Vítor Constâncio: Challenges for global economic growth

Remarks by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the 71st Plenary Meeting of the Group of Thirty, Versailles, 30 May 2014.

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Thank you for the invitation to speak in this session.

Our subject this morning is the "challenges for global economic growth". But let me first focus on the positive. Compared to this time last year, or indeed anytime since the financial crisis, our starting point seems brighter. Notwithstanding the dip in growth in the first quarter of the year, we see now evidence of greater traction in many advanced economies.

Progress, of course, varies across countries. Private sector deleveraging is moderating. The drag from fiscal consolidation has lessened. Improving labour markets are bolstering confidence and supporting demand.

But growth remains modest. In many countries, GDP levels are still below or barely above pre-crisis peaks. Euro area GDP in 2013 was 1.7% below 2007 levels; US was 5.9% higher; Japan was 0.4% higher; and in all countries growth rates are far short of pre-crisis trends. The recovery path remains fragile and unemployment is too high, particularly in Europe. Policy actions in the past two years have helped to curtail near-term risks. But risks to global growth remain tilted to the downside. And new challenges and sources of risk have arisen. There are now too many potential headwinds: a decline in potential growth of advanced economies resulting, among other things, from negative demographic trends and lacklustre investment; a new trend of lower growth of world trade possibly stemming from limits to continue extending supply chains (the elasticity of trade to GDP used to be close to 2 and has been flat at 1 since 2008); a retrenching of financial integration; a structural decrease of emerging countries growth rates. In more immediate terms, the risks stem from the possible reversal of risk assessment and consequently of compressed risk premia; secondly, risks relate, in particular to emerging economies as they adjust to normalising monetary conditions in the US and confront structural headwinds following a decade of stellar growth.

In my remarks I will touch on some of these general challenges for the global outlook, before discussing specific issues for the euro area.

The global challenges

The spillover effects of monetary normalisation in the US

At the global level, perhaps the issue that has received the greatest focus in recent months has been the implications of prospective US monetary normalisation. The announcement by the US about tapering about a year ago prompted sharp currency falls and asset price declines in several emerging markets. Further bouts of market volatility have been observed since then, including in January and February this year.

The episode has renewed debate about the spillover effects of monetary policies in advanced economies. There is no academic consensual view about the causes of capital flows. In-depth studies show that perceptions of global and relative risks, accompanied by mere volatility of capital markets associated with uncertainty, provide better explanations than monetary policy effects.[1] Nevertheless, spillovers are an unavoidable aspect of financial integration and the negative aspects of monetary normalisation in the US should not be

1 Hélène Rey (2013) "Dilemma not Trilemma: The global financial cycle and monetary policy independence", Jackson Hole, Kansas FED Conference.

overstated. We forget too easily that accommodative monetary policy has had positive spillovers since the start of the financial crisis. The gradual exit from unconventional policies in the US reflects the welcome recovery of a key pillar support for the global growth.

Clearly, policymakers in advanced economies should not be exempt from the responsibility to tread with care. In particular, clear and credible communication by central banks is important to minimise uncertainty and negative spillover effects from exiting unconventional monetary policy. International cooperation in an era of globalisation can provide significant gains. I agree with Raghuram Rajan when he highlights that global welfare does not depend only of domestic optimization of policies, important as they are. Emerging markets should also accept more flexibility in their exchange rates. The fact that in the second round of instability the countries with imbalances were the ones that suffered most, suggests that sound domestic policies are a crucial buffer to minimise adverse spillovers.

But I would also emphasise that the international community – mainly the IMF – must provide help in the form of improved liquidity facilities that reduce the incentive to build up excessive reserves and can be activated without stigma.

The structural slowdown in emerging markets

A second global theme has been the remarkable moderation of growth in emerging markets. To take just one statistic, aggregate emerging market growth has slowed sharply in recent years, from just under 8% in 2010 to around 4.5% last year.

One component of this slowdown has been a structural moderation. In retrospect, the early part of this century stands out as an exceptional period for emerging economies. Between 2000 and 2010, aggregate growth in emerging markets averaged 6% on an annual basis. That compared to around 4% in the preceding two decades. The future looks less rosy. Estimates from the IMF[2] point to a significant moderation in potential growth in large emerging markets.

The factors behind the slowdown are varied. But a common theme is that several countries are reaching the limits to their current growth models. China has become overly reliant on credit and investment; in India structural reforms slowed; Russia and Brazil have failed to diversify growth models and domestic investment has languished.

The answers to such problems are structural reforms and ambitious efforts which became now necessary. In view of emerging economies' growing importance, the success of this process of reform and adjustment will have a profound impact on the global outlook in the coming years.

Waning global trade integration

The third global theme I would like to touch on is the future for global trade. In recent years, world trade has been puzzlingly weak. Before the financial crisis, global imports typically rose considerably faster than activity. In the three decades before the great recession, trade rose almost twice as fast as output (an elasticity of trade to GDP growth averaging 1.8). But since 2011, world trade has plateaued relative to world GDP around the level reached in 2008.

Some of this weakness is likely to be cyclical. Global business investment, which typically has high trade content, has surprised on the downside in recent years and that has probably restrained the pace of global trade. As investment recovers, it should also spur a pick-up in global trade in the medium term.

However, there are a number of structural factors that could underlie the slow global trade growth. A first factor may be slower progress in trade liberalisation. While stalled talks at the

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[2] See Box 1.2 in October 2013 IMF's WEO.

global level have led to increased efforts towards bilateral and regional deals, the recent impetus towards trade growth seems to have lessened. A second factor stems from waning integration through global supply chains. Anecdotal evidence suggests that in the wake of a series of supply disruptions, firms are aiming to reduce the complexity and length of their supply chains. Perhaps, therefore, we might be approaching some natural limits of global trade integration. This would have profound implications for the global economy. For euro area countries, which are highly open to trade and where an important component of the recovery remains driven – for now – by external factors, the prospects for trade are also crucial.

Challenges for euro area

Let me now turn to the main challenges facing the euro area.

The euro area outlook is slowly improving. Four successive quarterly increases in activity, reflecting broad-based improvements across countries, provide encouraging signs that the recovery is gaining some momentum. Yet the pace of growth remains moderate. Demand is still weak and investment is 20% below its 2007 level. A subdued first quarter for this year underscores that the economy is far from being back to full health. Unemployment is way too high in many countries. Moreover, the recovery in real activity has been accompanied by a gradual, but pronounced, fall in inflation rates.

Against this background, I shall elaborate on three challenges for the euro area: (a) completing the repair of the banking system; (b) spurring productivity and competitiveness; (c) managing low inflation.

Repairing the euro area's banking system

Let me start with the rehabilitation of the financial system, which is crucial, in the short term, to strengthen confidence and stability and, in the long term, to spur economic growth.

2014 will be an important year for completing the process of bank balance-sheet repair, through the creation of the banking union, with a single supervisory mechanism (SSM) and a single resolution mechanism (SRM). The ECB is currently undertaking the comprehensive assessment of banks before the SSM takes up its supervisory tasks.

Banking union can bring significant benefits in terms of reducing European fragmentation of markets and leading to the sector's restructuring with general efficiency gains. At the same time, it will strengthen our ability to monitor developing financial risks. With a micro-prudential task and an extensive set of powers, the SSM should be able to monitor risks stemming from individual banks in the system and address them in a timely fashion. This is supported by the macro-prudential task conferred to the ECB for addressing risks from a system-wide perspective. Coupled with other components of the banking union – the SRM, rules for bail-in of shareholders and creditors, and eventually a deposit guarantee scheme – these reforms put European financial stability on a much sounder footing.

Spurring productivity growth and competitiveness

Yet improvements in financial system are not a sufficient condition for improved growth prospects. More needs to be done to spur productivity growth through reforms that foster innovation and competitiveness.

A recent, positive aspect has been that stressed euro area countries have taken significant steps in this regard. By reducing unit labour costs relative to euro area partners they have improved competitiveness and adjusted external imbalances. In 2013, all stressed countries – except Cyprus – registered a surplus in their current account balances. Cyprus is expected to run a surplus in 2014. Compared to 2009, the current account (and capital transfers) balance has improved by about 16pp (of GDP) in Greece, around 14pp in Cyprus and Portugal and between 10pp and 12pp in Ireland, Slovenia and Spain. Although weak domestic demand has contributed to declining current account surpluses, rebalancing has also been aided by strong export performance. Unit labour cost developments during the crisis have helped. In the past five years, the cumulative unit labour cost differential vis-à-vis the euro area fell by more than 20pp in Ireland, 16.5pp in Greece, 13.5pp in Spain, and 9pp in Portugal.

Yet euro area-wide potential growth has also declined. Falling capital accumulation and labour utilisation have brought potential growth from a level close to 2% in the years preceding the crisis to less than 1% on average between 2008 and 2012.[3] A recent study[4] of the Centre for European Policy Studies makes for sobering reading, suggesting that the prospective decline in the working age population (averaging 0.6% per annum until 2030) would translate to an annual growth rate of about only 1% to 1.5% until 2030. The long-term prospects of the euro area hinge, therefore, on generating a sizeable boosting of our productivity performance.

Dealing with low inflation

The final issue I wish to discuss is the low inflation in the euro area. We have witnessed a pronounced, albeit gradual, fall in inflation in the past year, standing at 0.7% in April, up from 0.5% in March. Euro area inflation is expected to remain low for a prolonged period of time.

To judge the appropriate policy response, we need to understand the drivers of the low inflation outturns.

A significant part of the fall can be explained by global factors. Indeed, the majority of advanced economies have seen a decline in inflation since 2011 and in most advanced economies inflation is now below central bank price stability objectives. In this generalised fall, lower energy and food contributions have played an important role. In our case, the euro appreciation since the first quarter of 2012 explains a reduction of 0.5pp in our inflation rate. This is connected with the fact that energy and food prices account for 80% of the overall decline in HICP inflation since that date.

Another part reflects the process of internal devaluation to regain price competitiveness in some euro area countries. Domestic inflation excluding food and energy has fallen well below the euro area average. The recent fall in services price inflation in the euro area, for example, is almost entirely accounted for by stressed euro area Member States.

Nonetheless, we are not complacent about the risks from a protracted period of low inflation. To date, we see no distinct signs of deflation and economic agents are not postponing purchases. But we recognise that, if too prolonged, periods of low or negative inflation could unleash forces that may affect the outlook, by destabilising inflation expectations and aggravating the burden of the debt overhang of both governments and households. Given these concerns, the ECB Governing Council has reaffirmed forward guidance and stressed its readiness to act with other measures if required.

Conclusions

Let me conclude. A session entitled “global challenges” can quickly nudge the speaker towards a rather pessimistic view, seeing only obstacles and impediments to a sustainable recovery path. But we should not let that happen. Of course, the recovery remains fragile and risks loom large. But the global outlook has begun to improve. Whether it is managing the exit from unconventional monetary policies, addressing structural challenges, completing the

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3 According to European Commission estimates.

4 CEPS “The Global Economy in 2030: Trends and Strategies for Europe”, April 2014.

repair of the banking system or responding to too low inflation, policy makers know their agenda and are taking action.

Euro area authorities are doing their part. Significant progress has been made towards banking union and in enacting structural reforms to restore competitiveness – although more remains to be done. At the ECB, we are ready to act to avoid low inflation becoming entrenched in a way that would destabilise the outlook for growth.