Peter Praet: Heterogeneity in a monetary union: What have we learned?

Speech by Peter Praet, Member of the Executive Board of the ECB, at the 14th ECB and its Watchers Conference, Frankfurt am Main, 15 June 2012.

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It is a great pleasure to be speaking here today at what has, over the years, become a prime opportunity for the European Central Bank to exchange views with ECB watchers on the challenges faced by monetary policy in the euro area. My remarks today will focus on the question of how imbalances in terms of competitiveness and private and public sector debt have gradually led to a worrying degree of heterogeneity in the euro area. I will also highlight the effects of the ECB's liquidity-providing operations, arguing that these contribute to more homogeneous financial conditions across the euro area and allow a smoother adjustment process during the transitional period needed in order to reabsorb accumulated imbalances. I will, however, also argue that these operations can only be regarded as temporary support, as the underlying structural problems and weaknesses require a truly structural response completing the overall architecture of EMU.

When the euro was first introduced, many critics claimed that EMU would not work because euro area countries' business cycles and economic structures were not sufficiently similar. But does economic integration really need to imply economic uniformity? I do not think so. This can clearly be seen in the United States. Regional economies are hit by different economic shocks and perform differently owing to their differing economic structures, even over extended periods. At the same time, institutional safeguards are required in order to ensure that heterogeneous developments do not become self-reinforcing and pose a threat to overall macroeconomic stability. Here in the euro area, we have to acknowledge that economic conditions have, today, become increasingly heterogeneous. But let me state very clearly up front that this does not imply that a common currency cannot succeed in the euro area. To my mind, this means that we need to address the institutional shortcomings and weaknesses of EMU in order to allow the euro area to cope with heterogeneous economic developments and large asymmetric shocks, as is the case in the United States. There, too, economic and monetary union did not occur overnight; it was a long process.

Otmar Issing[1] argued, more than a decade ago, that "one size *must* fit all". Provided that institutions adapt, EMU should be beneficial for all. Since the introduction of the euro, many of us have been aware of institutional deficiencies, both in terms of the prevention of imbalances and as regards the management of such imbalances in the event of a crisis. The crisis is now forcing us to address these deficiencies.

Allow me, in the remainder of my remarks, to look at how and why imbalances arose in the euro area and how the ECB's monetary policy responded to them.

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[1] Issing, O., "The single monetary policy of the European Central Bank: One size fits all", *International Finance*, 4:3, 2001, pp. 441–462.

How and why did imbalances arise in the euro area?

Financial uniformity with increasing imbalances

The situation prior to the financial crisis is best described as one in which euro area countries achieved a very high degree of convergence in terms of financial conditions, while at the same time large macroeconomic and financial imbalances were gradually accumulating.

With the advent of the euro, there was significant convergence in terms of the financial conditions in the various euro area countries. Euro area banks were able to trade with one another in a unified money market. Consequently, there was also significant convergence in terms of the interest rates that banks charged households and firms. Indeed, these are necessary conditions for a single monetary policy that affects all economic agents in the same way. However, the sovereign bonds of the various euro area countries were also priced at rates that were very similar, with those rates bearing little relation to the fiscal and macroeconomic fundamentals of the individual countries. With the benefit of hindsight, this is a puzzling outcome. Clearly, a single monetary policy should imply a single money market interest rate, as well as a single long-term risk-free interest rate. And with inflation expectations converging across the euro area, sovereign bond yields could be expected to become less dispersed. However, despite the single monetary policy, differences in the default risk of individual countries, consumers and firms remained. But financial markets were less wary of such risks, thereby establishing improper incentives for public and private sector borrowers.

One simple summary indicator of the degree of economic heterogeneity is cross-country inflation differentials. These reflect differences between countries in terms of the business cycle, productivity growth and the functioning of labour and product markets. They also affect countries' real interest rates, as well as the international price competitiveness of their goods and services. Monetary union resulted in inflation differentials in the euro area falling to a level comparable to the United States. However, although the two had inflation differentials of a similar size, the persistence of those seen in the euro area remained much greater, pointing to the possible existence of macroeconomic imbalances. As a result, since the introduction of the euro, the persistent inflation differentials in the euro area gave rise to a divergence of relative prices that is twice as large as the one observed in the United States. (Slide 2)

The main driver of those persistent inflation differentials is related to the cross-country differences observed since the introduction of the euro in the implementation of structural reforms and has little to do with real convergence or so-called "Balassa-Samuelson effects". In some euro area countries, governments failed to implement the necessary reforms in their product and labour markets. Consequently, wage growth exceeded productivity growth and prices rose faster than in other countries. (Slide 3) These inflation differentials led to divergent developments in international competitiveness and contributed to the accumulation of unprecedented current account positions in the euro area. (Slide 4)

In a number of countries, this all led to economic activity gradually shifting away from the more export-oriented manufacturing industry towards the more domestically oriented construction sector. Because sectoral reallocation is typically a slow process, it is very difficult to now readjust those countries' economies quickly in response to the crisis. In addition, in most countries there is a high degree of downward wage rigidity, which is a further impediment to rapid adjustment.

Accumulation of private and public sector debt in some countries

Moreover, the persistently higher inflation rates in some countries implied persistently lower real interest rates, particularly in light of the high degree of convergence in terms of nominal lending rates. Countries with lower real interest rates experienced stronger credit growth and housing booms, which placed further pressure on wages and prices. (Slide 5) Lower real interest rates also meant that it was easier for governments to borrow, slowing down fiscal consolidation. Governments did not adopt sufficiently counter-cyclical policies to limit their own accumulation of debt or to counteract the accumulation of debt in the private sector. In fact, because those economic booms were based on stronger domestic consumption and rising property prices, they led to improvements in cyclical fiscal balances as long as the boom went on, so that governments had few incentives to tighten fiscal policy before the bust set in.[2]

The accumulation of imbalances was exacerbated by institutional deficiencies

The question naturally arises as to why this unsustainable degree of heterogeneity occurred in the euro area and not the United States. In the United States, regional imbalances tend to be more mean-reverting, owing to higher levels of labour mobility and more flexible product and labour markets. At the same time, there is also less scope for unsustainable accumulation of debt at state level. Most states have adopted legislation that prevents them from accumulating the levels of debt seen in the euro area.[3]

The institutional design of the euro area has clearly given rise to moral hazard and lacked the capacity to credibly engage in measures to prevent rising imbalances.[4] Although there was an unseen accumulation of debt in some euro area countries, financial markets were allowed to set financial conditions in such a way that private and public sector borrowers in those countries could essentially continue to borrow at the same interest rates as borrowers in countries with much sounder fiscal and macroeconomic fundamentals. As a result, financial flows ran from countries with strong productivity growth to countries with weak productivity growth, fuelling a persistent economic boom based on the accumulation of debt. To be efficient, financial flows should instead have run towards countries with higher levels of productivity growth.

Heterogeneity during the crisis and the ECB's response

The financial crisis has led to a strong increase in heterogeneity within the euro area. The re-emergence of cross-country differentials in terms of financial conditions has contributed to divergence in macroeconomic and financial fundamentals. Conversely, these heterogeneous financial conditions mainly reflect persistent fiscal, macroeconomic and financial imbalances, as well as persistent structural problems in several countries.

The first dimension of heterogeneity concerns real developments. Some countries have recovered well while others continue to be affected by persistent structural problems. But some of the macroeconomic imbalances have begun to adjust. Competitiveness has improved in countries where labour costs used to persistently exceed the euro area average. That being said, such adjustment has remained too limited. Sizeable imbalances persist, particularly high levels of public and private sector debt and vulnerabilities in the financial sector. Looking ahead, it is of the essence that government policies decisively address these various fiscal, financial and structural impediments to growth.

This brings me to the second – and most evident – dimension of heterogeneity, namely the sharp divergence observed in financial conditions in euro area countries. In the course of the crisis, secured and unsecured money markets have become increasingly impaired,

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[2] See, for instance, Bénétrix, A. and Lane, P., *Fiscal cyclicality and EMU*, Trinity College Dublin, mimeo, 2012.

[3] See, for instance, Henning, R. and Kessler, M., "Fiscal federalism: US history for architects of Europe's fiscal union", *Bruegel Essay and Lecture Series*, 2012.

[4] See, for instance, Persson, T. and Tabellini, G., "Federal fiscal constitutions: risk sharing and moral hazard", *Econometrica*, 64, 1996, pp. 623–646.

especially across national borders. Countries' sovereign bond yields have diverged significantly. Corporate bond markets have also experienced tensions. Overall, there is ample evidence that country-specific factors have become more important in driving yields.

The emergence of fragmented financial markets within the euro area began in the aftermath of Lehman Brothers' default and intensified following the onset of the sovereign debt crisis in May 2010. Financial integration came to a halt and was partly reversed, as can be seen from the fact that non-bank debt securities were increasingly purchased domestically, with non-domestic euro area holders selling these bonds. (Slide 6) Euro area countries' financial sectors retreated within national borders.

As a result of those fragmented financial conditions, the transmission of the ECB's monetary policy stance to interest rates was increasingly impaired. Moreover, banks in countries in which government finances were under strain faced restricted access to the money market and other sources of financing, given the interconnectedness between banks and sovereign states. Had this been allowed to continue, these funding restrictions would probably have hampered growth in credit to households and non-financial corporations. This, combined with deleveraging needs, could have resulted in a "credit crunch" in several parts of the euro area, with negative consequences for the economy and price stability in the euro area.

In reacting to this exceptional degree of heterogeneity, the ECB's monetary policy continued to be guided by its objective of ensuring price stability for the euro area as a whole. Key ECB interest rates were reduced significantly. In addition, non-standard measures were adopted in order to support the functioning of the transmission mechanism by bringing back liquidity to dysfunctional markets. For instance, in light of the constraints in funding markets for banks, the maturities of longer-term refinancing operations were successively extended, culminating in the three-year operations conducted in December 2011 and February 2012. Following these operations, funding constraints have eased, with money market spreads declining. (Slides 7 and 8) Moreover, the already broad collateral framework has been extended further, with corresponding risk control measures to mitigate the Eurosystem's exposure to risk. This has made it easier for collateral-constrained banks to continue to participate in refinancing operations.

Overall, banks' recourse to refinancing operations has been particularly strong in those countries that have been worst affected by the crisis. While open to all, the ECB's non-standard measures have been used most intensively in countries facing financial stress. Cross-country differences in the use of non-standard measures have thus largely reflected heterogeneity in financial conditions across the euro area. Our policy measures have helped to reduce heterogeneity in financial conditions thereby ensuring a smoother transmission of monetary policy across the euro area.

The extent of the heterogeneity in banks' financing needs can also be inferred from national central banks' balances in TARGET2. These balances reflect the national central banks' net claims or liabilities resulting from commercial banks' cross-border payments in TARGET2. The increasing net liabilities of some national central banks are a reflection mainly of funding stress in their individual banking systems, with financial outflows being compensated for by increased recourse to Eurosystem refinancing operations. (Slide 9)

Our policy measures have, in particular, increased the ECB's intermediation between banks. Looking at the interbank market, reduced willingness to lend, especially across borders, has hampered the distribution of liquidity to those banks that are most in need of it, particularly banks in countries facing financial stress. Increases in deposits held with the Eurosystem by banks in financially strong countries can be seen as an indication of the degree of disintermediation in the money market. (Slide 10) Banks in such countries tend to be recipients of cross-border payment flows and therefore need less central bank liquidity than banks in countries facing financial stress.

The surplus of central bank liquidity in banks in financially stronger countries has raised concerns that such liquidity could fuel asset price bubbles in parts of the euro area, potentially posing a threat to price stability. These concerns are not warranted at the current juncture. Thus far, only a moderate recovery has been seen in asset prices. As regards the housing market, developments in money and credit – traditionally good leading indicators of booms in house prices – have remained subdued. However, we will continue to pay close attention to such developments.

Conclusion

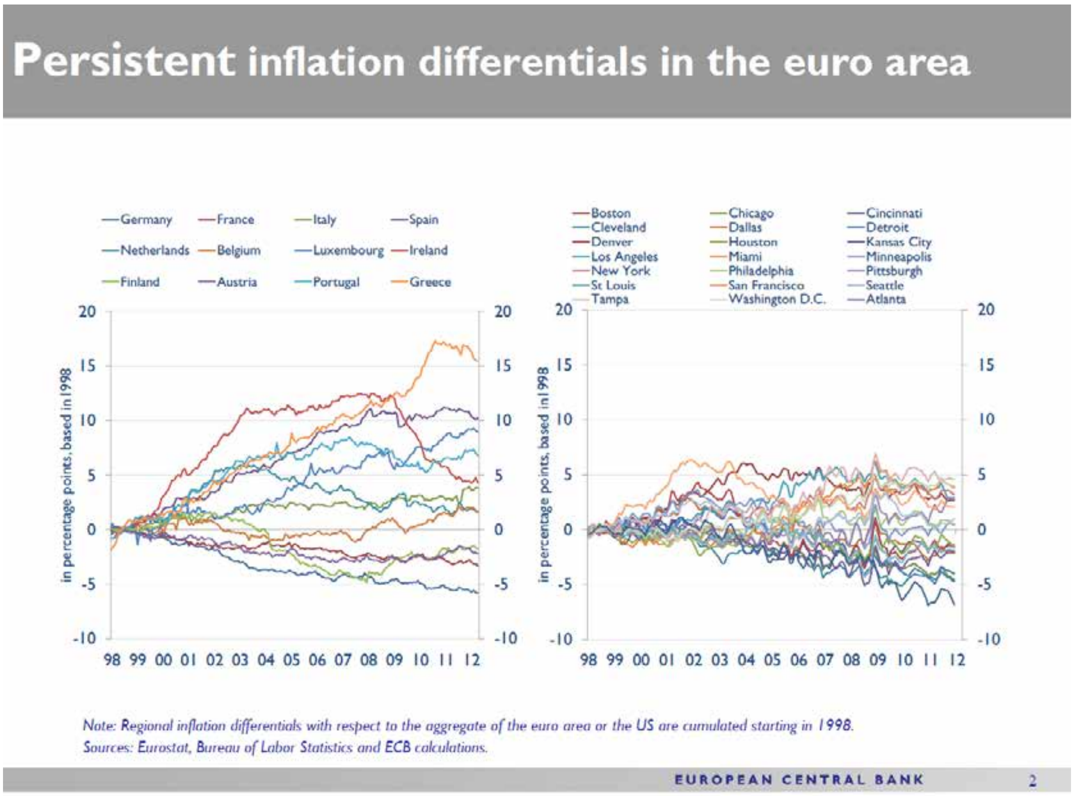
To sum up, the measures adopted by the ECB have contributed to greater homogeneity in the pass-through of policy rates to the economy, with a view to maintaining price stability. However, monetary policy cannot provide a lasting solution to the underlying problems causing this persistent heterogeneity. While the ECB can help to ensure a smooth adjustment process and offer temporary relief, this cannot replace the necessary structural adjustment. Instead, governments need to act in a variety of policy areas – particularly as regards fiscal consolidation, structural reforms and financial stability – within a reinforced governance framework at the European level. This is the only way that we can put the euro area back on a sustainable growth path.

The crisis has highlighted several shortcomings in the institutional framework of EMU, and these need to be addressed. This framework failed to ensure sound fiscal discipline in all euro area countries, as well as to prevent or correct the accumulation of financial and competitiveness imbalances. Crisis management and financial sector repair – such as the rescue and resolution of financial institutions – were left to national authorities, despite considerable cross-border activity in the financial sector. We saw only too clearly that the interconnectedness of banks and sovereign states can lead to adverse feedback loops between sovereign and bank financial conditions, with significant consequences for the macroeconomic stability of the euro area as a whole.

Several steps have already been taken with a view to enhancing the governance framework for EMU and improving the prevention and correction of fiscal, macroeconomic and competitiveness imbalances. At the same time, an overhaul of the framework for financial supervision and regulation has been initiated. Finally, firewalls and crisis management instruments have been established in order to further safeguard financial stability, particularly by addressing the risk of contagion across countries and financial market segments.

Looking ahead, further steps will need to be taken in order to supplement the single monetary policy with a more integrated framework for bank supervision, resolution and deposit insurance, as well as far more extensive coordination of government policies affecting competitiveness. As the President said this morning, if we are to achieve this, euro area countries will inevitably need to surrender more national sovereignty and increase their coordination of national policies. The global economy is becoming increasingly integrated. The importance of national sovereignty has been waning as a result of increasing economic interdependence at the global level. It is an illusion to think that, in an integrated world, countries will be able to decouple themselves from developments in other countries.

Thank you for your attention.


Persistent inflation differentials in the euro area
Germany
France
Italy
Spain
Netherlands
Belgium
Luxembourg
Ireland
Finland
Austria
Portugal
Greece
in percentage points, based in 1998
98 99 00 01 02 03 04 05 06 07 08 09 10 11 12
Boston
Cleveland
Denver
Los Angeles
New York
St Louis
Tampa
Chicago
Dallas
Houston
Miami
Philadelphia
San Francisco
Washington D.C.
Cincinnati
Detroit
Kansas City
Minneapolis
Pittsburgh
Seattle
Atlanta
in percentage points, based in 1998
98 99 00 01 02 03 04 05 06 07 08 09 10 11 12
Note: Regional inflation differentials with respect to the aggregate of the euro area or the US are cumulated starting in 1998.
Sources: Eurostat, Bureau of Labor Statistics and ECB calculations.
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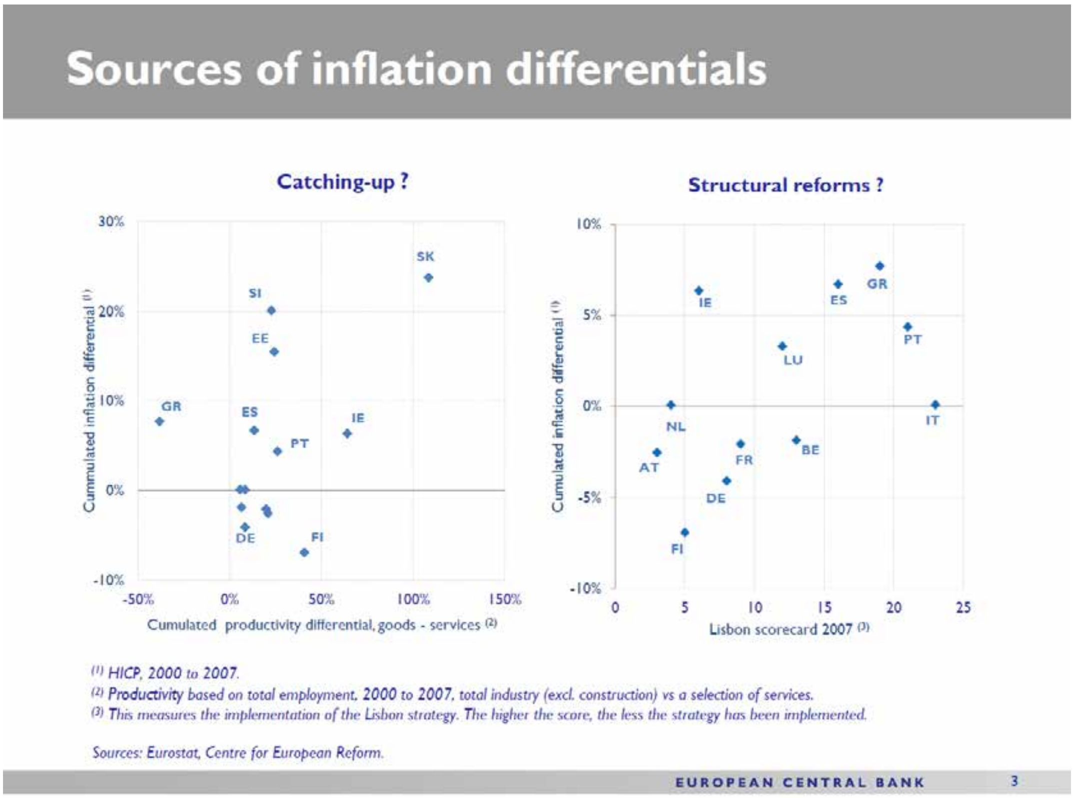
Sources of inflation differentials
Catching-up ?
Cummulated inflation differential (1)
Cumulated productivity differential, goods - services (2)
SK
SI
EE
GR
ES
IE
PT
DE
FI
Structural reforms ?
Cumulated inflation differential (1)
Lisbon scorecard 2007 (3)
IE
ES
GR
PT
LU
NL
IT
BE
FR
AT
DE
FI
(1) HICP, 2000 to 2007.
(2) Productivity based on total employment, 2000 to 2007, total industry (excl. construction) vs a selection of services.
(3) This measures the implementation of the Lisbon strategy. The higher the score, the less the strategy has been implemented.
Sources: Eurostat, Centre for European Reform.
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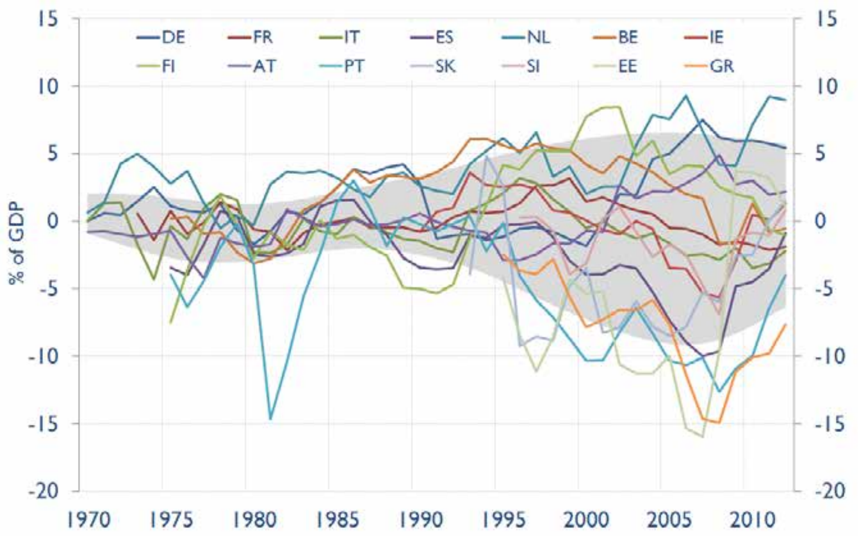
Current account divergences in EMU



Note: The grey area represents the difference between the HP filtered trend of the 90th and 10th percentile of the current account balances across countries.

Sources: OECD and ECB calculations.

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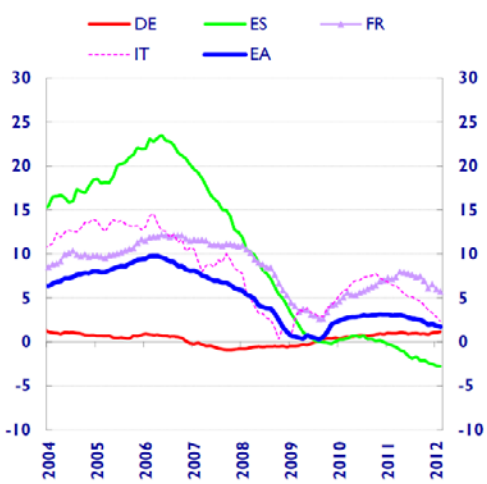
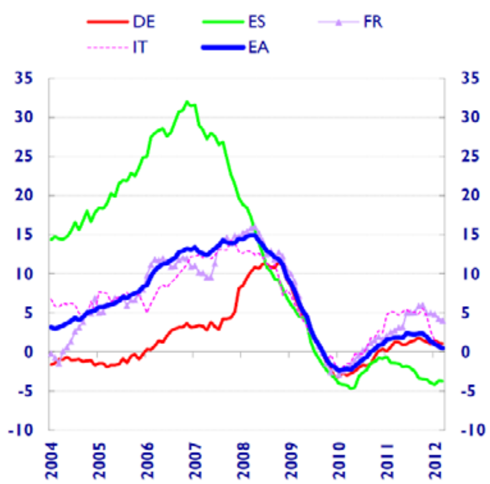
Lending to the non-financial private sector in the largest euro area countries

Household loan flows in "large countries"
(annual growth rates; not seasonally adjusted; adjusted for securitisation)



NFC loan flows in "large countries"
(annual growth rates; not seasonally adjusted; adjusted for securitisation)



Source: ECB and ECB calculations.

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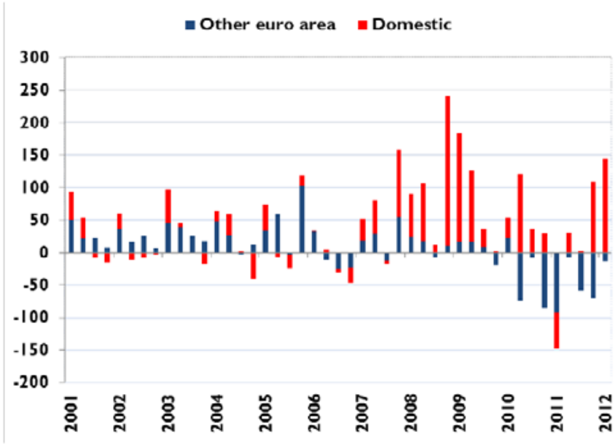
Heterogeneity during the crisis: financial flows

MFI holdings of Non-MFI debt securities, domestic vs other euro area countries (quarterly flows, EUR billions)



Notes: "Domestic" shows purchases by MFIs in a euro area country of government and (non-bank) private sector debt issued by that country. "Other euro area" shows purchases of such debt by MFIs in other euro area countries.

Source: ECB and ECB calculations.

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Repo (secure) market interest rate for banks In the largest euro area countries

Source: Commerzbank

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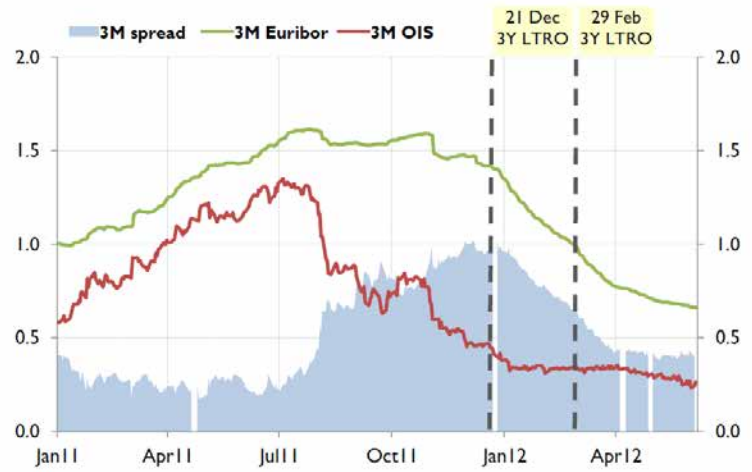
Money market spread compressed following three-year LTRO



Source: Thomson Reuters.

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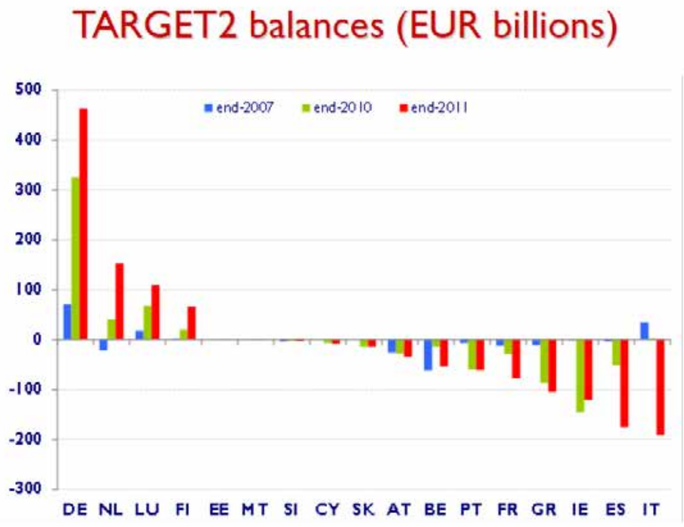
Heterogeneity during the crisis: TARGET2



Sources: NCBs.

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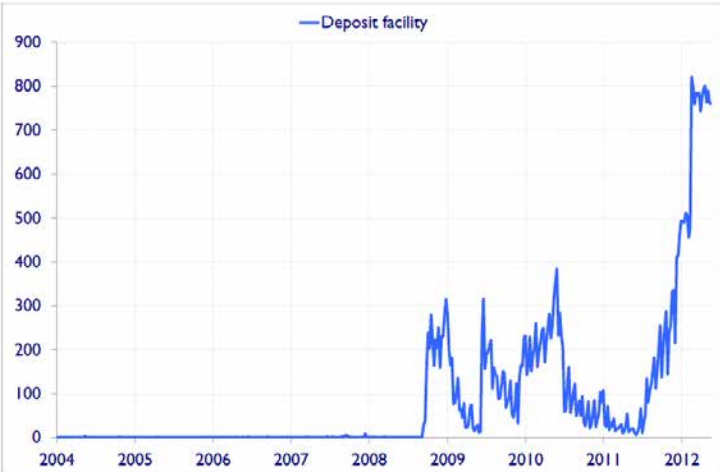
Heterogeneity during the crisis: excess reserves

Recourse to Eurosystem's deposit facility (EUR billions)



Note: Latest observation is for 1 June 2012.

Sources: ECB and ECB calculations.

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