Peter Praet: Reforms and growth in the euro area

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Panel intervention "Fixing finance", The Economist's Lisbon Summit, Lisbon, 18 February 2014.

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It is a great pleasure to be in Portugal today, where we are now seeing signs of a stabilisation in the economy. Economic activity is recovering, the unemployment rate is falling – although from very high levels – and the current account is in surplus. While it will take years for the scars left by the crisis on the economy and society to fade, confidence has been steadily improving during the recent months. Real GDP has been growing at positive rates since the second quarter of 2013 and the most recent information from industrial production, sales, and merchandise trade confirm that this trend is continuing.

Other euro area countries that have been hit hard by the crisis are also now beginning down the recovery path, while financial markets have started a more benign pricing of sovereign and private credit risk. All this is thanks to the progress that has been made in macroeconomic, structural and financial repair since the onset of the financial crisis. Especially since mid-2010, the start of the sovereign debt crisis, decisive action has been taken at national and European levels.

In the first part of my remarks today, I would like to give an overview of the key measures that have been taken in response to the crisis. My focus will be on the role played by the ECB. Monetary policy has been critical to averting a more severe economic calamity.

But the ECB has also made a wider contribution: we have contributed actively to the debate on the deepening of EMU and we have promoted progress toward the euro area's new financial architecture, the Banking Union.

This work of strengthening the euro area is not complete, however. And this is where I would like to focus the second part of my intervention. Specifically, I would like to ask: what further steps are needed to embark on a path of robust growth, both in stressed and non-stressed economies?

We know that achieving high sustainable growth will be indispensable to bring the unemployment rate back to acceptable levels and to support debt sustainability. But for this to happen, the euro area as a whole will need to persevere in its efforts to reform its economic fabric. The process of structural reform is demanding – and it therefore requires long-term commitment and strong ownership to be a success.

The starting point: the debt crisis and the emergence of financial fragmentation

Let me start by briefly reviewing the evolution of the crisis in the euro area.

Very broadly speaking, the crisis has had two main phases. The first phase began with the bankruptcy filing of Lehman Brothers in September 2008. Here the euro area shared in a global liquidity crunch that was largely imported from abroad. The second phase began in May 2010 with a sovereign crisis that was localised in the euro area, and that was partially exported to the world economy. This second phase was arguably the more pernicious for monetary union.

The re-pricing of sovereign risk in the euro area spread from Greece to other vulnerable economies, and from sovereign to private debt and vice versa. In the process, the liquidity crunch morphed into a systemic crisis for the banking sectors of a number of member countries, and for the integrity of monetary union as a whole. The traditional exposure of banks in vulnerable countries to their own sovereign issuers became a quick carrier of financial contagion as their sovereign bond holdings depreciated and eroded their capital in the eyes of creditors.

This adverse sovereign-bank feedback loop interacted with existing vulnerabilities. Countries with persistent competitiveness losses and associated large current account deficits – as was the case of Portugal – were particularly sensitive to a reversal in external financing. This was exacerbated by capital flight to core economies which started to deplete banks' deposits in the most vulnerable countries. Concerns that systemic sovereign issuers may lose market access fed fears that they may be forced to redeem their liabilities in a currency different from the euro, and thus *de facto* leave the euro area. "Redenomination fears" became a new source of market anxiety. There was a risk that such unwarranted concerns would become self-fulfilling and the spectre of destructive tail scenarios was looming.

In this context, the process of financial integration, which had evolved at a rapid pace since the inception of the euro, was partially reversed, giving way to fragmentation. Interbank financial fragmentation *per se* was not a new phenomenon in the post-Lehman world. However, during the most severe stages of the sovereign crisis the fractures across the euro area were not idiosyncratic but systemic – that is, they ran along national borders. This reversal of the integration process risked undoing one of the key benefits of the common currency.

Fragmentation led to an impairment of the monetary policy transmission mechanism. The monetary impulse that the ECB had swiftly introduced in response to the rising risks to price stability was no longer transmitted uniformly throughout the entire euro area. While the ECB had brought its official policy interest rates to historical lows, a number of countries were not in a position to take advantage of monetary accommodation. Banks in those countries were tightening credit conditions, running against the monetary policy intentions of the central bank, with negative repercussions on access to finance, in particular for small and medium-sized enterprises. This translated into a drag on the economic recovery.

As a result, the singleness of monetary policy was no longer ensured, posing significant challenges to the ECB's policy conduct.

Fixing the monetary transmission mechanism and the elimination of tail risks

The ECB responded forcefully to these challenges with a number of standard and non-standard monetary policy measures. The main purpose of the non-standard measures was to reduce financial fragmentation and restore an appropriate functioning of its monetary policy across the euro area. In particular, the measures were geared towards removing two sources of risk premia: bank funding risks and redenomination fears.

Higher funding risks for banks had been a symptom of the crisis ever since liquidity strains had first emerged, almost overnight, in the summer of 2007. They had escalated to systemic proportions after the Lehman demise.

Since the onset of the crisis, the ECB's mainstay response to this problem has been twofold: a policy of unlimited provision of liquidity at fixed interest rates against eligible collateral in the weekly main refinancing and longer-term operations, and an extension of maturity of the liquidity operations from 3 months to up to 3 years. This dual approach to crisis management has been reinforced by two further initiatives.

First, collateral rules have been adapted in various stages with a view to broadening the pool of assets that banks could mobilise for Eurosystem liquidity provision. This process – which has complemented the fixed-rate-full-allotment decision – has always balanced the need to be supportive to our counterparties with the goal of exercising an appropriate degree of risk control, and to protect our balance sheet. Incidentally, Portuguese banks have greatly benefited from these measures. For instance, they were able to strengthen collateral buffers by mobilising additional credit claims for the purpose of obtaining Eurosystem liquidity – and more effectively than other banking systems in the euro area.

Second, the refinancing risk faced by euro area banks has been minimised by giving them reassurance that monetary policy will remain accommodative for an extended period of time. In the course of 2013, this reassurance has taken two forms: conditional forward guidance on the level and direction of our policy rates in the future, and a pledge to maintain the fixed-rate-with-full-allotment policy for as long as needed and at least until mid-2015.

These measures proved powerful in addressing the funding risk faced by our counterparties throughout the crisis, as evidenced, for example, by the significant decline in money market term premia.

Addressing redenomination fear premia, however, is more alien to central banks, and therefore required a new approach. The Outright Monetary Transactions (OMT) initiative was the innovative instrument that we deployed to remove break-up fears from the market pricing of sovereign credit risk, and promote more regular financial conditions. The initiative proved an extremely effective instrument. It has not only reduced the fraction of sovereign spreads that reflected compensation for the redenomination fears, but also contributed more generally to the improvement in funding conditions for corporates, banks and individuals across the euro area.

In sum, non-standard measures by the ECB have helped ease liquidity pressures for the euro area in general, and continue to play a pivotal role in alleviating funding constraints for Portuguese banks in particular. And we have seen consistent signs that banks in Portugal – again, more visibly than within other stressed countries – are starting to pass the easing stimulus onto their customers, that is, to firms and households.

Fixing the euro area economic and financial system

These monetary policy measures would have been less effective, had they not been flanked by a serious drive toward financial reform. The key element of this ambitious reform agenda has been the Banking Union. It is probably the most ambitious and encompassing reform of the EU architecture since the institution of the single currency. The successful completion of the Banking Union should help to address bank funding fragmentation in a more structural way and give concrete support to credit supply conditions throughout the euro area.

Let me explain why.

With the creation of the Single Supervisory Mechanism (SSM) centred on the ECB, banks will be subject to a homogeneous set of rules and procedures. This will make the standards for prudential supervision in the euro area more comparable and evenly applied. As a consequence, supervision should act as a source of integration rather than – as often was the case in the past – an additional cause of fragmentation. But some preliminary steps are needed before the SSM can operate in full. The first and most important precondition is full information about the balance sheets of the euro area banking sector. This is why much of 2014 will be devoted to a comprehensive assessment of the conditions of our banking sector.

The Asset Quality Review (AQR) is a central building block in this assessment and a precondition to restore confidence in the banking system of the euro area. Transparency about banks' balance sheets will help revive private investors' interest in maintaining and increasing exposures to euro area banks. Indeed, expectations of a serious comprehensive assessment have already reinforced the positive trend in the financial markets. Looking forward, the strengthening of bank funding positions – both on the equity and on the debt side – that will result from the exercise will help support credit provision to productive sectors with clear benefits for economic growth in the euro area.

The ECB is therefore also playing a role in the repair of the financial sector through its new supervisory function. However, there are clear limits to what the ECB can and should do. These limits are defined by the ECB mandate as enshrined in the Treaty. In that respect, the strict separation between monetary and supervisory functions is instrumental in safeguarding against potential conflicts of interest between these two functions.

Moreover, finishing the repair process requires actions in other policy areas. At the European level, the most pressing is to complete the Banking Union. An effective Single Resolution Mechanism is particularly important, as it will further reduce the sovereign-bank nexus and thus work towards the elimination of fragmentation across national borders.

But fixing the financial system is not a sufficient condition for economy recovery. Healthy banks can better intermediate between those who save and those who want to invest, and are thereby necessary for future growth. Yet, proper framework conditions need to be in place so that the right incentives to invest exist. For example, it is important that firms can flexibly adjust to changing economic conditions, and that excessive rents in sheltered sectors do not distort the allocation of capital. Creating such framework conditions is largely the responsibility of national policies. Let me therefore now turn to the national dimension of the reform process.

Improving sustainability and growth

At the time of the sovereign crisis, the most pressing preoccupation of national governments was to repair public finances and restore the trust of financial markets. Therefore, fiscal consolidation was necessarily their first priority, and the national reactions in this domain were both forceful and effective.

Let me remind you of some key facts.

Between 2010 and 2013 Greece, Ireland, Portugal and Cyprus requested financial assistance from the EU and the IMF. These programmes involved far-reaching economic and financial policy adjustments. Other countries that had been hit by a confidence crisis, such as Spain and Italy, chose to undertake similar corrections. Spain also requested ESM programme for its financial sector.

As a result, structural fiscal balances (i.e. fiscal balances excluding the impact of the cycle and one-off costs) improved significantly in all these countries. From 2010 to 2013 this improvement was equal to about 15 percentage points in Greece, 6.5 percentage points in Portugal, 6.0 percentage points in Spain, 5.5 percentage points in Ireland and 4.0 percentage points in Italy. Some of these adjustments are unparalleled in scale from a historical perspective.

These fiscal corrections took place at a time when confidence had reached its lowest level, private sector saving ratios were sharply increasing, banks had to deleverage and access to finance by firms and households was impaired. The short-term costs in economic and social terms were therefore high.

Yet, those costs were also elevated by the fact that most of the stressed countries had entered the crisis with rigid institutions and economic structures. As a consequence, the necessary adjustment of prices and costs to restore competitiveness was slow, which exacerbated the negative impact on activity. Nominal rigidities increased the real cost of the adjustment and the burden has often been borne by the more vulnerable members of society.

A key complement to fiscal adjustment has therefore been structural reform. In several countries a series of bold structural reforms have been implemented. In Portugal in particular, the reform agenda has been broad-based and far-reaching. It has included public administration, health and pension systems, education, judicial systems, competition frameworks, industrial relations, labour markets, energy markets, network industries, services sectors and regulated professions.

Some concrete examples of structural reforms

The overall approach to structural reforms in stressed countries has been to proceed in a comprehensive manner. This is not only because certain reforms are mutually complementary – for example, the competitiveness benefits of a labour market reform may not materialise without accompanying product market reforms, as wages adjust but prices do not – but also because an encompassing approach ensures that the burden of reform is spread more fairly across society.

However, implementation obstacles to this approach have been significantly higher than initially expected. In general, it has been easier to change institutions and rules in the labour market than in product markets; it has been easier to change rules for "outsiders" than denting the vested interests of established "insiders"; and it has been easier to increase taxes rather than cutting expenditure. While these difficulties are in many cases gradually being overcome, the process is far for completed. Still, one should not underestimate the achievements so far.

Let me give you a few examples:

Looking at a well-established summary indicator of employment protection, the OECD index, Portugal, Spain and Greece have recorded notable improvements in 2013. In these three countries labour market institutions are currently assessed to be more flexible than in Luxembourg, Italy, France, Germany, Belgium and the Netherlands. This should help achieve a balance of employment protection that gives both stability – encouraging workers to invest in firm-specific skills – and mobility – allowing for reallocation between productive and non-productive sectors.[1]

These same countries have also introduced several measures to help connect wage levels more closely with actual productivity developments. The link between collective bargaining and economic conditions has been strengthened by the possibility for more firm-level agreements. In Greece, wage floors have been significantly reduced to boost youth employment creation; in Portugal, they have been frozen and overtime pay considerably reduced. Wage indexation has become less prominent in Spain and in Cyprus it has been abolished.

In all these countries the labour market reforms have started to have an impact on private sector wages. Private sector compensation per employee has fallen significantly in Greece since 2011, correcting what was an unsustainable increase prior to crisis, and it has also started to adjust in Spain, Portugal and Cyprus in 2012–13. I fully recognise the difficulties this process creates, yet this has to be set against the need for wages to adjust to reduce unemployment and restore external competitiveness. We are expecting that that these positive effects will dominate going forward and help employment to begin recovering in the near future.

In parallel, all programme countries have strengthened their active labour market policies, including by fostering traineeship programmes and dual-apprenticeship systems, also with the support of EU funds. This is important, as having an adequate social safety net and job search and retraining programmes can reduce unemployment duration and so lower the long-term costs of an adjustment phase. There is also a fairness dimension: we should not forget that some citizens paid high entry costs to enter previously closed professions, for example by purchasing expensive licences, and may now need help transitioning to new employment.

Product market reforms have generally aimed at improving competition in network industries – energy, telecommunication, transport – and highly regulated professions, as well as reducing administrative (licencing) burdens to wholesale and retail trade and provisions of services. Such reforms have tended to face greater implementation obstacles than labour market measures, partly owing to the micro or sector-specific dimension of the reform needs.

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1 Blanchard, O., F. Jaumotte, and P. Loungani (2013), "Labor Market Policies and IMF Advice in Advanced Economies During the Great Recession", IMF Research Department.

This has required policymakers to confront more concentrated opposition from vested interests within the sector that is subject to reform.

However, among programme countries, Portugal has some impressive achievements to show in terms improving product market functioning and economic framework conditions. These have included the change of competition law and the regulatory framework, the reform of the judicial system, and the reform of regulated professions and of the housing market. Finally, programme targets for privatisation were achieved ahead of time.

Structural reforms need a long-term commitment

As I said at the start of my remarks, an improvement of the underlying prospects for these economies has moved expectations. Perceptions about the sustainability of the recovery path in Portugal, in particular, have been reflected in persistent improvements in confidence and associated reductions in risk premia. Over time the economic and social pay-offs of reforms will be high, in terms of higher wealth and employment. High and sustainable GDP growth will in turn bring about improvements in fiscal positions and sizeable reductions in debt-to-GDP ratios in the medium to long-run, contributing therefore to long-term debt sustainability.

However, to reap these benefits implies a long-term commitment. The reform process is a continuum. A reform that has just been legislated does nothing for the citizens of a country, if it is not followed-up with effective implementation. Making sure that reforms transfer from the statute book to the real economy requires painstaking monitoring, as well as a prompt reaction in case outcomes deviate from expectations. When countries exit adjustment programmes, such an orientation will help prove to markets that reforms have been undertaken not only due to external pressure, but also out of a genuine recognition of their benefits. This is the best way to ensure sustainable market access supported by a robust growth outlook.

Recent empirical estimates based on the distance-to-frontier approach show the gains that could still be achieved. In Portugal, closing the gap from best practices via a fast implementation of product, labour and welfare state reforms would lead to an increase in per-capita GDP by 13.5% in 10 years.[2] In these projections, not only the pace of implementation matters, but also the degree of ambitiousness. If reforms target only a partial closure of the gap vis-à-vis the best performers then of course the GDP gains will also be reduced.

All this points to the need to establish a clear link between notional reforms and actual outcomes via an outcome-based accountability framework, which can increase or make more effective the implementation process.

The need for structural reforms in all euro area countries

Despite difficulties, the impetus for reform has been strong in the stressed countries, while it has been much weaker in the rest of the euro area. This is the natural outcome of a crisis-driven reform process. However, the crisis has clearly shown that a strategy of postponing reforms is self-defeating, as it contributed to the accumulation of imbalances and vulnerabilities in good times and increased the cost of adjustment in bad times.

It is therefore crucial that the reform process is strengthened in all euro area countries, also those not affected by the crisis. Research has shown that undertaking coordinated reforms in

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[2] See R. Bouis and R. Duval (2011), *Raising Potential Growth after the Crisis: A quantitative Assessment of the Potential Gains from Various Structural reforms in the OECD Area and Beyond*, OECD Economic Department Working Papers No. 835, OECD Publishing. http://dx.doi.org/10.1787/5kgk9qj18s8n-en. Fast implementation refers to phasing-in over 5-years, while slow implementation refers to phasing-in over 10-years.

all countries can boost GDP more than in a situation where each country acts alone.[3] A more widespread approach to reforms in all euro area countries can therefore contribute to a stronger recovery in the stressed countries and in the euro area as a whole, through positive supply and demand effects.

Conclusions

Let me conclude.

The euro area has come a long way in addressing its problems. The progress that has been made is remarkable and covers a wide range of areas and actors. The ECB has been central in stabilising the euro area economy, smoothing the adjustment process of the stressed countries and restoring the proper functioning of the monetary transmission channel. At the supra-national level, EU governance has been strengthened and, in particular, the Banking Union is being established. And at national level, progress is ongoing towards restoring fiscal soundness and driving forward structural reforms.

The pay-off from these reforms is becoming increasingly visible: in 2013, we already saw signs of a turnaround in most euro area countries. In Portugal, real GDP has started its recovery path, fiscal developments have been positive and the unemployment rate has started to fall. And consumer and business confidence has been on an upward trend for many months. A similar improvement in confidence has also occurred in other countries that had been affected by the crisis. Expectations regarding incomes and employment are steadily being upgraded. This is a sign that households and firms are starting to internalise the benefits of the reforms implemented so far.

Looking ahead, the task of all euro area policymakers is to ensure that the improvement in confidence will be validated by actual outcomes. If implementation of structural reforms is pursued ambitiously and the reform momentum upheld, it seems likely that growth will surprise on the upside in the coming years.

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[3] See Varga J., J. in't Ved (2013), *The growth impact of structural reforms*, Quarterly Report on the Euro Area, European Commission Vol. 12/4, page 17–27.