Jürgen Stark: Economic adjustment in a monetary union

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the Bank of Latvia annual conference "Global Challenges and Local Opportunities: Achievements and Prospects in the Baltic States", Riga, 12 October 2011.

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Exactly three years ago, in October 2008, the global financial crisis started to hit the Latvian economy. A strong policy reaction was unavoidable to stabilise the situation and correct past excesses. Latvia embarked on a remarkable economic adjustment process, laying the foundations of a renewed upturn. Although there is still a long way to go, strong policies, supported by international financial assistance, have resulted in a significant reduction of Latvia's macroeconomic imbalances.

Right now, some euro area countries are facing similar challenges to those facing Latvia during the past three years. Although the magnitudes and some other features may differ, the broad characteristics are the same. In both cases, there is a need for adjustment as a result of macroeconomic imbalances, losses in competitiveness and unsustainable economic policies. For both Latvia and euro area countries, the challenge is to implement an economic adjustment without using the nominal exchange rate as an instrument. In Latvia, the authorities chose not to use that option, whereas in the euro area that option is no longer available.

Adjusting without the nominal exchange rate is the topic of my speech today. The loss of the exchange rate as a policy instrument has important implications for economic policies, especially in a world where countries are faced with economic shocks that require adjustment. After discussing some conceptual issues, I will draw some lessons from the crisis for the euro area. Those lessons very clearly highlight that, in order to reap the benefits of a common currency, participating countries need to satisfy certain economic conditions. Finally, I will also reflect on Latvia's experience.

Conceptual considerations: economic adjustment in a monetary union

How do countries in a monetary union adjust to asymmetric macroeconomic shocks? In the absence of nominal exchange rate flexibility vis-à-vis the other countries participating in a monetary union, adjustment has to occur via other channels. Many years ago, Mundell argued that if a group of countries wanted to adopt a common currency, the shocks that they were exposed to had better be similar. If that were not the case, they would need to have strong alternative adjustment mechanisms.[1]

Mundell and others identified key conditions for such alternative adjustment mechanisms: price flexibility, factor mobility and fiscal transfers. Price flexibility is important in order to let countries affected by adverse economic shocks recover by adjusting wages and reducing relative prices in order to rebuild competitiveness. The second adjustment mechanism, cross-border factor mobility, or in particular labour mobility, helps to adjust to adverse shocks as people move out of the depressed economy until it regains competitiveness and the labour market in the country finds a new equilibrium. A third adjustment mechanism identified in the literature is fiscal transfers, flowing from the stronger countries or regions to the weaker parts of the monetary union.

[1] Mundell, R. (1961), "A Theory of Optimum Currency Areas", American Economic Review, 51, pp. 657–665.

Although these adjustment mechanisms are often referred to as being substitutes, they are in fact not. While the first two are important to solve the problem facing a country affected by an adverse shock, the third, fiscal transfers, only hides the problem. Temporary transfers can play a stabilising role and may be needed – subject to strict conditionality – if a country is affected by a very serious adverse shock. Open-ended transfers, however, are not a mode of adjustment. In fact, they are the opposite. They finance non-adjustment.

Therefore, the key adjustment mechanism in a monetary union is price and wage flexibility, assuming that cross-border labour mobility is limited. Wages and prices are essential for country adjustments, as they directly impact on the real exchange rate, and thus on a country's competitiveness. In fact, wages and prices are, by definition, the only remaining component of the real exchange rate that can be adjusted in the absence of nominal exchange rate flexibility.

It is also important in this regard to distinguish between temporary and permanent adverse shocks. Options that are attractive in the face of temporary shocks may be less so if the shock is permanent or highly persistent and vice versa. In the case of a permanent adverse shock, the country in question faces an adjustment to a permanently lower standard of living.

Economic flexibility can be promoted by removing the institutional barriers to flexible wage and price-setting mechanisms. If wages and prices are flexible enough and able to adjust to changes in economic conditions, then this will not only speed up the adjustment, but it will also help to avoid unwelcome fluctuations in output and unemployment. In a monetary union, most of the adjustment has to take place through national labour markets. Therefore, wage setting should appropriately reflect the different situations of sectors, of firms and of overall labour market conditions.

Lessons from the crisis

Let me move from conceptual issues to the actual situation in the euro area. What are the causes of imbalances in EMU that need to be adjusted now? What are the implications of these developments for the functioning of the monetary union? What lessons can we draw from this experience for economic adjustment in EMU?

The key point I want to make here is that macroeconomic imbalances and unsustainable fiscal policies are the root cause of the sovereign debt crisis in the euro area. The existing economic governance framework has not been able to prevent the emergence of excessive macroeconomic imbalances. Moreover, fiscal policy coordination in the euro area turned out to be completely insufficient.

Before I discuss what needs to be done to improve EMU's institutional framework, let me first say something on the causes of the macroeconomic imbalances in euro area countries.

Some countries have built up significant internal and external economic imbalances during the past decade, and recorded inflation rates persistently above the euro area average (see Slide 2, HICP inflation). The ECB repeatedly warned against emerging imbalances. Increases in labour compensation in some countries, driven in most cases by high public sector wage increases, exceeded productivity gains by a significant margin, leading to increases in unit labour costs in excess of the euro area average and a gradual erosion of competitiveness (see Slide 3, ULC indices). At the same time, growth in the unregulated financial sector and unsustainably strong domestic demand growth, coupled in some cases with excessive credit growth and large and sustained increases in real estate prices, resulted in large current account deficits (see Slide 4, CA deficits) and high levels of public and private debt (see Slide 5, public debt ratios).

Many factors contributed to these developments, including unrealistically optimistic expectations about future income developments and the underestimation of credit risks by financial institutions. A key factor was that wage and income policies were not sufficiently geared towards preserving competitiveness in a monetary union. Governments failed to address structural rigidities in the euro area economies – relating to, among other things, wage-setting institutions, including wage indexation, and to labour and product market regulation.

An institutional framework focusing on the early identification and correction of macroeconomic imbalances would have helped to prevent these problems. But the ongoing crisis is also a symptom of policy failures and deficiencies in the existing institutional framework governing economic policies in EMU. The Broad Economic Policy Guidelines, the central link in coordination of the Member States' economic policies, did not work. The instruments and procedures were available. But they were either not implemented or ignored, or they were watered down. Peer pressure among the Member States – potentially a strong tool of mutual fiscal surveillance – fell short of what was needed as countries did not attach sufficient importance to their joint responsibility for the stability of the euro area.

Several proposals have been made on how to overcome the flaws in the EMU governance framework and I will only say a few words on the changes we need here.[2] Addressing EMU's difficulties requires a major strengthening of the rules and organisations that govern fiscal and other economic policies. The identification of the necessary reforms has to begin with the ultimate objective: institutional arrangements that provide credible incentives for sound policies. Euro area countries and countries preparing for euro adoption should be aware that this requires the transfer of sovereignty to a central institution with much stronger powers. It also requires stricter rules on the preparation and implementation of budgets at the national level.

The recent agreement reached by the European Parliament and the Council on the economic governance package is a step in the right direction. But it falls short of the "quantum leap" in economic governance that the ECB has long advocated for the euro area.[3] I particularly regret that one of the key aspects of such a quantum leap – greater automaticity in decision-making through the use of reverse qualified majority voting to the maximum extent possible – has only partly been achieved. I therefore believe that, in the medium term, the review clause included in the package should be used to enable further enhancements to euro area economic governance that will contribute to a smoother functioning of EMU.

Reaping the benefits from the euro

The experience of the crisis has shown that participation in a monetary union places important demands on national economic policies. What economic conditions need to be satisfied for a country to fully reap the benefits from adopting the euro? I believe that the fundamental logic of the Treaty, and the convergence framework embedded in the Treaty, remains correct: countries have to make sure that they pursue sound macroeconomic policies. They should first and foremost focus on establishing sound fiscal and sustainable macroeconomic developments in their own country and complement this with the necessary structural reforms. By doing so, they will actually kill two birds with one stone, as they then also follow the best possible strategy for ensuring smooth integration into the euro area in a lasting manner.

Reaping the benefits of the euro is thus in the hands of the national authorities themselves. Not only can they improve market flexibility, but they can also conduct a well-designed fiscal policy. As I have stressed on many occasions, the best contribution fiscal policy can make to the proper functioning of the euro area is by being sustainable and medium-term oriented.

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2 For more details on fiscal reform proposals, see, for example, Schuknecht, L., Moutot, P., Rother, P. and Stark, J. (2011), "The Stability and Growth Pact – crisis and reform", Occasional Paper Series, No 129, European Central Bank, September.

3 See European Central Bank, Reinforcing economic governance in the euro area, 10 June 2010.

Moreover fiscal policy can and should also help mitigate undesirable trend growth differentials through "high quality" expenditure and tax policies. In particular, high and inefficient public expenditure can put a brake on economic activity by imposing a high tax burden on the economy and channelling resources into unproductive uses.

Let me stress that governments and social partners share responsibility for ensuring that wage determination sufficiently takes into account labour market conditions and does not jeopardise competitiveness and employment. Governments should also be aware that wage setting in the public sector can serve as a role model for the private sector. And social partners need to take into account the different conditions at the firm and sectoral level, internalising the repercussions of wage settlements on competitiveness and thus employment at their company and in their industry, sector or region. Sufficient wage differentiation would improve employment opportunities for less skilled workers and in regions or sectors with high unemployment. In this respect, excessive regulations – both in labour and product markets – undermine job creation, in particular for young and less qualified workers, as well as for all those who face problems entering the labour market.

The Latvian experience

Let me turn from the euro area to Latvia. Following years of excessive demand growth and serious overheating, Latvia recorded severe losses in output, particularly in 2009 (see Slide 6, GDP levels). This contraction was triggered by a major adverse shock, the global financial crisis, but would have occurred sooner or later anyway, as the macroeconomic imbalances that had been built up were unsustainable. The crisis that started in 2008 marked the beginning of a painful but remarkable adjustment process. Thanks to strong domestic policies combined with international support, this adjustment has laid the foundations for an economic recovery, underpinned by healthier balance sheets and improvements in competitiveness.

I believe that Latvia's experience harbours important lessons for countries inside the euro area that have to undergo a similar adjustment. The adjustment process in Latvia during the past few years shows that it is possible to reduce large macroeconomic imbalances without adjusting the nominal exchange rate. Such an adjustment benefits from a high degree of flexibility of the economy and needs to rely on a determined and strong policy response to rebalance the economy, regain competitiveness and lay the foundations for sustainable output growth. A sizeable fiscal adjustment was essential for strengthening fiscal sustainability and critical in regaining market confidence. Cuts in wage costs and prices were necessary to regain competitiveness that had been lost during the boom years. Exactly three years after the crisis hit, Latvia now seems close to concluding its international financial assistance programme.

What were the specific elements that underpinned this adjustment? I want to mention four elements in this regard. First, in the absence of nominal exchange rate flexibility, any real exchange rate adjustment had to be delivered via cuts in wage costs and prices combined with enhancements in labour productivity. The adjustment in wages was both market-driven, owing to a sharp decline in the demand for labour, and supported by policies aimed at cutting public sector wage costs. The labour market adjustment was not only achieved through wage cuts, but also through employment cuts, reductions in hours worked and a restructuring of production processes. As a result, unit labour costs declined significantly, partly offsetting their previous excessive gains (see Slide 7, ULC levels).

Second, sizeable fiscal consolidation was targeted at bringing Latvia's fiscal position back to a sustainable path, lowering sovereign funding needs and regaining market confidence. Efforts also focused on strengthening the budgetary framework and procedures. Following a sharp increase in fiscal deficits, Latvia's fiscal position has started to improve, but the deficit remains at a very high level (see Slide 8, fiscal balances).

A third element of the adjustment strategy comprised structural reforms to enhance market flexibility and medium-term growth. Measures focused on both labour and product markets, such as revisions to labour market legislation to strengthen labour market flexibility, improving the business climate by streamlining start-up procedures and tax administration, supporting exporting firms and combating the informal economy. Although clear progress has been made, I believe that the structural reform agenda remains unfinished.

Fourth and finally, the adjustment strategy comprised measures to strengthen financial stability and reduce private sector debt burdens. The authorities initially focused on securing liquidity in banks. Subsequently, adequate capitalisation became increasingly important, given the deterioration in the quality of banks' loan portfolios in the wake of the economic downturn. As a result, financial stability was maintained, although more time is still needed to repair private sector balance sheets.

Despite Latvia's adjustment so far, ensuring the continued success of the strategy will demand resolute implementation of further reforms on several fronts. Key challenges remain to ensure fiscal sustainability, strengthen the economic structure and improve the ability for the economy to grow without generating inflationary pressures. Latvia still has a low GDP per capita relative to many other EU countries (see Slide 9, GDP per capita), implying that it has an important potential to catch up vis-à-vis the rest of the EU. This catching-up process is likely to have a bearing on inflation in the medium term. Given the tightly pegged exchange rate and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances from building up again. Moreover, the severe economic downturn in Latvia has left its legacies in the form of a destruction of supply capacity and a very large decline in employment (see Slide 10, employment). It is essential for Latvia to strengthen the fundamental drivers of sustainable and balanced growth by enhancing the quality and quantity of labour supply and improving the quality of the business environment, which is hampered by, among other things, a large informal economy.

As regards euro adoption, the challenges that some euro area countries are currently facing illustrates very clearly the importance of sustainable convergence. Very careful preparation is required to make sure that convergence continues after euro adoption. Measures to reduce inflation temporarily or easily-reversible measures to lower the fiscal deficit do not represent sustainable convergence. The decision to adopt the euro is a very fundamental one and should not be taken lightly.

Concluding remarks

Let me conclude. Economic shocks are a fact of life and countries should be prepared to deal with them. This is all the more the case in a monetary union, where the nominal exchange rate is no longer available as an instrument of adjustment. The challenges that some euro area countries currently face underline the critical importance of strong adjustment mechanisms and the need to avoid macroeconomic imbalances and unsustainable fiscal policies. This all underlines the responsibility of national economic policy-makers. Stability begins at home. Strong economic adjustment mechanisms not only help to absorb adverse shocks, but they are also essential to reap the benefits of the euro.

The Latvian experience shows that adjusting to major adverse shocks and reducing large macroeconomic imbalances is not impossible. Using a combination of fiscal and nominal wage adjustment, structural reforms and measures to preserve financial stability, as well as international support, Latvia has been able to lay the foundations for its economy to stabilise and recover, although important challenges remain and the policy agenda remains unfinished. What matters is a broad political consensus, and a broad consensus in society, about the need for adjustment and the correction of past behaviour. I wish Latvia all the best in its efforts in this regard.

Thank you for your attention.