Vítor Constâncio: The future of euro governance – how to contain imbalances and preserve financial stability

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the conference "The ECB and Its Watchers" XII, Frankfurt am Main, 9 July 2010.

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1. Introduction

It is a great pleasure to participate at this conference for the first time in my official capacity as the ECB's Vice-President. The "ECB and Its Watchers" conference was a pioneering initiative and the fact that other central banks have chosen to emulate it is surely a powerful tribute to the usefulness of the event's format.

In my remarks today, I want to address some of the problems that the financial crisis has created for the governance of the euro area.

The euro area has responded adequately to the challenges that have arisen. Even though one might occasionally speak of some procrastination, which is understandable in a complex framework integrating several countries, important and bold decisions have been taken and new reform processes have been launched.

After the Lehman failure, we responded with the necessary liquidity provision to a financial sector hampered by clogged monetary and financial markets; fiscal policy implemented the necessary stimulus programmes; and the banking sector received indispensable and very extensive government support. Furthermore, Europe participated actively in the international efforts to design and adopt new regulations for the financial sector and has embarked on a thorough reform of its own regulatory and supervisory framework. The forthcoming establishment of the European Systemic Risk Board (ESRB) and three European Supervisory Authorities will address both the need for truly harmonised European regulation and the coordination required for a more effective European supervision.

The public sector support for demand and the stabilisation of the banking sector contributed to the avoidance of a depression and launched an incipient economic recovery that was gaining strength in the first quarter of the year. That was the moment when financial markets started to test the cohesiveness of the euro area and whether the setup was more than some kind of a vast multilateral currency board. This new chapter of the financial crisis, which threatens to weaken – but not kill – the recovery, has been named the sovereign risk phase. This has thus far been something of a misnomer, since some important countries with significant public finance imbalances have not been affected and only a few more vulnerable members of the euro area merited the attention of the markets.

The European response made clear that our economic and monetary union was more than a precarious arrangement among nation-states and stands as an important pillar of the European integration project. Proof of this can be found in the package of loans with stringent conditionality put together for Greece, in the creation of an European Financial Stability Facility with 500 billion euro, and in the adoption of further non-standard measures to defend the monetary transmission mechanism for the whole euro area by buying securities and providing liquidity. We did this in full consistency with our mandate to deliver price stability, and with the determination to overcome the unfounded misunderstanding that purchases of securities could in some inexplicable way be more inflationary than the use of the same securities in regular repurchase agreements. What counts, of course, are the overall development of primary liquidity and the management of short-term money market rates. Incidentally, measured in terms of the monetary base, provision of liquidity has decreased from €1256.8 billion on 7 May to the current level of €1149.8 billion and Eonia went up from 0.321 to 0.398 yesterday. At the same time, market inflation expectations are well anchored bellow 2% up to 10 years.

Apart from the determination shown in taking appropriate measures, Europe has also recognised that the current episode of the crisis points to the existence of real problems with respect to public finance imbalances and has even exposed some institutional weaknesses in our framework for monetary union, which need to be corrected. Consequently, Europe has now embarked on the preparation of significant reforms of the euro area governance in the context of the Task Force created under the leadership of President Van Rompuy.

Every good reform starts with a good understanding of the problems. The fundamental point relates to the issue of imbalances in euro area countries. By imbalances, I do not mean just fiscal imbalances, but also imbalances stemming from private sector behaviour. I will concentrate my remarks on the issue of imbalances, starting by analysing their causes and the necessary policies to correct and, preferably, avoid them in the future. Finally, I will draw conclusions as to what the experience implies for economic policy and economic governance.

2. Imbalances and adjustments in a monetary union

There are severe fiscal imbalances in euro area countries. Triggered, in particular, by developments in Greece, markets have dramatically reassessed their view of fiscal positions leading to sharp rises in bond yield spreads. This stands in sharp contrast to the markets' assessment of sovereign risk in euro area countries prior to the financial crisis, which can reasonably be characterised as one of "benign neglect".

It is indisputable that fiscal imbalances of the kind we have seen in some euro area countries need to be corrected in a timely and convincing manner. This has been recognised, as fiscal packages have been introduced in Ireland, Greece, Italy, Spain and Portugal over the last few months. Moreover, in order to give countries breathing space to carry out fiscal adjustment, unprecedented support measures have been introduced at the European level.

Fiscal deficits, however, are not the only macroeconomic imbalances we can see when we look across euro area countries. A number of indicators provide prima facie evidence of private sector imbalances where high indebtedness and excessive leverage have also developed over the years. In several countries, it was predominantly the increase in net private borrowing requirements that was responsible for growing current account deficits, which are large in some countries and have widened since the start of Monetary Union. In 2008, some 8 of the 16 euro area countries had a current account deficit ratio above 5%. In 1999, only 2 countries exceeded the 5% mark.

In some (but not all) of the countries with current account deficits, there were also sharp increases in domestic asset prices, particularly house prices. While house prices declined in Germany between 1999 and 2008, there was an average annual increase of more than 10% in Spain and Ireland. Other related symptoms include rapid credit growth and a build-up of private sector debt.

From a methodological point of view, I have to point out that much of the current discussion is frequently too narrowly focused on a limited and simplistic set of indicators (e. g. relative prices and current account balances) in a partial equilibrium context. There are also those who seem to think that the problems are confined only to fiscal policy. A spree of partial equilibrium analysis has been contaminating the debate.

To give an example of the importance of the general equilibrium approach: in simplistic accounts, rising current account deficits are often seen as being "caused" by losses in competitiveness. But it should not be forgotten that the co-movement between the current account deficit and measures of the "real exchange rate" reflect the joint response of two endogenous variables to shocks.

In some cases the imbalances could be considered, up to a point, an equilibrium response of the economy to certain shocks, which does not necessarily warrant a policy reaction. Two types of shocks that could be associated to such a development, could be, first, the permanent effect on the cost of financing and capital stemming from entering a new regime of low inflation and, second, the real convergence expected to happen in catching-up countries.

In benign scenarios, the apparent imbalances are largely self-correcting. Eventually, the inter-temporal budget constraints will induce consumers and firms to cut their expenditures, thereby reducing the current account imbalances. These adjustments will be accompanied by movements in relative prices, as the economies concerned rebalance domestic and external demand.

The fact that some episodes of current account deficits and rising relative prices could be natural economic adjustments to shocks that hit the economy does not, of course, imply that all such episodes are benign, equilibrium phenomena. Looking at developments in a number of euro area countries over the past 11 years, we have enough evidence of private sector imbalances that cannot be explained by reference to benign equilibrium phenomena.

How could such imbalances come about? I think there are three plausible (and not necessarily mutually exclusive) explanations:

First, expectations about growth seem to have become detached from reality and have indeed become excessively exuberant. If we are willing to depart from the assumption of strictly rational expectations and to allow for phenomenon such as learning, it is easy to see how initial booms – justified by equilibrium phenomena – induce economic agents to expect that the strong growth will continue indefinitely (or at least for a longer period than was warranted). In this regard, it is worth noting that most of the bubbles we have observed in history started in response to changes in fundamentals.

A second factor is the behaviour of the financial system. At the global level, the period was one in which financial intermediaries around the world were engaging in excessive risk-taking behaviour. This led to bad credit risk management and very loose credit conditions, which added fuel to the fire in the case of overheating economies.

Third, the standard adjustment mechanisms implied by theory seem not to have worked sufficiently well or sufficiently fast. In particular, the real appreciation channel seems to have been operating very slowly, and inflated animal spirits seems to have put in question the existence of the fully rational inter-temporal optimisers taken as given in many models.

In addition, the public sector itself may also have been affected by exuberant expectations. As a result, governments in some countries increased their expenditure and/or reduced taxes, expecting that the gains in output and increased revenues seen during the boom years would be permanent. Consequently, when these countries headed into a downturn, fiscal positions that looked healthy on the surface turned out to be precarious, deficits rose sharply and debt ratios moved along explosive trajectories. The financial crisis acted as a trigger to expose the fragilities that had been built up in earlier years and led to rapid reassessment on the part of economic agents.

Countries that have accumulated imbalances thus now face a long (and painful) process of adjustment to more warranted levels of spending and debt in both the public and the private sectors. A process of de-leveraging and balance sheet repair will have to take place in several cases. These adjustments will inevitably entail a period of low growth in domestic demand. This, in turn, will necessitate corrective adjustments in relative prices and wages in order to foster net exports and rebalance the economies in question.

3. Eliminating the imbalances

Even in the absence of explicit policy actions, we can expect a number of standard channels to start working, leading to a reduction of private sector imbalances and an eventual return of the economies to a more sustainable equilibrium pattern.

The reassessment of future prospects by households and firms will induce them to adjust their expenditure plans downwards. The resulting lower level of domestic demand will lead to lower imports, and thus serve to reduce the current account deficits. This mechanism is a more or less automatic response by agents to the changed environment. It is likely to be reinforced by the impact of banks' endeavours to restore their balance sheets by, inter alia, curtailing lending and by government efforts to rectify fiscal imbalances. In itself, the contraction of domestic demand brings strong downward pressure to bear on output. In order to counteract this effect, net exports will need to be pushed for.

In this respect, the so-called competitiveness channel will also play a role. Weaker demand will lead to lower wage and salary increases (and to reduced domestic prices) via the usual Phillips-curve mechanism. This will stimulate net exports, offsetting the effects of lower domestic demand on output. In the long run, the economy will be rebalanced. However, given evidence of the sluggishness of wage and, to a lesser extent, price adjustments, this restoration of competitiveness could be a very protracted and painful process.

This implies that policy has a crucial role to play in facilitating and speeding up the adjustment process. In particular, policy action is needed in four areas:

First, measures should be taken to increase wage flexibility and the adjustment of wages to appropriate levels. This could be achieved through measures to improve the functioning of labour markets with a view to enhancing wage flexibility and facilitating the transfer of workers from the non-traded to the traded sectors. In fact, we have already seen wage-setting developments in some European countries that many observers would have believed impossible just a few years ago.

Second, the adoption of measures to increase productivity growth is necessary to facilitate adjustment. Higher productivity growth will allow the affected countries to improve their gains in competitiveness for a given level of nominal wage growth. This benefit comes on top of the improvement in living standards that increases in productivity generate. Achieving higher productivity growth requires comprehensive structural reforms aimed, in particular, at sheltered sectors of the economy where there is insufficient competition.

Third, convincing fiscal consolidation to redress the fiscal imbalances is essential. Given the impairment of the credibility of fiscal policy in many countries, postponing adjustment is simply no longer an option. Markets need to be convinced right now. This message is now well understood and, in recent months, we have seen sizeable fiscal adjustments in a number of euro area countries. This is a very encouraging development, but it is essential to maintain the momentum and ensure that the new targets are met in the years ahead.

Fourth, repairing the balance sheets of banks and making banks more resilient are crucial prerequisites for the resumption of growth and for financing the reallocation of resources from the non-traded to the traded sectors. Many policy initiatives have already been taken in this respect, ranging from the establishment of "bad banks" to injections of capital and government guarantees' for bank debt. Of course, the liquidity policy of the Eurosystem has played a crucial role in supporting the financing of the overall economy since August 2007. At the same time, viewed from a longer-term perspective, effective regulation has a key role to play in strengthening the financial system. Currently envisaged changes in the regulation of banks aim at making banks better internalise the cost of their risk-taking and impose heavier capital charges on their riskier positions. This will reduce the danger of excessive credit flows such as those seen in the pre-crisis period, which were – in hindsight – not sustainable. It will also increase banks' loss absorption capabilities by increasing the level and the quality of their capital buffers.

The four points I have just mentioned relate to policy action to be taken in "deficit" countries in the euro area. A natural question to ask at this point is what policy action could be taken to help eliminate imbalances in "surplus" countries.

There is a debate underway on this issue. Some commentators argue that surplus countries should pursue policies that are symmetric to those of the deficit countries. If deficit countries have to restrict their domestic demand through fiscal contraction or wage containment, then surplus countries should increase their domestic expenditure by engaging in fiscal expansion or wage increases. This type of arguments can go too far. In some cases, there may be some room for manoeuvre, but even if it is ignored that the euro area is not a closed economy, so that all members have other markets to support their growth, it would not be right to ask countries to compromise unreasonably on their international competitiveness or to put the sustainability of their public finances at significant risk.

Still, it is true that a reduction of the current account deficits of some countries may, through the mechanics of the operation of a monetary union, imply a reduction of surpluses in other countries. From a euro area-wide point of view, wage moderation in the deficit countries is a negative inflationary shock to the area as whole. The ECB's monetary policy, which focuses on price stability in the euro area as a whole, would take that development into account. The resulting stance of monetary policy will affect wage and price developments in the surplus countries, aiding the adjustment in competitiveness. Similarly, the stance will affect demand in the surplus countries, again fostering adjustment.

That said, there is scope for some supply side policy measures in surplus countries to facilitate adjustment. In cases where the current account surpluses reflect structurally low consumption or limited domestic investment opportunities, structural reforms should be implemented. The range of possibilities includes structural measures in the non-traded sectors, such as the deregulation of the services sector, for instance, thereby increasing productivity and growth, as well as changes in taxation to change incentives to spend.

4. Avoiding imbalances in the future

The experience of imbalances in the euro area in recent years is a convincing reminder that "prevention is better than cure".

Looking ahead, the key question is what can be done to prevent the emergence of imbalances in the future. After the current crisis experience, the markets can be expected to better assess the differences in the risks to Monetary Union members and to increase both the spreads and the cost of capital when those risks start to rise. Market discipline as a result of proper credit risk management can be an important mechanism for preventing the emergence of imbalances.

Policy measures are nevertheless required and are of the same nature of those that I have already mentioned with respect to the correction of the existing imbalances, in particular those with regard to fiscal policy and unit labour costs. After all, viewed from a macroeconomic perspective, the successful participation in a monetary union implies an anti-cyclical fiscal policy and an appropriate evolution of wage costs in line with the development of relative productivity.

I believe that two other policy points also deserve to be mentioned.

First, I think that macro-prudential policy has an important role to play in preventing and/or mitigating the effects of imbalances in the financial system. The whole panoply of well-known analytical tools has to be used: sets of financial indicators, early-warning systems, stress tests, contagion models, macro-models that include the proper feedback between the financial sector and the real economy. Careful attention in this process must be paid to leverage indicators of the different types of economic agents: households, firms, banks and the state. Ensuring financial stability implies avoiding excessive debt and credit growth. The idea of macro-prudential policy is not new. Rather, what has changed is the institutional framework in which these policies can be set in place. In Europe, the establishment of the ESRB will provide the mechanism for identifying imbalances that endanger financial stability and create systemic risks at the level of the European Union. The ESRB membership reflects the composition of the 27 members of the General Council of the ECB and, although limited to issuing warnings and recommendations, the participation in the Board of one representative of the Commission and the three Chairs of the future European Supervisory Authorities ensures that proper action will follow the decisions of the ESRB. It is, in fact, the whole European System of Financial Supervision that will be responsible for guaranteeing that the functioning of both the financial sector and asset markets is not impaired to an extent that creates fundamental risks to the financing of the economy.

The second point with respect to policies appropriate for avoiding future imbalances relates to structural policies that are essential to promote productivity growth and to enhance the flexibility and competitiveness of the economies in question. In many cases, the restoration of competitiveness does not depend only on correcting relative costs and prices. In view of the structural shock of the import penetration emanating from very low-cost producers, what is necessary is to increase productivity and to change the productive structure.

To ensure a smooth functioning of Monetary Union, the whole set of necessary policies should be employed in a consistent manner, both across individual policy areas and across countries. This has clearly not been the case in the past. Hence, there is an urgent need to improve policy-making at both the national and the area-wide level. With respect to the latter, there is now a consensus on the need to reinforce economic governance within the euro area.

In this context, I would like to highlight the very ambitious proposals presented by the ECB, in the context of the Van Rompuy Task Force, for reinforcing the economic governance framework in the euro area.

The proposals of the Governing Council of the ECB point towards an overhaul of the institutional and rules-based framework for the surveillance of fiscal policies. On the institutional side, the Eurogroup should essentially be recognised as the guardian of fiscal sustainability, gaining new tasks and powers, including the review of national budgetary plans and the definition of ex ante fiscal policy guidelines for euro area countries. This enhanced role of the Eurogroup should be coupled with an increase of the quasi-automaticity of the Excessive Deficit Procedure, reducing the use of discretion.

Furthermore, one of the most important lessons that can be learned from the experience so far is that the implementation of the fiscal framework requires an effective regime of sanctions. This can be achieved by applying the following principles: first, initiating the imposition of sanctions at an early stage; second, increasing the scale of the sanctions over time and in relation to the severity of the fiscal imbalance; and, third, applying a broader and more stringent range of sanctions, including financial, non-financial and procedural sanctions, which would deepen the degree of EU intervention in national fiscal policies.

The overall framework would also be strengthened at the EU level by creating an independent fiscal agency within the Commission, which would act as a watchdog for the Eurogroup and the Council in the monitoring and assessment of national budgetary developments. At the national level, compliance would also be reinforced through the introduction in national legislation of fiscal rules and institutions that are consistent with the EU fiscal framework.

Another area for urgent reform relates to the establishment of an explicit and clear framework for the surveillance of competitiveness and the correction of economic imbalances. The ECB advocates in particular the introduction of targeted surveillance. On the basis of a clear and simple criterion, or a limited set of criteria, on key aspects of competitiveness linked to the functioning of EMU – based on measures of nominal competitiveness and other supporting indicators relating to the private and public sectors – countries would be categorised according to a colour-coded scheme of surveillance, which would be linked to increasing degrees of intrusiveness.

Finally, the ECB also put forward proposals regarding the establishment of a euro area crisis management institution, which would have many of the features of the European Financial Stability Facility. From the ECB's perspective, it is crucial to minimize the risk of moral hazard, which is always implicit in any ex ante rescue mechanism. Institutional safeguards would include strong conditionality – reproducing the EU/IMF financial support to Greece – and graded sanctions in case of non-compliance with conditionality, escalating to a de facto loss of fiscal autonomy as the extreme form of sanction.

Some of the ideas set out in the Commission's recent Communication on enhancing economic policy coordination for growth and jobs (30 June) are close to the ECB's proposals. However, I think that that our proposals are somewhat more ambitious because we feel that the situation requires a quantum leap forward in strengthening the foundations of EMU and moving towards a deeper economic union.

5. Conclusion

We are now experiencing the full effects of the imbalances – both public and private sector – that have accumulated in euro area countries over past years.

The euro area now faces two key challenges. The first is to take the necessary and difficult measures to restore fiscal positions and eliminate private sector imbalances. So far, this challenge seems to have been met. This can be seen, for example, in the decisive fiscal adjustment measures that have been adopted in the countries concerned and in the rapid adjustment of the private sector to the changed environment. It is essential to maintain the momentum and to restore sound and sustainable financial positions in both the private and the public sector.

The second challenge is to make sure that the lessons learned from this experience are well understood. We should put in place a framework of economic governance and a set of policies to prevent a recurrence. Here too, there is evidence of significant progress having been made in recent months.

Some commentators argue that the imbalances that we have seen in the euro area have seriously weakened Monetary Union, even posing a threat to its survival. I think that the opposite will turn out to be true. When both challenges are met, the result will be a euro area that will be far more robust, with a more resilient financial system, and with sounder fiscal positions and a more balanced development across countries.

Once again, I would like to thank the organisers for their invitation to participate in this event. I look forward to fruitful interaction with you over the next eight years.