Destructive Creations:
Lessons from the Financial Crisis and the Future of Europe

Presentation by Josef Ackermann
Chairman of the Board, Bank of Cyprus

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Introduction

Dear Members of the Executive Committee of the LSE Alumni Association,
Distinguished Guests,
Dear Colleagues,
Ladies and Gentlemen,

Thank you Mr. Sarris for your kind introductory remarks.

I would like to extent my thanks to Takis Taoushianis and the other members of the Executive Committee of the Cyprus LSE Alumni Association for inviting me to make a presentation to their members and other special guests.

I have accepted this invitation with great pleasure, for a number of reasons.

First, it is of course very difficult to say no to an invitation from a then fellow Chairman of the Board of the second largest bank in Cyprus!

Second, I welcome the opportunity to address an audience of economists, accountants, analysts and other professionals on an issue of broader common interest.

Professionals, play a vital role in every modern democratic society. As they tend to be well informed and technically trained, they are normally expected to serve as the main sounding board for analyzing, assessing, and criticizing constructively existing policies and developments in all fields of public policy. At the same time, they can contribute to or initiate new ideas or approaches to help address and hopefully solve some of the more challenging problems facing the society.

I am pleased to note that the LSE Alumni Association, as well other similar Alumni Associations and professional bodies in Cyprus, are indeed very active in doing that. I very much hope they will continue and even intensify these valuable efforts.

In this context, one of the things that impressed me when I first came to Cyprus was the high value and priority attached to education by every Cypriot family and the high scores that Cyprus has achieved in this area. According to Eurostat, Cyprus ranks as the third highest in the European Union in terms of the proportion of the population aged 15-64 with tertiary education, at 37.4% in 2016. It is no accident that professional services are such a thriving sector of

economic activity in Cyprus, accounting, together with information, financial, education, health services and arts, for more than half of gross value added in 2016.

University graduates are engaged throughout the Cypriot economy in large numbers, adding to productivity growth. Within the Bank of Cyprus itself, almost 52% of all employees in Cyprus have a university degree, of whom more than a third has a post-graduate degree. This is very impressive by European standards.

A few of these employees are, not surprisingly, LSE graduates. But the relations between LSE Alumni and the Bank of Cyprus are even closer. The father of the Chairman of the LSE Alumni Association, Mr. Michael Colokassides, who I understand is the oldest living LSE graduate in Cyprus, served as part of his distinguished career for three years as Governor of the Bank of Cyprus during the late 1970s. Similarly, Takis Taoushianis has served for a months as member of the Board of Directors of the Bank of Cyprus. Also, Michael Sarris was a member of the Bank's Economics Department in the early 1970s. One current member of the Board, Chris Patsalides, has a PhD in Economics from LSE, and so also does my Senior Advisor, Mikis Hadjimichael. I myself was a visiting Professor of Finance at LSE in the early 2000s.

Main Presentation

With this brief introduction, I would like now to begin the main part of my presentation to you this evening.

In my presentation, I will try to combine two subjects that are very important to me: the global financial system and the future of Europe. The title of my presentation is "Destructive Creations: Lessons from the Financial Crisis and the Future of Europe." Before concluding, I will also make some brief remarks about Cyprus.

Some of you may be wondering about the title of my presentation: Why "Destructive Creations?"

I'm sure you are all familiar with Josef Schumpeter's term "**creative destruction,**" which refers to the power that businesses have to drive growth and progress through innovation – by replacing traditional products, production methods, services and general economic processes with new and improved ones.

I have taken liberties with Schumpeter's term in my presentation to show, through the examples of the financial crisis and developments in Europe, that the consequences of creative destruction are not always uniformly positive and don't necessarily qualify as progress; in many cases creative destruction actually has the potential to produce "**destructive creations.**"

The recent financial crisis and the problems that the EU, and especially the Eurozone, has struggled with for years provide plenty of evidence for this. If we want to secure genuine progress for the financial system and Europe, we must learn the right lessons from these struggles.

Only if the members of the EU, and especially of the Economic and Monetary Union, muster the collective courage to identify and acknowledge the deficiencies of these major political innovations will they be in a position to correct them. Only then will they be able to prevent the great European project, which, taken as a whole and despite all the deficiencies, is still an example of positive creative destruction, from ultimately becoming a destructive creation.

But before we get ahead of ourselves, let's turn first to the lessons from the global financial crisis:

1) The lessons from the financial crisis

Before we can draw the right lessons from the financial crisis, we first need to agree on what the main causes of the crisis were.

You will be familiar with the answer most commonly cited by the media and the politically minded public: **greedy bankers**. Nonetheless, it is interesting to note that prior to the crisis there were very few complaints or concerns about the banking system and the financial sector in general in the US and Europe.

There's no doubt that the bankers have played their part in the crisis; but the greedy bankers answer doesn't go anywhere near far enough, and it completely fails to acknowledge the historical background to the crisis. Anyone who is happy with that answer alone will learn very little from this piece of financial history.

The crisis had **multiple causes** and many actors were involved:

- **governments** (which were happy to see an expansion of home ownership, especially in the US),

- **central banks** (and their loose monetary policies, especially in the US, which resulted in low risk premiums), and

- **financial regulators** (who failed to provide the macro-prudential supervision to control risks within individual financial institutions, or halt the growth and spread of these risks throughout the whole system).

- Then there were the **rating agencies** (and the obvious conflict of interest that comes from being paid by the banks),

- **investors** (who were chasing high yields) and,

- last but not least of course, my own industry, the **banks**.

I am sure you all know the **banks**' **main deficiencies**. They're easy to summarize:

- false incentives created by remuneration systems focused excessively on the short term;
- too high an appetite for risk, given the banks' limited ability to actually cope with these risks in an emergency;
- too little (hard) equity capital, or its mirror image, too much leverage, often exacerbated by off-balance sheet special purpose vehicles;
- inadequate risk models and weak risk control;
- excessively short-term, volatile financing; and
- drying up of market liquidity, which led to price collapses and substantial losses.

I could go on. But there's a danger of **not being able to see the wood for the trees**; because there was something else at play, more important than all the deficiencies I have listed, namely:

> The great creative destruction within the financial industry that was caused by the **securitization and atomization or slicing of loans and other financial products**

This was generally regarded before the crisis as a big step forward – one that encouraged economic growth and made the financial system more stable-- which was true, at least in principle.

Structured products and derivatives could be used to separate the risks from the loans and other credit products and spread the risk burden across many shoulders all over the world. The more people carrying the load, the heavier the load that can be carried. And we all assumed that everyone would only take on as much risk as they could sensibly bear.

But as the crisis showed, some took on way much more risk. Other market players couldn't know this, because the creative destroyers, while they may have been innovative, neglected to ensure the **transparency** required for the safe functioning of the new system. Neither the participants nor the regulators had an overview of where much of the risk finally ended up; or of how destructive this lack of transparency would be for the whole system now that everyone was so much more interlinked with everyone else.

Market players and regulators also failed to see that the systemic change toward securitization came hand in hand with a profound cultural change: banks, which had previously functioned as trustees, turned more and more into traders.

The banks' traditional core tasks of providing efficient payment services and transforming savings into productive investments slipped further and further into the background. Banks became increasingly distant from their role of serving the real economy and their customers, and they started doing more and more proprietary business with each other or with other market participants. To some extent, the financial system became self-referential.

For example, by 2006, the year before the financial crisis broke out, the global volume of financial assets had swollen to four times the size of real economic output in key advanced countries.

In summary, the creative destruction of securitization had enormous unintended consequences that transformed it into a destructive creation. The resulting significant losses led to systemic risks that required a systemic response.

So for me, the **most important lesson from the financial crisis** is this:

Creative destruction can only be classified as progress if it **proves itself in practice** and in times of crisis.

The innovators cannot always foresee and think through all the eventualities; indeed, an attempt to do so would slow progress to a snail's pace. So, it is incumbent on everyone involved in implementing major innovations to work carefully and prudently until the practical implications become clear. Above all, they must take great care to ensure that the consequences of the innovation are properly **transparent**, so that any undesirable developments or features can be corrected quickly.

In my personal experience, the banking regulators in particular have successfully tried to draw the **right lessons** from the financial crisis, and are now regulating the banks much more strictly. More specifically, they are demanding much more transparency than before. And thanks to their macro-prudential supervision, not only of individual institutions, but also of the ways these institutions are linked to each other and to the financial system as a whole, regulators are creating much more transparency about the interlinkages between different markets. In addition, the regulatory environment – particularly with regard to capital and refinancing structures – has been toughened up, which has made the banks more resilient. Yet, regulators face the challenge of maintaining an appropriate balance between micro-prudential requirements on banks with macro-prudential considerations. This is rather difficult in practice, especially across countries facing different economic conditions, an issue that it is in fact quite relevant for Cypriot banks at present. Moreover, given the radical and far-reaching nature of the regulatory changes that have been introduced in recent years, a pause in new reforms is needed to give banks and financial markets adequate time to digest the regulatory changes and thus reduce and hopefully eliminate regulatory uncertainty.

As long as a regulatory level playing field is maintained globally, the new tough regulatory reforms are all entirely positive. I believe it is negative, however, that Europe has failed to use the crisis to clean up and consolidate its banking market. The Americans did do this, and as a result their banks are now way ahead of the European banks in terms of profits and international competitiveness.

2) The sovereign debt crisis in the Eurozone as an extension of the financial crisis

The second conclusion I would draw is that the sovereign debt crisis in Europe was an extension of the financial crisis.

The deep recession triggered by the financial crisis led to lower tax revenues and higher welfare spending. This in turn created a **fiscal crisis** in poorly performing European countries. The process was exacerbated as, instead of being wound up at the expense of creditors, ailing banks were bailed out, except of course in Cyprus for which I will comment later, using taxpayers' money, or transitioned over to "bad banks." Given the sovereign debt crisis in Europe at the time, the authorities no doubt had their hands full rescuing defaulting countries and the European currency.

Increased government debt prompted the rating agencies to downgrade the states concerned. The resulting doubt about the creditworthiness of government bonds led in turn to uncertainty about bank balance sheets, which to a large extent were, and still are, made up of such bonds. A vicious circle.

The systemic stress that the financial crisis caused, especially for the innovation known as the Economic and Monetary Union, exposed a number of serious structural faults. It became apparent that, with the benefit of hindsight, the EMU had been designed as a **fair-weather arrangement**.

The crisis exposed a lack of shared tools for the orderly management of banking crises. The dissimilar approaches adopted by individual governments increased the general uncertainty, because investors no longer knew what to expect or how to assess risks.

Neither did the EMU have common appropriate tools to cope with over-indebted states. There was no financing mechanism to prevent state bankruptcy, and there is still today no insolvency mechanism for member states.

Under the pressure of events, the crisis had to be combated on an *ad hoc* basis with a laborious and time-consuming mixture of rescheduling, voluntary debt waivers, more or less traditional IMF programs and new multilateral funding mechanisms created by the EU states, including the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM).

Last but not least, the **zero-risk weighting of government bonds** within the banks' balance sheets proved to be destructive, not only making it easier for governments to borrow more, but also forging a two-way link between the stability of banks and the stability of states. The creators of the EMU should

have thought about this – and taken steps to avoid it – when they founded the system.

3) Loss of confidence in Europe

Another conclusion I would draw is that the European sovereign debt crisis has had a devastating effect on European citizens' confidence in the future of the European currency and of the EU as a whole.

To be fair, quite a lot has been done to put in place a common EU institutional framework, which has proven instrumental in ensuring uniformity and promoting policy action through peer pressure. However, it could be argued that Brussels has neglected the principle of **subsidiarity**, and as a consequence the European project had already lost much of its former appeal. Instead of focusing from the start on things that are best governed jointly – such as foreign and defense policy, infrastructure, immigration and the fight against terrorism – and leaving the individual member states to take care of things best left to national governments, the EU bureaucracy got bogged down in countless detailed measures in a rather too broad range of areas, interfering in member state policies in all areas of life.

Over the years, European citizens have begun to regard the EU as a **cumbersome Leviathan**, made even more unpopular by the fact that it didn't even have the **democratic legitimacy** that a national government can claim.

Recently, the issue of **immigration** has given us a stark reminder that the wrong priorities that had been set when the House of Europe was built. There is no effective common protection of the EU's external borders, and there is still no durable agreement on how exactly to deal with migrants coming into the EU, or how to share them between individual member states.

These deficiencies have led to a **strengthening of anti-European forces** and to **Brexit**. They threaten to turn the creative destruction of the EU into a destructive creation, to drag Europe back to the age of national states, and thus to sink it into global irrelevance.

4) Is confidence returning?

The question that arises more recently is whether confidence in the European Union is returning. Since the Brexit vote, EU citizens have regained some of their faith in the Union. In recent elections in the Netherlands and especially

France, nationalist conservatives and Eurosceptic forces failed to make a breakthrough. But, more recently, major gains have been made by such forces in Germany and Austria.

Brexit has prompted the remaining countries to draw closer together again. The far-reaching, almost incalculable consequences of withdrawal, which are becoming increasingly clear to the British and to people throughout Europe, seem to be acting as a deterrent, at least for now.

Many citizens are dissatisfied with the current state of the EU and the Eurozone, but instinctively sense that the nation state of the past does not offer a sensible alternative in the modern world.

Since the immigration crisis at the end of 2015, the number of **immigrants** has declined significantly, taking some of the heat out of discussions about the EU's shortcomings in this area.

The chauvinist stance of the new **US administration** has also helped dampen centrifugal forces within Europe.

We also know from experience that it takes an average of seven years to get over an economic crisis caused by over-indebtedness. We have now reached the seven-year point. The **sentiment indicators** for consumers and businesses are pointing clearly upward again, even reaching record levels in core Europe.

The **European Central Bank's** quantitative easing (QE) **policy** has stabilized the EU's markets and member countries, giving national governments breathing space to make the necessary reforms and, thanks to lower interest rates, providing governments and businesses with financial room for maneuver.

Most of the former **crisis countries** – in particular, Ireland, Portugal, Cyprus and Spain – seem to have put the worst behind them. I am also pleased to note that Greece as well seems now to have consolidated its fiscal position, it has made a return to capital markets, and is projected to return to positive economic growth.

Partly because of the **depreciation of the euro** over recent years, the EU as a whole is currently posting a strong economic growth.

Last but not least, the EU has at least started to correct some of the deficiencies, particularly in the financial sector, that were exposed by the sovereign debt crisis.

For example, it has established a common **European Banking Authority**, which is less susceptible to national banking interests and which imposes common standards. And there is now, at least in principle, a common legal framework for **winding up banks:** the Bank Restructuring and Resolution Directive.

5) Further major challenges

However, these lighter skies could quickly turn stormy again. Major challenges remain for the EU to overcome.

First, the issues of **migration** and the joint defense of the EU's external borders remain unresolved. There is still no common program to combat the factors that cause people to migrate away from their home countries in the first place. The EU's **agricultural policy** subsidizes European and especially French farmers, and in so doing it removes the opportunity for many farmers in poorer countries to make a living for themselves and their families. This issue has hardly been raised at all in the debate on how to counter the causes of migration. President Macron has skillfully distracted attention from the problem by taking a leading role in setting up refugee camps in the Maghreb states of North Africa.

Second, low growth has also made it impossible for the Italian government to reduce its large national debt, which is equivalent to 130 percent of GDP, or even just to make it more sustainable. Italy's primary budget surplus, which has long been one of its strengths, is declining. Any hope that parliamentary elections, which must be held by May 2018 at the latest, will bring an improvement is unrealistic. The anti-European left and the Five Star movement are currently polling at about 30 percent.

If it falters, Italy, unlike Cyprus, Greece or Portugal, is "too big to save". An **Italexit** would undoubtedly deliver a severe blow to the EU project.

Third, if President Macron fails to implement the long-overdue national structural reforms he has announced in **France**, the anti-EU National Front will gain new impetus, putting the survival of the whole European Union at risk. The new President's initial high popularity ratings have fluctuated dramatically in just a few months.

Fourth, so far, or at least until last week when a preliminary agreement was reached on three key issues, **Brexit negotiations** and the whole process of Britain withdrawing from the EU have been highly disordered, and might still lead to major upheavals. It seems at the moment that London is leaning towards a soft Brexit with a transition period, but the dynamics of the negotiations are hard to read. It is not impossible that they would end in a confrontational divorce. While the substantive Brexit negotiations are still at an early stage, care should be taken by all parties involved to ensure that short-term urges to punish the UK and impose heavy financial and adjustment burdens for abandoning the union, are balanced against the long-term benefits of maintaining close collaboration between the UK and the rest of Europe in the trade, financial, cultural, defense and political fields.

As a result of Brexit, the EU budget will be reduced by 10 billion euros (approximately by 7 percent) in the next budget period, which is likely to trigger a **new dispute over money** within the Union. The net contributing nations would hardly be willing to pay the difference, while the net recipients would be reluctant to abandon their cherished subsidies.

Fifth, further great uncertainty stems from the question of the **ECB** bringing an end to its low interest rate policy. Quantitative easing gave the Eurozone breathing space, which its members have used, to a greater or lesser extent, to initiate reforms. Yet, there is some concern that the low interest rate policy by the ECB and other major central banks has boosted unduly asset prices and has compressed bond yields. In this context, the ECB is now faced with the challenge of finding a smooth exit from its easy money policy. If this goes wrong, there is a danger of rates rising so fast that countries with funding problems could quickly find themselves in trouble again.

And finally, there is the still-unresolved problem of high unemployment – particularly **youth unemployment**. The lost decade of virtually zero growth since the financial crisis has exacerbated this problem.

Overall, EU unemployment currently stands at 8 percent; but for those under 25 years of age the jobless rate is 17 percent. In France it is 23 percent, in Italy 36 percent and in Spain 39 percent. In Greece, it is even higher. Large swathes of European youth are being deprived of their life chances. For them, the creative destruction of the EU is more of a destructive creation. This is a time bomb ticking away at the heart of Europe; if it is not defused soon, it might only spell trouble for Europe’s future.

6) Two ways out of the crisis

So, what should we do?

There are basically **two ways** of remedying these problems.

In broad terms, one is **deeper integration**; the other one is **greater self-responsibility by member states**.

The route to the first solution is sketched out in a "White Paper on the Future of Europe" published by the European Commission in March this year, and in the "Five Presidents' Report" to the European Council on completing Europe's Economic and Monetary Union (these presidents being Juncker, Tusk, Dijsselbloem, Draghi and Schulz). Ultimately, it boils down to a **renegotiation of the European treaties**.

With the election of Emmanuel Macron and the reelection of Angela Merkel, even though Germany has still to form a government after the September elections, many European politicians expect Germany and France to start a joint initiative in this direction.

But wholesale renegotiation of the European treaties is unlikely.

- For a start, any treaty change is only possible by unanimous consent. Given the conflicts of interests that exist within the EMU, this is a big ask.

- It is also unlikely that the French president will want to tackle the roots of the EMU's **basic problem**: namely, the huge divergence in the competitiveness of individual member states. He is unlikely to have an appetite for the only sustainable solution to this, which is for the countries that lag behind to grow their way out of trouble and catch up with the better-performing countries. To do this, they would have to undertake painful structural reforms, including wage restraint, liberalization of their labor markets, making conditions attractive for investors, dismantling the excesses of the welfare state and reducing the cost of bureaucracy, etc. Macron does not seem to be in favor of a rigorous return to Maastricht or to strict market-driven, stability-focused economic and financial policies in each member country.

- It would also appear that President Macron is much more interested in a **redistribution** from the north to the south, and ultimately wants to turn the EMU into a transfer union, in which the northern countries have to subsidize the southern ones on a permanent basis, with Germany in particular being asked to pay even more than in the past. For example, Macron would prefer to see Eurobonds, i.e. shared bonds with joint liability by all Eurozone states, a communal takeover of existing non-performing loans to clean up the banking system, a common deposit guarantee scheme for the Eurozone, a common unemployment insurance scheme and a genuine budget for the EU, including tax-raising powers and a European finance minister.

- However, a **European finance ministry** with its own budget and powers to interfere in national finances seems unrealistic.

Both things would require parliamentary control. The idea of an "EMU Chamber" has already been discussed by the European Parliament, but the majority of seats in this chamber would go to countries with below-average incomes. This wouldn't make it any easier for the wealthy northern states to warm up to the idea.

And Germany could only compromise its **budgetary and fiscal sovereignty** if its citizens agreed to this in a referendum and amended its constitution – which is extremely unlikely.

Germany and the fiscally conservative Baltic states--Austria, the Netherlands, Finland, Ireland and Spain--may possibly approve of an EMU finance ministry that has a very limited budget, but which would police compliance with the rules of the stability pact more rigorously than the Commission has done. But this would in turn be unattractive to the other states.

- A **common assumption of debt liability** through the issuance of Eurobonds would also be problematic. Firstly, it would require a solution for the legacy government debts and bank loans, because a pan-European regime could only get started once all national banking systems had wiped their slates clean. In other words, the risks have to be reduced before they can be shared. The moral hazard risk that some member states might tend to have larger-than-otherwise fiscal deficits as the funding costs would be shared would still be there. Secondly, the zero-risk weighting of government bonds in bank balance sheets would have to come to an end, which would lead to a sharp increase in the cost of financing for weaker EU countries.

Neither prerequisite is likely to be fulfilled.

Another solution to the EMU's fundamental problem of its members' different levels of competitiveness has been proposed, but it is equally unrealistic. This suggestion is that free-floating parallel national **currencies** could be established alongside the euro for a transitional period, so that less competitive countries can catch up more easily. At some point these countries should then re-enter the EMU at their parallel currencies' exchange rates, which should reflect the level of competitiveness each country would achieve by that point.

Firstly, however, this would require capital controls for as long as the parallel currencies existed. Secondly, the associated political and economic costs would be too high for just about any government to accept.

If Europe does not find a way to change, it will probably continue on a course characterized by **muddling through** and easy compromises. Initiatives to strengthen the EU are likely to be limited mainly to

- More cooperation on **defense and security**
- Expansion of the European Investment Program on the basis of the existing **European Fund for Strategic Investments**
- A **European Capital Market Union**. Brexit and the (partial) relocation of business from London will help here.
- An expansion of the **European Stability Mechanism** into a European Monetary Fund. This would take the place of the unloved IMF in the Eurozone and demonstrate European autonomy and solidarity. But it won't be easy to get agreement on what powers this Monetary Fund should have to intervene in the affairs of countries that get into difficulty.
- It may also be possible to supplement the common European monetary policy and to better control overall economic demand with a **limited EU budget**.

These emerging redesigns and new structures would represent an improvement on the current situation, but I fear that **business as usual** will not be enough this time for Europe to cope with the enormous challenges it faces.

For Britain, departure from the European family represents a **fundamental shock**. I don't get the impression that this is sufficiently clear to all the responsible people. The least you can say is that there is little evidence of the **strong leadership** required at a time like this.

I believe that Europe has returned to day-to-day business much too quickly after the Brexit vote. Yet, in economic terms, Britain's exit is equivalent to the exit of 19 to 20 of the EU's other 28 members.

As well as leading to the loss of a large part of its economic and therefore political and cultural weight, the EU's **internal balance of power** has also been disrupted by Brexit.

Until now, the core group of countries committed to the market economy and stability – Germany, Austria, the Netherlands, Finland and the UK – accounted for 35 percent of the EU's population. According to the Treaty of Nice, this is exactly the percentage required to avoid being outvoted in the European Council. The grouping of southern countries also had a blocking minority of 38 percent, which meant both sides were **forced to cooperate** and compromise.

Without Britain, the group around Germany is reduced to only 25 percent. So it can be overruled, putting the balance that is essential for unity in serious danger. This is another factor that threatens to weaken the future dynamism of the EU, or even sow the seeds of division.

Ladies and gentlemen, when the EU celebrated its 50th anniversary in 2007, it did so under the subtle slogan **"we have united for the better."** On one level, this simply expresses gratitude for the reconciliation of European peoples and states. On another level, however, it serves as a warning: "If we want to be happy, we need to be united."

And this is true. But unity does not necessarily mean more integration and greater centralization in Brussels, be it only piecemeal.

I believe that at this stage conditions are not ripe for pushing ahead for greater integration. This would be the wrong or premature path to choose. It would lead to a **dead end,** firstly, because it does not take sufficient account of our continent's **diversity** which is at once its weakness and its strength. And secondly, because it would be a **technocratic route** – one that does not involve the citizens of Europe enough and that does not offer any answer to the existing democratic deficit.

In my view, Europe can only have a positive future if it adopts the **second fundamental way** of solving its problems, the way of **subsidiarity**, **self-discipline** and **responsibility**. An effective implementation or adherence to this

approach would form the basis for facilitating down the line greater integration once broad political support and solidarity among member states is established.

At heart, the second approach is the principle that also unites **Switzerland**.

E pluribus unum – out of many one – is the wrong recipe for our continent. Europe must be united on the basis of *concordia in varietate*: **united in diversity**.

In other words, there has to be an agreement that the collective is best served when all the participating individual states live up to their responsibilities, do the hard work required and **accept liability** for their own failings.

And this is where we come back to the financial crisis. Like the financial crisis, the crisis afflicting the EU and the EMU has its roots in a violation of the **principle of taking responsibility for oneself and accepting liability for one's mistakes.**

If the banks had only loaded themselves up with as much as they **themselves** could still carry in the worst-case scenario, the financial crisis would not have occurred. The same can be said of the EMU's member states and the European debt crisis.

In the case of the banks, it was possible to violate the principle partly because, as I said at the start, there was insufficient market transparency, and partly because even if the worst came to the worst, the larger **banks** thought that they at least could count on being **rescued by the state**.

In the case of the European sovereign debt crisis, transparency wasn't such an issue, but the individual countries could be similarly confident that the Union would bail them out.

This is exactly what the financial markets were thinking too. With no exit rules in place and with countries continuing to disregard Maastricht, the markets assumed that individual **country risks** in the EMU would be **communalized. As a consequence, they** gravitated to just one more or less uniform interest rate on government bonds for all member states, virtually eliminating the spreads over German bonds, which was far too low to reflect the problem countries' true financial strength. This encouraged these countries to take on even more debt, thus virtually setting up the EMU for failure.

The theoretical policy recipe for an optimal common currency area that calls for the formation of a fiscal union and a political union may not be practical or desirable when member countries do not play by the rules or do not help themselves, and seem instead to push for a transfer union and impose sacrifices on other members.

Some Eurozone member states seem also to have ignored the discipline rule of a common currency area that requires members to contain the expansion of their wage and other cost structures to avoid a worsening in their competiveness, as the exchange rate instrument can no longer be used. Instead, they continued prior to the crisis the past practice of tolerating excessive cost increases which used to be corrected by periodic exchange rate devaluations prior to the EMU.

If the EMU had stuck strictly and credibly to the Maastricht rules, maintained a no-bail-out policy and upheld the principles of responsibility, self-discipline and liability for one's own mistakes, member countries that needed to make up ground would have had to put in the hard work if they wanted to remain members of the Union.

This would also have done a lot to remove the problem caused by zero-risk weighting for government bonds in bank risk-weighted assets, and strengthened the banking sector in Europe.

For all the skepticism, I am heartened by the fact that several countries in the EMU have successfully adopted this course in recent years.

The lack of adequate discipline and observance of the EMU rules may have contributed to the reluctance of the member states that observed the rules, the core or surplus countries in the EMU, to engage voluntarily in more expansionary policies than otherwise would have been the case to ease the adjustment burden of the deficit countries that were forced by market forces and their adjustment programs to undertake painful corrective policies.

In a sense, this is the most challenging part of a common currency area. How to encourage symmetric adjustment in case of exogenous or policy induced asymmetric shocks. Under these circumstances, the deficit countries are forced to adjust, but the surplus countries are not obliged to do so. The latter countries' room of maneuver also depends on their available fiscal space and the political flexibility to modify their desired policy settings to help assist

countries that through their policy mistakes have brought upon themselves and the common currency area major distortions and financial crises.

Having said that, I believe that there is some scope for the core EMU countries that have fiscal space, such as Germany which has enormous excess savings relative to its investment, to consider measures to expand their public and private investment so as to accelerate further output growth, with positive spillover effects for the rest of the EU and the global economy in general. Similarly, EMU countries that are more advanced in their cyclical economic position would need to accept the need for national inflation rates that are higher than the ECB target of close to 2% for the EMU as a whole, given that deficit countries continue to experience low or even negative inflation rates. This would also facilitate an earlier exit from the ECB's low interest policy and the QE program.

As the Eurozone is now experiencing stronger economic growth and the output gaps are being reduced, it is also of great importance that member countries gradually rebuild fiscal space so as to be able to help fight any future financial crisis. But also, it should now be politically easier to step up the introduction and implementation of the needed structural reforms to strengthen the productive potential of their economies.

Some Comments on Cyprus

Ladies and Gentlemen,

You may well be wondering how my analysis and recommendations affect Cyprus, or how one can objectively assess the experience with Cyprus' economic and financial crisis.

This would be a toll order to do full justice in the few minutes I have left. But as you may have realized, many of the points that I have made apply also to Cyprus.

In a nutshell, Cyprus' crisis was both a banking crisis and a fiscal crisis in its origin. As we all know very well, mistakes had been made in managing credit risks and adhering to prudent governance structures in the banking system, bank supervision was weak, fiscal imbalances were allowed to build up along with high cost structures, and long delays had been experienced in applying and agreeing to an early adjustment program on more reasonable terms. As a result, partly because of the impact of bank problems on sovereign ratings,

Cyprus lost market access in May 2011. By March 2013, Cyprus was no longer posing systemic risks for the EMU and the appetite for large bailouts had evaporated. Cyprus was thus forced by the new realities to accept a bailing in along the broad lines of the Bank Resolution and Recovery Directive that was under discussion, a process that has left many scars and has caused so much pain.

It can be argued that the creative destruction of Cyprus' offshore financial center business model in its original form that allowed a buildup of bank deposits and assets of up to 9 times GDP turned into Cyprus' version of a destructive creation. This was due to the underestimation of the gravity of the government contingent deposit guarantee liabilities, the underestimation of Greece's sovereign risks and the risks of a domestic credit and housing bubble, and the inattention to rigorous supervision and bank risk controls and governance structures.

Yet, much has been achieved since then, thanks to the sacrifices of the Cypriot people, the consistent implementation by the authorities of appropriate policies, and in part exogenous positive factors. In addition, major reforms in the banking system have been put in place, including appropriate risk controls, strengthened governance structures, an enhanced regulatory framework and tough supervision. Growth has returned and is gaining momentum, and enormous strides have been made in restoring confidence in the banking system and lowering non-performing loans from record high levels.

The Bank of Cyprus has played its part in the process, and we are proud by what has been achieved in just four years, especially if one recognizes that in March 2013 the Bank of Cyprus came very close to sharing the fate of Laiki Bank. Despite some concerns that have surfaced about the changing composition of the Bank's shareholders and of Board members and their ultimate objectives, the Bank of Cyprus has actually become more Cyprus focused than prior to the crisis, as the Bank's adventures in Eastern Europe or even Greece have been unwound.

But there is no room for complacency for anyone. We all have to do more. To use the language I have used in my analysis so far, we have to strengthen our discipline and play by the rules of the EMU. The government has to maintain fiscal discipline and build the necessary political consensus to promote the needed additional structural reforms that would improve the business environment, improve competitiveness, protect property rights through legal and other reforms, and thus stimulate a broadening of the output growth base.

The banks have to pursue further refinements of their business models and intensify theirs efforts to lower NPEs. The Cypriot society needs to avoid populist approaches and weak support for the principle of respecting one's financial and contractual obligations. Together we can make a big difference.

Conclusion

Ladies and Gentlemen,

Taking everything together, I believe it's still too early to say for sure whether future generations will regard the EU and the EMU as examples of creative destruction, or as destructive creations.

What is already certain, however, is that if the latter were true, it would be a catastrophe of historic proportions for Europe. Because it would mean that the **continent of enlightenment and industrialization**, the **birthplace of western culture** would in global terms, and especially in comparison to the major players – the United States and China – sink into **insignificance**.

We should not forget how the EU started. In the aftermath of the two world wars, courageous and far-sighted French and German leaders saw the need to unite Europe to help avoid new wars among European nations. These efforts were enhanced over time into more ambitious economic and political undertakings. Europe has gained a considerable collective voice and economic and negotiating power. We would lose all that to other existing economic powers if we led Europe return to individual states.

Yes, Europe is condemned to be united for the better. After Brexit, this is truer than ever. But what it really needs is not so much institutional unity through a premature rush to even greater integration, but more a unity built on common ideals.

Thank you very much for your attention.