Jürgen Stark: In the aftermath of the global economic crisis – What next?

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the ECONOMIST conference – 15th Roundtable with the Government of Greece, Attica, 18 May 2011.

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Introduction

It is a pleasure to be here today. In my introductory remarks I would like to discuss briefly the main underlying causes for the current problems of some euro area countries. Such an understanding of the causes is essential in order to develop strategies for "Restoring Confidence in the European Economy", the main topic of this session of the conference. In the remainder of my initial remarks I will then outline the key policy elements of such a strategy, both at the national and at the European level.

The majority of EMU member states is about to overcome the economic consequences of the global financial crisis. The economic recovery in the euro area has been sustained and has become more broadly based. The economy no longer needs the degree of economic or monetary stimulus as adopted during the height of the crisis in late 2008 and early 2009. Economic growth in the first quarter of 2011 has turned out significantly stronger than expected. Germany, in particular, is experiencing high growth rates, falling unemployment and a declining government deficit. To a great extent these positive developments are attributable to economic reforms adopted in the past which are now taking effect. Some countries, at the euro area's periphery, Greece, Ireland and Portugal, find themselves in a critical economic situation.

The origins of the current crisis

The current problems in these countries have a number of root causes which have led to significant macroeconomic imbalances and vulnerabilities. In the years prior to the recent crisis, price and costs developments diverged noticeably within the euro area over extended periods of time. The cumulative impact of those differences has meant the gradual but significant erosion of the competitiveness positions in a number of euro area countries.

The mechanisms underlying these developments have varied between countries but mostly have been linked with strong growth in domestic demand, relative to the supply capacity of the economy. Demand pressures were often related to overly optimistic expectations about future incomes and profits. That triggered high spending, reduced saving and excessive indebtedness by the private sector and often increased risk-taking by the financial sector. This process was often exacerbated by low real interest rates and an insufficiently tight fiscal stance. Even where headline fiscal numbers such as the deficit or the debt ratio still suggested a healthy fiscal situation, the underlying reality was that government finances were often buoyed artificially by cyclically sensitive revenues. With the deterioration of the economic situation the structural weaknesses in the underlying fiscal position became evident culminating in the current sovereign debt crisis in some euro area countries.

These developments highlight important shortcomings not only at the level of national policy-making but also with respect to the institutional framework at the European level. The Stability and Growth Pact (SGP) was watered down in 2005 and has been ineffective in preventing the build-up of significant fiscal imbalances. Peer pressure has not worked and the changes in the fiscal rules in 2005 have led to excessive political interference and the lack of effective implementation. Moreover, the institutional framework so far lacks any effective tools for macroeconomic surveillance which could prevent the emergence of macroeconomic imbalances. The Broad Economic Policy Guidelines have proven not to be an effective tool.

Before turning to the necessary policy responses I would like to stress that the fiscal and macroeconomic policy challenges are not problems which some euro area countries face in isolation but are also evident in many other advanced economies outside the euro area. Government deficit and debt levels have reached historically high levels. Concerns about the soundness of fiscal policies are a broader phenomenon, as, for example, discussed in IMF research and highlighted by the recent lowering of the outlook for the U.S. sovereign debt rating. Also issues of competitiveness and external imbalances are global in nature and not specific to the euro area. But this is not an excuse for the Europeans not to bring their house in order.

What has to be done?

A number of policy implications for the euro area follow from this analysis. The main objective has to be a smooth functioning of EMU which implies that countries follow a path of sustainable and balanced growth. The strategy to achieve this consists of two key elements: first, to unwind the imbalances that had arisen during the first decade of EMU; and second, to ensure an adequate institutional framework and sufficient structural flexibility of individual Member States so that the risk of such imbalances occurring again is minimised.

The first challenge is to restore price and cost competitiveness. In a monetary union such as the euro area, with a single currency and a single monetary policy, the main adjustment mechanism is the competitiveness channel which works via an adjustment in relative prices and costs. Over the next few years, the restoration of competitiveness will require significant further adjustments in a number of countries which have seen an erosion of competitiveness.

The second key challenge at the current juncture is that governments need to return to sustainable fiscal positions. Even in the short-term fiscal consolidation will help to regain confidence and thus have a positive impact on economic activity. This should be underpinned by structural reforms to enhance the growth potential. For some countries returning to sustainable fiscal positions requires significant further fiscal consolidation efforts, especially in countries with large external deficits and high levels of indebtedness. But this call for fiscal discipline applies more widely – in all countries the implementation of strong fiscal consolidation efforts is required and effective rules need to be adopted that anchor fiscal prudence in overall budgetary decisions in the future.

Third, both competitiveness and fiscal sustainability should be supported by higher productivity growth. That implies that structural reforms should be targeted to remove remaining rigidities in the labour and product markets. In recent years, the progress with respect to structural reforms in euro area countries has overall clearly been disappointing and not commensurate with the requirements of participating in a common currency area. The Europe 2020 Strategy for jobs and smart, sustainable and inclusive growth may provide the institutional framework at the European level for ambitious progress with respect to structural reforms.

These policy requirements gain particular urgency for those countries currently receiving EU/IMF financial assistance. The policy conditionality associated with these programmes has been designed to address the main imbalances and vulnerabilities, taking into account the specificities of the individual countries. Full compliance with the policy conditionality of the assistance programmes is absolutely essential to unwind existing imbalances and restore market confidence.

Turning to the necessary policy response at the European level, the reinforcement of the fiscal rules and the introduction of a new surveillance framework for macroeconomic imbalances are necessary elements in strengthening overall economic governance in the euro area. The current proposals are a step in the right direction but so far fail to constitute the necessary quantum leap for euro area countries. As to macroeconomic surveillance, it is of paramount importance that the procedure has a clear focus on those countries which pose the most serious threat to the smooth functioning of EMU. These are – as the present experience shows – countries with large and persistent current account deficits, significant accumulated losses of competitiveness and high levels of private and public sector indebtedness. Moreover, the procedures should be quasi-automatic, limiting excessive political interference in the process. Furthermore, it would be useful to have a more gradual application of financial sanctions to provide clear incentives for appropriate macroeconomic policies.

Concluding remarks

Policy-makers in individual euro area countries have to come to terms with the realities of being part of a monetary union and adjust policies accordingly. This means pursuing sound and sustainable fiscal policies, preventing the build-up of macroeconomic imbalances and ensuring that the economy has the necessary shock-absorption capacity – and in particular flexibility – to ensure a smooth adjustment to country-specific developments. In that respect, ambitious and front-loaded structural reforms are essential. The EU 2020 Strategy can play a useful role in that respect. Of course, the ultimate responsibility for effective reform lies with national governments who have to ensure the economic flexibility and growth potential necessary to reap the full benefits of being a member of the euro area. Some loss of sovereignty is part of the reality of sharing and benefiting from a common currency. If this is not acknowledged in time, it may imply an even larger loss of sovereignty at a later stage.

The ECB considers it fundamental to set up an effective surveillance mechanism in the euro area in order to prevent challenges similar to those experienced currently by some euro area countries from re-emerging in the future. It is equally important that markets can play their disciplinary role in an efficient manner. This requires transparency in the surveillance process and the realisation of markets that the no-bail out clause does indeed constitute one of the binding constraints of EMU.

As in the past, the ECB will continue to deliver on its mandate and ensure price stability for the euro area over the medium term. This will provide an important anchor of stability to each individual euro area country, an anchor which is particularly valuable for those countries undergoing a difficult adjustment process. Individual Member States will benefit from this stability. At the same time, they have the responsibility to ensure the smooth functioning of the common currency area. This requires further efforts in all euro area countries to make sure that, in terms of monetary policy, one size does indeed fit all.