Peter Praet: The “Great Rebalancing” of the euro area and the global economy

Keynote speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Hamburg Summit “China meets Europe”, Hamburg, 30 November 2012.

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Many thanks for your kind invitation to speak at this summit on the future of China and Europe in the global economy.

The pre-crisis period is sometimes referred to as the “Great Moderation”,[1] and the onset of the crisis in 2007 and 2008 as the “Great Recession”.[2] Today I’d like to provide an additional perspective and suggest that we may now be experiencing a “Great Rebalancing”.

The period before the crisis was marked by the global build-up of large external and domestic imbalances. The United States had large current account deficits and China large surpluses, while there were serious macroeconomic imbalances across the euro area. However, the eruption of the global crisis about five years ago marked the start of a major rebalancing. Demand patterns – both at the global level and within the euro area – have been undergoing a significant rebalancing process, which has admittedly been painful in some ways, but necessary from an overall perspective.

A key question now is whether this process is cyclical or structural. Today I will argue that part of the “Great Rebalancing” is structural, which is welcome. But another part is cyclical, meaning that it might fade out as soon as global economic growth turns a corner. So it’s a concern that if countries are not sufficiently committed to carrying out the necessary reforms, unsustainable imbalances might re-emerge which would then put the global recovery at risk.

Let me now focus, in turn, on signs of a “Great Rebalancing” in the United States, the euro area, and China, as well as on the role of macroeconomic policies in this process.

Let me start with the United States. Before the collapse of Lehman Brothers in 2008, the large external deficits of the United States were a major source of concern. The US current account deficit reached 6% of GDP in 2006, its highest level since 1945. Such deficits reflected a wide array of factors, including a housing bubble, increasingly leveraged households and growing fiscal deficits. Many observers feared an abrupt unwinding of these deficits, leading to a disorderly adjustment in global financial markets.[3]

The adjustment started with the collapse of Lehman Brothers. Some of the internal and external imbalances in the US economy that were at the origin of the crisis have now begun to correct. The real estate market has gone through a major adjustment, declining by 30% compared to its pre-crisis peak; excessive leverage of households and financial firms has been reduced; and the US current account deficit has roughly halved relative to pre-crisis levels, to about 3% of GDP.

The adjustment will only remain durable, however, if efforts to complete the necessary reforms continue. These include continuing financial sector and regulatory reform; designing a credible strategy for medium-term fiscal consolidation to ensure the sustainability of public

[1] See “The Great Moderation”, remarks by Federal Reserve Chairman Ben Bernanke at the meetings of the Eastern Economic Association, Washington DC, 20 February 2004.

[2] See Rogoff, K., “*The Second Great Contraction*”, Project Syndicate, 2 August 2011.

[3] See, for example, Obstfeld, M. and Rogoff, K., “Global current account imbalances and exchange rate adjustments”, *Brookings Papers on Economic Activity*, 1:2005, pp. 67–123.

finances; and pursuing structural reforms to help strengthen the competitiveness of the export sector.

Consider now the situation on this side of the Atlantic.

The euro area as a whole was not imbalanced prior to the crisis, nor is it so even today. The current account of the euro area has been roughly balanced since the start of Economic and Monetary Union in 1999. On average, the general government primary budget of euro area Member States will be almost in balance this year, and will record a small surplus next year, according to the IMF.

However, this has masked significant intra-euro area imbalances in terms of current account positions, competitiveness and public finances. For instance, the real effective exchange rates of Greece, Ireland, Italy, Portugal and Spain had appreciated on average by 16% relative to that of Germany between 1999 and 2008, whereas the real effective exchange rate of the euro appreciated by only 3% over the same period.

A significant process of rebalancing is now under way in Europe, particularly in the euro area. After several years of artificial calm in global financial markets and the hunt for yield before the crisis, there has been a major repricing of risk. This has led to a marked tightening of borrowing conditions, initially for financial corporations and subsequently for sovereigns. Some of the most severely affected sovereigns were euro area Member States that had enjoyed relatively benign financing conditions before 2008. But they had not taken sufficient advantage of these conditions to put public finances on a sustainable path, or implement structural reforms that would have improved their economic competitiveness and smoothed their adjustment.

A sometimes painful, but necessary, rebalancing process has started within the euro area. Some fundamental progress has already been made in tackling intra-euro area imbalances:

- Budgetary deficits are being reduced. The IMF expects the euro area to have a primary budget deficit of 0.5% of GDP this year, well below the average of the G20 advanced economies (4.8% of GDP). Moreover, it is those countries most in need that are making the largest structural adjustments;
- Competitiveness in programme and vulnerable countries is being restored. In the countries most affected by the crisis, noticeable progress is being made in the correction of unit labour costs and current account imbalances. In full EU-IMF programme countries (Greece, Ireland and Portugal), unit labour costs have improved by around 10% since 2008, relative to the euro area average. This has translated into current account deficits that are on average more than five percentage points of GDP lower than they were then;
- Thanks to the ECB’s non-standard measures, which have given European banks the breathing space needed to implement their restructuring plans in an orderly fashion, those banks have substantially increased their capital buffers. There has been no disorderly deleveraging, which was perceived as a major concern at the end of last year.

This process of rebalancing within the euro area is coupled with sluggish growth and slower euro area import growth, which is arguably not without cyclical implications for the rest of the world. In particular, trade between the euro area and China has recently declined. In the first half of 2012 China’s exports to euro area countries contracted by around 3% in nominal terms, compared with growth of about 30% between 2002, when China joined the WTO, and 2008, when the crisis erupted. In 2008 more than 15% of Chinese goods exports were destined for the euro area, a share which was also rising relative to that of the United States and Japan. By contrast, that share has since declined to about 13%.

The crisis not only exposed the imbalances existing within the euro area but also revealed the incomplete character of Economic and Monetary Union (EMU). The governance framework underpinning EMU proved insufficient to create adequate incentives to address macroeconomic imbalances, foster sound public finances and prevent the propagation of shocks to the European financial system.

In order to secure long-term stability in the euro area and ensure a durable rebalancing, some of the initial design flaws in the euro area's governance structure need to be fixed permanently. This requires a concerted effort from governments to complete EMU.

In this regard, the "Four Presidents" (of the European Council, the European Commission, the Eurogroup and the ECB) have identified four pillars on which to build a genuine EMU and so a more stable and prosperous Europe. These pillars are: a banking union with a single supervisor; a fiscal union that can effectively prevent and correct unsustainable budgets; an economic union that can guarantee sufficient competitiveness to sustain high employment; and a political union that can deeply engage euro area citizens.

Progress is being made on all four pillars to build a genuine EMU. However, the road towards a complete EMU is still long. A firm commitment from governments is the best insurance that we are building the bridge to a more stable and prosperous euro area, one in which the rebalancing we observe today will be here to stay.

There is evidence that rebalancing has also started in China. The current account surplus has narrowed markedly, from 10% of GDP in 2007 to less than 3% of GDP in 2011; foreign exchange reserve accumulation has slowed down significantly, with reserve holdings remaining roughly stable in the course of 2012; and, finally, there seem to be signs that the economy is gradually shifting from external sources of demand to domestic sources . A key question is how much of this rebalancing is due to cyclical factors, in particular slower growth in advanced economies. There have been concerns that China's growth model remains overly reliant on investment at the expense of consumption, and that house price valuations are stretched.

So in China, too, a permanent rebalancing hinges on the continuation of structural reforms, including: the continued expansion of social safety nets; the reform of the banking sector; the gradual liberalisation of the capital account; and the strengthening of exchange rate flexibility, as envisaged by Chinese authorities. The latter two are pre-conditions for further currency internationalisation to allow foreign investors to invest in China, deepen financial markets and improve the allocation of capital in the economy.

What is the role of monetary and fiscal policies in this process? In those cases where unsustainable fiscal policies were at the very origin of imbalances, the priority is to restore and ensure the medium-term sustainability of public finances. Another priority is to strengthen financial sector stability and avert the build-up of risks and vulnerabilities, including unsustainable lending booms, through adequate regulatory, supervisory and macro-prudential tools.

As regards monetary policy, central banks in advanced economies have also been doing their part, helping to make the rebalancing process as smooth as possible. Central banks acted within their particular mandates, which in the euro area is to preserve price stability over the medium term. They have taken non-standard measures, which have helped avoid an abrupt deleveraging of the banking sector, which might have had highly-damaging consequences.

There have also been concerns, notably among emerging market policy-makers, that measures taken by central banks in advanced economies could foster excessive flows of capital to their economies, put upward pressure on their exchange rates and lead to bubbles in domestic financial asset prices. The relation between monetary policy in advanced economies and global financial flows is not purely mechanistic, however. Financial flows to emerging economies depend on a host of factors over and beyond interest rate differentials, including the attractiveness of emerging market economies themselves in terms of growth potential or global risk aversion. Moreover, the monetary policy of major advanced economies is not only beneficial to their domestic economies, but has positive externalities for the growth of the global economy as a whole, including emerging market economies.

Let me now conclude.

The outbreak of the crisis triggered a “Great Rebalancing” process at the global level. It is a painful, but necessary, process, which is partly cyclical. Each continent, America, Europe and Asia, must continue making every effort to ensure that this process remains durable.

In recent years, particular attention has been paid to the situation and reform agenda in the euro area. However, not only euro area countries, but all other countries too, have to implement structural reforms, many of which are discussed within the G20, to progress towards more sustainable and balanced growth. We, in Europe, are doing our part by endeavouring to advance on the reforms needed for a durable intra-euro area rebalancing.