Peter Praet: Adjustment and growth in the euro area

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the European Business Summit, Brussels, 16 May 2013.

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Introduction

Thank you very much for inviting me to speak at this conference of the European Business Summit.

The theme of my address today is “Adjustment and Growth in the Euro Area”. This is a title that, to some, may sound contradictory. Many of you will have come across commentators who claim that adjustment is in fact inimical to growth; and that consolidating government budgets while introducing structural reforms is the main cause of our current difficulties.

Yet, in my view, this is a short-sighted assessment. While it is clear that fiscal consolidation has affected economic activity in the euro area in the short-term, it does not follow from this that adjustment and growth are incompatible. Restoring the sustainability of public finances and implementing well-designed structural reforms are key to restoring confidence. Measures that are now being undertaken help to lay the foundations for future growth and bring back a climate of confidence already in the short-term.

First, by prioritising fiscal consolidation, euro area countries can anchor medium-term expectations about public debt sustainability, which is essential to support confidence among investors and taxpayers. As many euro area countries already have high public debt levels, and some have seen their market access threatened, credible fiscal consolidation ensures that debt can be refinanced at affordable rates in the future, and fiscal crises avoided. Moreover, if consolidation is focused to the greatest extent possible on unproductive expenditure items rather than those, like investment, that are conducive to long-term growth, the negative effects on growth can be contained.

Second, by implementing structural reforms, euro area countries should raise their future growth potential. Research has shown that a comprehensive package of product and labour market reforms could significantly increase euro area output – by more than 4.5% over 5 years, according to a recent IMF study. This improved outlook, when incorporated into medium-term expectations, should encourage forward-looking firms to increase investment, and could hence lead to higher growth also in the short-term. Such reforms should be undertaken with due protection of the most vulnerable members of society.

The key point is that for adjustment and growth to be mutually supportive, the commitment to reform has to be *credible*. Investors, firms and households have to be convinced beyond doubt that governments will stay the course. If they fear policy commitments may be delayed or reversed in the future, they will neither be sufficiently confident in the sustainability of public finances nor in future growth potential to alter their behaviour today. “Wait-and-see” will remain the rational response and short-term growth will lag behind potential.

In other words, proposing to reverse course on fiscal and structural reforms does not support growth. In fact, it only weakens credibility and hence undermines the hard work that has already been done to put the euro area on a surer footing.

For the remainder of my remarks, I would like to first review the ongoing process of adjustment across the euro area and what has been done by national authorities, and the ECB acting within its price stability mandate, to facilitate that process. Thereafter, I will put forward some suggestions for what remains to be done by euro area governments to ensure a return to growth as speedily as possible.

1. Restoring growth and employment in the euro area

Let me begin by reviewing the economic situation.

Euro area real GDP still remains about three percentage points below its pre-crisis peak, although this aggregate figure hides some divergence. For the group of countries which are still under some financial stress (Greece, Spain, Ireland, Italy, Portugal, Cyprus and Slovenia), real GDP remains near the trough of the crisis reached in 2009. Other euro area countries, however, had by 2011 already recovered the previous maximum level of real GDP.

The same is true of labour markets. The employment rate in the euro area as a whole is still more than two percentage points below its peak, according to OECD figures. However, Germany has increased its employment rate by more than three percentage points (to 73.1%) while, at the other extreme, Greece has seen its employment rate dropping by more than ten percentage points (to 50.1%). Youth unemployment rates in a number of stressed countries also remain unacceptably high.

Looking forward, we expect the euro area economy to resume growth at a modest pace later in 2013, although it will take more time for this to feed through into higher employment.

Why is growth not rebounding more quickly and evenly across the euro area?

A key explanation is that the adjustment process has been hindered by adverse feedback loops resulting from the interaction of accumulated fiscal and macroeconomic imbalances, weak bank balance sheets and the lack of a genuinely European approach to bank resolution and recapitalisation. To give just one example of such interactions, large fiscal imbalances in a Member State can lead financial markets to drive up yields on its sovereign debt. This in turn creates higher funding costs for its domestic banks and reduces their profitability, thereby hampering credit growth to the real economy. Lower credit growth then contributes to lower nominal GDP, which not only further weakens banks' balance sheets by increasing non-performing loans, but also increases concerns about the sustainability of sovereign debt through the denominator effect; and thus, the feedback loop restarts again. Without a European approach to banking sector repair, if the sovereign intervenes to break the feedback loop by recapitalising or resolving banks, it may only heighten market concerns about its debt sustainability and aggravate the situation.

a. Actions by governments

Addressing such adverse feedback loops between government finances, credit and growth implies a triple policy response from governments: First, fiscal consolidation and current account rebalancing to secure public debt sustainability and lower external financing needs. Second, structural reforms to increase potential growth and offset the potential negative effects of fiscal consolidation. Third, comprehensive banking sector repair to acknowledge impaired assets and strengthen bank balance sheets. Fortunately, in all three areas the euro area is heading in the right direction.

First, fiscal and macroeconomic imbalances have improved significantly: fiscal deficits have declined from their 2009 peaks throughout the euro area based on sizeable consolidation efforts and despite strong economic headwinds, while there has been a pronounced reduction of current account deficits. However, these sizeable flow adjustments have not yet fully translated into improvements in the accumulated stock of imbalances – public debt ratios on the fiscal side, net international investment positions on the macroeconomic side – because of depressed nominal GDP growth.

Most EU countries made significant progress towards further reducing budgetary imbalances in 2012, in an environment of weaker than expected output growth. The euro area government deficit has decreased to 3.7% of GDP (3.1% of GDP excluding one-off government support for financial institutions). In 2013, the Commission expects the euro area deficit to reach 2.9% of GDP – i.e. below the Maastricht reference value. This level would be less than half the peak reached in 2009 (6.4% of GDP), and it puts the euro area as a whole

on track to comply with the commitment made by G-20 leaders in Toronto in 2010 to halve fiscal deficits by 2013. It has to be stressed that correcting for the effects of the weak cycle the fiscal adjustment has been even larger than suggested by these figures.

Progress with fiscal consolidation has been particularly strong in countries subject to an economic adjustment programme. The primary structural deficit (cyclically-adjusted deficit net of interest payments and net of one-off factors and temporary measures) as a ratio of GDP over the period 2009–2012 has fallen by around 14 percentage points in Greece, 6 percentage points in Portugal and 4 percentage points in Ireland. The true adjustment effort is likely to have been even larger than these numbers suggest due to significant revenue shortfalls in a context of rebalancing from (tax-rich) domestic demand towards (tax-poor) exports. This rebalancing has also been associated with significant improvements in current account positions. Current account deficits fell on average by 10 percentage points of GDP in Greece, Ireland and Portugal from 2008–2012, and by 8 percentage points of GDP in Spain over the same period.

Second, the euro area witnessed a renewed momentum to implement structural reforms. It has been well-understood by euro area countries that restoring fiscal sustainability must rest not only on fiscal adjustment to achieve sizeable primary surpluses, but also on measures to revive growth to avoid adverse snowball effects undoing the debt-stabilising impact of primary surpluses. This requires structural reforms that improve labour market and product market functioning and hence increase potential growth. There are numerous studies, for instance by the OECD and the IMF, showing the significant benefits in terms of employment and growth that could accrue to the euro area from such measures – and not only in the medium-term. A credible commitment by euro area governments to implement structural reforms could already create a permanent upward shift in expectations of future growth, improve labour market performance, and as a welcome side-effect, improve the health of public finances over the medium-term. And to a certain extent, this is what we are seeing in the euro area today.

As regards labour market reforms, several euro area countries have moved towards a negotiating framework for wages and working conditions based more on firm-level agreements. This should enhance competitiveness by promoting a closer link between wages and productivity and, at the same time, allow firms to rapidly adjust their internal organisation of labour and production in response to changing economic conditions. In addition, labour market functioning has been strengthened by addressing distortions related to the "two-tier" systems that characterise a number of euro area economies – in particular Spain and Italy. These measures should support social fairness by bringing to an end the situation where vulnerable temporary workers, mainly young people, *de facto* bear the full burden of the adjustment. Moreover, they should increase potential growth by improving the employment conditions of young workers and their relatively lower opportunities for on-the-job training, which significantly hampers human capital formation; and by reducing inefficient labour turnover, since firms would be less reluctant to transform temporary jobs into permanent ones.

At the same time, to reduce unemployment traps and create incentives for job-seeking, welfare systems are being reformed so as to shift from a system providing security "on the job" to one providing income support "in the market", while setting up strict eligibility criteria and a system of active labour market policies. Together with these labour market measures, reform efforts have focused on increasing competition in a number of sectors, including retail and wholesale, transport, energy, and professional services; reducing the administrative requirements to set up or expand businesses; and improving the efficiency of civil justice and public administration.

Third, euro area countries have taken a series of measures to address balance sheet weaknesses in the banking sector. Capital requirements are in the process of being strengthened following the conclusion of the Capital Requirements IV Directive, which

transposes the Basel III agreement into EU law. At the same time, a number of banks raised new capital to address balance sheet weaknesses. The greatest progress in financial sector repair has of course taken place in the countries under EU-IMF programmes, where there has been a comprehensive restructuring and recapitalisation of the domestic banking sectors. Spain has also taken decisive measures to address the imbalances of the past via its ESM indirect bank recapitalisation programme.

b. Actions by the ECB

What is the role of the ECB in this process?

While the ECB has consistently played its part and maintained price stability in the euro area, it is important to keep in mind that the role that the central bank can play in terms of crisis resolution is limited. The ECB's monetary policy can only play a crisis mitigation role. Hence, our monetary policy approach has focused on providing liquidity support, intended to relieve banks of liquidity and funding stress by giving them unlimited access to central bank money at a fixed price against adequate collateral. To facilitate this support, we expanded the set of eligible assets that can be used as collateral and extended the maturity of our lending. It is widely recognised that these measures have been effective in averting a disorderly spiral of deleveraging in the banking system, which would have taken place in an environment of severe liquidity constraints and fire sales. This was necessary in order to avoid deflationary downward pressures that would have prevented us from delivering on our mandate of preserving price stability in the euro area.

However, to mitigate the crisis we have also had to go beyond liquidity support, in particular to counter financial fragmentation in the euro area – created by the adverse feedback loops I described above – that was disrupting the transmission of monetary policy across the euro area. Diverging credit conditions by countries, by sectors and by size of companies have prevented the ECB's very accommodative monetary policy stance from being passed on evenly in the financing conditions faced by euro area firms and households. As the euro area economy relies heavily on bank credit, this has serious implications for growth and ultimately for our ability to maintain price stability.

In particular, in the first half of last year we perceived a situation last year where severe upward pressure on sovereign yields was being driven by unfounded fears about the future of the euro area. These fears were causing investors to charge risk premia to lend to some Member States that could not be justified by economic fundamentals. We therefore decided to open the possibility of undertaking Outright Monetary Transactions (OMTs), entailing *ex ante* unlimited interventions in short- to medium-term securities issued by governments which have submitted to strict and effective conditionality, in order to eliminate the pricing of un-warranted tail risks in the bond markets. This has played an important role in reducing financial market fragmentation, as financial markets understood OMTs as a credible backstop for countering redenomination risk.

2. What remains to be done

These measures by the ECB, however, can only buy time; they cannot substitute for the responsibilities of national governments to address the unsound fiscal, economic and financial policies that are the root causes of the crisis. And while a great deal has already been done by euro area authorities to address these root causes, there are three areas in which more progress still needs to be made.

First, the euro area needs to continue to deepen structural reforms aimed at enhancing competition, flexibility, efficiency, and productivity. The reform process takes time, and so a medium-term, comprehensive approach is crucial to anchor expectations and maximise the positive effects of adjustment in the short-term. The greatest challenge today is to maintain reform momentum and implement fully those changes which have already been announced or even enacted into law. Concretely, this means, for the labour markets, addressing the

remaining insider-outsider dualities and enhancing labour mobility, including across borders. For product markets, the key challenge is to open up regulated professions and network industries that are sheltered from competition by government regulations. This requires a simplification and streamlining of regulations, a reduction of barriers to entry and limits to competition, a resolute deepening of the Single Market in Europe. Going forward, structural reforms also need to go into the government sector itself. In several euro area countries, modernisation of public administration is essential to increase efficiency in the provision of public goods, like infrastructure, and essential services, like civil justice. This will also support fiscal consolidation, by reducing the size of the government sector.

Second, the euro area needs to persevere in fiscal consolidation efforts and reduce steadily the government debt ratio. Despite the important progress on fiscal consolidation, debt ratios have yet failed to stabilise in most euro area countries, as improvements in primary balances were outweighed by the debt-rising impact of unfavourable developments in interest-growth differentials and deficit-debt adjustments. The euro area government debt ratio is projected to rise further to above 95% of GDP in 2013 – far above the 60% Maastricht reference value – with debt ratios displaying large differences across countries. Further adjustment is thus inevitable, and unfortunately it must take place in an environment of rising consolidation fatigue. Five years into the crisis this rise in consolidation fatigue is understandable. Going forward, it will be important for policymakers to communicate effectively both on the need for further adjustment and how this adjustment will be distributed in an equitable way across different groups of the population.

In this context, it is necessary to review consolidation strategies that have relied predominantly on tax rate increases, exacerbating the burden on already compliant taxpayers, without much broadening of the tax bases. Such an approach has had substantial negative effects on disposable income and demand, at the same time raising resistance and negative reactions in the electorate, based on inter-temporal uncertainty and fairness considerations. Due protection of the most vulnerable is needed here. On the expenditure side, adjustment has relied disproportionally on cuts in government investment, thereby weakening the prospects for long-term growth. Going forward, there is a need to focus adjustment on unproductive expenditure while as far as possible safeguarding government expenditure that is conducive to long-term growth.

Third, the euro area needs to press ahead with constructing a genuine Banking Union. A first and important step has been made with the decision to create the Single Supervisory Mechanism (SSM), the responsibility for which was assigned to the ECB. Political agreement by the ECOFIN Council and the European Parliament was reached on a legislative package in March, and technical agreement is expected very soon, so that national parliamentary proceedings can start, which should be concluded by the summer. The existence of the SSM, by reducing regulatory capture and increasing supervisory consistency and coherence, should play an important role in increasing confidence in the overall euro area banking system, and as a result, reduce fragmentation of interbank and other financial markets.

However, for the Banking Union to be fully effective, a Single Resolution Mechanism (SRM) to accompany the SSM is essential. This is the case for a number of reasons. First, an SRM would allow for the euro area to complete the process of banking sector repair without aggravating market concerns over public debt sustainability, which would help break the adverse feedback loop I described above and restore the functioning of the credit channel. Second, this confidence in EU level resolution capacity would ensure that the SSM can be a credible supervisor, as it would be able to push non-viable banks towards winding down without endangering financial stability. Third, an SRM would facilitate speedy and effective resolution of large and complex cross-border banks, removing the need for drawn-out and inefficient cooperation between multiple national authorities.

To generate these benefits, in our view the SRM must be built around a Single Resolution Authority and a European Resolution Fund.

Conclusion

Let me now conclude.

The ongoing process of adjustment in the euro area, if persevered with, will create a path out of the crisis. There is no doubt that this path is a challenging one, as it depends on deep-rooted reforms to the structure of the euro area's economies, and these require courage to implement and a willingness to confront vested interests. But it is critical that governments stay the course, as this will allow the confidence effects of a brighter outlook to start being felt already in the short-term.

For its part, the ECB will continue to fulfil its mandate to maintain price stability, and to use its standard and non-standard measures to support the flow of credit to the real economy. But one must also recognise the limits to what we as the central bank can achieve. We cannot remove barriers to bank lending that stem from insufficient capital or lack of bank repair: these can only be addressed by governments. This is why establishing a Banking Union with a strong Single Resolution Mechanism is a priority. I am glad that the elements of a Banking Union are beginning to fall into place. A swift implementation of the remaining elements is needed.

Significant progress has been made on fiscal consolidation and structural reform. Looking ahead, credibility is crucial. Therefore, I welcome the stronger rules for fiscal and macroeconomic policies like the Fiscal Compact.

All these ongoing important adjustment efforts in the euro area should restore confidence in the short-term and lead steadily back to sustainable growth.

Thank you for your attention.