The Euro: From Crisis to Resolution?

Some Reflections from Ireland on the Road Thus Far

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I'd like to share with you today some reflections on what happened in Ireland in recent years. I'd like to talk about the context in which policy decisions in Ireland were made during the years of strong growth and during the crisis. A theme I'd like to emphasise is that we can only get a proper perspective on what happened to the Irish economy by considering not only events in Ireland but also developments in the rest of Europe and in the broader global economy.

Economic developments and policies in the run up to the crisis

We are all too well aware that a period of remarkably rapid growth and rising prosperity in the global economy in the early part of this century gave way suddenly to the most severe financial crisis since the 1930s. The crisis has had a damaging impact on the lives of millions of people around the world, not least in a small open economy like Ireland.

The first signs of financial stress were seen on this side of the Atlantic in 2006 and 2007 as the sub-prime mortgage problems emerged in the U.S. housing market. Banks in Europe experienced some tightening in funding conditions, especially in the second half of 2007, in part because of uncertainty about which banks were holding US sub-prime debt. The problems at Northern Rock in the UK were an early sign of growing problems in Europe.

Irish banks had little exposure to US sub-prime assets. But our banking system, our public finances and our economy in general were vulnerable to external shocks in other ways that were not well understood at the time.

The recession had a devastating effect on Ireland's public finances. Economists today say that budgetary policy in the years preceding the crisis was not sufficiently countercyclical.

With the benefit of hindsight, budgetary policy should have leaned more heavily against the wind. But let's be clear about what that would have meant.

It would have meant higher income taxes, lower levels of employment, and higher unemployment. It would have meant less spending on education, healthcare, research and development, infrastructure, and social welfare. These expenditures at the time were widely seen as highly desirable.

We achieved budget surpluses averaging 1.5 per cent of GDP every year from 1997 to 2006 and reduced the unemployment rate to 4 per cent.

A countercyclical policy stance would probably have required budget surpluses of 5-6 per cent of GDP and an unemployment rate around 7 per cent. The question we ought to reflect upon is whether the political system could have come up with such an outcome in the context of strong economic growth and widespread confidence about continued strong performance.

We know too well from recent experience that large budget deficits bring serious political challenges, but so too do large budget surpluses. There was no support from any quarter for higher taxes and lower spending. The debate among political parties was about how best to spend the extra resources that were coming in to the Exchequer. There was a strong feeling in the country at the time that a unique opportunity to tackle the State's historical problems of underemployment and under-investment had arrived. Keeping taxes on income low was part of a strategy to assist many tens of thousands of low income workers to avoid poverty traps so that employment opportunities and take-home pay could be maximised. On the other hand, reliance on taxes from construction related activity increased. Inevitably, not all the buoyancy from these tax categories went to debt reduction, but rather to improving services about which there was an impatient concern. When the downturn came, we were not as well positioned on the tax revenue side as we could have been. Professor Honohan estimates that had these cyclically sensitive taxes been back at their 1987 share of total revenue, the fall in revenue in 2008 would have been 8% instead of the 14% that emerged.

Ireland was hit in 2008 not just by a fiscal crisis, but also by a banking crisis. After the turn of the century, bank lending in Ireland began to grow faster than GDP. Like banking systems in many other countries, Irish banks funded this growth in lending by increasing their reliance on international wholesale money markets. The creation of the single currency in Europe radically changed the financial environment. The elimination of exchange rate risk and the deeper integration of wholesale money markets in the euro area spurred huge cross-border flows of capital. Low interest rates in Europe -- in part in response to sluggish growth in the euro area's largest economy, Germany – encouraged large inflows of money into both fast growing peripheral economies in Europe and into riskier types of assets as investors searched for better returns.

This growing reliance on money from overseas to fund the banks rendered the Irish banking system vulnerable to changes in conditions internationally. The mounting risks, which are now so clear in hindsight, were not fully appreciated at the time. Flows of capital that are large relative to the size of the economy are a common feature of small open economies like Ireland, as are large flows of goods and services. Unlike other countries in Europe, Ireland did not possess a sizeable stock of accumulated savings to finance domestic investment, so it seemed perfectly reasonable to borrow from abroad for investment purposes.

Yes, some small open economies had in the past run into difficulties because of sudden changes in market sentiment. The relative strengths we had built up led to a belief that led to complacency. The view of most economists was that our growing balance of payments deficit was largely irrelevant, since we were part of a currency union.

Banking regulation and supervision in Ireland was on the surface compliant with international standards, but turned out to be complacent and permissive. In retrospect, we have learned to our cost on both sides of the Atlantic that this so-called "light touch" approach to regulation was fatally flawed because it put the emphasis on regulatory process rather than outcomes. We have taken these lessons on board in Ireland and have transformed the regulatory regime to guard against something similar happening again.

WHAT WERE THE CAUSES OF THE EURO CRISIS?

In order to evaluate the future challenges we have first to go back to the causes of the Euro crisis and to recognise that it reflects the interaction of a European and international banking crisis combined with a sovereign debt crisis.

Not surprisingly, given the scale of the Euro crisis and the damage which has been caused to individuals, businesses and economies, a very heated debate is on-going in Europe as well as in the US on what were the causes. This raises the issue of how come the crisis was not anticipated.

Some analysts have focused on the international crisis in financial markets following the collapse of Lehman Bros and have argued that this was the main factor which precipitated the Euro crisis. Others have suggested the crisis was primarily or exclusively due to policy errors or structural problems in individual European countries. Yet others have suggested there was an overall design defect in the creation of the Euro single currency which resulted in the widespread availability of very cheap and abundant credit without any international control mechanisms.

Like many such arguments, I believe there is some truth in all of these views despite the tendency for everyone to point the finger at others. I know from my own experience that understanding the validity of different perspectives is important in making progress and I believe the same applies to the Euro crisis.

Some people may expect me as a previous Prime Minister of a European country to defensively suggest that the Euro crisis was caused only by international factors or developments in the US, but I simply do not believe that this is the case. This is despite some evidence that the global financial crisis began in the US sub-prime market and spread to the world's financial system causing unprecedented loan losses. However, the picture is much more complex and in understanding the Euro crisis we need to first understand the crisis in the banking sectors. As early as November 2008, the Bank of England estimated that global banking losses could reach 3 trillion dollars and the experience since suggests the final costs may be even greater. This is therefore the greatest world financial crisis since most of us were born and its causes were multiple. While international factors were, I believe, a critical component in the Euro crisis, the crisis also reflected a range of factors within individual European countries and with the design of the Euro. It is also important to recognise that Europe is a community of very different economies with great divergence in the strengths and weaknesses of individual countries. For example, Spain, Germany, Ireland, Italy, Portugal, Greece, and France all have very different problems and very different prospects.

There was a range of differing domestic vulnerabilities in a number of European countries which were not fully recognised and which would have inevitably caused major problems. The crisis in the Euro was, however, the result of the interaction between the global market factors and weaknesses in individual economies. It was also inextricably related to structural issues within the Euro and when faced with the global crisis, these led to the near collapse of the banking system in many countries and a related sovereign debt crisis. At its core was a fundamental misjudgement of risk.

In meeting leaders in other European countries, I have been all too aware of the debate of whether the Euro crisis and the crisis in numerous banking systems were caused by actions within individual countries, or was due primarily to international financial developments or to fundamental problems in the Euro. This is the subject of intensive and sometimes bitter arguments in many European countries and to some extent in the US.

There is also an understandable need to try and find somebody to blame, when a crisis of this magnitude occurs which has caused such damage to people's lives and ambitions. This often means a simplification of the complexities involved. In some respects the Euro crisis is like multiple plane crashes occurring at the same time where manufacturing design faults, exceptional conditions, pilot errors and mistakes by air traffic controllers all led to unexpected and disastrous results. In a major independent report by a Commission of Investigation into the Banking Sector in Ireland which examined the cause of the banking crisis in our country they noted that "systemic financial crises require a great number of institutions, enterprises and individuals to simultaneously follow unsound policies or practices". I think this applies also to all the countries impacted by the Euro crisis. I would add to this the special responsibilities and indeed mistakes made by governments and by international institutions. However, if we are to learn from the crisis it is necessary to understand why many of the actions taken seemed sensible at the time. This is not as a basis for defence but as a guide to understanding and all involved need to approach this in an open way. In the report of the Commission of Investigation which I referred to, they suggested that "when it all ended, suddenly and inexplicably, participants had difficulty accepting their appropriate share of the blame for something in which so many others were also involved and that seemed so reasonable at the time". I think, however, it is important for all participants to consider the causes in as undefensive a way as possible and I hope to attempt this in this lecture.

With hindsight one of the remarkable and very damaging assumptions which was made throughout Europe and also in the US was that any problems or vulnerabilities which existed could be handled by market forces and existing policies without new interventions. This was based on the widespread belief that international growth would continue and that financial markets were both stable and efficient. Few believe this anymore.

The IMF did not envisage any more than anyone else the extent of the contraction which would hit Ireland or the other European countries or how quickly the sentiments of the financial markets would change with disastrous consequences.

There were also numerous other positive views on the prospects for the Irish and other European economies in 2007 from the OECD, the European Union, Moodys, and many other commentators. In hindsight, grave mistakes were made in the judgement of the sustainability of European economies and the capital adequacy of the banks in Europe. Prior to the crisis, the overall assessment was that while there were vulnerabilities and risks, the central expectation was that there was likely to be a soft landing, a gradual slowing of growth and a belief that the banking sector had sufficient capital. At the time, I shared this positive view of the prospects for the Irish economy and this was a mistake. . With hindsight the resultant scale of the economic depression meant that the actions taken prior to the crisis to minimise potential vulnerabilities were in no way adequate and there was also a failure to understand that financial markets could be so unstable.

WITH HINDSIGHT, MISTAKES WERE MADE PRIOR TO CRISIS

Given what we now know, it is clear that serious mistakes were made in individual European countries including in Ireland, prior to the Euro crisis and these all go back to a fundamental misjudgement of risk. Mistakes were also made at an international level.

Six mistakes which I believe were particularly relevant to the Euro crisis include the following:

(1) First, fundamental errors were made within the management of individual banks which led to excessive risk taking.

(2) Banks in individual European countries particularly in fast growing economies like Ireland became far too dependent on wholesale funding which when the international credit market froze left European banks vulnerable.

(3) There were inadequate financial regulatory controls in both the EU and in the US based on mistaken views of governance within banks and the adequacy of existing controls and the extent of the risk. This included deficiencies in the regulation of those financial institutions which were too big to fail, and I believe that auditors, regulators and governments and international agencies all share part of this responsibility.

(4) There was failure internationally to impose adequate international stability risk assessments and protection systems which took account of the interaction of international financial systems.

(5) As we now know many countries in Europe have been faced with the terrible combination of both fiscal and banking crises. This was in part because insufficient fiscal surpluses were accumulated in the good times to deal with the depth of the downturn. Based on a belief that growth would continue albeit at more modest levels, public expenditure and public investments were made at a level which assumed incorrectly that there would not be a dramatic collapse in government revenues in a short period. Such public expenditures helped improve the living standards of individuals, created employment and addressed much needed gaps in infrastructure in different European countries. However, the extent of the international depression meant these levels of expenditure were not sustainable and it was a mistake not to build in greater surpluses to deal with this.

(6) Finally, there was an absence of any adequate European wide structures to deal with the emerging crisis. When the crisis happened both Europe at a central level and individual countries were left floundering to try and design appropriate and adequate policy responses. Europe has to some extent attempted ever since to play catch up although increasingly the responses have been more significant.

All of these mistakes were made because of an underestimation of risk and a belief in the stability of financial markets. Both of these pillars have now been seen as built on clay.

WHAT ARE LESSONS WHICH MUST BE LEARNED?

The dramatic and on-going unprecedented turmoil and crisis in the Euro raises a number of important lessons which must be learned and which I hope will guide future policy for the next century. The key lessons in my view which should be accepted are as follows:

– Governments must in good times build greater fiscal surpluses to deal with unexpected downturns, although the scale of what would have been required would have seen remarkable levels of surpluses being accumulated in individual countries. Economists and policymakers must in this area pay more attention to how such measures could be made acceptable to citizens in various countries. I personally doubt that in the pre-crisis period citizens would have accepted Governments accumulating the level of surpluses which would have been required even if leaders had the insights into the future to believe they were warranted. I am pleased to see that some economists in Europe are starting to consider this issue and for example, three Italian economists, Bari, di Varo and Rugosa have been assessing the political feasibility of countries recording large fiscal surpluses. Their estimates suggest that Italy might under some assumptions need to run surpluses of between 4.6% in 2016 and 2.2% as far away as 2045 to abolish the long-run debt dynamics. They conclude that "whether such political commitment is credible is however an open question, but such large surpluses are not out of reach". My own view is that there may be a much greater political acceptance of such policies now than existed in the past but the strains on governments generating very large fiscal surpluses as counter cyclical measures should not be underestimated. How to secure widespread acceptance for such surpluses when electorates expect governments to improve health and education, and enhance infrastructure will be a challenge.

– Another lesson is that the regulation and supervisory rules for the financial institutions must have a much greater international element which would prevent contagion from developments in one country and prevent the need for small countries to take unilateral actions in times of crisis.

– The regulation of banks must reflect more fundamentally the absorptive capacity of the banks to respond to losses arising not only from any unexpected downturn in the individual economies but from the contagion impact of any international financial crises.

– Bankers in institutions of systemic importance must never again be let set their remuneration policies in a manner with incentivises excessive risk taking and short term gain.

– The capital requirements on banks must be set to ensure that the need for the exceptional support of Governments is never again required.

The policy response in Ireland

I'd like to turn attention to how we responded to the crisis in Ireland and what role the evolving policy framework in Europe played in shaping our responses as we continue to deal with it.

The main sign of an emerging crisis in Europe in 2008 was that European banks were finding it increasingly difficult to borrow on wholesale markets. There was a sense in Europe of a growing problem, but there was no sense, at least until September of that year, that there was a full-blown crisis approaching. Because different EU Member States were feeling the effects of the US sub-prime in different ways, there was no broad co-ordinated response and a Europe-wide approach to possible bank failures was not developed.

The lack of a Europe-wide crisis-resolution framework meant that, in relation to banks, the principle of subsidiarity applied: Banks in each Member State were the responsibility of that Member State. As the economist Charles Goodhart once said, "Banks are international in life but national in death." Although a new single currency had been launched in Europe in 1999, the system of banking regulation and supervision in Europe had not been adapted. Banking oversight continued to be done at the national level. Deposit insurance was still offered at the national level. Although cross-border flows of capital through wholesale markets soared, retail banking remained largely a national activity. This lack of diversification created risks for individual Member States in the event of a banking crisis.

In Ireland, funding conditions in 2008 were getting more difficult and the weakening in the property market was a growing concern. The trigger point was the disorderly collapse of Lehman Brothers in the middle of September 2008. Funding difficulties for Ireland's banks became acute, but banks in other countries were also having problems in funding themselves. In late September, Fortis encountered severe problems which required a take-over of that institution by governments in the Benelux countries. Other major, highly regarded banks across Europe were also running into real trouble, especially banks whose business model required considerable wholesale funding. Compared with banks in other Member States, Irish banks were hard hit by the collapse of Lehman Brothers and the seizing up of US money markets because banks in Ireland had borrowed heavily by issuing short-term commercial paper to US investors.

By the first week or two of October, there had been major interventions in the banking sectors in many EU Member States. In Ireland, we introduced a broad bank guarantee, similar to what had been introduced in the banking crisis in Sweden in the early 1990s.

I'd like to spend some time discussing the bank guarantee as is it the subject of much criticism. Indeed there appears to be a common narrative that Ireland's problems began on the night that the guarantee was introduced. But this narrative fails to consider the counterfactual scenario. It completely ignores the question: What would have occurred in the absence of such a guarantee?

Had we not guaranteed the funding of the banks, we faced the real risk of a run on the banks with devastating consequences for the availability of credit, the payments system, jobs, the economy and peoples' savings. As I mentioned earlier, there were no euro-area wide mechanisms to stabilise stressed banks and protect deposits, so it fell to the Irish government to step in with an impactful initiative to try to stabilise the situation. In the event, in the months following the introduction of the guarantee, the Irish banks attracted tens of billions of fresh funding on foot of the guarantee, which kept them functioning and bought Ireland and Europe critically needed time.

I have often asked myself: What could we have done differently? The Honohan report on the banking crisis published in 2010 examined the guarantee in detail (one of the few studies to have done so) and agreed that an extensive guarantee was needed, but questioned whether the scheme was too broad. In particular, the report questioned the inclusion of certain debt instruments in the scheme, namely subordinated debt, or junior bonds, and existing long-term senior bonds issued by the banks.

Whether a narrower guarantee would have staved off an implosion of the banking system at a lower cost to the State is a matter for economic historians to ruminate on. We had to deal with this crisis in real time. Our view at the time was that we would get one shot at calming the markets.

If, for any reason, the extent and nature of the guarantee was unclear or considered inadequate, our fear was that the guarantee would not have the desired effect and there would be no opportunity to provide further clarification. We felt we should make the position as clear and as unambiguous as possible

We also believed that, given the interconnectedness of the banking system, the luxury of allowing one bank to fail and believing that it would not impact on other banks did not exist.

At the time the guarantee was given, the advice was that the banks were solvent but were experiencing a liquidity problem. In those circumstances, it is difficult to see how any government would have experimented with allowing any one bank to fail or take any risk in that regard. Of course, it subsequently transpired that the banks were insolvent but that was not known at the time of the guarantee and furthermore, much of this insolvency was due to the further deterioration in markets caused by world recession and the recession in Ireland which directly affected the value of property assets. This in turn reduced the banks' assets which created the insolvency. If Ireland had been dealing with the problem in a context other than that of deep world and domestic recession, then the outcome could have been different.

Regarding the scope of the guarantee, it is true that some types of junior bonds were included in the scheme. But it is important to note that we set a limited duration of two years on this broad guarantee. That scheme expired in September 2010 and junior bonds were no longer guaranteed by the State after that date. Critically, the bulk of the junior bonds covered by the Guarantee were scheduled to mature, that is, to be repaid, after September 2010. They did not mature during the period of the guarantee. Their inclusion in the scheme did not preclude the bonds eventually sharing in the burden of the banks losses. And in the event, when the true scale of bank losses had been revealed, these junior bonds did take their share of the losses. There was about €20 billion of junior bank bonds outstanding in September 2008 and average discounts of between 80-90 percent were eventually applied to these bonds under legislation introduced by my government.

It is the case that no discounts were applied to senior bonds, which raises the question as to whether the State could have reduced the bill for the banks by excluding senior bonds from the guarantee, either at the beginning or subsequently. The extent to which losses could be imposed on senior bonds of European banks is limited by the legal framework that requires equal treatment of all senior bank creditors, including senior bondholders and depositors. This state of affairs is very different from the US, where senior bonds and depositors can be treated differently.

Notwithstanding these legal issues, what the passage of time has shown is that, in reality, as a member of the euro area, the senior bonds of Irish banks had to be repaid in full, even if there had been no guarantee. At no stage during the crisis would the European authorities, especially the European Central Bank, have countenanced the dishonouring of senior bank bonds. The euro area policy of “No bank failures and no burning of senior bank creditors” has been a constant during the crisis. And as a member of the euro area, Ireland must play by the rules.

A question that is sometimes asked is why Ireland didn’t renege on the guarantee when the true scale of the banking losses became apparent. The reality is that the guarantee was enacted by Ireland’s parliament by a huge majority and reneging on it would have amounted to a declaration that Ireland was a bankrupt state.

The view of the European Central Bank at the time of the introduction of the guarantee was that it was up to governments in each Member State to stabilise their own banking systems. Only in October 2008 could one say that there was the start of a European approach to the crisis. The first summit of the Heads of State of the Eurogroup, which I attended, took place in Paris in the middle of that month. It was only at this stage that there was a sort of common prescription for how to deal with banks in crisis. The prescription included better mechanisms for coordination of policy responses by Member States. There was a belated recognition that up until that point, each Member State had been left to fight its own battles using principally its own resources and that this state of affairs was not satisfactory. In the months that followed, there was a marked step up in the level of activity at a European level, including enhanced regulatory coordination, development of new legislation for banks, and better systems for communication in relation to distressed banks.

In Ireland, having given a broad bank guarantee, we turned our attention to banks balance sheets and governance. By the end of 2008 we were developing recapitalisation plans and in 2009 we announced and commenced work on setting up an asset management company, the National Asset Management Agency (NAMA), to clean up bank balance sheets by purchasing from the bank at a discount the most difficult types of loans, mostly development and commercial property. Anglo Irish Bank was nationalised early in the year in January 2009.

Other European countries were looking at similar approaches. In the UK, the approach was to offer insurance to the banks against loans losses, while the German government also adopted a bad bank approach in relation to, for example, assets of Hypo Real Estate.

For us, despite enormous efforts and a heavy commitment of taxpayer money, it was hard to get ahead of the banking problems. There was a cycle of falling property prices adversely affecting banks’ balance sheets, leading to greater demand for capital. But we did seem to be making progress, and markets seemed to be turning our way, at last, in the spring of 2010.

But we were increasingly concerned that the same types of funding shortages and solvency concerns that had proved so disastrous for the banking system were now spreading to sovereigns.

In Europe, we were developing a response to this in the form of the European Financial Stability Facility (EFSF) which was established in May 2010 as a precaution against sovereign difficulties. Markets were increasingly worried about Greece in particular, but this seemed to open up new concerns about sovereigns more generally, particularly those which were heavily indebted or might become so. And because of the costs of bank interventions, Ireland was now seen as being in that camp. The continuing threat from the banking costs, the deteriorating Greek situation, and a growing sense that despite the establishment of the EFSF, European systems might not cope well with a sovereign crisis lead to a jump in bond yields for Ireland and other Member States. The Deauville Declaration, which threatened to put losses on to bondholders in the event of a sovereign crisis, proved especially damaging for sovereign bond markets in Europe.

We have seen the implications of that policy effectively reversed over a period of time and European heads of government have been in almost constant session, meeting nearly once a month, seeking to further develop this framework.

By October 2010, we decided that a tactical withdrawal from the bond markets was appropriate, given the high interest rates that lenders were demanding. But the hammering by markets of vulnerable sovereigns continued and there was great anxiety in Europe about Ireland as the next target of the markets. There was a sense that Ireland had to be "dealt with" in some way. Ireland agreed on the terms of its participation in an EU/IMF support programme at the end of November 2010.

Before formally applying for the EU/IMF programme, we wanted to know what such a programme would entail. As the government of the day, we had a duty to protect the interests of the country and its taxpayers. Our agreement with the IMF/EU officials that the National Recovery Plan would form the basis of the programme provided us with reassurance about what we would be signing up for and this allowed us to formally apply for external support.

In signing up the EU/IMF programme, we were aware that the 5.8 per cent average interest rate attached to the loans was high. It was, however, the best rate on offer at the time, as some Member States were anxious to dissuade countries from borrowing from the EFSF. The policy framework in Europe for troubled sovereigns was still evolving, and we were aware that any changes in the interest rate regime would be applicable to all borrowings from the EFSF. In the event, the principle of equal treatment meant that when the interest rate on loans to Greece was lowered in July 2010, both Ireland and Portugal also enjoyed interest rate cuts. These cuts were very welcome and Irish bonds yields have eased markedly since.

Ireland has had an extraordinary high level of compliance with the programme, which in turn has boosted international confidence in the country's prospects.

Many of the causes of the crisis have to some extent now been addressed or are in the process of being tackled. Banks in many countries have been recapitalised, attitudes to risk in lending have changed dramatically (possibly too much) and the very painful process of fiscal adjustment is being implemented in most countries although in some there is huge resistance and concerns over the feasibility of plans. While most economists accept the need for such adjustments particularly in small open economies, this adjustment means that people are losing jobs, that families cannot afford to maintain mortgages and that the ambitions of many have been crushed. The real costs of this adjustment is being borne by citizens in various EU countries.

Governments in Euro countries are currently faced with three major interrelated problems, namely a rise in sovereign yields, the impacts of bank deleverage on economic activity and the contraction due to fiscal consolidation. This means in practice that the scope for Government action may be much more limited than is frequently believed by the media and indeed by the electorate in different countries. This imbalance between what governments can do and what are the expectations set is frequently encouraged by politicians operating in a world of competitive adversarial politics. The danger of this is growing dissatisfaction with governments and the resultant loss in confidence.

THE FUTURE OF THE EURO?

This is all taking place against a background of media discussions about the possibility of a break up of the Euro which is impacting on investment and consumer spending. Potential outcomes which have been mooted also include the possibility that one or more member states of the Euro area would either voluntarily or be required to leave the single currency. There have also been comments about the possibility of the total disintegration of the Euro.

While such opinions have become more frequent since the start of the financial crisis and even more recently given the severe problems in Greece, it should be noted that such possibilities have been raised for many years going back to even before Europe commenced a single currency.

From a practical policy point of view it is important to recognise the technical difficulties which would be involved reintroducing a national currency for whatever country might consider leaving.

The realities are also that the contagion impacts of any break-up of a single currency in an internationally integrated world economy is such that there are enormous pressures to ensure it doesn’t happen.

Apart from the difficulties in leaving a monetary union and the absence of any directly comparable precedents, more fundamentally one has to ask whether the economic problems which would lead to a country leaving would be alleviated or worsened.

It must also be recognised that any country leaving the Euro raises numerous economic problems the scale of which often are not fully considered. These include how to fund debt in the country which would exit and what would be the impact on availability of funding and on debt serving costs and interest rate spreads both in the country leaving and the countries remaining.

We are, however, in a world of much uncertainty and the past in this area may not be a very good guide to what will happen. If the recent Euro crisis teaches us anything it should be to have great humility about our ability to predict the future.

However, I believe that European and US leaders will sort out the problems of the Euro and create a sustainable economic future for the international economy. This, however, is very unlikely to be completed in one big step or as a result of one single international summit. Rather the future is likely to be more messy involving step by step reforms, to provide the basis for a competitive and financially stable Europe.

The reasons why any one initiative on its own is unlikely to be the solution can be seen by examining the relatively recent action by the European Central Bank to offer a three year Long-Term Refinancing Operation (LTRO) to try and respond to repeated concerns about bank losses and fiscal sustainability. This initiative arose because yet again interbank funding nearly dried up in the Euro area and sovereign spreads reached new highs. The adverse interactions between sovereign debt, bank funding, fiscal consolidation and the real economy is one of the distinctive features of the Euro crisis. For example, concerns about sovereign risk can result in higher debt spreads. This means that the cost of borrowing for governments increase and can lead to concerns about whether individual governments will meet their fiscal budget targets. This in turn can lead to a greater front loading of reductions in government expenditure which in turn impacts on economic growth. The resultant declines in growth then raise new concerns about sovereign risks. At the same time bank asset quality disimproves due to new write downs on their sovereign debt and this can lead to further restrictions on bank lending as they adjust to meet new high capital requirements. This in turn can lead to further restrictions on credit which impact on growth.

The reasons why I have confidence that the probability is that future challenges will be solved is influenced by the dramatic changes in the policies and policy infrastructure in Europe since the start of the Euro crisis. While legitimate criticisms can be made of the speed and scale of responses undertaken at a European level, it is important to recognise how the policy supports now in place are unrecognisable compared to the position which countries faced at the start of the crisis.

There was, for example, no central stability funds available to support Euro countries in difficulty, no co-ordinated approach to minimise stability risks at a European level and a stark reluctance of the European Central Bank to do anything directly or indirectly to ensure the sovereign debt crisis did not lead to further financial shocks. It appears to me that European institutions have started to follow part of the lead which the US Federal Reserve played following the financial crisis in the US, although on a smaller scale and using somewhat different instruments. In the meanwhile, Europe continues to grapple with the on-going crisis. The rescue funds, the creation of which would have been unimaginable in some Member States at one stage, are under continuous redesign. We now have the Fiscal Compact and new surveillance of euro area economies. The Fiscal Compact will hopefully operate more effectively now that the Stability and Growth Pact (SGP). It is worth noting that Ireland never violated the SGP but that didn't prevent the budgetary crisis. The Compact is about returning budgets in member states to sustainable positions. As a member currency union that is something to which we should all subscribe. I note also that access to the European Stability Mechanism is restricted to countries which are part of the Compact. It seems to me that we need to have insurance to protect our funding sources in case Ireland is not back in the markets as planned and additional official support from GSM is required after 2013. It simply does not make sense to close that particular door, given the fragile state of financial markets that the government faces.

The European Central Bank under new leadership is playing a more forceful role, buying Spanish and Italian sovereign debt and injecting more than €1 trillion of 3-year money into the banking system at low interest rates. Some euro area policies are still in place: No banks have been permitted to fail and there has been no burning of senior bank bondholders.

No one can predict with certainly which way this crisis will turn from here. There are no precedents for what Europe faces. Historical experiences of currency crises are not really applicable because the euro area is an unprecedented construct.

But I am confident that there is the political will in Europe to retain the euro. What we have seen during the crisis is that political efforts rise when the problem grow. What is needed now, however, is for Europe to get ahead of its problems. There is a good argument for closer fiscal cooperation in the form of Eurobonds, though I recognize the political difficulties associated with such a move and indeed some countries have put their face against it. Those who argue against, state that conventional Eurobonds suffer from incentive problems, creating the risk of a future, even larger crisis. However I have seen a proposal in academic discussion which refers to what are called conditional Eurobonds which would meet many of the concerns that opponents to the issuing of Eurobonds presently have and that idea should be pursued at the European political level.

In the near term, the authorities in Europe must boost confidence and restore robust economic growth. Efforts at sorting out the public finances and banking systems across Europe will falter unless economies can be returned to growth. ECB policy will continue to have an important role to play in this regard.

In addition to the willingness of ECB to now lend much greater funding to European banks at low interest rates and for longer periods via their three year Long Term Financing Operations, Europe has now developed a number of key responses including the new fiscal compact with concerns co-ordinated initiatives to ensure Euro member countries reduce structural deficits. Possibly more important is the Euro area government support via the European Financial Stability Facility and the offer of funding to the IMF.

Most significant of all is that European leaders have demonstrated a willingness to take whatever actions are needed to ensure the Euro survives even when this involved reversing previous decisions on "no go" areas. This does not mean that we can have certainty that the future shape of the policies of the Euro will continue to evolve as circumstances dictate. There is also a danger that the measures being undertaken will damage the long term cohesion of the European Union unless policy is very carefully designed.

This raises the issue of what the future Euro will look like. I believe the new phase of the development of the Euro area is likely to involve:

- Much greater fiscal discipline in individual EU countries.
- More integrated financial regulation and a more highly capitalised banking sector.
- Structural changes to bring a fairer distribution of burden sharing of the costs arising from the recent crisis. This may involve new innovative initiatives such as conditional Eurobonds or other ways of balancing country risks and responsibilities. In this context I would urge the international community to support Greece and other countries in difficulty and to ensure that any plans are implementable and provide a basis for legitimate hope for the citizens.
- Fundamental revisions to how bond markets interact with the real economy will I believe also be required as will a reconsideration of the role played by rating agencies.
- Robust mechanisms to deal with any future financial crisis will also be needed.

More significantly and more challenging Europe will need to involve new ways to enhance democratic involvement in European decisions. Both on the burden sharing and on the democratic process I think Europe may be able to learn some lessons from the United States which has the most successful monetary union in economic history.

I, however, believe that the balance of probability is that the Euro and the Eurozone will address its challenges and will remain as one of the most successful economic unions.

FUTURE OF IRELAND WITHIN THE EURO

But most of the real reform is at the domestic level within each Member State. In the end, short of large scale transfers, no country with a debt problem can escape fiscal adjustment; no country with an unemployment problem can find a full solution in an EU measure; and no country with an imbalanced economic structure can deal with it other than by taking the right domestic decisions.

The adjustments that have been required in Ireland have been very painful for many citizens. About €20 billion of budgetary adjustments during our time in office and almost €4 billion in this government's first budget. These adjustments eventually stabilised and then reversed the tide of rising budget deficits. The public recognise that the budgetary position must be returned to balance; otherwise interest payments will command a greater share of tax revenues.

But the road ahead on the budgetary front remains challenging. Another €9 billion in adjustments are planned for the next three years to reduce deficit to 3 percent of GDP by 2015.

Ireland has also made impressive strides in improving competitiveness over the past four years. After seeing reduction in output of almost 15 percent between 2008 and 2010, overall economic activity in Ireland has been roughly flat for the past two-and-a half years, boosted by growing exports, and the tough budgetary policy that halted the contraction in GDP. Ireland is now running a balance of payments surplus, having registered a record trade surplus of €45 billion last year. Inflows of FDI into Ireland remain strong. But the priority has to be to return the economy to robust growth, because only sustainable growth will reduce the unemployment rate.

Ireland's adjustment path and return to markets can be helped by continued restructuring of the banking system. The next reform must involve a deal on the Anglo Irish Bank promissory notes. These were issued to Anglo because the State did not have sufficient cash on hand to recapitalise that bank. We could have tried to raise the funds on the markets by issuing regular government bonds, but the promissory note structure offers two significant advantages. First, we avoided the high interest rates that markets were demanding on Irish government bonds. Instead, Anglo can present the promissory notes at the Central Bank of Ireland and borrow from there at relatively low interests. Second, promissory notes are a form of debt that can be restructured at some future date without running the risk of triggering default clauses in other types of government debt. Had we initially recapitalised Anglo using regular government debt, we would have shut the door on any possible deal on the debt in the future. Last July's revision to the EFSF which allows Member States to borrow for bank recapitalisation purposes opens up new possibilities to refinancing the bank-related debt to the benefit of Ireland. Transfers of certain difficult-to-value long-term loans from going concern banks to the Irish Bank Resolution Corporation (IBRC) would have the dual benefit of providing a sustainable asset base for the IBRC and clearing up other banks' balance sheets.

The Irish economy now has one of the best capitalised banking systems in the world and an improved business environment and enhanced competitiveness. It has world class infrastructure and a highly skilled population. Ireland was one of the first Eurozone countries to recognise the scale of the problems and to take action early on recapitalising the banks and on reducing the fiscal deficit. There are, however, major challenges for our people in tackling unemployment and the legacy of the Euro crisis and the extent of the pain involved for our people should be recognised and Ireland is still hurting badly. All in authority have to take their share of responsibility for our present dilemma, and I, Taoiseach at the time and a former Minister for Finance do so more than most.

Governments make mistakes in good times and in bad times and I and others have apologised for those made by my Government and for previous Governments led by my party. There have been attempts to cast everything we did as errors but I prefer to let history in time analyse the policies and decisions and with the benefit of a longer view to examine and judge on the issues.

I have sought to show at this lecture that the content of policy has to be judged in the context in which it operated and the assumptions that lay behind it. Objective mistakes are readily acknowledged and were the present insights which we have gained in analysing this crisis present at an earlier time we would certainly have not ended up where we are now, though we would still be in a very difficult position given the confluence of all these events coming together simultaneously.

Looking to the future I believe, however, that Ireland is likely to be one of the first Eurozone countries to emerge from this crisis and I believe there is potential for Ireland to return to significant growth.

I believe Ireland is one of the best locations in the world to establish and to grow a business. This is not just rhetoric but is reflected in the rapid on-going overseas investment which is occurring in Ireland. Ireland is not just open for business but as, I believe, any independent assessment would indicate it is among the best places in Europe to start and grow an international business. This will ultimately pay off for our citizens. Indeed all of the fundamental strengths which prior to the crisis meant that Ireland had one of the highest growth rates of GNP per capita among advanced countries for a very long period are still in place and in many respects our advantages have improved in terms of increased cost competitiveness.

We must hope that Europe and Ireland will return to sustainable growth but the process of reform and adjustment will need to continue and problems will arise. The Euro is likely to be different in its institutional arrangements. I also believe Europe will develop into a much more integrated economy with more international controls to minimise the possibility of a similar crisis emerging. How to do this while facilitating the fundamental rights of European countries to choose their own unique and individual paths to development, which is the basis of democracy, will be a major challenge for the current and next generation of world policymakers. Perhaps some of you in the audience today will take up this challenge.

Thank you for your attention.