Jörg Asmussen: Key issues about the crisis and the European response

Intervention by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the Center for Strategic and International Studies, Washington DC, 20 April 2012.

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It is a pleasure to be here today at the Center for Strategic and International Studies and I would like to thank Karl-Theodor zu Guttenberg for his kind invitation. In recent years a common theme in U.S. foreign policy discussions was whether to disengage from Europe and focus on the Pacific. Today it seems that people in Washington are more interested than ever in European affairs. Unfortunately, it is for entirely the wrong reasons. How nice it would be to go back to those days of being irrelevant!

I would like to set the stage for our discussion today by addressing some of the key issues about the crisis and the European response to it. These issues get to the heart of the major debates in the U.S. and Europe at the moment. They are complex and they require us to think long-term and avoid simplifications. Ultimately, they are about what kind of Europe we want for the future.

In particular, I will focus my intervention on three questions:

Is the worst of the crisis over?

Is the European response to the crisis killing growth?

Is the ECB's response to the crisis swamping the world with liquidity?

Is the worst of the crisis over?

Policy-makers are often asked if the worst of the crisis is over. It is a difficult question to answer. If we are optimistic we are accused of cheerleading. If we are pessimistic we risk panicking the markets and setting off self-fulfilling cycles. So we have to go by what the data are telling us. And the data show a clear stabilisation in the global economy since last year.

The U.S. is showing signs of a sustained recovery. Data releases have consistently surprised on the upside throughout the first quarter of this year, although April was more mixed. Survey data point to a moderate expansion in economic activity in early 2012. Unemployment is now at the lowest level since January 2009.

In the euro area, survey data confirm a stabilisation in economic activity at a low level in early 2012. We continue to expect the euro area economy to recover gradually in the course of the year. The outlook is supported by strong export growth to the U.S. and emerging markets. Downside risks remain, however, related to a possible worsening of the sovereign debt crisis.

Financial markets are also now generally less volatile – although we must closely monitor the situation in the Spanish government bond market. Certainly the doomsday predictions from the fourth quarter of last year seem to have been avoided.

We should not forget that, only five months ago, *der Spiegel,* the leading German weekly magazine ran an article entitled "A continent stares into the abyss", which declared that the end-game for the euro had begun. The front cover of *The Economist* magazine in the same week asked "Is this really the end?", set against an image of a burning 1 euro coin hurtling towards oblivion. What changed in this time? In my view, the explanation is actions taken at three levels.

First, Member States recognised the seriousness of the situation and implemented major reforms. Spain has begun addressing its competitiveness problem with the most significant labour market reform in a generation. It is also improving central control over regional spending. Italy is increasing competition and modernising its public administration to increase its potential growth. The debt exchange in Greece was successful, which gives the country a fresh start to address its fiscal and competitiveness issues. Ireland and Portugal have continued to implement their EU-IMF programmes, which are both on track.

Second, Europe has strengthened its economic governance. Fiscal rules have been reinforced through the agreement on the fiscal compact, which obliges all euro area countries to run a structural balanced budget. It also shifts the onus for enforcement away from Brussels and onto national institutions, encouraging greater ownership.

Monitoring of economic policies will go deeper through the new "enhanced surveillance" legislation. It allows the Commission to send missions to countries experiencing or threatened with financial difficulties and recommend policy changes. This gives the Commission the power to demand some reforms that the U.S. federal government could not demand of a U.S. state.

Euro area firewalls have been strengthened by the decision to increase the total resources to around I trillion US dollars. Altogether, this presents a convincing package for markets: a tough new set of rules, a strong regime for monitoring those rules, and a credible safety net to back it up.

Third, the ECB has played its part by preventing a funding crisis in the banking sector. The two 3-year LTROs launched in December and February have eased bank funding pressures and stopped further deleveraging. This should over time support lending to firms and households across the euro area.

These actions have pulled the euro area back from the very dangerous situation we faced last year. But the crisis of public and private debt in some countries is clearly not over. The recent rise in Spanish yields is evidence of this. This is no longer a problem that can be addressed through bigger firewalls or a more active ECB. It can only be addressed through consistent and determined reform, even if it is painful in the short term.

In the Spanish case the shift in market sentiment is a result of poor communication on deficit targets and delays in announcing the budget. In other words, Spain currently has a credibility problem with the markets. But this can be fixed by taking measures to regain credibility.

Overall, we should not wait for a "silver bullet" to end the crisis. It does not exist. The end of the crisis will come only after a series of comprehensive steps taken over a number of years. This means all Member States and EU institutions playing their part.

Let me stress that we are greatly helped in this task by excellent transatlantic cooperation, not least between the ECB and the Federal Reserve. Among other things, the provision of dollar swaps lines has been a key weapon in fighting the crisis since 2007. So the U.S. is also playing an important role in supporting the European recovery.

Is the European response to the crisis killing growth?

This leads into my second question: is the response I just described – fiscal consolidation and structural reforms – killing growth in Europe? It is important to understand that we see things differently in Europe and the U.S. In our view, strong public finances are a pre-condition for sustainable growth. We see fiscal consolidation as supporting growth, because it creates confidence effects that will support consumption and investment in the future.

Certainly, the short term effects of consolidation can be negative. We recognise this. That is why we always recommend that consolidation is accompanied by productivity-enhancing structural reforms. This means *inter alia* opening up closed professions, increasing the efficiency of public administration and improving judicial systems. These are reforms that will ultimately benefit the majority of people, by increasing the growth-potential of these economies.

Take the example of Spain. The labour market reforms I mentioned are essential to increase employment. The Spanish labour market has for too long been organised in a way that protects insiders. This is what lies behind the very high rate of youth unemployment.

It may be the case that these reforms will not return some of the current problem countries to pre-crisis growth rates. So there will inevitably be calls for more stimulus. But we should keep in mind that the last ten years were not representative: it was a boom period, built on credit, creating ever larger imbalances.

That party is now over. We need to learn the lessons from it. And the lesson from the bursting of a debt bubble cannot be to load up on more debt. These countries need reforms that undo previous excesses and re-build their economies on a more sustainable basis. This is the direction in which Europe is currently heading. And there is really no alternative.

There is one area, however, where I fear we are not learning the right lessons in Europe. Several European countries face a vicious circle where weak domestic banks cause fiscal difficulties for governments, which in turn undermines public debt sustainability and further damages banks' balance sheets.

In the U.S., such a feedback loop does not exist, because federal institutions act as shock absorbers. They prevent local crises from becoming systemic: for example, banks can be recapitalised through the U.S. Treasury and resolved through the Federal Deposit Insurance Corporation. In Europe we need to look to the U.S. for inspiration in this area. This is why I have called for a European bank resolution authority.

Is the ECB's response to the crisis swamping the world with liquidity?

Let me turn now in more detail to the recent actions by the ECB – in particular, the question whether the 3-year Long Term Refinancing Operations (LTROs) have swamped the world with liquidity. Behind this question is the implication that increasing central bank liquidity *always* leads to distortions, be it inflation or currency volatility. But this misunderstands what central bank liquidity is.

ECB liquidity is a very specific form of money. It can be used only to make payments between banks with accounts at the ECB and to meet reserve requirements. There is no automatic mechanism which converts this liquidity into loans or asset purchases. Banks take such decisions based on factors like their financial strength, their risk aversion and the demand for credit by non-financial corporations and private households.

So we should not make simplistic assertions about one factor leading to another. We should ask: what are we seeing in the data? Looking at credit growth in the euro area, we see few signs of distortions. The LTROs have certainly prevented an abrupt deleveraging. But loans to the euro area private sector increased by only 1.1% in February, compared with an average of around 7% since the start of the euro.

Looking at capital flows to other parts of the world, we see a broadly balanced picture. The euro has in fact appreciated in effective terms since we conducted the first LTRO in December 2011. There have been significant capital inflows due to renewed interest and confidence by foreign investors.

The strongest effect of the LTROs has been on bank funding. Euro area banks issued EUR 55 billion in senior unsecured bank debt in the first two months of this year, more than the whole amount in the second half of last year. This is exactly what the LTROs were intended to achieve: to prevent a bank funding crisis. Over time we expect this to feed into higher credit for firms and households.

When this happens, we will be constantly alert to any threats of inflation. Our commitment to price stability is steadfast and credible. And observers recognise this. Following the two 3 year LTROs market indicators of inflation expectations – that is, investors risking their own money – show no signs of inflation above our medium-term objective.

So to conclude, the euro area still has a lot of work to do to put itself back on a sustainable footing. This work is difficult because it goes to the root of our economic problems. But it is also essential. Solutions that would paper over these problems by creating more debt are not in Europe's long-term interest. They would solve this crisis by creating the conditions for the next one.

But we also need to be patient. The euro area is made up of 17 different democracies. And as you know very well in Washington, democracy is sometimes messy. Events may not play out as an economist would determine in his or her model. We may not take the most direct route to our destination. But important thing is that, in the end, we get there. I am confident that in Europe we are heading slowly but surely down the right track.

Thank you for your attention.