Benoît Cœuré: The three dimensions of the euro area crisis

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the Asia-Europe Economic Forum conference on “European troubles, Asian worries”, Brussels, 21 January 2013.

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Ladies and Gentlemen, dear friends,

It is a great pleasure to speak to you tonight. I would like to express my appreciation to the Asia-Europe Economic Forum for its collective thinking on our common economic challenges.

The economic policy debate over recent years has been preoccupied with the “European troubles” – as the conference title indicates. It is certainly encouraging that the focus of this debate is starting to shift from: “How much worse does it get?” to “Is it finally getting better?”. There are signs of convalescence and “re-integration” in European financial markets. Yet, these are revertible and should by no means induce complacency. As Christine Lagarde warned last week: “We stopped the collapse, we should avoid a relapse, and it’s not time to relax”.

This holds true for analysts and policy-makers alike. There should be no “relapse” in thinking about the crisis. To ultimately succeed, policy action must be based on a comprehensive and principle-based diagnosis of the problem. And to obtain such a diagnosis, one sometimes has to step back and look at the overall picture. That is what I will do in today’s speech.

To this end, let me start with the following basic question: what is the exact nature of the crisis that we have been discussing for so long?

The use of the term “crisis”, in the singular, is, in itself, somewhat misleading: all crises are combinations of several distinct phases and dimensions which all require their own specific response. The euro area crisis has often been described as the combination of a sovereign debt crisis, a banking crisis, and a macroeconomic crisis.[1] Here, I will take a different perspective and argue that some key dimensions of the crisis are not specific to the euro area. I see three key dimensions of crisis that we have to deal with. The first one takes the form of a classic debt deleveraging cycle. This dimension is probably the most visible materialisation of crisis but it is only a symptom of the underlying problem. In fact, there is a deeper dimension which I will refer to as a second dimension of the crisis, the “crisis of the social contract”. The latter reflects a fundamental misalignment between the economic status that industrial countries have grown accustomed to and the material conditions that are affordable without a profound shift in economic policies. But in engineering such a shift, a third dimension comes to the fore, namely a crisis of the institutional architecture. As regards this third dimension, I will focus on the European context where policy-makers have to conduct a fundamental overhaul of EMU simultaneously with their acute crisis fighting efforts.

I will argue that these different crisis dimensions reinforce each other and pose particular challenges for policy-makers, both in designing appropriate policy responses and in communicating them. I will also argue that, in contrast to the former two crisis dimensions, which affect all mature economies, the third dimension is the most specific to the European context.

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[1] See Jay C. Shambaugh, “The Euro’s Three Crises”, Brookings Papers on Economic Activity, Spring 2012, or the special report of the German Council of Economic Experts, “After the Euro Area Summit: Time to Implement Long-term Solutions”, July 2012.

Three dimensions of the crisis

Debt deleveraging

The global deleveraging process will feature prominently in tomorrow's conference programme, so I will restrict myself to a stylised account of the most salient features only.

Its roots can be found in the pre-crisis period, when economic activity markedly exceeded the sustainable long-term trend. This excess, which was observable in virtually all major industrialised countries, was fuelled by an aggressive accumulation of debt in various sectors of the economy, driven by, inter alia: unchecked financial innovation; the absence of binding and consistent macro- and micro-prudential policies that could prevent escalating stability risks; and a failure of financial markets to appropriately sanction failed public policies and unsound business models.

As a consequence, ever more consumption was financed by borrowing against future incomes. But instead of systematically reflecting this inter-temporal shift of consumption opportunities in higher real borrowing costs, credit conditions were largely unaffected. Mispricing of credit can be protracted, but it exposes the credit market to sudden reversals of sentiment. This occurred when a number of shocks, initially fairly confined to the US financial sector, spread sustainability fears through the global chain of financial cross-exposures. The continuous frontloading of aggregate demand through financial leverage came to an abrupt end. The bubble duly burst.

The ensuing financial turbulence quickly morphed into a general deterioration in overall credit conditions; and this dragged down economic activity and threatened fiscal sustainability in numerous countries. Moreover, many governments had to intervene in domestic banking sectors to preserve financial stability. This resulted in a massive transfer of liabilities which in some cases overwhelmed government balance sheets.

Let me emphasise two issues at this stage. First, while the depth of the current crisis in Europe and in other industrialised countries is unprecedented in recent history, its structure is by no means unique. For example, much of the above-mentioned evolution could be observed in the Asian crisis in the late 1990s and in countless currency crises in developing economies before and since.

Second, from a broader perspective, the concrete manifestation of the deleveraging pressures is of secondary relevance: whether the strains show up on governments', households' or firms' balance sheets has important short-run distributional implications. But ultimately, they confront policy-makers with the same challenges: in the acute crisis phase, they have to promote and control the balance sheet adjustments – which are necessary – by way of policies that avoid depressionary spirals of the kind seen in the 1930s. Once they succeed, economic activity will likely resume its upward trend, albeit from a lower base. At this stage, the common challenge for policy-makers is to "re-base" growth on a new and sustainable trajectory. And the extent of this rebasing can be substantial. For example, the latest IMF World Economic Outlook suggests that estimates for potential output in advanced economies may have to be revised downwards by around 10 percentage points in level compared with pre-crisis trends, not to mention possible revision in trend growth rates.[2]

Given the exceptional size of the initial imbalance during the current crisis and limited flexibility in labour, product and service markets in the euro area, this deleveraging may well extend over a protracted period of time.

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[2] Source: IMF World Economic Outlook – October 2012; Chapter 1.

A misalignment in the social contract

This brings me to the second dimension of the debt crisis, which is the recognition that governments around the world have entered into long-term commitments beyond the limits of sustainability. Importantly, these commitments are not necessarily the product of an explicit contract, like a bond or a loan. In fact, in large part they take the form of implicit policy promises.

The re-basing of economic activity thus has broader implications. Inevitably, it forces countries to reassess their social contracts. And such a reassessment is nowhere more visible than in the fiscal domain where political consensus is translated into tangible distributive choices.

To understand this dimension, it is useful to consider a stylised version of the inter-temporal government balance sheet: the government has explicit financial liabilities – as recorded in gross government debt figures. And it has assets, including for instance its stakes in publicly owned companies and holdings of public capital more broadly. But these two items are comparatively small. Much more important are implicit fiscal assets and liabilities. Implicit fiscal assets are the discounted value of all future tax revenues. Implicit fiscal liabilities are the discounted value of all future primary expenditure.

If the residual value of the balance sheet or "public equity" is negative, then somebody has to pick up the bill at some point: either taxes have to increase – implying a loss for the taxpayer; or government expenditure has to be reduced – implying a loss for those who benefit from public services; or the value of the debt has to be reduced – which means a loss for the creditors. In this framework, monetisation of government liabilities through a permanently higher inflation rate is comparable with a tax imposed on consumers. In all industrialised economies, it is explicitly discarded by central banks' price stability mandate.

The recognition of losses, and the choice of who has to bear such losses are essentially political decisions. They can be postponed so long as governments have easy access to market finance. But market access can dry up, as experienced during this crisis by some countries, where potential creditors have come to doubt that they will be repaid.

Such doubts can either pertain to the *economic ability* of governments to stay current on their financial obligations. In other words, market participants may conclude that the public sector is on the wrong side of the "Laffer curve", so that a further tightening of the fiscal stance would be counterproductive. Or, they doubt the *political ability* of governments (let alone their willingness) to service their debts in view of political constraints. That is, creditors may come to realise that their explicit claim on the government is not necessarily senior to the implicit promises that the government made to taxpayers and beneficiaries of government spending.

As a result, the use of government balance sheets to borrow from future generations becomes more costly. At this point a gap opens up between the economic status that countries are accustomed to and the status that is affordable given the sustainable growth trajectory. In the crisis, this gap grew wider and became harder to close by the re-basing of economic activity. But the gap predated the crisis. Warnings on the long-run sustainability of public finances, arising from unfunded social promises in a context of ageing populations, were legion long before the crisis erupted. And these warning were indeed addressed to most industrialised countries around the globe. Nonetheless, in the five years prior to the current crisis, which were marked by very favourable cyclical conditions, government spending still outpaced GDP growth in most industrialised countries. In fact, this trend was more pronounced in the US and Japan – where the average growth rate in government spending exceeded the average nominal GDP growth rate by 1½ and 2 percentage points respectively – than in the euro area where this difference only amounted to around one quarter percentage point.

This second dimension is a crisis of the social contract, a contract that was established in the post-war era and that was fair and affordable at that time. It was fair because it implied

solidarity towards the generation that experienced the war. It was affordable because of favourable demographics and growth prospects that were supported by rapid technological progress and a replenishment of the lost social capital. To sustain the key elements of this social contract a profound shift in economic policies is necessary in order to rethink the contract and, at the same time, elevate the long-term rate of growth.

The incomplete institutional architecture of EMU

Engineering such shift in policies requires a sound and robust institutional environment with an ability to produce political consensus – which brings me to the third dimension of the debt crisis in Europe, namely the incomplete architecture of Economic and Monetary Union.

In this regard, the crisis has uncovered four shortcomings in particular: first, the EU fiscal rules were incapable of promoting prudent fiscal policies in good times; second, there was no robust mechanism to prevent macroeconomic imbalances within the EU or to correct them; third, insufficient coordination of macro and micro-prudential supervision of financial sectors allowed a build-up of vulnerabilities in banking sectors; and finally, the absence of a crisis management framework frustrated efforts to contain contagion between countries and between the balance sheets of banks and sovereigns, respectively.

These shortcomings were a catalyst for the other two crisis dimensions: they facilitated excessive leverage throughout the economy which in turn sowed the seeds for the ongoing deleveraging crisis; they did not address the spillovers stemming from interconnected financial systems in a single currency area, and they failed to impose tough budget constraints on governments, thus allowing them to postpone their efforts to address the crisis of the social contract, and leaving them without adequate fiscal space to cushion the crisis.

In several European countries the current episode of fiscal austerity is sometimes attributed to the renewed focus of the institutional setting on budgetary discipline. But, in fact, the ongoing fiscal tightening is a necessary consequence of the misalignment of the social contract: already during the boom period preceding the crisis, public commitments in these countries were entered into at the cost of future generations; the crisis then revealed that: first, projected expenditure was too high in view of plausible revenues; and second, these projected revenues had to be revised downwards as the whole economy was rebased downwards. Moreover, the problem is by no means specific to the euro area, as vividly documented by the intense political debates in other industrialised economies, such as the US, the UK or Japan. The misleading attribution of fiscal austerity to European governance arrangements creates excessive political costs for the much needed strengthening of institutions, and should be rejected.

However, even if such attribution is misleading, it demonstrates that the three dimensions of the crisis interact in a way that creates a "political trap" in which political consensus is hampered by a wrong diagnosis of the crisis, thus delaying the necessary policy shifts. The "political trap" is compounded by the strong inter-governmental dimension of European governance: elected leaders are locally mandated through local political processes, that fail to internalise positive cross-country externalities arising from policy changes. For political leaders this should imply that they have to step up their efforts in clearly communicating the current economic problems and feasible options. At national level, they must ensure that the body politic coalesces around policies aiming at restoring the credit of the state, as this is the only way to preserve our social model. And they must accept that European interest will be better promoted by strong community institutions.

Crisis resolution

Against this background, addressing the three dimensions of the crisis at once may appear as a daunting task. But precisely because the dimensions are so closely intertwined, successful reforms in either one of them can trigger a virtuous circle in the others.

The reform agenda should rest on several pillars. At its core, a rethinking of the social contract is necessary to restore economic sustainability. This clearly has to comprise some degree of spending reduction and/or tax increase, which in the short-term will negatively impact growth. Yet, this should also be complemented by reforms of labour and product markets with a focus on raising work-force participation, including through longer working lives, and on increasing price flexibility.

Some argue that even structural reforms would immediately restrain spending and activity. This needs to be strongly qualified. Structural reforms which open up closed professions and dismantle rent-seeking oligopolies in the production and distribution of goods and services can promote a shift of supply and lower prices, which in turn can sustain real incomes at times when nominal incomes do not grow or even fall. In these conditions, engineering a positive output shock will be the key remedy to the European troubles. It would (partly) offset the negative shock of the "Great Recession", when economic activity was rebased to a permanently lower level. If it supports skills and the ability to innovate, it could even increase long-term output trends. As a further side effect, it would crucially contribute to induce a "re-convergence" of Europe's economies, in other words, the gap between net debtor and net credit countries would be narrowed. This in turn would facilitate consensus on a common course of action in the ongoing revamping of the institutional architecture.

What is the role of monetary policy in this context? What it can do is to stabilise growth near its trend over extended horizons, but it cannot raise the trend. Hence, it only constitutes a line of defence against an escalation of the three dimensional crisis. It has resolutely addressed risks of deflationary spirals, for instance resulting from a collapse of the banking system; it has prevented the materialisation of self-fulfilling catastrophic equilibria, such as the self-fulfilling nature of redenomination risk; and it has ensured an appropriate degree of monetary accommodation to address large underutilisation of resources, to the extent that these gaps had created negative risks to medium-term price stability.

However, despite tentative evidence for a relaxation of financial market tensions, also in response to our recently announced Outright Monetary Transactions programme, there is no credible substitute for the positive output shock I described earlier. And triggering such an output shock is clearly a matter for elected governments, at national and European level.

Conclusion

Let me conclude on a positive note.

Looking at Europe today, I believe there is growing evidence that electorates and policy-makers stand ready to address these challenges. Concrete reforms are under way that many would have thought impossible in Europe. Think, for example, of the major sharing of sovereignty implicit in the decision to move towards a European banking union. Think also of the ambitious structural reform agendas adopted in several countries.

Much remains to be done, but the momentum has shifted. Increasingly, European citizens understand that the upside to structural reform is enormous, given its potential to make the economy more efficient, reduce rents, and increase their standard of living. Those who fear the political cost of such a shift in economic policies should bear in mind that the alternative would be a fundamental revision of the current social promises, and ultimately a debasing of the European model.