Klaas Knot: The eurozone crisis – causes and solutions

Speech by Mr Klaas Knot, President of the Netherlands Bank, to the Asia Society, Hong Kong, 15 October 2012.

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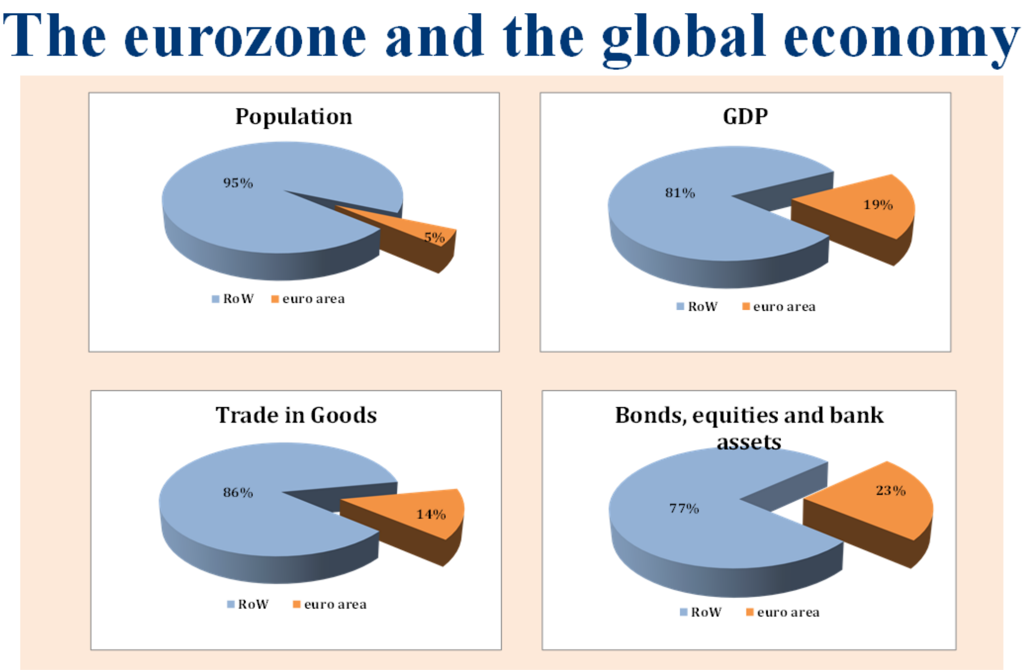
Thank you for this opportunity to exchange views with you on this topical issue. I've accepted this invitation with pleasure. For you should know that Hong Kong has always held a fascination for me, if only because of its breathtaking dynamics. But, much as I would like to dwell on that, I've been invited here to discuss the crisis in the euro area. And I gladly do so, for I feel this crisis needs some explaining.

I will first briefly touch upon the role of the Eurozone in the global economy, to clarify why it is so important for everyone that the European project will be successful.

After that, I'll discuss the implications of the European sovereign debt crisis for the future design of EMU.

I will argue that at the root of the crisis we find some individual euro area countries pursuing wrong policies, as well as a failing system of mutual surveillance in the euro area.

These deficiencies pose a number of challenges for the future of EMU. While the introduction of the euro has increased macroeconomic stability and furthered trade and financial integration, the sovereign debt crisis clearly demonstrates that the job is not done yet.



The importance of the Eurozone for the global economy does not directly follow from the size of its population.

But the other indicators on the chart show that major economic problems in the Eurozone without a doubt have repercussions on the rest of the world.

The Eurozone accounts for almost 20% of world GDP, and almost 15% of world trade.

The latter figure is corrected for intra-EMU trade, so it only shows the share in world trade of the Eurozone as if it were a single country. Including intra-EMU trade, the share of the Eurozone in world trade is over 25%.

Finally, the share of the Eurozone in global outstanding bonds, equity and bank assets is almost 25%. This indicates that the euro area is an important player for financial markets.

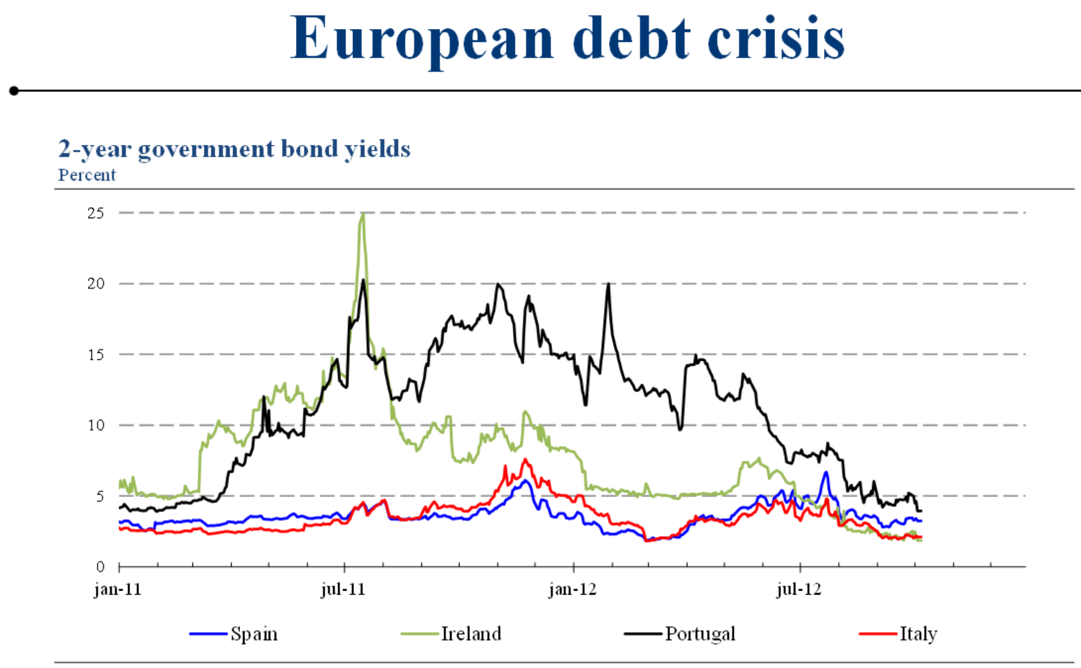
Given its role in the global economy, it is obvious that a solution of the European sovereign debt crisis is of vital importance for everyone.

If EMU were to fall apart, the consequences for Europe, but also for the global economy would be severe.

Therefore, European policymakers and central bankers do their utmost to solve this crisis.

In what follows, I will first focus on the causes of the sovereign debt crisis.

I will conclude by presenting my views on the implications for a stable design of EMU.



Since the Eurozone crisis erupted, European policy makers have done a lot to restore confidence.

Important developments include the creation of the emergency facility EFSF/ESM, i.e. the European Financial Stability Facility and European Stability Mechanism, to assist vulnerable euro countries during their reform efforts.

Another significant step is the signing of the Fiscal Compact, a treaty in which the political leaders of the euro area countries (and most other EU countries) further strengthened the rules governing budgetary discipline in Europe.

The ECB also took unconventional measures to prevent the sovereign debt crisis from severely dragging down the real economy and from frustrating monetary transmission and its efforts to maintain price stability.

We first introduced the Securities Markets Programme, or SMP, for interventions in the secondary government bond markets of vulnerable countries in order to restore their proper functioning.

We also introduced a refinancing operation with a maturity of three years, which injected around EUR 500 billion of “new” liquidity into the European banking system.

This provided the banking system with the liquidity security they needed in light of the market tensions and, thus, helped to avoid a sharp reduction in credit supply to the economy.

While these measures calmed markets for a certain period, as the chart indicates, tensions kept returning every time. In my view, this is because the actions of governments and the actions of the ECB were not aligned.

In particular, European politicians tended to slow down their efforts after ECB measures had temporarily reduced market pressure. This was especially visible for the SMP. Instead of stimulating politicians to solve the underlying causes of this crisis, the SMP discouraged them to do so.

To remedy this situation, the ECB recently replaced the SMP with a new instrument for secondary market interventions: Outright Monetary Transactions or OMTs.

The great advantage of OMTs is that they come with strict conditionality for the countries involved. This is meant to ensure that these countries cannot slow down their efforts after ECB interventions have eased market pressure.

The ECB will only intervene in euro countries committed to and complying with the structural economic adjustment programme attached to support from either EFS or ESM, and the IMF.

This way, the actions of the ECB and the actions of governments do not undermine, but reinforce each other.

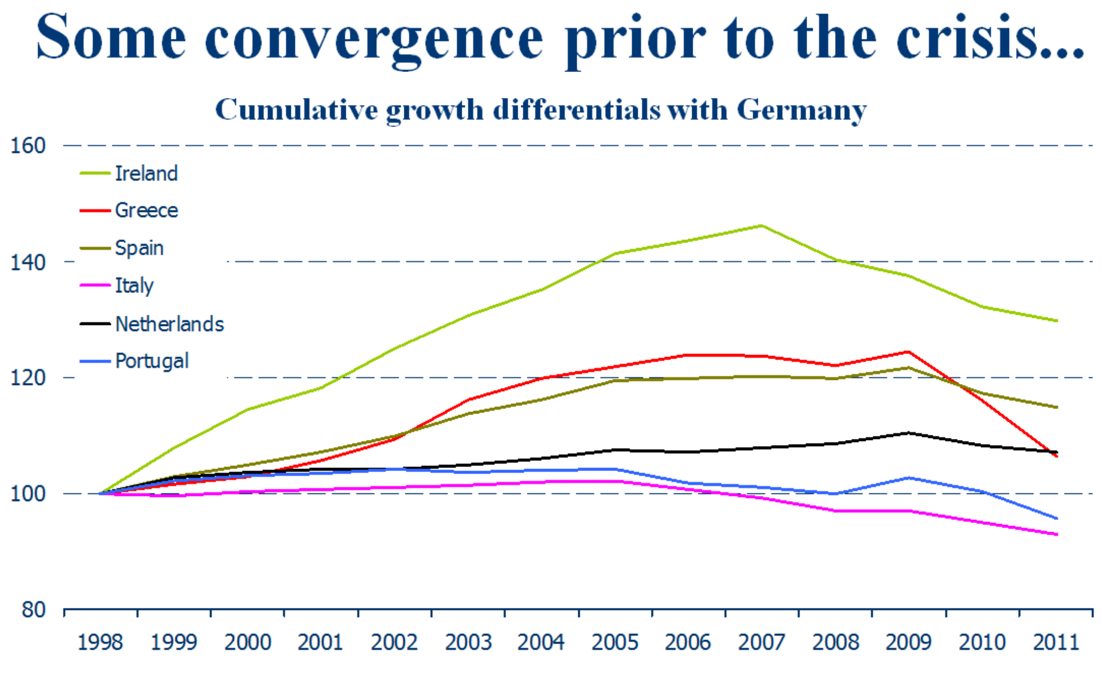
In response to the announcement of OMTs, most stressed sovereign debt markets have recently calmed down substantially. I will now switch to the macroeconomic causes, but would be happy to answer any queries you may have on OMT and other ECB actions after I finish.

As my talk so far indicates, in analysing and solving the sovereign debt crisis, the focus was mainly on fiscal and monetary factors rather than on the macroeconomic causes of the crisis. However, these causes are at least as important as the fiscal slippages some countries allowed themselves.

At the start of EMU, per capita income levels between countries differed significantly.

It was assumed that catching-up countries would experience faster economic growth.

This is what did happen, but not quite to the extent expected.



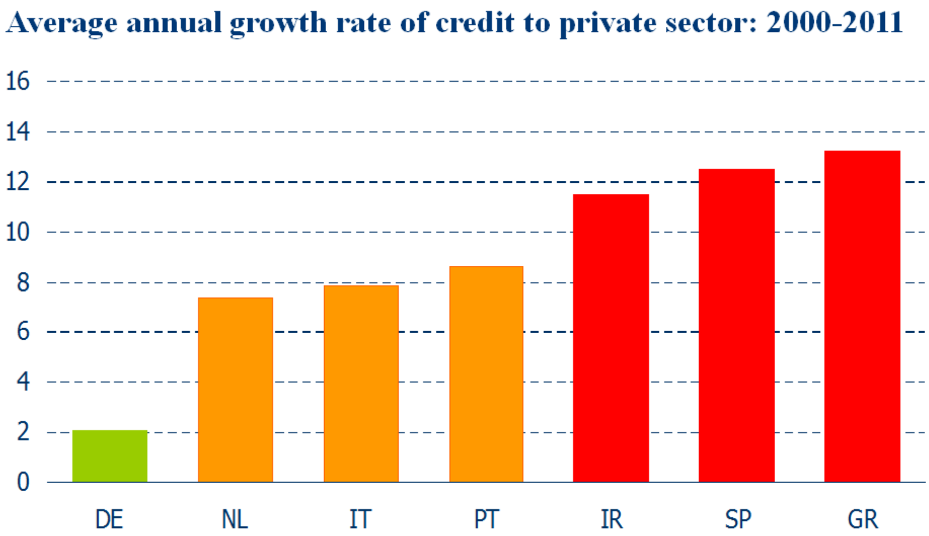
Prior to the crisis, mainly Ireland, and to a lesser extent also Greece and Spain, showed signs of real convergence.

Their cumulative growth differentials compared to Germany reached 20 to 45% in 2007.

Note that Italy and Portugal hardly experienced any real convergence towards the German welfare level, even before the crisis.

Even the Netherlands “converged” more than these countries.

…but with borrowed money…



Unfortunately, the catching-up process largely took place through debt, either public or private.

As the chart shows, in some countries credit to the private sector grew by more than 10% a year for over a decade.

As a result, their debt with the rest of the world ran up tremendously.

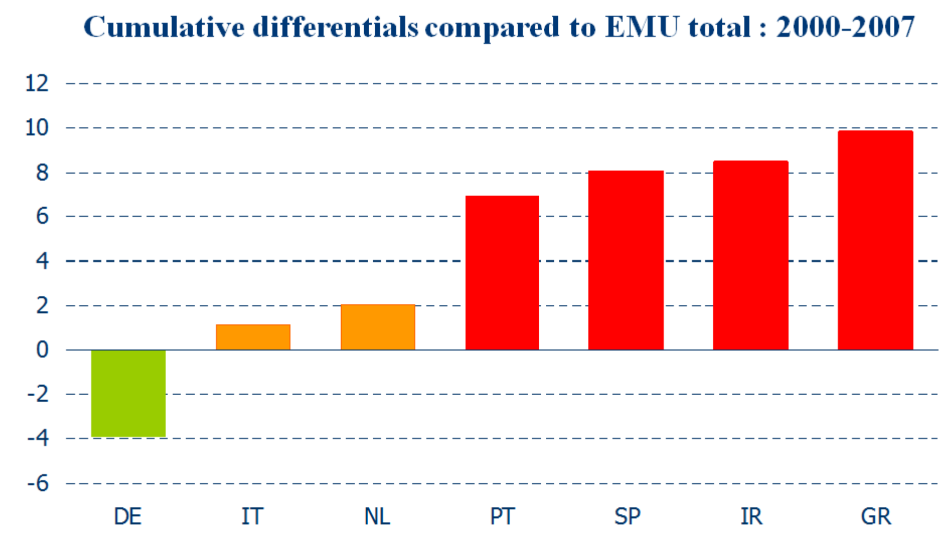
This was most dramatically the case in Ireland, which moved from a net creditor position of 52% of GDP in 1999 to a net debtor position of 71% of GDP in 2008.

Note that the Netherlands is not doing particularly well with regard to this measure either.

This is mainly the result of the growth in mortgage loans.

In my view the high stock of mortgage debt is among today’s biggest vulnerabilities of the Dutch economy, but fortunately some initial measures have been taken to reverse the trend here.

…and accompanied by inflation…



Besides being largely based on credit, real convergence was accompanied by high inflation, as you find visualised on this chart.

Whereas Germany experienced lower inflation compared to the euro area average, the inflation rates in Greece, Ireland, Spain and Portugal were much higher than the EMU average.

This substantial deterioration of competitiveness mainly reflects the development of unit labour costs.

Let me pause for a moment here, and note that economic developments in Germany in the last decade have been phenomenal.

It isn't that long ago that Germany was called the sick man of Europe.

Partly due to the ample supply of low-paid workers from East Germany, the labour market institutions in Germany were no longer sustainable. This led to the so-called Harz reforms, which made the German labour market more flexible and tempered unit labour costs and inflation.

Turning back to the euro area, before EMU came into being, its current member countries followed different economic strategies.

Between 1970 and 1999, unit labour costs in Germany, the Netherlands and Austria grew by a factor of 2.5 to 3.

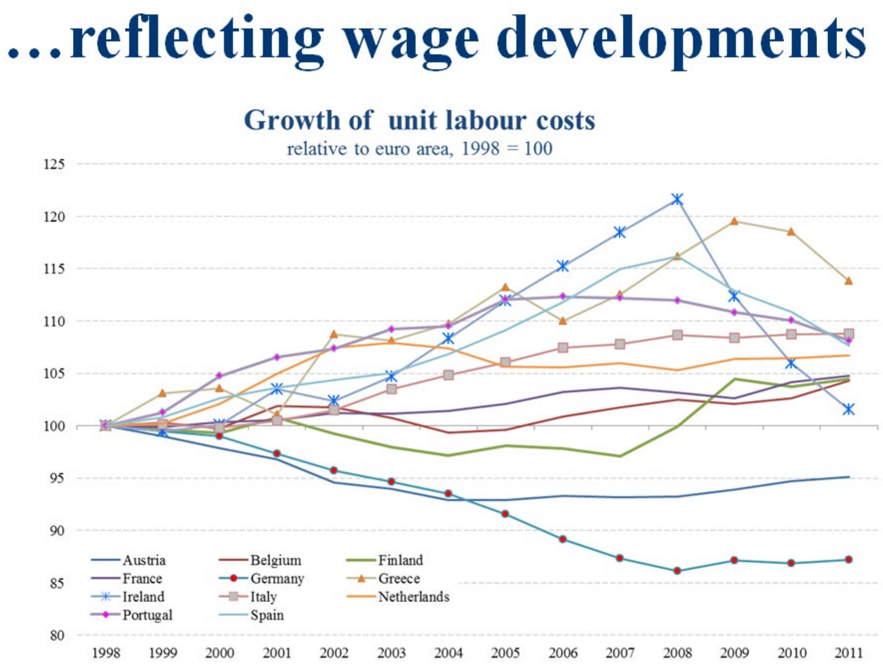
During these 28 years prior to EMU, unit labour costs grew by a factor of 12 in Italy, 14 in Spain, 35 in Portugal and 55 in Greece.

By regularly devaluing their currencies, these countries were able to restore competitiveness.

But after the launch of EMU, this policy option was no longer available, of course.

The hope was that these countries would adapt to this new reality and unit labour costs growth would slow down.

But is this what happened?



This chart shows the cumulative growth of unit labour costs relative to the euro area average from the start of EMU.

While countries like Germany, Austria and Finland continued their modest wage policies, unit labour costs in Southern European countries went up at a much higher pace, undermining their competitiveness.

This proved unsustainable.

The countries that found themselves in the top of the chart when the sovereign debt tensions started in 2009 – that is Greece, Spain, Ireland, Portugal and Italy – all ran into trouble one after the other.

This is no coincidence.

Currently, adjustments are hard-handedly being enforced by the markets.

In the said countries, probably with the exception of Ireland, product and labour markets didn't function properly and they still don't.

Markets are overregulated and labour markets are highly inflexible.

By addressing these problems, labour productivity can increase, thereby lowering unit labour costs.

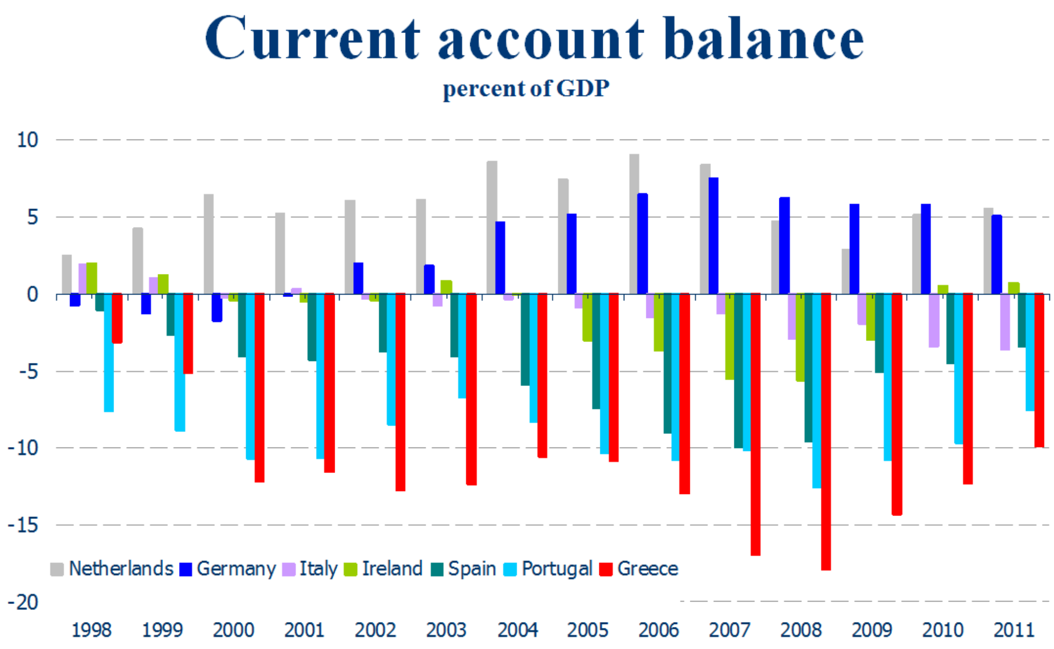
I am not saying this will be easy, but I'm convinced that such steps are absolutely necessary for EMU to function properly.

As the chart also shows, in the Netherlands unit labour cost growth was also relatively high during the first years of EMU.

This, however, wasn't caused by the high inflation rates and low flexibility of the labour market, but reflected the low unemployment rate in the Netherlands in that period.

For many years, the unemployment rate in the Netherlands was the lowest in the euro area.

Current account balance



The divergences in unit labour cost developments and price competitiveness within the euro area are reflected in the current account balances of the individual countries.

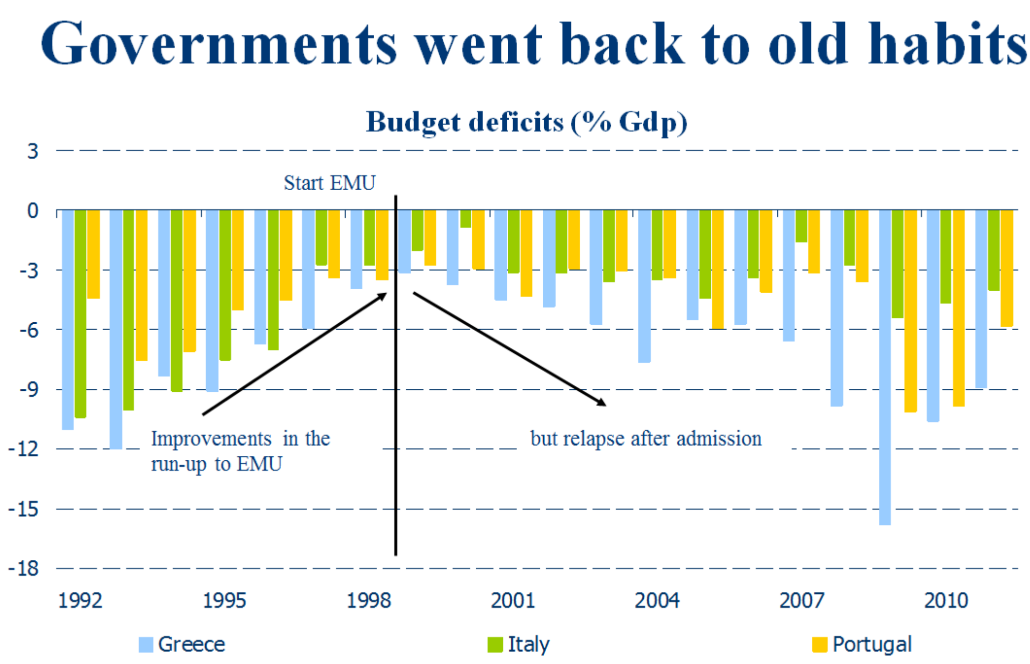
As you can tell from this chart, before the crisis, most southern European countries and, to a lesser extent, Ireland experienced high and steadily increasing current account deficits, while the current account surpluses of Germany and the Netherlands improved further.

For many years it was thought that in a monetary union, the current account balances of individual countries were no longer relevant.

It was only the balance of payment of the euro area as a whole that mattered.

We know better now.

Governments went back to old habits



Of course, besides competitiveness problems, the crisis also had fiscal causes.

As can be told from the chart, the stability and growth pact didn't prevent some governments from taking up old habits once they had fulfilled the convergence criteria that enabled them to join EMU.

We shouldn't forget, however, that this was facilitated by some of the core countries of EMU.

When it became clear that fiscal policies in these core countries wouldn't be able to meet the rules of the Stability and Growth Pact, it was not the policies that were changed but the Pact.

This was clearly a mistake.

Besides, the gradual deterioration of the budget balance in countries like Italy and Portugal was partly due to their competitiveness problems.

Since devaluing out of these problems was no longer an option, the decline in competitiveness slowed down economic and employment growth.

This dampened tax revenues while stimulating social security expenditures.

Looking at it this way, the lack of fiscal discipline partly reflected the lack of macroeconomic discipline.

More in general, budgetary policy was supposed to absorb temporary cyclical differences, by allowing the automatic stabilisers to do their work.

For example, during a downturn, public spending automatically goes up as more people receive unemployment benefits, while tax revenues decrease.

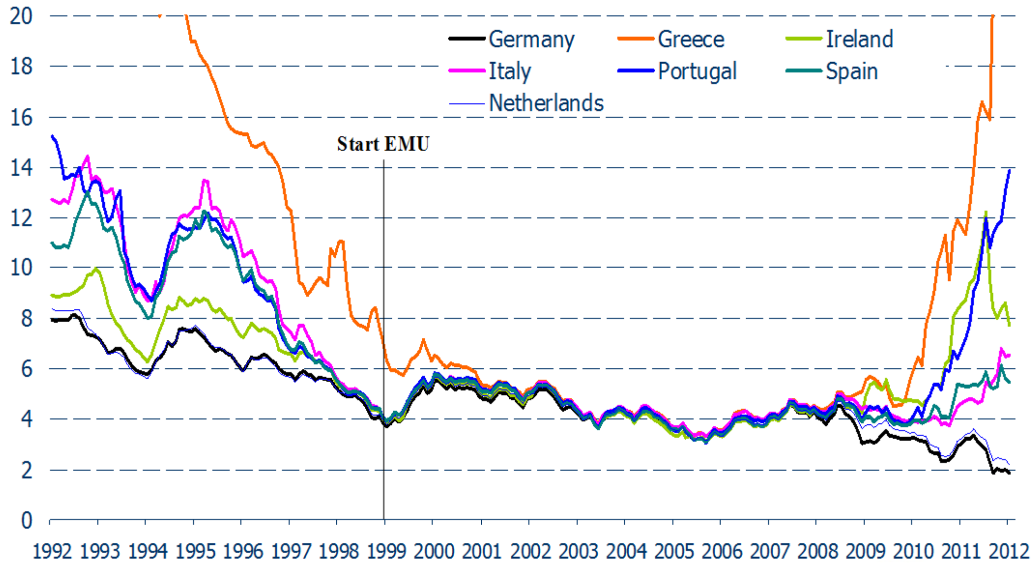
Such 'automatic' response to cyclical developments stabilises the economy.

But in most member states, the automatic stabilisers have failed to operate properly since 1999.

Instead, a number of governments followed pro-cyclical budgetary policies, by loosening the budgetary reins during the economic booms, and tightening them during the busts.

In other words, budgetary policies have hampered the functioning of EMU.

"On/off"market discipline



Budgetary discipline in EMU was supposed to be exacted not only by the stability and growth pact, but also by market discipline.

Markets were expected to restrain profligate governments by charging them higher interest rates and, thus, forcing them to change their ways.

As is evident from the chart, market discipline was largely absent during the first ten years of EMU, allowing governments to pursue unsustainable policies.

And when markets finally started to differentiate between governments, they did so with a vengeance.

Although market discipline is now imposing necessary corrections, a stable monetary union cannot be based on this mechanism.

So what would a stable monetary union look like in my view?

A stable design of EMU

- Strengthening growth potential and competitiveness
- Politically independent enforcement of the fiscal rules, guarding the debt ceiling of 60%
- European supervision, resolution and DGS
- Eurobonds as the capstone of EMU?

As I argued earlier, some euro area countries have not fully adapted to the fact that they lost the option of devaluation in order to restore competitiveness.

If they had, they would have increased their flexibility and growth potential by reforming their labour and product markets.

Given the spillover effects of postponed structural reforms on the functioning of EMU, these reforms cannot be the sole responsibility of the governments concerned, but should also have a “European” dimension.

This may take different forms.

Political leaders already took an important step with the creation of the Macroeconomic Imbalances Procedure. They did so as they acknowledged that diverging competitiveness within a monetary union ultimately creates severe spillovers for all members.

However, the Macroeconomic Imbalances Procedure could be strengthened by increasing its focus and enforceability.

This could be done, for instance, by introducing more reversed Qualified Majority Voting in these areas.

Furthermore, minimum standards or best practices could be introduced in policy areas where spillovers have turned out to be especially high, such as labour market policies.

Importantly, what should be avoided is harmonisation of practices towards some kind of EMU average, as this would compel strong countries to embark on mediocre policies.

Secondly, debt ratios should gradually be brought well below the ceiling of 60%.

This lower debt ratio can only be realised and maintained through independent enforcement of the European fiscal rules, and by anchoring these rules in national legislation.

A politically independent European authority that can increasingly intervene in the fiscal policy of countries breaking the agreements is essential here.

Thirdly, the diabolic loop between banks and sovereigns in the Eurozone must be dealt with.

This calls for European banking supervision, in combination with common mechanisms to resolve banks and guarantee customer deposits.

This set-up should apply to all banks in the Eurozone (and preferably the EU) and not only to the cross-border banks.

After all, as the experience in Spain and Ireland has shown, a financial crisis involving small, domestically orientated banks can still jeopardize national debt sustainability and European financial stability.

If – and only if – these conditions are met, Eurobonds could be a serious option. Given how remote we still are from the 60% debt target, this will likely be a matter of decades rather than years.

But once we would be there, Eurobonds could enhance the stability of EMU in several ways.

They would prevent a liquidity problem in one euro area country from needlessly transforming into a solvency problem.

Moreover, they could provide a fire wall against the danger of contagion. Although Eurobonds are not suitable as a crisis instrument, they could be the light at the end of the tunnel for the people of vulnerable euro area countries.

For the people in those countries need to feel that their sacrifices will contribute to a permanent solution; one that will safeguard them from the short-sightedness of both politicians and markets.

Let me finish my address today by saying that finding a structural way out of the crisis will not only be beneficial for the Netherlands and the rest of Europe, but also for the world economy.

Thank you for your attention.