Gertrude Tumpel-Gugerell: Policy challenges facing the euro area

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the Distinguished Speaker Seminar, European Economic and Financial Centre, London, 23 July 2010.

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Ladies and Gentlemen,

It is a great honour for me to have been invited to speak here today by the European Economic and Financial Centre.

My topic today will be the policy challenges facing the euro area, which is a rich topic: in fact, there is no shortage of challenges for us. What started as financial turmoil in August 2007 turned into a global financial crisis following the failure of Lehman Brothers in September 2008. More recently we have witnessed an exacerbation of sovereign debt concerns. The economic outlook is still surrounded by a high degree of uncertainty. However, a path out of the worst financial crisis of our generation seems to be in sight, and there are signs that a recovery is under way. Yet, the return to normality could be gradual. It requires support. Therefore, we need to assess all developments carefully.

As Albert Einstein once said, we have to "*Learn from yesterday, live for today, hope for tomorrow. The important thing is not to stop questioning".* In fact, we have learnt a lot from the past few years. Facing the current challenges and addressing them now and in the future will be key to more sustainable growth, more stable financial markets and an even more successful euro.

I will start with the achievements of the euro and the single monetary policy, particularly in recent years. I will then set out some of the main challenges ahead, along with the remedies and policy priorities.

I. The ECB's actions during the crisis

The euro area has been the focus of a great deal of attention in the last few weeks. But let me be frank: the euro itself is not the issue. Quite the contrary, the euro is an achievement that has met with great success.

The introduction of the euro has resulted in deeper financial and economic integration with great benefits for the economy of the euro area as a whole and beyond. Intra-euro area trade in goods and services has increased notably. The "home bias" in financial markets has declined steadily. And, since the launch of the euro, an increasing share of foreign direct investments are taking place between euro area countries.

Perhaps the most important benefit of the euro has been the success of the monetary policy framework for the 16 – soon to be 17 – countries participating in the common currency. The framework has secured price stability for the euro area and inflationary expectations have remained well anchored, even during the crisis.

Moreover, from the start of the financial turmoil in August 2007 the ECB and the Eurosystem have proven to be very effective in implementing the policies needed – both conventional and unconventional policies. In fact, the outcomes could have been far worse – both globally and across the euro area – without the prompt actions of the ECB and the Eurosystem. I will briefly discuss what the ECB has done in response to the challenges faced, thereby, contributing to setting the stage for a sound recovery in Europe.

First, nearly three years ago, amid the initial strong signs of problems in the money markets around the world on 9 August 2007, the ECB acted quickly to address the severe tensions in the interbank market.

Second, after the failure of Lehman Brothers on 15 September 2008 the ECB acted decisively. In terms of conventional monetary policy actions, we reduced our key interest rates to unprecedented low levels. In addition, we introduced a series of non-standard measures to support credit provision by banks to the euro area economy. These measures, which we call "enhanced credit support", essentially comprised five elements: we lengthened the maximum maturity of refinancing operations, we extended the list of eligible collateral, we provided liquidity in foreign currencies, we initiated a covered bond purchase programme and, first and foremost, we provided unlimited liquidity in all refinancing operations at a fixed rate.

Third, in early May this year renewed market tensions emerged in some segments of the euro area debt securities markets. As these tensions hampered the monetary policy transmission mechanism, we launched the Securities Markets Programme (SMP), intervening in the debt securities markets to support the proper transmission of monetary policy impulses to the wider economy and, ultimately, to the general price level.

These measures have proven to be extremely important for the euro area economy, shielding it from far worse outcomes. Let me give you some illustrations of the effectiveness and the success of our actions.

First, following the reduction in key ECB interest rates and backed by our extraordinary liquidity support to euro area banks, money market rates decreased considerably from their peak levels recorded in 2008. Spreads between secured and unsecured money market rates declined significantly: for example, the spread between the three-month EURIBOR and the three-month overnight index swap rate decreased by 170 basis points from its peak recorded in October 2008, falling to about 30 basis points one year later and remaining close to this level thereafter.

Second, the enhanced credit support measures, including the covered bond purchase programme, contributed decisively to improving the funding situation of euro area banks. For instance, issuance and secondary market activity for covered bonds began to revive in mid-2009, and bank bond spreads for unsecured funding have fallen considerably.

Moreover, the improved funding of banks appears to have contributed to a smooth pass-through of our policy rate decreases to bank lending rates. In parallel to the 325 basis point reduction in the key ECB interest rates since October 2008, average short-term rates on loans to households for house purchase and loans to non-financial corporations have declined by around 310 basis points and 340 basis points respectively. In addition, improvements in the liquidity situation of banks and their access to market funding have led to a loosening of credit standards for loans to households and non-financial corporations since the start of 2009, although credit standards for non-financial corporations have picked up somewhat recently.

And, third, the inception of our Securities Markets Programme in early May has helped to ease considerably the tensions in euro area government debt markets. Sovereign bond spreads and credit default swap (CDS) premia have fallen significantly from the peak levels that they reached in the first week of May. The dispersion across euro area government bond yields remains elevated, but it is somewhat below the peak levels recorded in the first week of May. Together with the commitments made by many euro area governments with respect to their public finances, the ECB's purchases should contribute to further improvements in these markets.

Overall, I believe that the bold and decisive measures that we have taken since autumn 2007 have been instrumental in preventing dramatic disruptions in the functioning of specific financial market segments. We have avoided severe impairments in the provision of credit to firms and households, and have prepared the ground for a gradual recovery of the euro area economy from the worst cyclical downturn experienced since the Great Depression. Indeed, after a period of sharp decline, the outlook for growth is improving. Business and consumer confidence indicators have trended upwards over the last few quarters and the Eurosystem staff macroeconomic projections, as well as those of other organisations, foresee a further rebound in GDP growth in 2010 and 2011.

The outlook for growth is also supported by the improvements that we see in the financial market. The banking sector appears to be well on the road to recovery. Capital positions have strengthened, the profit situation has improved, with loan losses peaking last year, and, notwithstanding the recent renewed tensions, market-based indicators have improved broadly. Moreover, the redemption of the €440 billion 12-month liquidity operation has only led to additional demand in the ECB's shorter-term operations of less than half that amount. The resulting withdrawal of €240 billion of central bank liquidity went very smoothly overall, without any renewed tensions in the interbank money market.

III. The euro area's main challenges

This positive outlook and the many achievements over the last decade notwithstanding, the crisis has exposed various challenges facing the euro area. In my view, there are three challenges that deserve particular attention.

1. The first challenge pertains to cross-country differences in real economic performance. Over the past few years we have seen moderate growth and productivity developments in some euro area countries and diverging competitiveness developments across the euro area. Euro area countries still have to implement further structural reforms – albeit to varying extents. Such reforms will lead to higher growth and employment and can contribute to less divergence in developments across countries.

In fact, we have long known that structural reforms pay off. For instance, measures which increase competition in consumer markets can curtail monopoly rents and lead to higher employment and output. The introduction of the Single Market has decreased monopoly rents by a quarter.[1] Studies have found that this may also have led to an increase in potential output in the range of 5%–10%.[2] Labour market reforms also have an impact. For instance, adjusting the unemployment benefit replacement ratio by 5 percentage points has been estimated to give rise to an increase of 1.5% in output and 1.7% in employment over a period of five years.

2. The second challenge is posed by public finances in euro area countries. Since the launch of the euro we have witnessed cross-country differences in the enforcement of fiscal discipline. While fiscal developments since the launch of the euro have been much better, overall, than developments in the period prior to the start of economic and monetary union (EMU), there has only been a limited reduction in the overall level of indebtedness across the euro area [Euro area aggregate in % of GDP: government budget balance: 1995: –5.0, 2007: –0.6, 2009: –6.3, 2011: –6.1; government gross debt: 1995: 72.5, 2007: 66.0, 2009: 78.7, 2011: 88.5]. Moreover, some countries did not comply with their commitments under the Stability and Growth Pact even in good times.

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1 H. Badinger, 2007, "Has the EU's Single Market Programme fostered competition? Testing for a decrease in mark-up ratios in EU industries", Oxford Bulletin of Economics and Statistics, 69(4), pp. 497–519.

2 See W. Roeger, J. Varga and J. in't Veld, 2008, "Structural reforms in the EU: a simulation-based analysis using the QUEST model with endogenous growth", European Commission Economic Papers, No 351; and T. Bayoumi, D. Laxton, P. Pesenti, 2004, "Benefits and spillovers of greater competition in Europe: a macroeconomic assessment", European Central Bank Working Paper No 341.

3. The third challenge is posed by the lack of transparency and regulation in financial markets. In many respects, the recent crisis can be seen as the direct result of vulnerabilities and imbalances in the financial system. The risks stemming from financial innovations were compounded by insufficient risk management and adverse incentives. We have all seen the negative effects on economies around the globe. A key lesson is that systemic risks were largely misunderstood and thus underestimated.

From a longer-term perspective, concrete efforts will be needed to address all three challenges and to sustain the recovery, rendering it solid, sustainable and long lasting. I will now turn to the remedies and policy actions needed to address these challenges.

IV. Addressing the challenges

For the first challenge, ***improving real economic performance,*** there are at least three policy priorities.

- First, policies are needed which ***enhance competition and innovation*** to speed up restructuring and investment, thus creating new business opportunities. Increased labour market flexibility, as well as investment in education and research, are required to create employment opportunities and enhance competitiveness. Restructuring of the banking sector to establish solid business models, better risk management and increased transparency will be essential.
- Second, there is a ***need to safeguard and strengthen the Single Market*** in Europe. While the Single Market is at an advanced stage, there is still room for further progress. A clear example is the energy market, where greater integration would help to minimise costs and prices, improve energy security and support the wider use of renewable energy sources.[3] Another example is the Single Market for services. Implementing the internal European services market would undoubtedly bring great benefits in terms of productivity and employment gains. One specific example in this respect is the completion of the Single Euro Payments Area (SEPA), with harmonised retail payment instruments and standards which can bring tremendous cost savings to companies and consumers.
- Third, we need to ***invest in education and technologies***. The global economic slowdown has had a severe impact on labour markets. Since early 2008 the number of unemployed people in the euro area has risen by over 4½ million. Policies aimed at improving labour market flexibility need to be combined with measures to raise the level of participation and the skill level of the labour force. While some of the policy measures designed to maintain employment through the crisis have proven effective, it is important to ensure that these temporary support measures do not become permanent.

For the second challenge, ***securing sound national public finances***, fiscal discipline is essential. It is true that the fiscal stimulus measures have made a contribution equivalent to roughly 2% of GDP in the euro area (not counting off-balance-sheet measures and the economic support provided by automatic fiscal stabilisers) and, therefore, has helped to

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[3] On 7 June 2010 the ECB released the 2010 Structural Issues Report on energy markets and the euro area macroeconomy. It notes "Price levels vary across energy markets owing to taxes, energy policies and cost structures. Differences in competition and market concentration as well as the degree of vertical integration also exert an influence. Although European energy markets have been liberalised and competition has increased, de facto competition still remains lower than de jure competition. Pre-tax price dispersion remains sizeable in electricity and gas markets. Nonetheless, evidence can be found that past market liberalisation has supported price reduction in these sectors. Further reforms towards a more competitive environment creating a level playing field across the euro area would diminish price dispersion and benefit consumers and firms".

soften the economic impact of the crisis. But with the economic outlook improving, it is now time to phase out these special measures and to start fiscal consolidation, in line with the recommendations made in the country-specific excessive deficit procedures. For a number of countries, this process should start in 2010 and for the remainder it should start in 2011 at the latest.

Hence, we welcome the fact that a number of euro area governments have now adopted fiscal consolidation measures and set out ambitious fiscal targets. On 7 June the euro area finance ministers agreed on the spring 2010 orientations for fiscal policies in euro area countries. These decisive actions by euro area governments have reassured markets, as reflected in the fact that all new issuances of government debt have been successfully concluded and have met with adequate demand.

In this context, coordinated action at the European level is essential. Each country must fulfil its responsibilities and European governments must work together. This is in line with the conclusions of the latest G20 meeting in Toronto, where the G20 economies committed to fiscal plans that will at least halve deficits by 2013 and stabilise or reduce government debt-to-GDP ratios by 2016. This should support a sound and sustainable economic recovery on a global level.

Budgetary surveillance in Europe also needs to be improved. It is essential that governance and enforcement structures in the economic policy framework of the euro area be strengthened. Reinforcing surveillance of national budgetary policies and ensuring rigorous compliance with the fiscal rules will be key. Furthermore, it is extremely important that close oversight of relative competitiveness developments be implemented and that a surveillance mechanism be established to address imbalances in the euro area countries.

For the third challenge, ***undertaking a comprehensive reform of the financial sector and of financial regulation with the aim of securing financial stability***, the responsible authorities need to build a safer financial system by enhancing their financial sector surveillance, both at a micro-prudential and macro-prudential level. Financial institutions also play a decisive role, as they have to improve their risk management practices. A key challenge for policy-makers will be to design appropriate measures to enhance the stability of the financial system without imposing restrictions that would unnecessarily hamper financial innovation and reduce the efficiency of the system.

At the micro-prudential level, several initiatives are now under way to create more effective supervisory regulation, taking into account the lessons learnt from the crisis. The proposals of the Basel Committee – which are known as “Basel III” – aim to enhance capital and liquidity regulation to improve loss absorption capacity, mitigate pro-cyclicality and increase resilience to shocks. These measures – when phased in gradually as the economy recovers – will contribute to long-term economic growth, not least by helping to prevent the high costs of a crisis such as we are currently experiencing.

An effective macro-prudential framework aims to deliver a thorough analysis of systemic risks, formulate appropriate policies to address such risks, identify, in a timely fashion, the emergence and build-up of vulnerabilities, and decide on effective (pre-emptive) intervention.

In this respect, as you are all well aware, the individual results of the stress test exercise for banks in the EU carried out by the Committee of European Banking Supervisors (CEBS) in cooperation with the ECB are expected to be published later today. As previously announced, appropriate action will have to be taken where needed. On the one hand, sound balance sheets, effective risk management and transparent, robust business models are key to strengthening banks’ resilience to shocks and to ensuring adequate access to finance, thereby laying the foundations for sustainable growth, job creation and financial stability. On the other hand, stress tests contribute to the effectiveness of financial intermediation by providing more information about the condition of financial institutions and of the financial system as a whole. By combining transparency regarding the results of stress tests with appropriate measures to deal with potential weaknesses, European authorities will send a clear message to market participants about the resilience of the financial system. Of course, I cannot say more about the details of the results until they are published later today.

Concluding remarks

To conclude, looking back, the ECB has been credible in delivering price stability even throughout the recent crisis and in the current challenging period. The policy measures implemented by the ECB were indispensable to support the functioning of the euro area's banking sector. They have supported credit flows to the economy and thus dampened the effects of the crisis to the extent possible. Even worse outcomes were prevented.

Looking ahead, we now need to learn lessons and focus on what is needed to ensure that the recovery is sound and sustainable. Price stability is the central contribution that monetary policy can make to economic growth, job creation, and financial stability.

Several challenges remain. While we have long understood the national costs of failure to reform, now we know that knock-on effects can occur of neglecting fiscal sustainability and there are financial stability implications if reforms are deferred for too long. Moreover, the need to undertake product and labour market reforms to spur economic growth has grown tremendously.

More generally, financial stability issues will be a major focus for policy-makers. Various central banks have been given new tasks and responsibilities in this domain. For example, the ECB will contribute to the European Systemic Risk Board (ESRB) which will conduct macro-prudential oversight at the European level.

Ultimately, central banks cannot act alone, particularly in a monetary union. Actions are required to address all issues and challenges, and to spur long-term economic growth. We all have to work together. National governments, regulators and supervisors, as well as the private sector and the financial industry have to proceed with the difficult, but vital, measures required to ensure sustainable and sound economic growth and the stability of our financial system.

Thank you for your attention.