José Manuel Durão Barroso
President of the European Commission

«Overcoming the crisis: Challenges and opportunities»

European Economic Association Congress
Barcelona
25 August 2009

Ladies and gentlemen,
Minister Castells,
Professor Mas-Colell,
Professor Stern,

It is an honour to be speaking to the European Economic Association today. And it is a pleasure to be back in Barcelona and respond to the invitation of professor Stern, recognised for his efforts on climate change fighting. It is a curious coincidence that I am attending your annual congress for the first time just when the economics profession is coming under scrutiny. Many people – including the British Queen – are asking why you failed to see the crisis coming. Others even argue that you helped to cause it. It seems that mainstream economic models were unable to capture some of the complexities which were necessary to grasp the current crisis.

Yet, the critics have certainly gone too far. Perhaps our perceptions of human behaviour the science of economics were unrealistic. Perhaps we put too much faith in it and failed to understand its inherent limitations. Perhaps, we failed to understand, for example, that economic models, though immensely useful reference tools, are simplifications that may fail, at times, to provide useful approximations to the complexities of human behaviour.

Many economists were concerned about the imbalances in financial markets and the global economy. A few showed remarkable prescience. For example, Robert Shiller, focused on the stock market, in his 2000 book, Irrational Exuberance. In the second edition, published in 2005, he enlarged the book to include an extended discussion on housing markets. Maybe these economists should have been even louder in their warnings. But would they have been listened to? Would the will to act have been found? Was one system of public opinion, our political system, ready to listen?

In the end, the failure to predict and head off the crisis was a collective failure. A failure on the part of economists, but also banks, regulators, supervising and - yes - politicians too.

We have to be modest and try to identify what went wrong.
In any case, it is really not useful to play the 'blame game.' What matters now is that

we all draw the lessons from the crisis and apply them in future.

From what I read, I understand that the crisis has unleashed a great deal of fresh thinking in economics. Macro-economists are apparently re-examining their models. Financial economists are revisiting the influence of incentives on market efficiency.

I am told that there is new research too on policy responses to crises. Research on how to conduct monetary policy when interest rates are close to zero, on interactions between fiscal and monetary policy, and on the effects of fiscal stimulus. Economists are, of course, notorious for disagreeing with each other. As George Bernard Shaw famously said, "If all economists were laid end to end, they would not reach a conclusion." I gather that divisions between macro-economists are now deeper as a result of the crisis than they have been for some time. But this may, of course, be a spur to greater creativity.

I believe that whatever people are now saying about the 'dismal science', we politicians and policy makers will continue to be very dependent on your advice! Indeed, that advice will be more necessary than ever as we face up to the daunting challenges which lie ahead. In facing those challenges, I think we must all show a degree of humility. Recent events have demonstrated that. We should be more cautious in future about making forecasts or setting out policy recommendations.

Ladies and gentlemen,

The crisis poses huge challenges. It also presents us with significant opportunities. Most of the challenges require urgent and decisive action; the opportunities may take longer to harvest. Our short term actions must lay the basis for sustainable and equitable growth in future.

The EU response to the crisis has been very significant – and rightly so. Central banks have cut interest rates to historically low levels, and provided huge amounts of liquidity to the financial system. Some of them have even embarked on non-orthodox measures to provide credit to the economy. European governments have channelled massive support to their banking systems, through guarantees and recapitalisation. Since October 2008, the Commission has approved a total of EUR 3.6 trillion – equivalent to 30.5% of GDP - of State Aid measures to financial institutions. So far, EUR 1.5 trillion (12.6% GDP) have been effectively used under the four main headings of debt guarantees, which account for the largest part of the support; recapitalisation; liquidity support; and the treatment of impaired assets. This has been done in a coordinated fashion, following guidelines issued by the Commission.

As regards the so-called 'real economy', the Commission proposed a European Recovery Plan in November last year, which received full endorsement from the European Council and included a significant and co-ordinated fiscal stimulus. Its implementation is on track. The overall fiscal effort, including automatic stabilisers, will amount to 5-6% GDP in 2009-2010.

This response has avoided a financial meltdown and prevented a major decline in economic activity. Indeed, the Commission's latest estimates show that, while EU GDP continued to decrease in the second quarter of this year, the pace of

contraction slowed. In some countries, GDP data for the second quarter were positive. Nevertheless, and as expected, economic activity will contract this year in the EU. The unemployment rate will reach two digits, and unfortunately will keep on rising, for some time, even once growth has returned. Labour market developments always lag behind those in the economy, both when the economic outlook is deteriorating and when it is recovering. Indeed, unemployment started to increase only in the second part of last year, a good year after the crisis started.
The Commission has been strongly focused on unemployment since the beginning of the crisis. Because also for social reasons, this is the most serious threat we are facing in Europe, it has become our number one priority. The European Recovery Plan includes and advocates measures to maintain and create employment. We have been careful to design these measures so that they are reversible and do not create the wrong incentives.

The recent recovery spots are fragile and do not allow for any complacency. In any case, it is clear that global growth will not return to pre-crisis levels for some time – if at all. Those growth rates – and the economic model behind them – were simply not sustainable. This has been dramatically illustrated by recent events.

With unemployment increasing, investment down and some production capacities destroyed, the crisis will leave the EU with subdued growth potential. So, at macro-economic level, the priority at the current juncture is to continue to sustain overall demand. This means maintaining the monetary policy stance, continuing to implement the European Recovery Plan, and maintaining government support for the banking sector.

It is clearly too early to withdraw support for the economy and the financial sector. Identifying the right time to exit requires deep analytical work. The task is particularly difficult because it relies on the quantification of unobserved variables like potential output and the output gap. In addition, it must be co-ordinated at international level, particularly in the G20, of which the Commission is now a full member and we were in the origins of creating this process at global kevek,

However, we must already prepare our exit strategy. The best course is to provide the support needed today, and commit ourselves to tough targets tomorrow. That way, we can reassure the markets that the entirely warranted increases in government debt will be reversed at some point, without endangering our recovery. Happily, in Europe, we are well placed to do this. Our fiscal policies are well anchored in the revised Stability and Growth Pact, which provides a stable, medium term framework, and is also sufficiently flexible. Most importantly, it provides for flexibility in the setting of deadlines for the correction of excessive deficits.

Due to a combination of cyclical factors and discretionary action, most Member States will have a government deficit well above to 3% of GDP this year, an excessive deficit in the jargon of the Treaty. These deficits must be corrected. But this must done in an intelligent way – using the flexibility allowed by the Pact.

In most cases, bringing the deficit below 3% will take some time. The deadline should not be the same for all Member States, and should aim at avoiding pro-cyclicality, though this may not apply in Member States where the imbalances are such that fiscal adjustment is a matter of urgency. This is the case particularly in those Member States which are receiving Balance of Payments Assistance.

Ladies and gentlemen,

There is also work to do in securing the robustness of the EU financial sector, if we want to restore growth on a durable basis. The first priority is to get bank credit flowing again. In order to lend, banks must be in a sound position. Some will need additional capital. It is vital to know the concrete situation of each bank, in particular the large banking groups with significant cross-border activities, in order to assess whether or not this is the case. The Commission will therefore continue to encourage stress testing for the systemically important banks. Stress tests should be based on commonly agreed EU parameters so that the results are comparable. It will then be up to Member States to decide what to do with the results of the stress tests.

Stress tests are not a panacea. As important is to deal rapidly with the impaired assets on banks' balance sheets, in cases where this is relevant. The Commission issued guidelines on this. Interestingly, however, only a few Member States have made use of them. This suggests that impaired assets are not, in fact, a widespread problem in the EU.

The second priority is to make sure that those banks receiving assistance will be viable once public support is withdrawn. Bank restructuring must be carried out in a way that ensures financial stability while maintaining a level playing field. The Commission will not abdicate its responsibility for the implementation of European competition law.

As I have said, the priority is to restore growth. For now, and for some time to come, we are relying on the significant stimulus given by macro-economic policy instruments. But that cannot go on indefinitely. As I have indicated, we are already preparing our exit strategy.

The point is that the usefulness of these macro-instruments will inevitably become exhausted. Indeed, they may at some point become harmful. Such policies can be compared to an additive to the fuel of a car engine. Yes, the additive helps the car to move, and move more quickly. But too much of the additive will damage the engine.

So, at some point, new sources of growth will have to take the relay. Let me briefly outline some of these:

- First of all it is critical to open and develop markets and investment regimes: as the world's largest exporter, the EU has an interest in fighting for open markets and investment regimes. Yet, at the same time, we must be ready defend our interests. In many cases, it is non-tariff barriers which are the major barrier to EU exports. So, we will push for greater regulatory co-operation with our main trading partners;

- We need to re-visit the single market; it is our greatest asset, but it is still not complete and we are still not exploiting its full potential;

- Another important point are the networks of the future: all Europeans must have access to high speed broadband; and a secure energy supply and good inter-connections are essential to power growth. The Baltic interconnectors and the Nabucco pipeline projects have shown what can be achieved; we need to see these initiative through to completion and launch others;

• A deep overhaul of our innovation policies: among other things, we must harnesses the power of government procurement and set out a new intellectual property strategy;

• An even greater emphasis on skills is important: The crisis will change Europe's labour market a great deal. Some industries and sectors will decline. We will have to ensure a smooth restructuring process, and help people to move into different sectors. The investments we will be making to create a green economy will also create new, green jobs. Meanwhile, the ageing of our population will create more so-called "white jobs" – caring for older people – and indeed children – as more and more women enter the labour force. Our task is to ensure that people have the skills they need to move into some of these jobs. They must be prepared for the jobs of tomorrow – not the jobs of yesterday.

• Ensuring a smooth transition to the low carbon, resource-efficient economy. This is a great opportunity, not a problem but a chance. This means maximising the opportunities for business. And making sure that our environmental policies take account of the situation of European industry and its capacity to adjust. We need more industry determined, applied research to bring new, cutting edge products and clean technologies to market. I am delighted that Professor Mas-Collel is here today. He has just taken up the position of Secretary General of the European Research Council (ERC). We created the ERC in 2007 as part of our common European Research Area. It has already acquired an admirable reputation for funding excellence and making funding available for blue sky research. I wish Professor Mas-Collel the very best in his new functions. I think that one of the sectors we have to invest more is precisely research and innovation.

• Finally, improving the quality of public expenditure could be a key growth factor. With reduced resources coming from financial markets, governments may have to step up growth enhancing expenditures. Yet, at the same time, they will be subject to severe constraints themselves. Prioritisation will be paramount. So, I believe that there may be a case for extending the surveillance under the Stability and Growth Pact to include an assessment of both expenditure and taxation to see whether they are sufficiently growth friendly.

Ladies and gentlemen,

Managing the crisis, preparing to exit from it, restoring growth built on a new, more sustainable paradigm: this is the outline of my economic thinking. I am profoundly confident about Europe's prospects. Not just because of our immense strengths: our stable democracies; our single market; our successful single currency and so on. Not just because of everything we have achieved in the past five years, namely making a success of the biggest enlargement in our history and becoming the first region in the world to implement far-reaching, legally binding energy and climate change targets.

But because, in a strange way, I think that we have been strengthened by the crisis. It has taught us just how interdependent our economies are at European and gobal level. We now know that, to safeguard our prosperity, we must co-ordinate our policies better and earlier in future. We have emerged with a renewed sense of purpose. I believe that we will now go from strength to strength and that, with resolve and imagine, Europe will be a leading player in the 21st century economy.

Thank you.