Jörg Asmussen: Europe 2014 – an outlook from the ECB

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the Council on Foreign Relations, New York, 21 November 2013.

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The latest economic data suggest that the euro area is gradually advancing on the road to recovery – but doubts remain about where that road is leading. Some commentators think that the road will be so long and difficult that Europe will face a "lost decade", like Japan experienced in the 1990s. Yet this is not my view.

I would like to us my remarks today to argue that the changes taking place in the euro area today will allow us to take a different path from Japan – although we need to persevere to ensure that a "lost decade" is definitively avoided.

At the same time, observers should understand that the process of restructuring and reform this entails has certain economic consequences – namely a period of current account surpluses. I see this as part of a healthy adjustment that will help the euro area to play a constructive role in global demand in the future.

1. Learning the lessons of Japan

Let me start by illustrating how the euro area is learning the lessons of Japan.

The term a "lost decade" came to be applied to Japan not just because economic outcomes were poor, but also because little was done to address its structural challenges. In other words, what was "lost" was not only current growth, but the opportunity to fix its underlying problems and lay the foundations for future growth.

This is not at all the picture that I see in the euro area today – and precisely because we have the Japanese experience to guide us. Certainly, our growth and employment outcomes are currently weak. But below the surface fundamental reform and restructuring is taking place. We are determined not to let our crisis go to waste.

A key lesson we have learnt from the Japanese experience is the importance of banking sector repair and structural reform. Indeed, a recent paper on the Japanese experience identified delays in these areas as the main factors retarding Japan's recovery from the crisis.[1] On both fronts, the euro area is now making progress.

First, substantial bank balance sheet repair has taken place since 2008. By October this year banks had raised around €225 billion of fresh capital and a further €275 billion has been injected by governments – equivalent in total to more than 5% of euro area GDP. As a result, the median Tier 1 capital ratio of euro area banks currently stands above 12%.

Nevertheless, we can see that investors are not yet convinced that the banking sector has fully healed – as evidenced by euro area banks' price-to-book ratios of less than 1. This is why the ECB's is now undertaking a rigorous and comprehensive assessment of banks' balance sheets. We want to make sure that investors have all the facts they need.

Such transparency should dispel investor doubts where they are not warranted. It should encourage proper pricing of risk where it is misaligned. And it should encourage corrective actions where they are needed. As such, we trust that it will have a similar effect to the Federal Reserve's stress test in 2009 that helped lift the fog over the US banking sector.

[1] T. Hoshi & A. Kashyap (2013), "Will the U.S and Europe Avoid a Lost Decade? Lessons from Japan's Post Crisis Experience", paper presented at the 14th Jacques Polak Annual Research Conference, November 2013.

Looking further ahead, next year we will have a new European supervisor in place and the year after a new resolution framework and potentially a single resolution mechanism. This will allow for tougher supervision on weak banks, and ensure that non-viable banks can be wound down safely and effectively.

Though I expect most banking sector repair to be complete by then, this banking union gives us the powers to ensure that banks contribute to the recovery rather than hold it back.

We have also seen a good deal of structural reform in the euro area, in particular in countries under stress. Thanks to early labour market reforms, according to the OECD index labour market institutions in Portugal, Spain and Greece are now more flexible than those in France, Germany and the Netherlands.

Reforms to increase competition and improve the business environment have been slower, but in several countries we are now seeing movement in the right direction. Governments have improved regulatory frameworks, reformed judicial systems, removed protections from regulated professions and raised the quality of public administration.

For comparison, in Japan attempts at structural reform did not start in earnest until around 2001. Even then, the paper I referred to earlier finds that the Japanese reform programme had 35 initiatives out of which only 8 were directly growth-enhancing. In terms of reform, the euro area is therefore clearly on a different trajectory.

What role about the role of monetary policy?

Monetary policy is clearly not the solution to structural problems. Yet maintaining price stability through a period of adjustment is essential. Otherwise, real debt burdens rise and, in the euro area, rebalancing between countries becomes more difficult.

Japan was unable to avoid deflationary pressures, but this is not a scenario that we foresee for the euro area. Inflation expectations are firmly anchored and we see no risks of deflation in the medium-term.

We recently cut our main interest rate to ensure that we maintain inflation at below but close to 2% over the medium-term. This objective was the anchor of all our policy actions before the crisis; it has remained the anchor during the current crisis; and it will remain the anchor as the euro area economy proceeds towards recovery.

2. The economic consequences of adjustment

A comprehensive process of restructuring and reform such as we are seeing in the euro area naturally has economic consequences. Let me turn to those consequences in the second part of my remarks.

As the public sector is consolidating, and the private sector is deleveraging and rebalancing towards exports, the external sector has to go into surplus for a period of time. The euro area current account surplus is expected to rise above 2% this year.

There have been some claims recently that this constitutes a “beggar-thy-neighbour” approach as Europe is importing global demand. I find this quite contradictory. Observers cannot call on the one hand for Europe to avoid the mistakes of Japan, and then on the other hand criticise Europe for the inevitable consequences of doing so.

It is also a very short-term view. Europe’s contribution to global demand in the years before the crisis came largely through governments, firms and households taking on too much debt. This had to change. The ongoing process of reform and restructuring will allow Europe to support global demand in the future – but in a sustainable and stable way.

I would add that ensuring balanced growth between major economies would be greatly helped by efforts to accelerate regional free trade agreements, in particular the Transatlantic Trade and Investment Partnership (TTIP) between Europe and the US.

It has been estimated that a comprehensive and ambitious TTIP would create 400,000 new jobs in the EU and raise EU GDP by €119 billion a year. The economic gains for the US economy would be around €95 billion a year. And these benefits would also accrue to the rest of the world by increasing its income by almost €100 billion a year.

Such efforts on a regional level would in turn create momentum to revive the stalled multilateral agreements.

Looking within the euro area, the main focus has recently been on the German current account surplus. There are various negative claims made about this, for instance that German competitiveness hinders intra-euro area adjustment and the return of stressed countries to growth.

I think we need a more nuanced view.

First, at a macroeconomic level Germany is already contributing to euro area rebalancing.

Its surplus with the euro area has more than halved since 2007 – falling from 4% of GDP to 2% of GDP – and with stressed countries it has virtually disappeared – falling from 2% of GDP in 2007 to 0.5% of GDP. This is being driven in a large part by higher domestic demand which is structural, not cyclical in nature.

Second, at a microeconomic level Germany's export performance supports both upstream producers and downstream producers in the rest of Europe.

Germany is at the centre of the European value chain and is a gateway to global value chains. So it is simplistic to assume that Germany becoming less competitive would automatically help others – it may indeed harm them.

The solution to rebalancing is for other countries to become more competitive, not for Germany to become less so. We need to maximise competitive pressures within Europe to achieve higher efficiency, innovation and productivity growth.

And thanks to the structural reforms that are taking place, this is actually what we are seeing. For example, since 2011 Portugal's export market share has increased by 11 percentage points and Spain's by 8 percentage points.

At the same time, I see a vital need for new investment in Germany. Investment is still around 1 percentage point of GDP lower than it was in 2007, and in that year Germany already had the lowest investment ratio in the euro area. To raise investment we need structural reforms in Germany as well – for instance to liberalise the services sector – thus creating a virtuous circle of higher potential growth and better investment opportunities.

And by definition, if more German savings were invested at home, the current account surplus would also fall.

To conclude, I do not see the current decade in the euro area as "lost" – I think it is being used well.

The decade of adjustment we are facing now is to correct the mistakes of the previous decade. But in the process, I trust we are fixing our problems at the root.

Looking forward to 2014, the key challenge is to stay on this path to create the fastest possible rebound in growth and job creation.

This entails building a genuine banking union with a strong single resolution mechanism; it entails finding new ways to support structural reform implementation, for instance through so-called reform contracts; and it entails deepening our political union to ensure full legitimacy in the eyes of citizens.

All this requires effort and determination to achieve – but it is well within our reach.