it is clear that the task of rebalancing the Greek economy must be carried out by Greece itself.

Besides Greece, we have two other countries which have an adjustment program, i.e. Ireland and Portugal. These countries are implementing their programs which will restore the public finances to a sustainable path. Especially Portugal needs also to make structural reforms which increase the growth potential of the country. I am confident that the programs will proceed as agreed. One might note that in the case of Ireland at least, the confidence of the financial markets has recently been improving already. Portugal has taken a positive start.

The adjustment programs of the program countries in Europe are jointly monitored by the EU, IMF and the ECB, and financed by the temporary European Financial Stability vehicle, the EFSF. The EFSF is financed through the issuance of bonds guaranteed by the European states. Because of this reason, rigorous monitoring of the program countries is necessary. It is important that individual countries are responsible and also feel responsible for their own fiscal policies. It is also important that the guarantor countries see that the programs are implemented in a rigorous way.

The third category of countries is constituted by two larger economies, which have not needed a support program, but have been subject to market suspicions – that is Italy and Spain. Both of these countries had a serious budgetary consolidation already in their stability programs approved last spring 2011. Moreover, during the summer both countries enacted significant additional measures which I think exceeded the expectations of their peers. Especially Italy, which has larger accumulated debt, has undertaken bold budgetary cuts. Both countries have speeded up their budgetary consolidation and are implementing balanced budget rules to their constitutions.

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Turning now to banking, we can see that the markets and banks themselves are not happy with the condition of the banking system, as shares have declined and interbank markets are not working as well as one would hope and expect.

In Europe, the systemic liquidity of the sector is supported by the European Central Bank which continues to provide liquidity on a full allotment basis, against a broad range of collateral, both marketable and non-marketable. The ECB has committed itself to continuing this flexible method of liquidity provision as long as necessary. And the amount of collateral available in the market is large enough to allow even much greater creation of liquidity than at present, if demanded.

I think that the main problem with the banking system is that a further recapitalization of banks is already long overdue. This is the case throughout the world. Perhaps this task is especially urgent for the euro area, because uncertainty regarding the health of banks aggravates the negative effects of economic imbalances and divergence in the area.
This should be the task primarily of the shareholders of the weaker banks, who should refrain from taking dividends or should inject more capital if needed. In some cases, government investment in bank equity may also be necessary.

Coming from Finland, I can understand very well the political problems involved in cleaning up the banking system. In the 1990’s, after the great Finnish banking crisis, the Finnish government had to support the asset management company that handled the banks’ problem assets, in amounts that at one point reached about 10 per cent of GDP. Most of this money was later recovered, but in the meantime taxpayers were furious. The public frustration with the costs of the banking crisis has not been forgotten in my country.

Despite the short-term discomfort it entails, the resolution of banking problems is necessary for us to move forward to a lasting recovery. On the one hand, the recapitalization of the weaker but viable banks is necessary to restore confidence. On the other hand, the well-managed closure of weakest banks is necessary, so that they do not distort the market for the viable banks.

An important part of the decisions of July 21 by the euro area heads of state or government was that the use of funds raised by the European Financial Stability Facility was agreed to be made more flexible. This will make the EFSF a better tool in supporting the present tasks of crisis management. According to the decisions, loans from the EFSF can be used to recapitalize banks – not only in the program countries, but in other countries as well.

The third front of advance for the EU is the improvement of fiscal and economic governance. While the fiscal correction front deals with the present imbalances, the governance front will mainly be directed towards the future, in order to reduce the likelihood of recurrence of deficit problems. Of course, credible institutions which would ensure future stability should reflect back on the present situation as well, improving credibility and confidence already now.

When the monetary union was planned in Europe, there was much debate about the degree of economic convergence between countries that would be necessary for a monetary union. Some people thought that a high degree of economic convergence was a necessary precondition, whereas others argued that membership in a monetary union and the necessity to hold on to it would perforce bring about the necessary adjustments and convergence.

Because of the insistence of Germany and others, emphasis was placed on economic convergence when the monetary union was established: reasonable entry criteria were set for membership in the union, and members’ fiscal behavior was regulated by the Stability and Growth Pact.

Now we know that this emphasis on convergence did not carry enough force. In 2005, the pact was actually made more flexible than originally, despite the resistance of the ECB. That happened when some big countries faced the prospect of being subjected to the EU’s “excessive deficit procedure.” Then, shaken by the steep recession of 2008, several countries got unexpectedly to the danger zone. The current crisis has demonstrated very clearly that an ambitious reform of the economic governance framework is in the interest of the European Union, its members, and the euro area in particular.

Now, we need even tighter economic convergence, and we need better economic governance within the EMU. We must strengthen economic governance mechanisms in the euro area to minimize the risk of additional crises in government finances in the future.

The “Euro Plus” pact signed last spring was a step in the right direction. The signatories – all euro area countries and some other EU countries – committed themselves to several important reforms, such as to implement the EU’s budget guidelines to their national legislation. These nationally implemented norms could help “internalize” the fiscal discipline in each country and render the matter less of an issue of EU policing of the countries’ current fiscal actions. The Euro Plus pact also broadened the scope of policy coordination.
Previously, the stress had been on deficits and debt; now, the competiveness issues (such as relative labor costs) and financial stability were also included.

As I already mentioned, the EU is just now adopting an important legislative package which will strengthen the stability and growth pact and the macroeconomic surveillance framework of the EU.

This package includes, among other things, a directive on the budgetary frameworks of the member countries. This will be important for what is called the “European semester” – the new annual review of members’ budgets BEFORE their adoption nationally. The package will also make the sanctions enforcing the Stability and Growth Pact more automatic, by the so-called reverse voting mechanism.

Both the preventive and the corrective arms of the Stability and Growth Pact will be made stricter. In the preventive arm, policy coordination will extend to the growth rate of public expenditure of the member countries; in the corrective arm, the debt norm (60 per cent of the GDP) will be promoted to an equal position to the deficit norm (3 per cent).

Also macroeconomic policy coordination is strengthened by the “six pack” legislative package. It includes regulation of macroeconomic imbalances which is aimed to prevent the accumulation of imbalances or loss of competiveness of any member of the euro area. The imbalances covered include current account deficits and surpluses, among other things. This policy coordination is underpinned by sanctions which are levied on a country which does not follow the recommendations of the EU council to address these excessive imbalances.