Benoît Coeuré: Adjustment and growth in the euro area economies

Speech by Mr Benoît Coeuré, Member of the Executive Board of the European Central Bank, at the Nova School of Business and Economics and the Bank of Portugal, Lisbon, 22 February 2013.

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Introduction[1]

Dear Governor Costa, Ladies and Gentlemen,

It is a great pleasure to be here today and share with you my thoughts on the adjustment under way in the euro area. This is a challenging issue, especially here in Lisbon, as Portugal is at the heart of this process.

Taking the Lehman collapse as a starting point, the economic and financial crisis has now lasted four and a half years, almost one-third the age of the euro. For the stressed countries, this has been a tough time. It saw a sharp decline in GDP and a sharp rise in unemployment, with young people particularly affected. People's daily lives have not yet visibly improved. This is why it is important to focus on the progress made during the past five years and on why and how reforms can create income and jobs.

I have in mind three questions: (i) How much adjustment is still needed? (ii) Why have the costs been so high? (iii) Are conditions in place to restore growth? The public would probably formulate these questions differently: can we hope that things will get better? Will the policies work? And will we see an improvement in our daily lives?

To answer these questions I will organise my talk in three parts.

First, I will briefly recall how the imbalances and structural problems came about and how deep they were before the steps towards reform were taken. This is critical to understand the subsequent adjustment process, the costs involved and the way forward. I will then describe the progress to date. The adjustment process is not yet complete but it has already been significant, and some countries, including Portugal, have taken important steps towards sustainability.

Second, I will reflect on the factors that have made the adjustment more painful than it would have been otherwise. My main point will be that a number of rigidities have been preventing a more significant and swift downward nominal adjustment, thereby causing a sharp fall in production and employment. On top of these rigidities, the interplay of an impaired credit channel, fiscal consolidation and falling confidence has deepened the recession.

Third, I will argue that there are good reasons to be cautiously optimistic, if reforms continue as planned. European solidarity has helped to smooth the adjustment and prevented sudden-stop scenarios. It is also giving national governments an opportunity to strengthen the conditions for growth, productivity and employment and reap the full benefits of the monetary union.

Let me now turn to the first part of the talk.

(1) Tangible progress on correcting imbalances

Since the start of Economic and Monetary Union, the key macro and structural variables of euro area countries have diverged greatly. While *ex ante* expectations of a fast convergence

[1] I wish to thank Beatrice Pierluigi for her contributions to this speech. I remain solely responsible for the opinions contained herein.

across euro area countries might initially have been reasonable, given the favourable environment created by the monetary union, the degree of sustainable convergence *ex post* turned out to be very limited. In many countries, excessive private/public consumption and residential investment spending, partly resulting from excessive debt accumulation, led to persistently higher HICP and unit labour costs with respect to the euro area average. At the same time, the supply side was not able to catch up with demand, due to the fact that investment spending was not channelled towards activities able to generate high future returns and due to important structural rigidities in the labour and product markets, which policy-makers largely neglected to tackle in the years before 2009. This process was aggravated by weak fiscal institutions and prudential supervision. All this contributed to the accumulation of large imbalances and vulnerabilities. In this environment, the EU framework for economic governance proved to be unable to enforce an early implementation of critical reforms or to prevent imbalances.

Let me make the point with a few figures. The charts that I will show today focus on the three programme countries as well as Spain. Of course, the adjustment process is in fact taking place in a larger number of countries, some of which joined the euro area after 2007.

[Slide 1] A property worth 100 in 1998 would have sold at 280 in 2007 in Spain and Ireland and at 230 in Greece. Between 1998 and 2007 bank lending for house purchases increased by more than 400% in Spain, 500% in Ireland and 800% in Greece. The credit boom led to a sharp increase in private sector indebtedness. But such imbalances have not only been a private sector story. Between 1998 and 2007 the compensation of employees in the public sector (that is the number of employees times their per capita wages) increased cumulatively by close to 180% in Ireland (i.e. five times the euro area average) and by close to 110% in Greece (i.e. three times the euro area average). Public spending growth has systematically exceeded nominal GDP growth also in Portugal (about double the average for the area). Fiscal discipline had been clearly insufficient. Even when the headline fiscal deficit was suggesting a healthy situation until around 2008, that was misleading as GDP was above potential and strong tax revenues resulting from housing booms were not sustainable.

During the 2008–09 crisis, the sharp drop in domestic demand caused a significant fall in revenues, which in some previously booming countries were based on very cyclically sensitive taxes, such as corporate taxes, stamp duties and capital gains taxes. At the same time, government spending was increased by crisis-related measures. Moreover, rescue operations for banks, especially in Ireland, strongly contributed to a deterioration of public finances, while bank guarantees increased the contingent liabilities of euro area governments.

[Slide 2] The mathematics of all these developments is very simple. By mid-2010 a number of euro area countries, even some that did not see such an accumulation of imbalances, began to be affected by an unprecedented sovereign debt crisis; financial markets were starting to perceive debt levels as unsustainable. From this point on, governments under close scrutiny by those markets had to take action to regain their confidence. They were not left to their own devices. A fully-fledged EU and IMF financing package – known formally as the Economic Adjustment Programmes – came to the aid of Greece, Ireland and Portugal between 2010 and 2012. These programmes involved far-reaching economic and financial policy adjustments, including in the area of structural reforms. Spain, meanwhile, launched a financial sector adjustment programme supported by its European partners. Moreover, a permanent solidarity framework – the European Stability Mechanism – is now in place. It can provide financial assistance to Member States in difficulty, thereby reducing threats to financial stability in the euro area.

And from an early stage onwards, the Eurosystem provided very substantial liquidity support to the banking sector, which had been severely affected by the seizing-up of the interbank market. The ECB's non-standard measures played a critical role in preventing a deflationary scenario, especially as the sovereign debt crisis escalated from mid-2010 onwards. For

instance, it provided banks with all the liquidity they were seeking by adopting fixed rate tender procedures with full allotment, against an expanded list of eligible collateral, and for extended periods. This helped to stabilise the funding situations of banks in Greece, Ireland and Portugal, and later on in Spain and Italy[2]. According to the Banco de Portugal, the ECB's liquidity provision to Portuguese banks reached €60.5 billion in June 2012, representing more than a third of the country's GDP. In August last year the ECB announced the Outright Monetary Transactions programme to counteract unjustified speculation about a euro break-up and to rectify the resulting distortions in the transmission mechanism of monetary policy. As a result of these actions, and against the background of a renewed commitment by governments to ensure the integrity of the euro area, financial conditions have substantially improved over time and across market segments. Banks have been able to decrease their reliance on ECB funding, including by repaying (parts of the) amounts received under its longer-term refinancing operations. In Portugal, central bank funding is now back to around €50 billion, more than 15 percent below its peak. Euro area financial markets are gradually returning to normal.

[Slide 3] So to what extent have the imbalances been corrected? The current account balances clearly show a strong correction. In the three programme countries the current account balances in percent of GDP improved by more than 9 percentage points between 2008 and 2012. In Spain the current account deficit improved by more than 7 percentage points over the same period. Most of the adjustment has been driven by a contraction in domestic demand. However, in Ireland, Spain and Portugal export performance has been very strong compared with the pre-crisis period. Portugal's exports of goods and services grew on average by nearly 7% between 2010 and 2012, compared with 4.4% between 1999 and 2008. In particular, gains in markets outside the euro area have been large and there are early indications that the export specialisation of these countries has been shifting in a way that may support further structural export expansion.[3]

[Slide 4] We have seen a significant improvement in cost competitiveness as measured by unit labour costs (ULC). Between 2008 and 2012, in the three programme countries cumulated ULC growth was about 12 percentage points below the euro area average. Ireland saw by far the largest adjustment, with a cumulated ULC gain of 18 percentage points vis-à-vis the euro area. Greece, Portugal and Spain saw a ten-percentage-point ULC gain vis-à-vis the euro area average. As shown by Buti and Turrini (2012),[4] this development was not fully associated with gains in productivity from lay-offs but rather, at least in part, with slower wage growth dynamics. In addition, such a decline in deficit countries seems to have occurred mostly in non-tradable sectors, which is consistent with internal rebalancing. In other countries, such as Italy, where competitiveness fell sharply prior to the crisis, there has so far been no evident correction of competitiveness. In other words, the pace of adjustment has been different across countries; imbalances have not been corrected everywhere to the same extent.

[Slide 5] Finally, we have observed a very strong improvement in structural primary fiscal balances – that is, fiscal balances adjusted for the economic cycle and for one-off factors. In Greece, the structural primary balance in percent of GDP, which had reached extremely high levels in 2009, is estimated to have improved by more than 13 percentage points cumulatively between 2009 and 2012. In Portugal, the structural improvement has been

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[2] See ECB Monthly Bulletin Article (2011), *The ECB's non-standard measures – impact and phasing out*, July 2011, pages 55-69.

[3] Cheptea, Fontagne and Zignago (2012), *European Exports Performance*, Banque de France WP 393.

[4] Buti, M, and A. Turrini (2012), Slow but steady? *Achievements and shortcomings of competitive disinflation within the euro area*, ECFIN economic brief, Issue 16, November.

about 6 percentage points of GDP. These improvements give an idea of the real adjustment effort made by these countries.

[Slide 6] But being cautiously optimistic does not mean that there are no major challenges or tasks ahead of us. Indeed, the economic and social priority is to reduce the very high unemployment level. In particular, the delayed downward adjustment of prices and nominal wages has sharply increased the real cost of adjustment and the burden borne by the more vulnerable members of society. Private sector wage costs saw barely any downward correction in some countries, even when unemployment was starting to rise substantially (especially in Spain, but initially in Greece as well). Among the programme countries, Ireland is the only one where the downward adjustment of relative prices has been sizeable, a factor which has helped it to avoid an even stronger decline in output and employment. The disconnect between the adjustment in unit labour costs and the adjustment in the harmonised index of consumer prices (HICP) reflects the lack of competition in the domestic economy. It also reflects other cost factors affecting the evolution of prices, including fiscal consolidation being partly achieved through higher indirect taxes and administrative prices.[5] It calls for great determination in reducing the excessive profit margins that result from monopolistic competition, in particular in sectors sheltered from international competition.[6] Reducing rents is not only a matter of efficiency in the adjustment process: it is also a matter of equity in sharing the burden of adjustment. And this point leads me to the second part of my talk.

(2) The aggravating factors

[Slide 7] The adjustment has been costly, in some cases very costly. Some of the costs in terms of falling output and employment were, unfortunately, unavoidable. In particular, some of the job losses in the non-tradable sector are the outcome of the necessary rebalancing towards tradables and away from previously unsustainable domestic demand growth. However, the rise in unemployment in a number of countries has been aggravated by delays in structural reforms and, as I said, by a lack of downward flexibility in prices and wages after 2008. Job losses were largest among low-skilled, temporary workers in Spain and in the non-manufacturing sectors.[7] As employment fell, unemployment – particularly of the young – jumped, especially in Greece and Spain, where more than a quarter of the total labour force is currently without a job.

There was also a sharp increase in unemployment in the Baltic states – it rose from 5% in 2007 to 18% in 2010 on average in Estonia, Lithuania and Latvia. However, since 2010 in all three countries unemployment has fallen relatively quickly. By the end of 2012 it had improved by about 10 percentage points.[8] In the most stressed euro area countries, there are no signs of a reversal yet. This is the result of the inherited very rigid product and labour markets, which have started to change and need to continue to do so vigorously to prevent further job losses. Again, this is not only a matter of efficiency, but also a matter of equity. Europe cannot afford a lost generation.

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5 See ECB Monthly Bulletin Box (2012), *Rebalancing of competitiveness within the euro area and its implications for inflation*, June 2012, pages 64–66.

6 The higher profit margins of the past two years need to be interpreted carefully as they in part represent a rebound after the contraction in 2008-09, and are related to composition effects and capital deepening via labour shedding.

7 See ECB Structural Issues Report (2012), *Euro area labour markets and the crisis*, ECB Occasional Paper No 138, October 2012.

8 On average in the three Baltic states compensation per employee fell by 10.4 pp cumulatively between 2009 and 2010.

[Slide 8] What about output? Per capita GDP has been falling steeply in Greece. In Ireland the turning point was reached in 2011; in Spain, Portugal and Greece that point is expected to come in 2013 or early 2014. Is this expectation credible? Controlling for exogenous variables, such as world demand, term-of-trade or oil shocks, the expectation depends on a resolute pursuit of the reform and consolidation policies as well as on three key interrelated aspects: the impact of fiscal consolidation; the access to finance for corporates and households; and the restoration of confidence. Let me consider these in turn.

Since the sovereign debt crisis escalated in mid-2010, in the stressed countries the fiscal stance has become very restrictive, access to finance has become very limited and confidence very low. In such an environment it is not possible to isolate the short-term impact of these three elements while private and public sector balance-sheet adjustment is under way. Fiscal multipliers were large at the start of the adjustment process, as the IMF has shown.[9] But analytical work also shows that an increase in the estimated short-term fiscal multiplier can be triggered by an impaired credit channel, high spreads and a non-credible fiscal policy.[10] Moreover, increased political uncertainties and a lack of implementation of structural reforms can lead to a loss of confidence, undermining demand and investment. The related output losses should not be attributed to fiscal consolidation.

Let me elaborate further on the credibility issue. The improvement in structural fiscal balances that I talked about earlier needs to continue so as to ensure that the debt dynamics remain sustainable. This is part of the fight against the loss of market confidence. Progress in fiscal adjustment has already boosted market confidence, as successful bond issuance by Portugal and Ireland indicates. There is no credible alternative to this, as imbalances need to be unwound, access to market restored, and debt made sustainable in order to return to robust and sustainable growth in the medium term. High debt is bad for growth.[11] The output losses we have seen in recent years are also caused by excessive public and private debt accumulated until 2009.

Let me turn to the credit channel now. We have evidence of a further significant fragmentation of the credit supply since mid-2010; this has been shown by the ECB's Bank Lending Survey as well as its biannual survey on the access to finance of SMEs in the euro area (SAFE). In countries where the banking sector has experienced large balance sheet shocks related to deteriorating sovereign debt, access to bank credit has tightened substantially. Elevated risk premia in the stressed countries have in turn had repercussions on access to finance, in particular for SMEs. In contrast, large corporations can resort to corporate debt instead of bank loans, especially during financial crises, or to foreign loans instead of domestic loans in the case of large multinationals, as happened, for instance, in Ireland.[12] SMEs employ around three-quarters of the euro area's workforce and they generate around 60% of its value added. Their restricted access to finance in a number of euro area countries is clearly a threat to economic recovery. A number of governments, including Portugal's, are implementing measures to support the financing of SMEs. We see these measures together with the use of EU financial instruments (EIB and EU structural funds) as very important in unlocking access to funding and investment growth. The ECB has

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[9] See Blanchard O., D. Leigh (2012), *Global Forecast Errors and Fiscal Multipliers*, IMF Working Paper No 13/1.

[10] See Roeger W., in 't Veld J.(2009), Fiscal Policy with Credit Constrained Households, European Economy Economic Paper No 357 and ECB Monthly Bulletin Box (2012), *Fiscal multipliers based on the ECB's New Area-Wide Model*, December 2012, pages 83–85

[11] See Reinhart C., V. Reinhart, K. Rogoff (2012), Public Debt Overhangs: *Advanced-Economy Episodes since 1800*, Journal of Economic Perspective, 26(3), pages 69–86, and Checherita-Westphal C., P. Rother (2012), *The impact of high government debt on economic growth and its channels: an empirical investigation for the euro area*, European Economic Review, 56, pages 1392–1405.

[12] See De Fiore F., H. Uhlig, 2011, *Bank Finance versus Bond Finance*, Journal of Money Credit and Banking 43, pages 1399–1421.

alleviated the funding constraints of banks extending loans to SMEs by accepting such loans, and asset-backed securities (ABS) backed by pools of loans, as collateral in its monetary policy operations. The Banco de Portugal has been proactive in implementing these measures. Additional credit claims alone account for around 15 percent of total collateral posted by Portuguese banks with the ECB, and help to generate a large collateral buffer. The ECB will support a revival of the ABS market in the euro area, which would help SMEs to benefit from the improving financing conditions. Let me also point out that the restructuring and strong capitalisation of banks is an important condition for restoring the smooth provision of credit to euro area corporates and households.

I turn now to the issue of confidence and this allows me to close the circle and go back to the high unemployment costs observed so far. High uncertainty related to falling disposable income and increased unemployment has pushed up the precautionary savings of households. High uncertainty has also kept household confidence low, despite government actions going in the right direction. In this environment, lower prices would improve the purchasing power of households and reduce uncertainty. Confidence will be boosted if governments make sure that the burden of the adjustment is equally shared and not distorted by privileged groups and vested interests.

(3) The way forward: going structural

Thanks to the actions of the EU governments and the ECB, and with IMF support, signs of stabilisation in the euro area have been increasing in recent months. This provides an opportunity to make further decisive steps forwards. In stressed countries, governments have initiated reforms which are unprecedented in their ambition and scope. There has been an increase in the implementation of politically sensitive reforms in many areas, including public administration, health and pension systems, education, judicial systems, competition frameworks, industrial relations, labour markets, energy markets, network industries, service sectors and in the regulated professions. This list will sound very familiar to you as the Portuguese adjustment programme is covering all these areas. The reforms are consistent with the goals set by the European Union in 2000 in its Lisbon Strategy, but at the time there were no incentives to act on these commitments. Such reforms, if well designed and fully implemented, will reorient the engines of growth towards high-productivity sectors and enable companies to thrive in the Single Market and in the global economy. Studies based on general equilibrium models have confirmed that the long-run growth effects of such reforms are indeed positive and potentially very high.[13]

[Slide 9] This is my last chart. It shows model-based simulations carried out for the Portuguese economy by using a large-scale new-Keynesian dynamic general equilibrium model of the euro area and the world economy.[14] In the model simulations shown, the wage mark-up is reduced by 10 percentage points over a period of five years. The size of the reduction mimics the cumulated gross wage differential between Germany and the rest of the euro area countries between 2005 and 2010, that is, in the five years after Hartz IV reform. To obtain a comparable set of results, the price mark-up is also reduced by 10 percentage points over five years. These simulations show clearly that to maximise the impact of reforms on GDP and employment it is important that those reforms have to reduce both wage and price mark-ups. The simulations also show that the impact of reforms is positive already in the second year and increases progressively afterwards. All this is consistent with other

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[13] See Gomes S., P. Jacquinot, M. Mohr, M. Pisani (2011), *Structural reforms and macroeconomic performance in the euro area countries. A model-based assessment*, ECB working paper no. 1323; and Angelini E., A. Dieppe, B. Pierluigi (2013), *Learning about wage and price mark-ups in euro area countries*, ECB Working Paper No 1512.

[14] See Gomes S., P. Jacquinot, M. Pisani (2010), The EAGLE. *A model for policy analysis of macroeconomic interdependence in the euro area*. ECB Working Paper No 1195.

studies done for other countries.[15] The simulations exclude the reforms that enhance total factor productivity, which I mentioned earlier. These would further add to the impact on GDP and employment.

To conclude, Portugal can already count on key achievements in labour and product markets that were thought impossible only a few years ago. The support of its European partners has been and will remain instrumental in this process. Structural reforms always take time to have their full beneficial impact on the economy. Having entered the second half of the adjustment programme, these benefits should increasingly become tangible. I do not underestimate the pain that these changes inflict. But they are necessary in order to lay the foundations for robust and sustainable growth. Growth-oriented policies are no substitutes for fiscal and external adjustment: they are mutually reinforcing.

If designed in a way that reduces rents and fights vested interests, they will not only improve the efficiency of the adjustment process but also its equity, to the benefit of the poorest, the youngest, and of future generations. They will support medium to long-term growth and therefore employment and fiscal sustainability. They will help economies to reap the full benefits of belonging to the Single Market and to the Economic and Monetary Union. They will help societies to sustain social models which would otherwise be debased by the permanent output loss caused by the crisis, and the related loss of tax revenues.[16]

I should add that there is a need for reforms in all euro area countries, including the larger ones, albeit to varying degrees and in different areas. Even if a euro area country doesn't feel the pressure of financial markets and programme conditionality, its government should take seriously the responsibility to carry out necessary reforms that will ultimately support growth elsewhere in the region. And it is the responsibility of all euro area governments, jointly, to advance the reforms outlined last December by the President of the European Council that will give stable foundations to the single currency. The Single Supervisory Mechanism is an important first step, to be complemented as soon as possible by a Single Resolution Authority and Fund; further steps towards an economic, fiscal and political union should follow, completing our Economic and Monetary Union. If there is a lesson to be learnt for all euro area countries, it will be to make sure that in the future they make the necessary changes pro-actively and not in response to a crisis.

Thank you for your attention.

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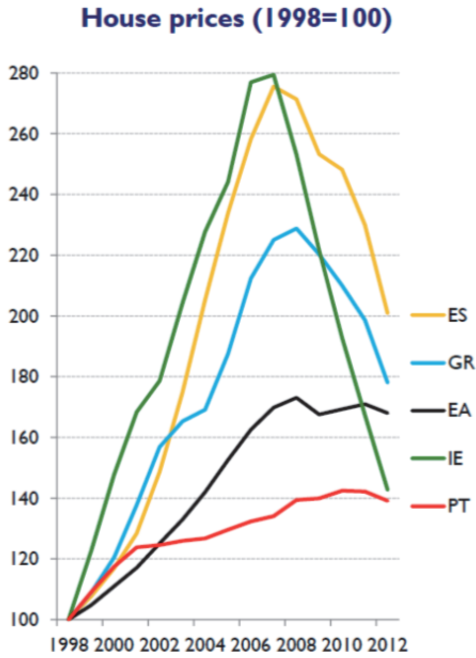
[15] A coordinated reduction of mark-ups would lead to a similar impact on GDP growth in the adjusting countries. International spillovers of reforms are generally found to be limited. For a review, see Dieppe A. et al. (2012), *Competitiveness and external imbalances within the euro area*, ECB Occasional Paper No 139.

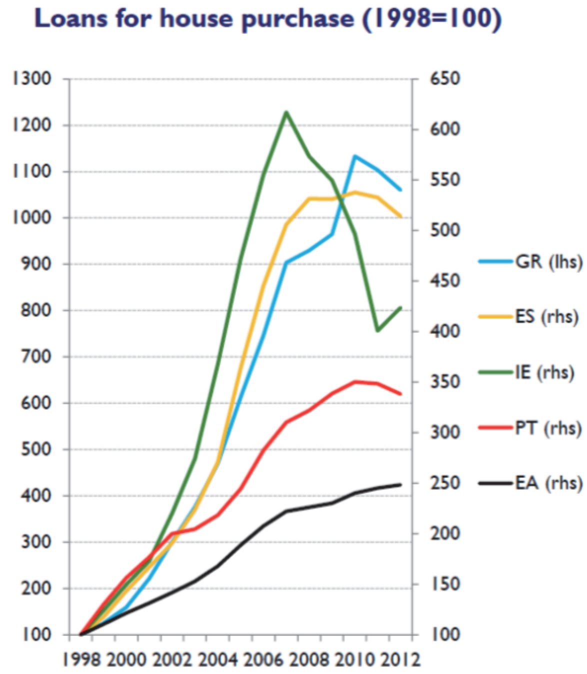
[16] See Coeuré B. (2013), *The three dimensions of the euro area crisis*, speech at the Asia-Europe Economic Forum conference on "European troubles, Asian worries", Brussels, 21 January.

Slide 1

House prices and credit growth



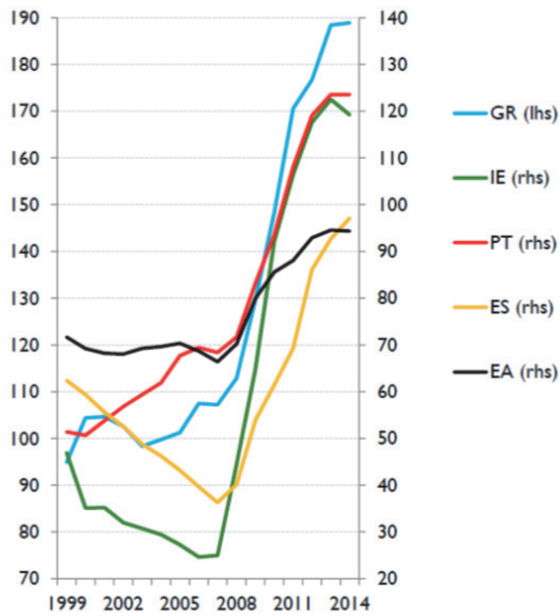
Source: ECB. Latest data is Q3-2012



Slide 2

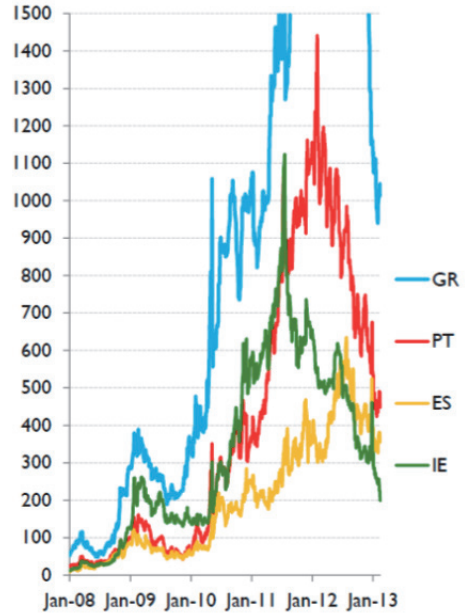
Government debt and risk premia

General government debt (in % of GDP)



Source: EC. Note: 2012-2014 is EC forecast.

Spread vis-à-vis German Bund (in basis points)

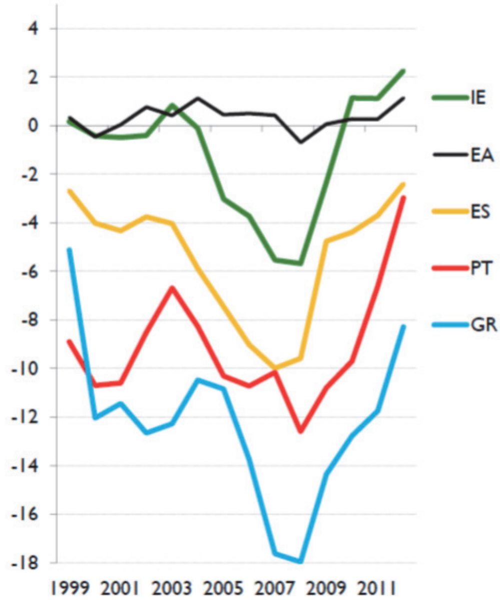


Source: Bloomberg. Latest data: 14 February 2013

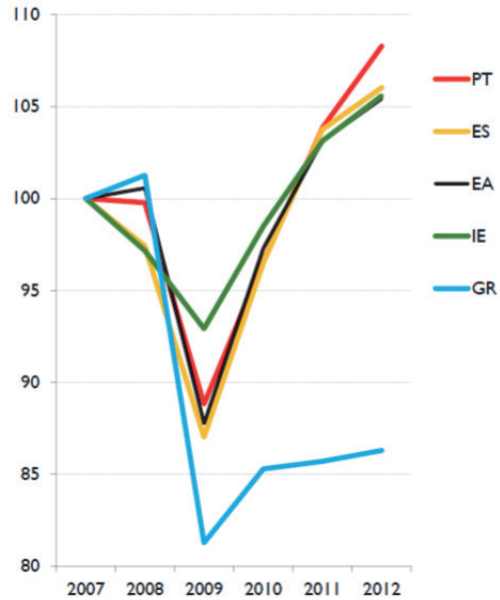
Slide 3

Current account and export growth

Current account in % of GDP



Real per capita exports of goods and services (2007=100)

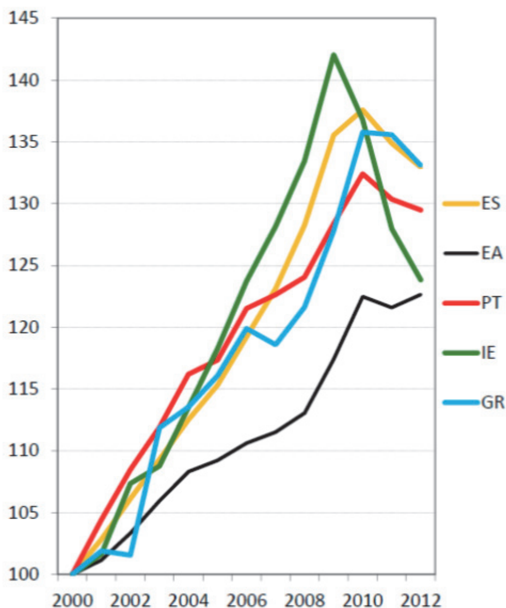


Source: EC. Note: 2012-2014 is EC forecast.

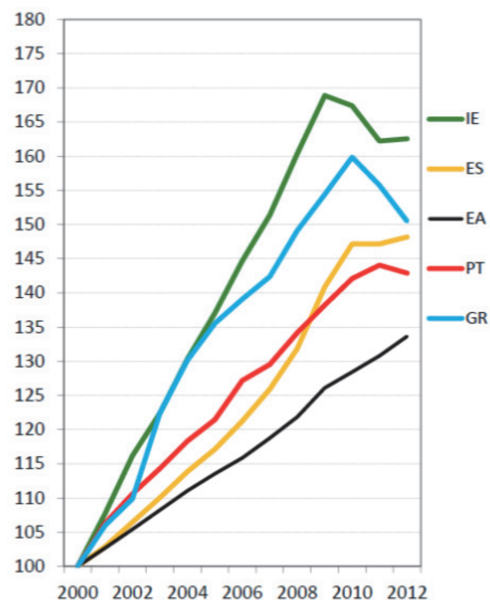
Slide 4

Unit labour costs and wages

ULC (2000=100)



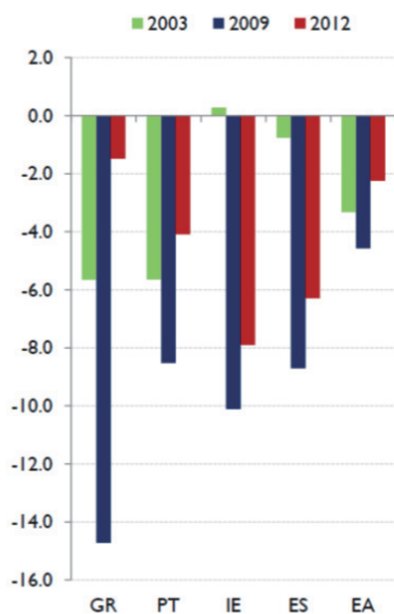
Compensation per employee (2000=100)

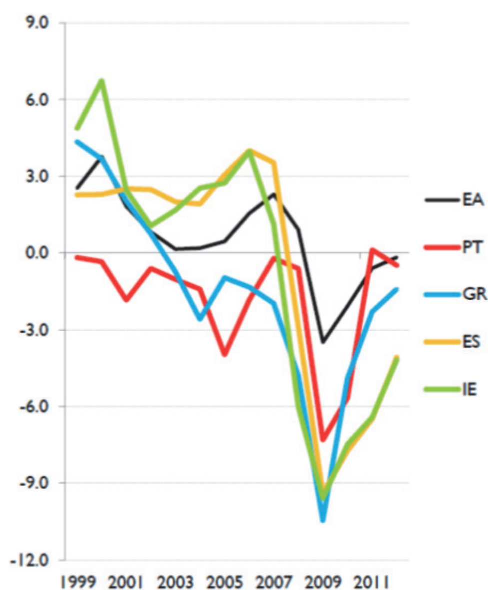


Source: EC.

Slide 5

Structural and primary balances

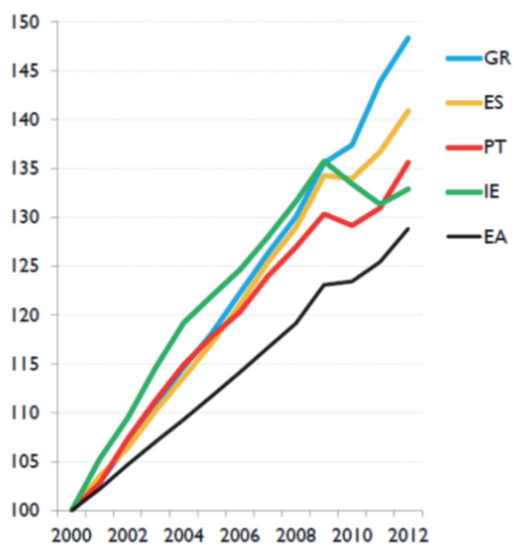


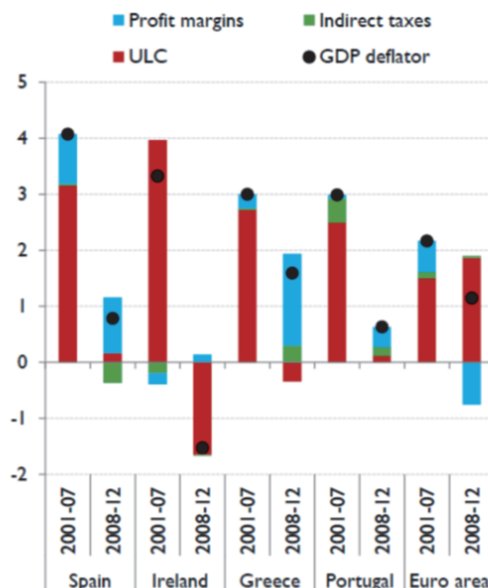


Source: EC.

Slide 6

HICP and GDP deflator

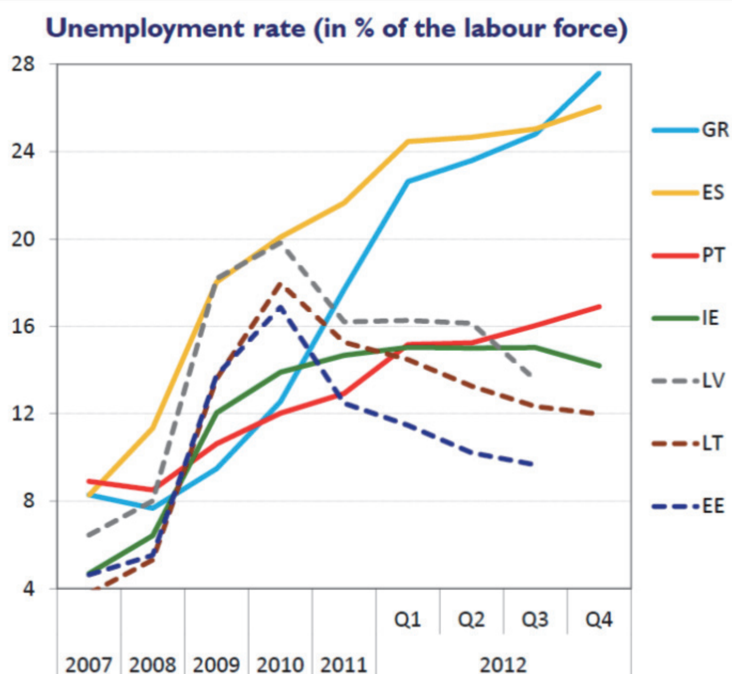




Source: Eurostat. Data for the GDP deflator at factor cost only available since 2000. Latest observation: 2012 Q3.

Slide 7

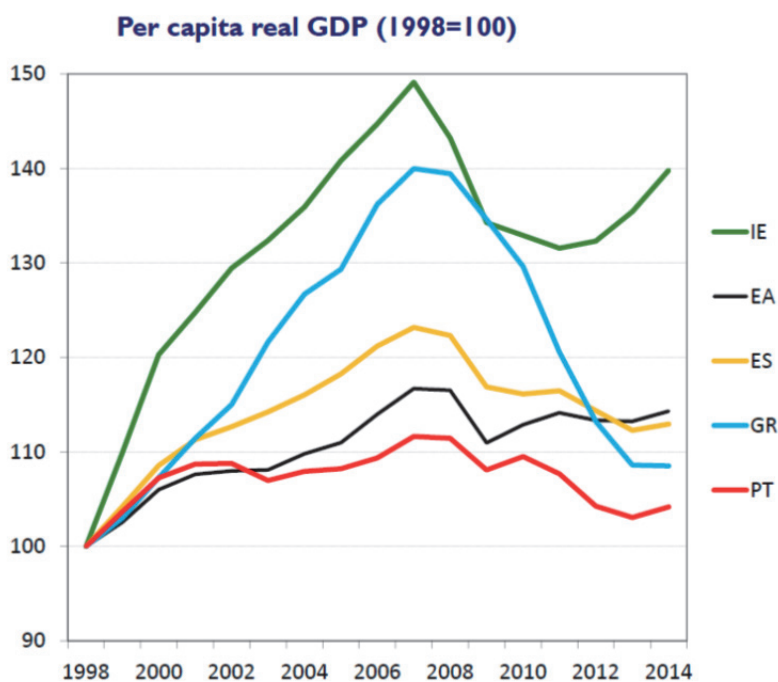
Unemployment rate



Source: LFS

Slide 8

Per capita real GDP



Source: EC, 2012-2014 is EC forecast

Slide 9

Impact of structural reforms

Deviations from pre-reform levels in percent. Source: EAGLE (calibrated for Portugal). Notes: The reform is a reduction of wage and price mark-ups by 10 p.p. distributed in a gradual way and has a full impact after five years.