# Jürgen Stark: Economic situation and fiscal challenges

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the Forecaster Club of New York, New York, 2 December 2011.

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As the ECB's Governing Council meets on Thursday next week, we are now in the pre-decision period and nothing that I say should in any way be interpreted in terms of future monetary policy decisions.

## Introduction

Thank you very much for the invitation to speak today to this distinguished audience at the Forecasters Club here in New York.

Large parts of Europe are suffering from the ongoing sovereign debt crisis. An increasing number of sovereigns are facing financing problems. A solution needs to be found urgently. But fingers are pointing in different directions.

In my view solving the current sovereign debt crisis is primarily in the hands of governments. Its root cause lies in lax fiscal policies and associated deteriorating public finances in some euro area countries. Stability criteria were violated, fiscal rules ignored and statistics tweaked. Growth dividends were not used for necessary consolidation in good times. In the same vein, competitiveness positions worsened in many euro area countries, due to a lack of structural reforms. These developments have raised doubts in financial markets on the political will and capacity to live up to their commitments and to do whatever is needed to comply with the rules of the game within a monetary union. To solve the crisis requires determined fiscal consolidation and ambitious structural reforms. These must be the prime answers for tackling current challenges. At the same time, it has to be recognised that sovereign debt issues are not confined to the euro area but have become an important issue for all advanced economies.

Thus, I will focus my presentation today on the policy responses to the crisis and the requirements I see as essential in the areas of monetary policy, fiscal policy and structural reforms to cope with current challenges.

## Macroeconomic and monetary environment

Let me start with briefly sketching the economic and financial developments in the euro area during the years of crisis up to now.

Following the collapse of Lehman, financial market tensions escalated in 2008. As a consequence, we witnessed a severe global recession. After the deep recession that started in 2008, euro area real GDP started to contract and stood in the first half of 2009 about 5% below its level one year earlier, compared to a contraction of the US economy of close to 5% taking into account the recent revisions to US national account data. Continued strong external demand as well as a strengthening of domestic demand where the main drivers behind the subsequent economic recovery (slide 3). At present, it seems that some of the downside risks we had identified earlier have been materialising. Looking ahead, short-term indicators and survey data suggest that real GDP growth may be very moderate towards the end of this year and at the beginning of next year. Indeed, economic activity in the euro area is adversely affected by a moderation in the pace of global demand. In addition, the crisis continues to weigh on confidence and financing conditions in the euro area. These developments are expected to dampen activity. At the same time, activity should benefit from

continued positive economic growth in the emerging market economies, the continued extremely low levels of short-term interest rates and the various measures that have been implemented to support the functioning of the financial sector.

Having said this, uncertainty remains very high and risks to the economic outlook on the downside.

Turning to prices, average inflation in the euro area rose to 1.6% in 2010, and continued increasing in 2011. It stood at 3% in November, according the Eurostat's flash estimate, unchanged from previous months, still significantly lower than in the US. The main drivers behind the elevated inflation rates since the end of last year have been oil and other commodity price surges. As of late, increases in indirect taxes due to fiscal consolidation needs have been an additional driver. At the same time, domestic price pressures have remained moderate. Survey data up to October point to some easing in pipeline pressures, especially at the earlier stages of the pricing chain, i.e. producer prices for intermediate goods. In view of the rather weak growth prospects and continued slack in labour markets, labour cost pressures are likely to remain contained in the medium term.

Looking ahead, euro area inflation rates are likely to decline in the coming months. They are expected to fall below 2% in the course of 2012. In the medium term, inflation rates should remain moderate. This is in line with latest available inflation forecasts from public sources. Medium to longer-term inflation expectations according to both survey and market based measures remain well anchored in line with the ECB's aim of keeping inflation rates below, but close to, 2% over the medium term.

As to monetary and credit developments, following double digit growth rates in the build-up of the financial crisis, signalling risks for macroeconomic instabilities and price stability, annual growth in the broad monetary aggregate M3 and in loans to the private sector fell sharply between 2008 and mid-2010 (slide 5). Since then, money and credit growth started to recover. However, underlying growth trends remained moderate, correcting a sizeable part of the excess liquidity that had been accumulated before the start of the crisis.

**Monetary policy**

The ECB from the very beginning of the crisis has taken decisive and swift action through both its standard and non-standard monetary policy measures. In a first response to intensified financial market tensions, and based on our assessment of medium-term risks to price stability in the euro area, we reduced our key interest rates by 325 basis points between October 2008 and May 2009 and kept them unchanged until April 2011. During this time, the main refinancing rate of the Eurosystem stood at 1%. (slide 6). Over the same period, the overnight money market interest rate (EONIA) also decreased rapidly, reaching levels as low as 0.3%.

Earlier this year, in April and July, we raised interest rates in two steps, each time by 25 basis points. At that time, we were concerned that prevailing upward price pressures, mainly from energy and commodity prices, could translate into second-round effects in wage and price-setting and to broad-based inflationary pressure. However, the picture has changed since then. The economic outlook has worsened amidst continued high uncertainty and intensified downside risks. In such an environment, it is reasonable to expect moderate price, cost and wage pressure. This assessment has led us to the decision last month to reduce rates by 25 basis points. Our main refinancing rate therefore now stands at 1.25%, and the rates on the deposit facility and marginal lending facility at 0.75% and 1.75% respectively (slide 7).

At the same time, we have introduced a number of non-standard monetary policy measures, with the aim to support credit flows from banks and thereby ensure that our interest rate is transmitted properly to households and firms. Notably, the design of these measures has taken into account the pivotal role of banks in financing the real economy of the euro area

(slide 8). They focused on a proper functioning of the banking sector, by ensuring that funding markets, notably the money market, continued functioning. The main non-standard monetary policy measure in that context is the full allotment of liquidity demand by banks, at fixed, low rates, against eligible collateral.

In addition, the ECB also engaged in buying government securities via its Securities Markets Programme (SMP). The Governing Council's aim of this programme is to restore a proper transmission process that threatened to become impaired given dysfunctional market segments, as witnessed by very high interest rate spreads on sovereign bonds (slide 9). This is a major difference with quantitative easing in other major countries where such bond purchases are conducted in financing governments and against the background of official interest rates being close to the lower zero bound. The aim of quantitative easing is to have a more accommodative monetary policy stance via lowering long-term interest rates. By contrast, the ECB's purchases of bonds aim to ensure that our official short-term interest rates are transmitted in a proper way to the economy. Another difference is that the ECB fully sterilises the liquidity injected in the market through its SMP while this is not the case in the US and the UK. The ECB has much less government securities on its balance sheet than the central banks of the US and the UK (slide 10). To be fair, this difference not only reflects the quantitative easing policy conducted in the UK and the US. In the US, for instance, government bonds already were an important item on the balance sheet of the Federal Reserve before the crisis. The Federal Reserve typically implements its monetary policy through purchases and sales of government bonds.

Let me also emphasise that all the non-standard monetary policy measures taken by the ECB are temporary in nature and complementary, rather than supplementary, to our interest rate instrument.

At the same time, we should not forget the adverse side-effects of interest rates being kept at very low levels for a long time. In fact, the period preceding the start of the financial market tensions in August 2007 is reminiscent of the associated risks. Notably, the very low level of global interest rates after 2001 and the resulting ample liquidity conditions at the global level has laid the basis for the current crisis. In addition, maintaining very low interests rates for a protracted period may weaken the financial incentive for deleveraging for both the banking and non-financial sectors, and can result in "evergreening" of outstanding loans. Very low interest rates may also discourage banks from trading in interbank money markets. This is an important market for the transmission of monetary policy. Related, it has adverse effects on some financial institutions such as money market funds.

Overall, the combination of standard and non-standard monetary policy measures has been successful in maintaining inflation rates below, but close to, 2% over the medium term, while ensuring the transmission of monetary policy in difficult times. This is witnessed by fairly stable inflation expectations around ECB's objective (slide 11). The ECB therefore has delivered fully on its mandate.

Unfortunately, that cannot be said of all policymakers involved, resulting in the lingering of the sovereign debt crisis. To tackle the crisis decisively first and foremost requires tackling its root cause will require ambitious fiscal policies and structural reforms.

## Fiscal policy

Let me now turn to the fiscal situation in the euro area in more detail. The severe imbalances that came to the forefront in the wake of the financial and economic crisis – to a significant extent – are related to past policy mistakes. In this context, one needs to bear in mind that the euro area neither constitutes a fully-fledged federation nor a political or fiscal union. While monetary policy is centralised, budgetary sovereignty remains to a large extent at the Member State level. The Stability and Growth Pact has been put in place to ensure a sufficient degree of fiscal coordination. However, this rules-based framework, which is built

on peer-pressure, was not sufficient to ensure a smooth functioning of the monetary union. This calls for a more pronounced transfer of sovereignty to the European level and the move towards a fiscal union.

Countries have joined the euro area and benefited from its advantages but some have failed to live up to the responsibilities that are inherent in being part of a monetary union. In particular, many euro area countries failed to achieve sufficiently sound fiscal positions in line with the rules of the European Fiscal Framework in previous economic good times. This was the consequence of a lax enforcement of the provisions of the Stability and Growth Pact, notably due to a deficient governance framework at the European level. As a result, many countries already entered the crisis with weak fiscal positions which amplified the fiscal deterioration.

In 2010, the aggregate fiscal balance of the euro area stood at more than 6% of GDP up from an almost balanced budget in 2000; euro area debt amounted to more than 85% of GDP in 2010. Moreover, 14 out of 17 euro area countries are currently facing an excessive deficit procedure related to a budgetary deficit above the 3% of GDP reference value of the Treaty. Particularly high deficits exist in the countries subject to EU/IMF programmes, i.e. in Ireland, Greece and Portugal, but also in some large euro area countries, notably Spain and France. As consequence, sizeable and persistent structural adjustment will be necessary in most euro area countries to put debt back on a declining path and reduce it to a sustainable level, in line with the 60% of GDP debt criterion of the Stability and Growth Pact.

However, most advanced economies face substantial fiscal consolidation requirements. Notably, for the US, the IMF estimates that general government gross debt will reach 100% of GDP in 2011 and that it will continue to rise through the year 2016. At the same time, the general government deficit is expected to remain close to 10% of GDP in 2011 (slide 12).

As you can see from the slide, significant aggregate structural adjustment of 1 percentage-point of GDP per year will be necessary in the euro area to reduce the debt ratio to below 60% of GDP by 2030. For the US, even such a relatively ambitious adjustment path would keep the debt-to-GDP at around 75% of GDP by 2030. These scenarios highlight the significant fiscal challenges we are facing on both sides of the Atlantic in the aftermath of the financial and economic crisis.

In European countries, the correction of excessive deficits is on its way. The pace of fiscal adjustment has been set by the European Council in a way that reflects country-specific imbalances. Most countries will have to reduce their deficit ratio to below 3% of GDP by 2013 at the latest. Accordingly, euro area Member States have presented medium-term consolidation strategies in their Stability Programmes which point to a strongly expenditure-based adjustment. Such an approach is warranted in view of strong increases in government spending during the crisis in most countries. Moreover, past experience suggests that successful consolidations typically have a strong expenditure component.

In addition, case study evidence from previous consolidation episodes indicates that ambitious expenditure reform was typically carried out in the context of a broader economic reform programmes, comprising structural reforms to promote potential growth and institutional reform, e.g. to strengthen the budgetary framework. In fact, many euro area countries, notably the ones subject to EU/IMF programmes, are following such a strategy which I would like to call the European approach to fiscal adjustment.

If effectively implemented, such reform programmes would enable countries to address their sustainability risks and, at the same time, limit potential short-term costs of fiscal tightening through growth-enhancing structural reform. Especially in the current environment of heightened market sensitivity, ambitious reform efforts should quickly trigger positive confidence effects and be conducive to macroeconomic stabilisation.

It is, therefore, of the utmost importance that European governments implement the announced fiscal consolidation and reform measures and ensure – by all means – the

delivery of agreed fiscal targets. This will be crucial to regain market confidence, notably in countries with very high and strongly rising debt ratios and pronounced risks related to the expected ageing-related fiscal burden. For these countries, with a view to ensuring a sufficiently swift return to sound and sustainable fiscal positions, it appears to be advisable to implement fiscal adjustment beyond what is required to correct excessive deficits and converge towards the medium-term budgetary objective, typically a balanced budget.

Only if national governments strictly adhere to ambitious fiscal consolidation and reform does it make sense to seek ways to buy some time to implement the planned measures. The European Financial Stability Facility is the appropriate vehicle for that but before coming operational European governments need to deliver on their commitment to leverage funds available to this facility. Public programmes should be based on strong conditionality, as otherwise incentives to take the necessary national measures would be weakened. In addition, surveillance mechanisms at the European level need to be strengthened to monitor progress and avoid major derailments in the future.

Decision-making in crisis times is different in our democratic systems. In the US, a medium-term fiscal exit strategy has yet to be clearly specified. The bipartisan congressional committee on deficit reduction did not reach an agreement on measures to reduce the public deficit. At the same time, the recent downgrade of US long-term government debt and rising sovereign CDS spreads signal that no advanced economy is immune to a loss of market confidence in its public finances. It is therefore essential for the US to formulate a credible fiscal consolidation programme that returns its government debt to a declining path towards sustainable levels.

## Structural reforms

As I mentioned before, deteriorating competitiveness positions in some euro area countries contributed to the current crisis. These countries therefore need to restore price and cost competitiveness. Apart from labour cost moderation, this calls for structural reforms targeted at removing remaining rigidities in labour and product markets, thereby raising potential economic growth. The measures should focus on enhancing wage flexibility and increasing competition in product markets, particularly in services.

However, the need for structural reform does not stop with the euro area countries hit most by the sovereign debt crisis. For instance, the US economy would benefit from a more sustainable growth model, where solid and medium-term oriented economic policies strengthen potential growth and job creation. This would include structural reforms that address weaknesses in the labour market and in particular reduce long-term unemployment. Policies that stabilise the housing market, such as facilitating refinancing of mortgage debt, would also help households to deleverage and support private consumption in the medium term. Sustainable growth is also enhanced by policies that avoid the build-up of excessive misalignments in asset prices. At a global level, continuing imbalances require ongoing efforts to address factors or policies that foster disequilibrium flows around the globe. Enhancing exchange rate flexibility in emerging economies with large external surpluses would mitigate the risk of a disorderly unwinding of global imbalances.

## Conclusion

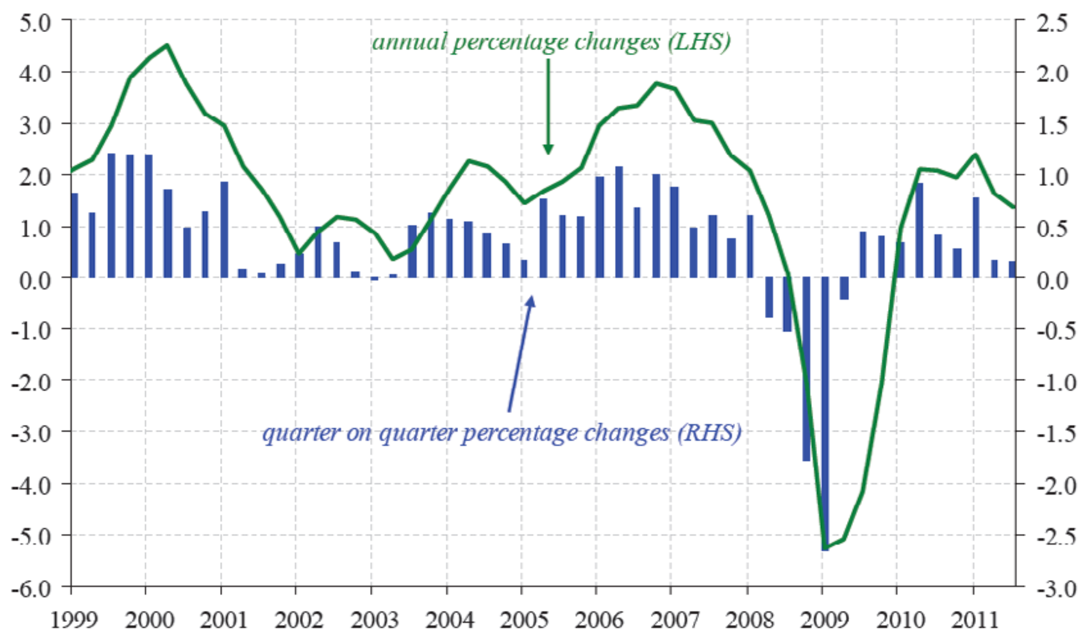
The lingering and expanding sovereign debt crisis must be halted to avoid macroeconomic and financial disaster, in the euro area and beyond. No country is immune anymore to a loss of market confidence in its public finances. With fiscal imbalances and deteriorating competitiveness in euro area countries at the root of the current crisis, there can in my view be no discussion which policymakers should make a move. Ambitious fiscal consolidation and structural reforms by national governments in the euro area are required now – or actually, yesterday. Only if the course of national policies is the right one can an

accompanying financing scheme as the EFSF play a useful role to bridge the period when market access remains restricted. Monetary policy in the euro area was and will remain an anchor of confidence and stability. It will remain dedicated to its mandate of maintaining price stability. This is the necessary and central contribution that monetary policy can make to fostering sustainable growth, job creation and financial stability. Monetary policy should not be overburdened.

Thank you for your attention.

## Real GDP growth

*(annual percentage changes)*

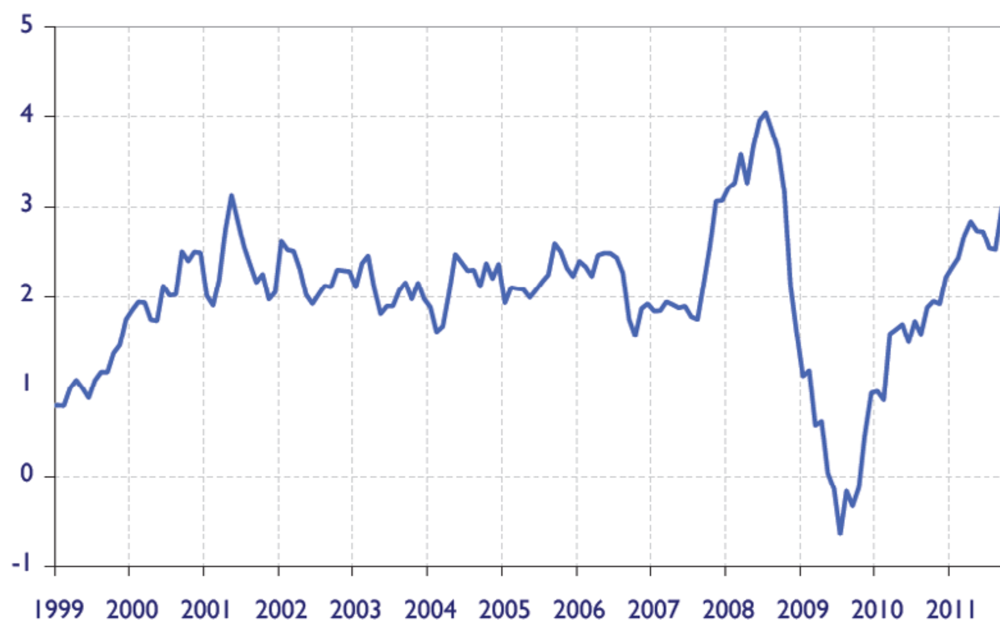



*Latest observations: Q3 2011.*
*Source: Eurostat.*

EUROPEAN CENTRAL BANK 3

## Inflation in the euro area

*(annual percentage change)*

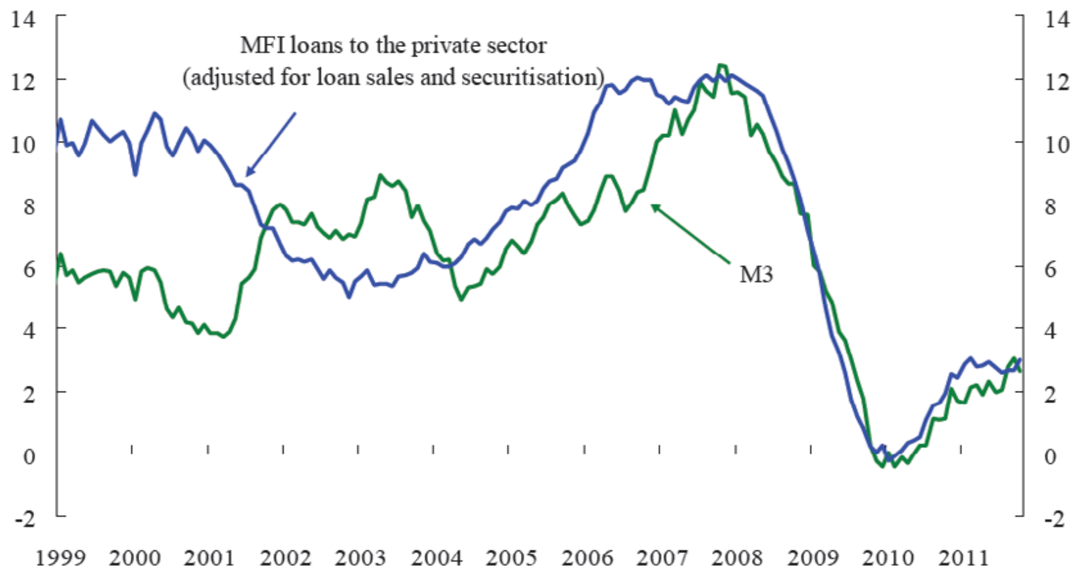



*Latest observations: October 2011.*
*Source: Eurostat.*

EUROPEAN CENTRAL BANK 4

## Euro area monetary aggregates

*(annual percentage changes; adjusted for seasonal and calendar effects)*

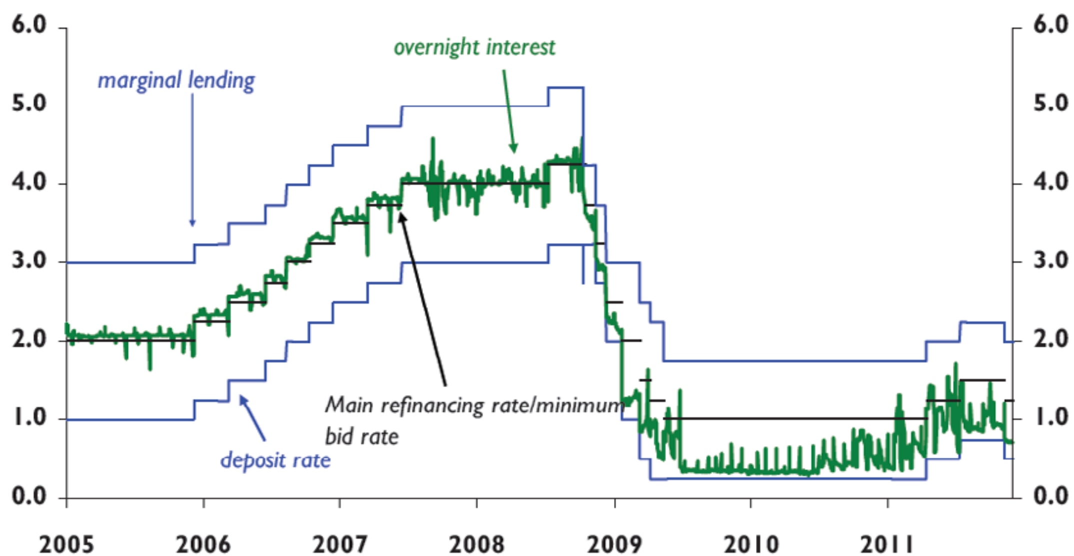



*Latest observations: October 2011.*
*Source: ECB.*

EUROPEAN CENTRAL BANK 5

## Key ECB interest rates

*(percentage per annum)*




*Latest observations: 30 November 2011 for policy rates and 29 November 2011 for overnight interest rate.*
*Sources: ECB, Reuters.*

EUROPEAN CENTRAL BANK 6

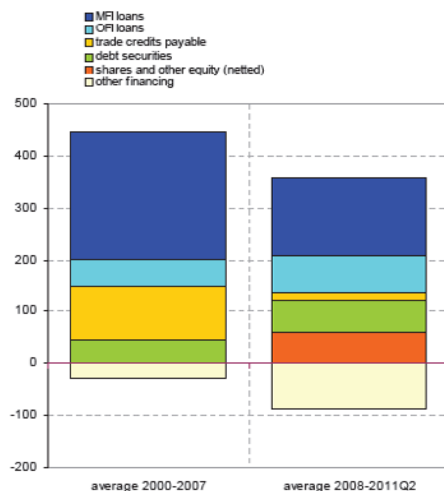
## Risks of very low interest rates for long

- **May create basis for future period of instability**
- **Little financial incentive for de-leveraging for banking and non-financial sectors**
- **Negative impact on trading activity on money markets and on some financial institutions (money market funds)**

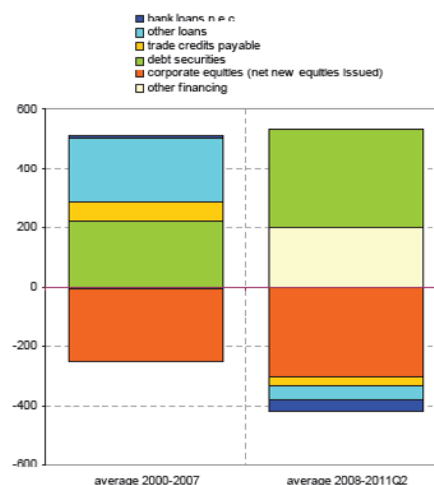
EUROPEAN CENTRAL BANK 7

## External financing of non-financial corporations in the euro area and the United States

Euro area: (based on transactions, in EUR billions)




US: (based on transactions, in USD billions)



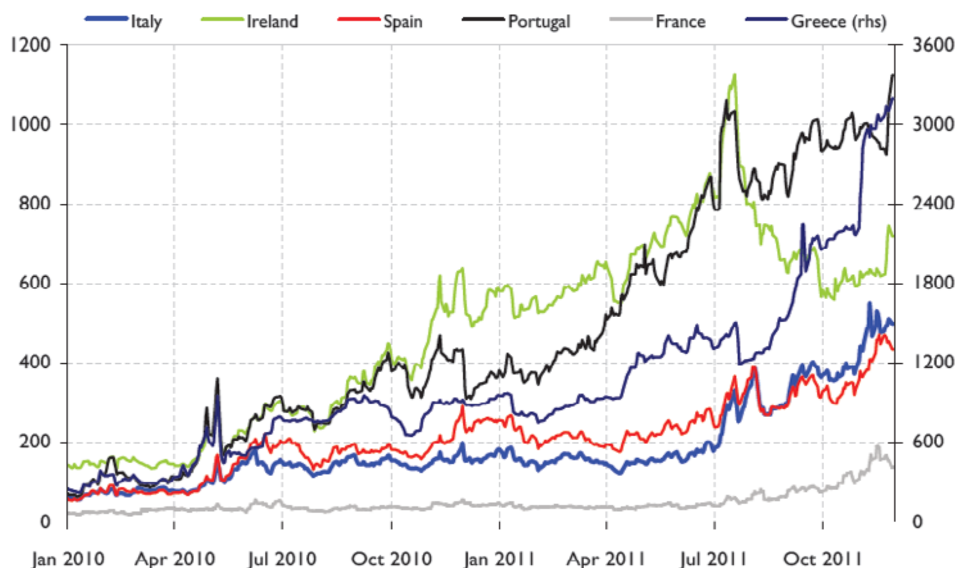

Sources : Integrated euro area accounts, Board of Governors of the Federal Reserve System.

Notes: For the euro area: In order to increase the comparability with the United States, 'total external financing' has been netted with shares and other equity investment, other accounts receivables (excluding trade credits receivable) and loans granted by non-financial corporations. Shares and other equity have been "consolidated" by netting out non-financial corporations' equity investment. 'Other financing' includes other accounts payable excluding trade credits payable, financial derivatives and financing through direct pension commitments. In order to increase the comparability with the United States, inter-company loans have been "consolidated" by netting loans granted by non-financial corporations.

For the US: 'Total external financing' has been netted with 'other miscellaneous assets'. 'Other financing' includes miscellaneous liabilites (netted), taxes payable and proprietors' net investment. Bank loans n.e.c. is the statistical category "bank loans not elsewhere classified" in the US Flow of funds.

EUROPEAN CENTRAL BANK 8

## Sovereign bond yield spreads in the euro area

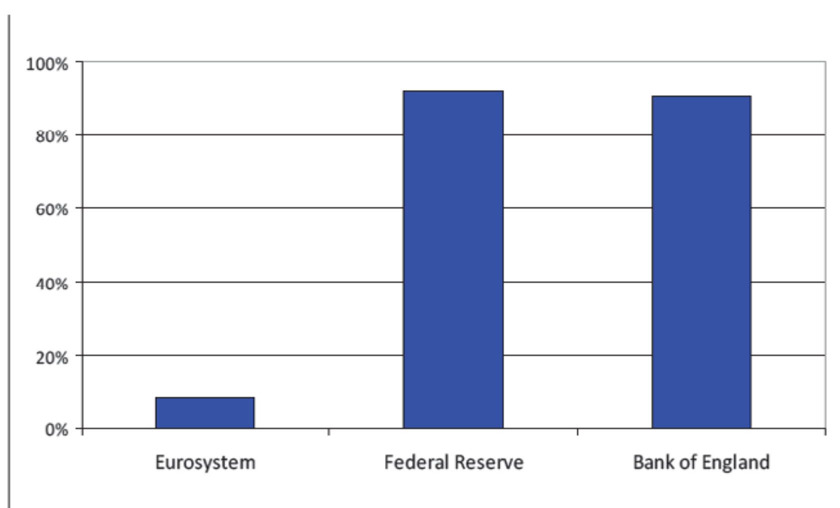



*Note: 10 year government bond yield spreads against the German bund.*
*Latest observations: 29 November 2011.*

EUROPEAN CENTRAL BANK 9

## Non-standard security purchase programmes in the euro area, the US and then UK

(as a % of total consolidated balance sheet size)

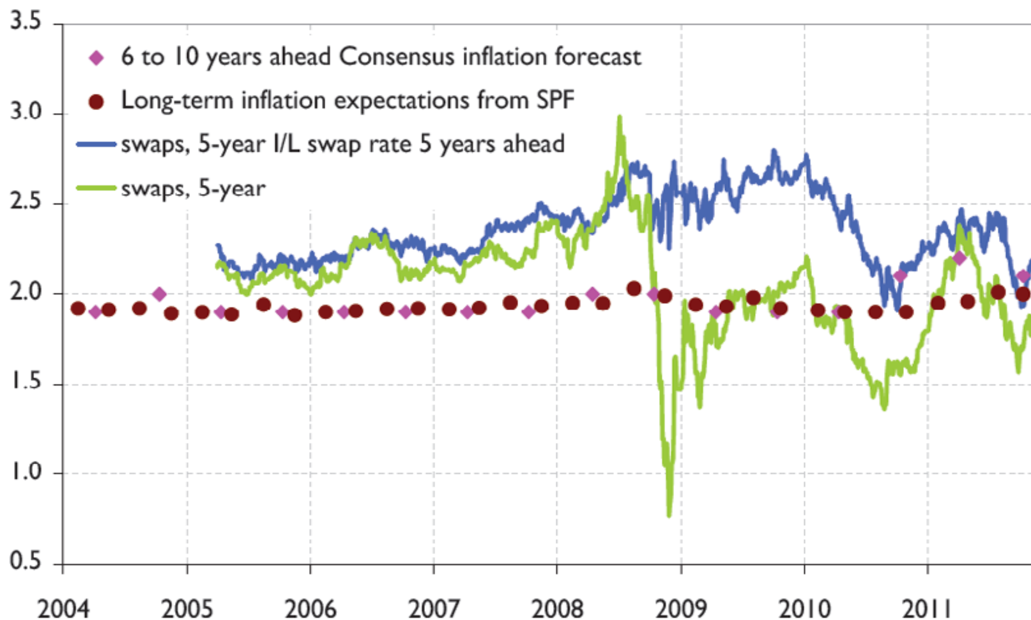



*Note: Bonds include government and private bonds.*
*Latest observations: 25 November 2011 for the Eurosystem, 23 November 2011 for the Federal Reserve and the Bank of England.*

EUROPEAN CENTRAL BANK 10

## Inflation expectations in the euro area

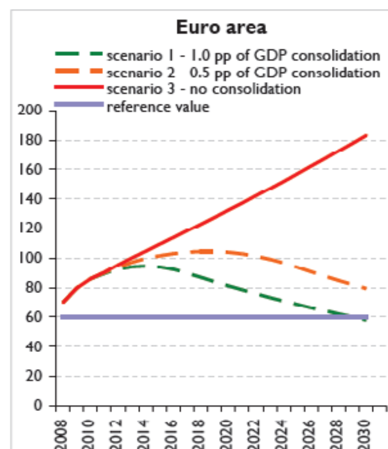
*(percent per annum)*

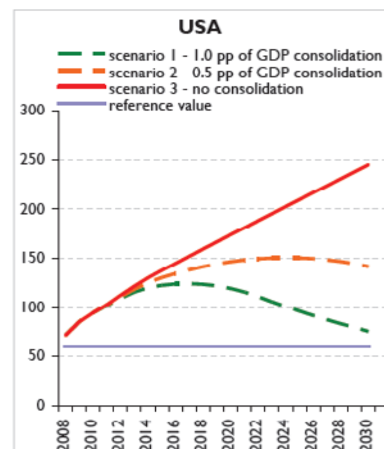



*Latest observations: 28 November 2011.*
*Sources: Reuters, ECB, Consensus Economics and ECB calculations.*



## Debt scenarios: Euro area and United States




Source: ECB calculations.
Notes: All three scenarios use the IMF World Economic Outlook (September 2011) forecast for general government debt and primary balance up to 2010 as a starting point. Fiscal developments as of 2011 are determined by three alternatives scenarios: Scenario 1 assumes a rather rapid fiscal consolidation process, with the primary balance improving by 1.0 percentage point of GDP per year until an overall balanced budget is reached. Scenario 2 assumes a less ambitious consolidation path, with the primary balance improving by only 0.5 percentage point of GDP per year until an overall balanced budget is reached. Scenario 3 assumes that no consolidation efforts are made. The primary balance remains constant at the forecast value for 2010 over the whole simulation period. The macroeconomic assumptions underlying the three scenarios are as follows: nominal GDP growth comes from the IMF World Economic Outlook (September 2011) up to 2016 and afterwards it is equal to the value of 2016. The nominal implicit interest rate on government debt is assumed constant at the value recorded in 2008 (as the values for the period 2009-10 could be distorted by the financial crisis).

# Background slides

## Recent fiscal developments

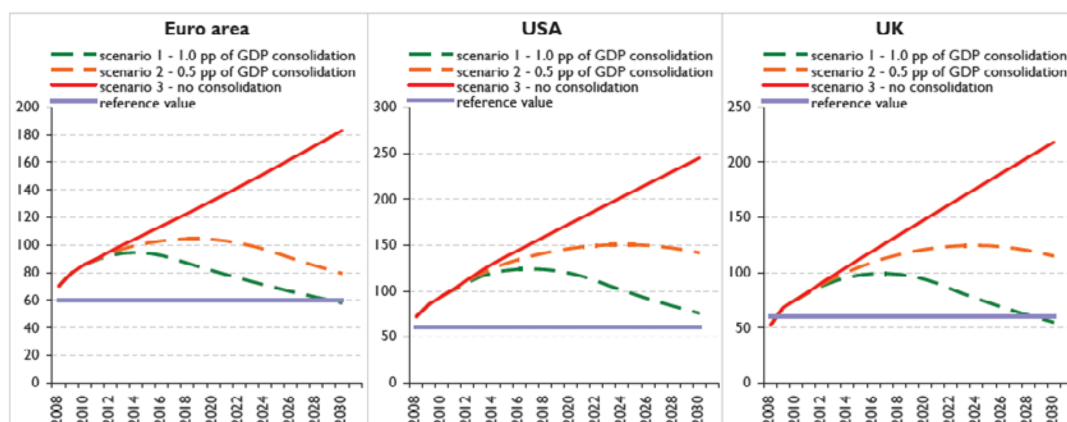
**General government fiscal positions**

| (% of GDP) | budget balance 2010 | 2011 | 2012 | 2013 | gross debt 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|
| Belgium | -4.1 | -3.6 | -4.6 | -4.5 | 96.2 | 97.2 | 99.2 | 100.3 |
| Germany | -4.3 | -1.3 | -1.0 | -0.7 | 83.2 | 81.7 | 81.2 | 79.9 |
| Estonia | 0.2 | 0.8 | -1.8 | -0.8 | 6.7 | 5.8 | 6.0 | 6.1 |
| Ireland | -31.3 | -10.3 | -8.6 | -7.8 | 94.9 | 108.1 | 117.5 | 121.1 |
| Greece | -10.6 | -8.9 | -7.0 | -6.8 | 144.9 | 162.8 | 198.3 | 198.5 |
| Spain | -9.3 | -6.6 | -5.9 | -5.3 | 61.0 | 69.6 | 73.8 | 78.0 |
| France | -7.1 | -5.8 | -5.3 | -5.1 | 82.3 | 85.4 | 89.2 | 91.7 |
| Italy | -4.6 | -4.0 | -2.3 | -1.2 | 118.4 | 120.5 | 120.5 | 118.7 |
| Cyprus | -5.3 | -6.7 | -4.9 | -4.7 | 61.5 | 64.9 | 68.4 | 70.9 |
| Luxembourg | -1.1 | -0.6 | -1.1 | -0.9 | 19.1 | 19.5 | 20.2 | 20.3 |
| Malta | -3.6 | -3.0 | -3.5 | -3.6 | 69.0 | 69.6 | 70.8 | 71.5 |
| Netherlands | -5.1 | -4.3 | -3.1 | -2.7 | 62.9 | 64.2 | 64.9 | 66.0 |
| Austria | -4.4 | -3.4 | -3.1 | -2.9 | 71.8 | 72.2 | 73.3 | 73.7 |
| Portugal | -9.8 | -5.8 | -4.5 | -3.2 | 93.3 | 101.6 | 111.0 | 112.1 |
| Slovenia | -5.8 | -5.7 | -5.3 | -5.7 | 38.8 | 45.5 | 50.1 | 54.6 |
| Slovakia | -7.7 | -5.8 | -4.9 | -5.0 | 41.0 | 44.5 | 47.5 | 51.1 |
| Finland | -2.5 | -1.0 | -0.7 | -0.7 | 48.3 | 49.1 | 51.8 | 53.5 |
| Euro area | -6.2 | -4.1 | -3.4 | -3.0 | 85.6 | 88.0 | 90.4 | 90.9 |
| United States | -10.3 | -9.6 | -7.9 | -6.2 | 94.4 | 100.0 | 105.0 | 108.9 |
| United Kingdom | -10.3 | -9.4 | -7.8 | -5.8 | 79.9 | 84.0 | 88.8 | 85.9 |
| Japan | -9.2 | -10.3 | -9.1 | -7.8 | 220.0 | 233.1 | 238.4 | 242.9 |

Sources: European Commission Autumn 2011 Forecast and IMF World Economic Outlook (September 2011) in the case of Japan and the United States.



## Debt scenarios (EA, US, UK)




Source: ECB calculations.
Notes: All three scenarios use the IMF World Economic Outlook (September 2011) forecast for general government debt and primary balance up to 2010 as a starting point. Fiscal developments as of 2011 are determined by three alternatives scenarios: Scenario 1 assumes a rather rapid fiscal consolidation process, with the primary balance improving by 1.0 percentage point of GDP per year until an overall balanced budget is reached. Scenario 2 assumes a less ambitious consolidation path, with the primary balance improving by only 0.5 percentage point of GDP per year until an overall balanced budget is reached. Scenario 3 assumes that no consolidation efforts are made. The primary balance remains constant at the forecast value for 2010 over the whole simulation period. The macroeconomic assumptions underlying the three scenarios are as follows: nominal GDP growth comes from the IMF World Economic Outlook (September 2011) up to 2016 and afterwards it is equal to the value of 2016. The nominal implicit interest rate on government debt is assumed constant at the value recorded in 2008 (as the values for the period 2009-10 could be distorted by the financial crisis).