Vítor Constâncio: Growth challenges for Asia and Europe

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the Asia Europe Economic Forum, Berlin, 15 May 2014.

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Ladies and gentlemen,

I would like to thank the organisers for inviting me to speak at this year's Asia Europe Economic Forum, in particular as relations between the two continents are getting stronger and more relevant. This is particularly important at the current juncture, as we are regaining growth after the global financial crisis. In my remarks, I would first like to explore the growing interrelations between Europe and Asia before then discussing growth challenges in the euro area. I would like to end with some reflections regarding global challenges which are of relevance for both Europe and Asia.

Intensifying Asian-European relations

Asian-European relations have become closer over recent decades. This is true both in an economic sense, and when viewing relations between the two continents from a wider perspective. And despite the recent slowdown in globalisation since the financial crisis, links between Europe and Asia are likely to become even stronger, as additional Asian countries broaden their integration in the global economy.

As to economic relations, we have seen a ***surge in two-way trade volumes and investment flows***, in particular because of China. In 2013, total EU trade with Asia reached EUR 1.25 trillion, almost double the value recorded a decade ago and representing over one-third of total EU trade. At the same time, the EU accounted for over 28% of Asian trade last year, far ahead of any other trading partner, including the United States. Most of EU imports coming from Asia arise from China (16.6% of total EU imports), but Japan (3.4%), India (2.2%) and South Korea (2.1%) are also among its top ten import source countries. The EU is also a major investor in Asia. In 2011, 22% of EU outward investment went to Asia, while 20% originated in the region. Financial links are also multiplying and strengthening. According to the BIS, banking exposures of a sample of ten major reporting euro area countries vis-à-vis Asia rose from USD 144 billion in early 2005 to USD 340 billion at the end of last year, although this only represents about 3% of total exposures.

These economic developments have driven, and have themselves been boosted by, a ***growing number of agreements*** with a gradually increasing scope. The first comprehensive EU Free Trade Agreement (FTA) with an Asian partner (South Korea) has been in force since 2011, rendering 70% of bilateral trade duty-free. At the end of 2012, the EU and Singapore concluded a comprehensive FTA, the first EU agreement with an ASEAN country covering trade and services. Talks on investment are on-going. FTA negotiations with Japan began in April 2013, while talks on a comprehensive investment agreement with China started in January this year.

The stronger links between Asia and Europe which I just mentioned have ***deepened the interdependency of the two areas***. The IMF estimates that a –1% growth shock in emerging markets would have a negative impact on euro area output of –0.3%.[1] Internal estimates suggest that a shock of that size in China alone would bring down GDP in the euro

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[1] *World Economic Outlook*, April 2013, Chapter 2.

area by 0.1–0.2%.[2] However, these impacts could be larger if the shock was accompanied by confidence effects, a rise in global risk aversion and capital flow reversals

Since the financial crisis, growth in emerging markets has come down considerably, currently standing at about 4% as compared with over 6% in the period 2000–07. China has experienced one of the largest drops in its growth rate, from over 10% before 2008 to 7.7% last year. External factors such as lower demand from advanced economies and tighter global financial conditions can probably explain a good part of this growth deceleration. However, the question remains whether we might not be witnessing a more structural change in Asia's growth potential. I would like to focus briefly on some examples concerning emerging Asia's two largest economies, China and India.

In China, demographic developments and declining returns on very high investment in a number of heavy industries are likely to be behind some of the recent growth deceleration. In addition, high credit growth and increased leverage since 2008 has led to very high corporate debt, increasing risks in the financial system. It is clear that China's new government is implementing a far-reaching programme of structural reforms, including in the financial sector. For instance, China has already made significant progress in liberalising interest rates. Formally, only bank deposit rates are still controlled directly by authorities. But de facto liberalisation has progressed even further as non-bank institutions have recently offered consumers alternatives, for instance in the form of deposits via internet-based accounts. Nonetheless, the challenge to allocate capital efficiently and to improve the performance of state-owned enterprises in a true competitive environment remains. Efforts by the authorities to give a greater role to market forces and competition, including from foreign firms, will ensure investment flows to productivity-enhancing projects.

In India, concerns persist about infrastructure bottlenecks linked to low public investment, which could hold back the country's growth potential. High and volatile inflation and administrative hurdles further increase uncertainty and act as a deterrent to investment. Sizeable government deficits also help crowd out private investment. This adds to the challenges that India faces to be able to increase its potential growth sufficiently to absorb the new workers that are entering the workforce and thus reap the benefits of its favourable demographic developments.

Hence, it would seem that the steadfast implementation of a programme of structural reforms is necessary to arrest the decline in potential growth.

Similar challenges regarding potential growth also apply to the euro area. Let me now turn to these. Developments in the euro area also have clear implications and spillover effects on Asia.

The euro area – overcoming growth challenges

The ***euro area recovery is proceeding***, though at a moderate pace, with GDP increasing for three consecutive quarters. GDP is projected to grow at 1.2% in 2014, according to our own projections and those of the European Commission and the IMF. There is an on-going economic recovery in the euro area which is broad-based as it is now happening in all member countries. These signs are encouraging, even though growth remains below rates observed before the global recession and unemployment rates, in particular for young people, remain unduly high.

What I would like to do now is to elaborate on ***what can be done to strengthen the recovery in the euro area***. I would like to focus on three factors: the rehabilitation of the

[2] These estimates are based on the NiGEM and a global VAR.

euro area's banking system, the achievement of efficient credit allocation and sustainable debt levels, and the implementation of structural reforms to spur productivity growth.

Starting with the ***rehabilitation of the euro area's banking system***, public capital injections and state guarantees were necessary during the crisis, and the ECB had to provide liquidity to banks in its capacity as lender of last resort. A number of banks were undercapitalised and had fragile funding structures. How did these problems come about? According to the standard growth theory, capital should flow towards countries and sectors with low capital-to-output ratios and hence higher marginal returns on capital, which tend to be located in lower income countries. While such flows towards these countries were observed before the financial crisis, they were allocated to sectors where the marginal product of capital was low partly due to very loose credit conditions and an incomplete single market in capital as retail banking remained largely fragmented and cross-border equity markets were hardly developed at all.[3]

An improvement of this situation is important as financial development is crucial for long-term economic growth, as we can see from the positive relationship between financial development and economic growth over the past 20 years. This is because financial deepening alleviates financing constraints at the firm level. However, there is evidence of a ***threshold at which the positive effect of more credit on growth starts petering out.*** We have indeed observed in the past a number of boom-bust cycles induced by financial market excesses which I would classify into three types: asset price booms, credit booms and real estate booms. The global financial crisis was preceded by all three which resulted in strong deleveraging needs of the private sector. As a result, we are now in a situation of a ***creditless recovery in the euro area***, with low levels of credit to the private sector and nevertheless positive, though low, GDP growth

Currently, some ***progress towards financial stabilisation is being achieved***. Banks are reducing their liquidity buffers, repaying our LTROs and regaining the confidence of the markets. Quantity-based indicators confirm a stabilisation in bond markets and improved integration in equity markets.

The second measure which could help to overcome the sluggishness of the euro area recovery is to ***ensure efficient credit allocation***. Before the crisis, capital flows were not allocated efficiently because catching-up economies lacked appropriate structural and institutional frameworks. The risks related to private debt levels were underestimated. Recent analysis by the Eurosystem's Competitiveness Network (CompNet) provides evidence that the distribution between the most and the least productive firms in individual euro area countries is very large and skewed: there are a few highly productive firms and many which have low productivity.[4] As a result, resources should be reallocated both across sectors and within sectors towards the most productive firms.

With regard to both of the elements I just mentioned, the rehabilitation of the euro area's banking system and efficient credit allocation, a lot of ***progress has been made through the creation of the banking union***, with the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The ECB's comprehensive assessment is being conducted before the SSM takes up its supervisory tasks, with the aim of completing the repair of balance sheets of banks subject to the SSM and of improving their capital and solvency positions. It is an important step in bringing about greater transparency of the banks' balance sheets and consistency of supervisory practices in Europe. While the first pillar, the asset quality review (AQR) should enhance transparency of bank exposures, the second pillar, the stress test which is being performed in close cooperation with the

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3 See *Financial Integration in Europe,* European Central Bank, April 2008.

4 See Di Mauro, F. (2014), "Firm-level data: Who said that they are too difficult to use for policy?", VoxEU 11 March 2014.

European Banking Authority (EBA) has the aim of examining the resilience of banks' balance sheets to stress scenarios.

The main benefits I expect from the SSM are an improvement in the quality of supervision, a more homogeneous application of rules and standards, the improvement of incentives for deeper banking integration and a strengthening of the application of macro-prudential policies.

These achievements towards a banking union are particularly important in the euro area as about 75% of the real economy's financing needs are still met by the banking sector.

While this progress on the banking union is encouraging, further challenges lie ahead, or, as André Sapir put it recently, "The foundations of a banking union have been laid, but changes in the financial landscape are yet to come".[5]

The third factor that would help to sustain the recovery is the ***implementation of structural reforms to spur productivity growth***. Such reforms comprise, for example, raising the quality of human capital, fostering research and development, reducing administrative burdens so as to create a business environment that favours entrepreneurship, deepening the single market and strengthening competitive forces in the non-tradables sector. Why do I, and also my colleagues at the ECB, stress the importance of this factor so much? If you look back at the period before the crisis, the aforementioned flow of capital to catching-up economies did not lead to total factor productivity increases in these countries. This would have been an important condition for sustainable convergence between euro area countries. One of the reasons was an incomplete single market in goods and services. As mentioned earlier, capital flows in catching-up economies were allocated to sectors where the marginal product of capital was low and falling, also because this was counterbalanced by rising profit margins.[6] Indeed, a lack of competition led to excessive rents and distorted price signals. As a result, capital was channelled away from more productive sectors, thereby leading to lower aggregate productivity. This is also indicated by the previously mentioned firm-level analysis conducted by the Eurosystem's CompNet, which suggests that there is strong heterogeneity of firm labour productivity within and across countries.[7] This period was also characterised by an overestimation of the sustainability of consumption and investment growth, of future productive capacity and of potential growth in the long term.

More recently, in the stressed euro area countries, a lot of progress has already been achieved, with relative unit labour costs below what they were in 2008 and successful external adjustments. It is now necessary to be assured that this progress is not purely cyclically driven but structural and therefore sustainable. The reform efforts are producing some visible effects; for instance, the current account of stressed countries in the euro area, which used to be in a significant deficit position, has now moved into surplus. Further effort is also needed to implement reforms which boost productivity through an increase in the quality of human capital and a fostering of research and development.

Overall, these reforms should help to increase growth in the euro area,. This should also be achieved by fostering investment in the long term, boosting the quantity of investment, mobilising resources in the private sector and increasing the quality of infrastructure projects. ***Re-establishing confidence*** is of the utmost importance ***for a sustained recovery in the euro area***. We observed a strong drop in domestic private investment following the onset of the global financial crisis. This was the result not only of the credit constraints I mentioned

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5 See the article "European banking union: Foundations laid but bricks still to fall in place", FT 8 May 2014.

6 See European Commission, 2013, "Catching-up processes in the euro area", in *Quarterly Report on the Euro Area,* Vol. 12, Issue 1, March 2013.

7 See CompNet Task Force, 2014, "Micro-based evidence of EU competitiveness: the CompNet database", ECB Working Paper Series No 1634, February 2014.

earlier, but also of a steep drop in confidence in the euro area due to the uncertainty surrounding the financial crisis. On the positive side, I would like to stress that recent indicators suggest a slow return of confidence which – hopefully – will also help investment to slowly get back to levels observed before the crisis.

Before I turn to global challenges, I would also like to say a few words about ***low annual inflation in the euro area***, which has stood at rates of between 0.5% and 0.9% since October last year. We expect euro area inflation to remain low for a prolonged period. ***That said, we still see no distinct signs of deflation in the euro area for the time being.*** The main reasons are the following: first, ***long-term inflation expectations remain well anchored***, according to measures extracted from both financial instruments and surveys. Second, ***the lower inflation rates in the euro area can in large part be explained by global factors***, in particular with regard to energy and food prices.[8] Third, ***there is no evidence so far that economic agents are postponing expenditure plans***, which is sometimes seen as an indication of deflation. Domestic demand is strengthening, as suggested by the rise in consumer confidence, which in April reached a level last seen in 2007.[9] And fourth, much of the decline in core euro area inflation comes from the countries that were or are still under a demanding adjustment programme. This suggests that part of this decline reflects a relative price adjustment needed to restore competitiveness, and as I mentioned earlier, this is to be welcomed.

This does not mean at all that we are complacent about risks arising from a too protracted period of low inflation. We have therefore reaffirmed our forward guidance and stressed that we are determined to act swiftly if required and do not rule out further monetary policy easing.

Global challenges

After covering some of the challenges relevant for Asia and for Europe, let me now turn to global challenges.

Recent turbulence in financial markets in some emerging economies fuelled the debate about ***spillover effects of monetary policy*** as the question arose as to whether they could be driven by the tapering-off of unconventional monetary policy measures in the United States. Spillover effects in general are unavoidable consequences of globalisation and have been documented in recent research, for example at the ECB.[10] Part of the afore-mentioned recent turbulence in financial markets is related to self-fulfilling effects in emerging economies, owing to herd behaviour and the fact that asset prices are picking up and debt levels are also rising as a result of the higher equity values resulting from higher equity prices.

This raises the question as to whether the Federal Reserve, the ECB and other central banks in advanced economies are insufficiently sensitive to the impact of their unconventional policies on emerging market economies, or whether the complaints of emerging markets about these spillover effects are unjustified. This topic has been widely discussed; it was, for example, one of the core themes discussed at the 2013 Jackson Hole central bank

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[8] According to ECB staff estimates, developments in energy and food prices and the impact of indirect taxes explain around three-quarters of the overall decline in HICP inflation.

[9] Some of the global factors that have dampened inflation (such as lower commodity prices) contribute to improve real disposable incomes and support spending.

[10] See, for example, Lo Duca, M., G. Nicoletti and A. Vidal Martinez, 2014, "Global corporate bond issuance: what role for US quantitative easing?", ECB Working Paper Series, No 1649, March 2014. The authors find evidence that bond issuance in emerging markets since 2009 would have been halved without quantitative easing in the United States.

conference. We also recently had a very enriching panel discussion on this at the Hutchins Center on Fiscal and Monetary Policy at Brookings.[11]

In this context, I would like to stress three points. First, ***we should not neglect the positive spillover effects from accommodative conventional and unconventional monetary policies in advanced economies since the start of the global financial crisis.*** For example, in the US, estimates suggest that the purchases of long-term Treasury bonds reduced yields by up to –120 bp. Moreover, UMPs in the US supported GDP growth, even though there is more uncertainty regarding the magnitude of the effects.[12] These policies have prevented even more pronounced and protracted financial market dysfunctioning that would almost certainly have been transmitted to the rest of the world. In addition, they have supported the recovery in advanced economies, thereby stimulating demand for imports from the rest of the world.

This notwithstanding, unconventional monetary policies have also led to instances of higher volatility in other economies. For example, there is evidence that some elements of unconventional monetary policy in advanced economies have accentuated the pro-cyclicality of capital flows, in particular to emerging market economies.

The ***timing of an exit from unconventional monetary policies*** has been called into question. Here it has to be kept in mind that the world – including emerging market economies – would have been in a much worse position if the central banks of advanced economies had exited from unconventional measures at an earlier stage. Time was needed to stabilise the whole financial system. In addition, there is still a negative output gap in advanced economies, with, in the euro area, high unemployment, while in emerging economies the output gap is much smaller and they are close to full employment. This suggests that a cooperative solution to reduce the spillover effects of an exit from unconventional monetary policy measures would consist in advanced economies making progress to sustain aggregate demand and growth, and emerging markets accepting an appreciation of their currencies – which they often refuse to do.

However, unconventional monetary policies have not been the primary driving force for this increase in pro-cyclicality, and adverse developments did not arise uniformly across economies. And this brings me to my second point: ***it seems rather that country-specific factors such as weak institutions, external and domestic financial imbalances, limited exchange rate flexibility and fiscal imbalances were also factors behind the volatility***.[13] For example, the sell-off in emerging market economies in January 2014 was concentrated in economies which were more vulnerable; healthier economies in East Asia were largely unaffected. This evidence suggests that the adoption of sound domestic policies allows emerging economies to minimise adverse spillovers, and at the same time benefit from a stronger recovery in advanced economies. Spillover effects could therefore be reduced by improving macroprudential policies, controlling the total leverage of the financial system in both advanced and emerging economies.

The third point I would like to make in the context of spillover effects is that ***advanced economies are carefully communicating their monetary policy strategies***, thereby doing their part to minimise any possible negative spillover effects from the exit from unconventional monetary policies. Unconventional monetary policy measures have to be

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[11] After a keynote speech by Raghuram Rajan, Governor of India's central bank, a panel discussion took place with Charles Evans, President of the Federal Reserve Bank of Chicago; Alexandre Tombini, Governor of the Central Bank of Brazil; Eswar Prasad, the New Century Chair in International Trade and Economic and a senior fellow of the Brookings Global Economy and Development programme, and myself.

[12] See IMF, 2013, "Unconventional Monetary Policies – Recent Experiences and Prospects.

[13] See IMF, 2013, "Word Economic Outlook", and Fratzscher, M., M. Lo Duca and R. Straub, 2013, "On the international spillovers of US quantitative easing", ECB Working Paper Series No 1557, June 2013.

ended at some point, given the possible negative side effects such as excessive risk-taking and complacency regarding structural reforms. With clear and credible communication on the parameters of exit by advanced economy central banks we help to clarify our reaction function and vulnerable economies get the opportunity to adopt the policies needed to ensure that abrupt market corrections will not materialise in the future. This clear and careful communication is also reflected in our forward guidance, which we reiterated at our last press conference one week ago.

Notwithstanding these arguments, ***cooperation to reduce negative spillover effects of monetary policy or the exit from unconventional measures is important.*** There are already several forums where central bankers meet, such as the BIS meetings. On such occasions, central banks explain their policies and the situation of their own countries. Such collaboration helps to understand the possible reaction function as well as possible spillover effects on other countries.

In addition, the ***network of standing swap arrangements concluded in October 2013*** among the major central banks reflects their long-standing cooperation and the systemic importance of their economies and financial systems. It enables emergency liquidity to flow to major financial hubs and, through these hubs, to other markets, thereby contributing to global financial stability.

Another measure which would reduce negative spillover effects would be to ***enhance global safety nets***, mostly via the IMF. A number of instruments which go in this direction have already been created for countries with strong domestic policy frameworks, including such instruments as the IMF's Flexible Credit Line (FCL) and Precautionary and Liquidity Line (PLL). Improving global safety nets helps to reduce the need for countries to accumulate reserves.

Concluding remarks

Relationships between Asia and the euro area have strengthened over recent decades. While this is a positive development, it has also increased interdependencies, including negative spillover effects, both from Asia to Europe and from Europe to Asia.

Both regions have domestic challenges to cope with, regarding in particular structural reforms to adjust the composition of growth in some Asian countries, and the rehabilitation of the banking system, the achievement of efficient credit allocation and sustainable debt levels, and the implementation of structural reforms to spur productivity growth in the euro area. Progress has been made in some areas, for example with the banking union in Europe, but much remains to be done.

At the global level, the spillover effects of monetary policy, including the exit from unconventional measures, continue to be in focus. While part of the volatility in the financial markets of emerging market economies has other explanations, it is important to ensure proper communication of and cooperation between central banks, a policy that has always been pursued by the ECB.

Thank you very much for your attention!