Benoît Cœuré: Rebalancing in the euro area – are we nearly there yet?

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, to the Danish Economic Society, Kolding, 15 January 2016.

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Ladies and gentlemen, Mr President, dear Per,

The euro area crisis was a crisis fuelled by imbalances. Imbalances laid the ground for economic and financial turmoil, in part due to the euro area's design flaws. And the difficult process of repairing imbalances within that design sustained the turmoil further and let its consequences become entrenched, tearing our social fabric. If we want lasting stability and growth in the euro area, we cannot let the same things happen again.

The long-term solution is to complete our monetary union and make it less vulnerable to shocks. The foundations of this road have been laid by the Five Presidents' Report, and it implies setting up new risk-sharing mechanisms among the participating economies. But that will not happen in a situation where large imbalances between member countries already exist and are considered as a state of nature. Just like John Rawls pointed out with his concept of the "veil of ignorance", it is impossible to achieve an optimal solution for a group if the winners and losers are clear a priori. Citizens are rightly suspicious that risk sharing may turn into risk shedding. We can only strengthen the euro area, to the benefit of all, if all member countries imagine themselves in comparable positions behind a veil of ignorance.

This is why resetting all our economies onto a path of *sustainable rebalancing* is essential. Sustainable rebalancing is key to reducing risks. It is key to creating the preconditions for all euro area countries to stabilise, grow and converge. And it is key to laying the groundwork for Economic and Monetary Union to be completed.

The euro area has been going through such a rebalancing process for several years now. So what I would like to do in my remarks is review where we stand today. How far has rebalancing come? Is that rebalancing sustainable? And, if not, what do we need to do to make it sustainable?

These questions do not only matter for the euro area. They matter for the rest of the world as well, since rebalancing has important implications for global growth. If every economy were to react to their domestic challenges by exporting their slack, it would only trigger a race to the bottom. Therefore, only through achieving a *truly* sustainable rebalancing can the euro area start generating rather than absorbing global demand.

Dimensions of sustainable rebalancing

So what is sustainable rebalancing? There are four aspects we need to consider.

The first is that *external and internal rebalancing* are twin concepts. For rebalancing to become truly sustainable, progress on both fronts is required. This follows from Macroeconomics 101: the current account position is the mirror image of the balance of savings and investment. External rebalancing achieved through, for example, raising savings and depressing domestic investment, might not be compatible with robust growth or high levels of employment.

The second aspect is the interaction between *flows and stocks*. Rebalancing has traditionally been seen as resolving flow imbalances, e.g. the current account. But it is also about sustaining sufficient flows over time to stabilise stock imbalances. That is because, even with a balanced current account, excessive net external liabilities create instability and may be unsustainable. And as is the case today in many euro area economies, an internal debt overhang slows down the economic recovery and hence impedes internal rebalancing.

The third aspect is the role of *surplus and deficit countries*. Rebalancing could, in theory, be achieved by all euro area countries adjusting vis-à-vis the rest of the world. But, in reality, as 50% of euro area trade is intra-area, it must involve rebalancing within the euro area as well. And to be sustainable, that rebalancing cannot take place solely through demand depression in deficit countries in a way that prevents their internal balance. It requires symmetrical adjustment in surplus countries too. "Symmetrical", of course, does not mean that all countries should have a perfectly balanced current account, but rather that both excessive deficits and excessive surpluses should be adjusted.

The fourth aspect is the *cyclical and structural* drivers of rebalancing. If current account improvements are being driven mainly by lower imports in a weak economy, they are likely to unwind when the economy recovers and imports rise again. But if they are being driven by structural changes – such as competitiveness gains and reallocation of resources towards productive sectors – they are more likely to be sustainable in the steady state, both externally and internally.

All four aspects are integral to the rebalancing process. Sustainable rebalancing requires that adjustment is stable, symmetrical and structural. Only under those conditions can all economies achieve full employment in a way that is robust to global developments.

So what do we see in the euro area today?

Progress with rebalancing

The imbalances that built up in the euro area before the crisis were sizeable. Current account deficits in the five (former) programme countries – Greece, Portugal, Ireland, Spain and Cyprus – had doubled from, on average, around 5% of GDP in 2000 to about 10% of GDP in 2008. Moreover, those imbalances were financed largely by volatile, debt-based cross-border flows. That left several countries vulnerable to a rapid reversal in financing, with little ex-post sharing of risks between private borrowers and lenders – a so-called "sudden stop".

Since then, we have seen considerable flow improvements, especially in the countries that entered the crisis with large current account deficits. Deficits in the (former) programme countries have adjusted dramatically. On average they are in balance today. Only Greece and Cyprus are still recording small deficits, while the other countries have moderate surpluses. In the three Baltic countries the improvement was even more dramatic, averaging 17 percentage points since 2007.

The composition of adjustment has also been encouraging. Aside from Ireland and, to some extent, the Baltics, import compression played a strong role in closing current account deficits in the first phase of the crisis. But since 2012, improvements in deficit countries have been driven predominantly by robust growth in exports. The previous dramatic fall in internal demand in stressed countries had in fact not only depressed imports. It had pushed firms to look for new international markets as well.[1]

Demand for exports in deficit countries has also been supported by intra-euro area rebalancing. In particular, though Germany continues to run a record overall current account surplus, its trade surplus vis-à-vis the euro area has diminished. It fell from close to 4% of GDP in late 2007 to around 1% of GDP today.[2] Imports from the euro area have also increased notably. In this sense there has been some symmetry in the adjustment process.

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[1] See Bobeica, E., Esteves, P.S., Rua, A. and Staehr, K. (2015), "Exports and domestic demand pressure: a dynamic panel data model for the euro area countries", *ECB Working Paper Series*, No 1777.

[2] Bundesbank trade balance data corrected for the so-called "Rotterdam effect", that is, the fact that German intra-area imports are "inflated" by imports from (mainly) the Netherlands which are actually imports from countries outside the euro area.

Several factors suggest that these developments are not purely cyclical.

On the demand side, estimates by the ECB, as well as the IMF and the European Commission, suggest that – with the exception of Greece – the majority of current account adjustment in deficit countries has been “non-cyclical”.[3] “Non-cyclical”, however, does not mean “structural”. What it means is simply that, though falling demand did depress imports during the crisis, potential growth has fallen as well. Thus, when the output gap closes, current account positions should not substantially worsen. “Non-cyclical”, however, does not mean “structural”. What it means is simply that, though falling demand did depress imports during the crisis, potential growth has fallen as well. Thus, when the output gap closes, current account positions should not substantially worsen.

On the supply side, there is also evidence of structural shifts in deficit countries that should help sustain their export performance. Cost competitiveness – measured in terms of real effective exchange rates deflated by unit labour costs (ULCs) – has improved strongly since the start of the crisis. In most cases real effective exchange rates now stand close to 1999 levels or even below. That suggests much of the pre-crisis “excesses” have been reversed.

To give some examples, in Ireland the improvement in cost competitiveness from peak to trough is close to 50 percentage points. In Greece and Latvia the figure is around 30 percentage points. Spain and Cyprus have seen improvements of 20–25 percentage points, while for Portugal the figure is around 15 percentage points. In each case, the largest part of the improvement has come from relative cost adjustments rather than changes in the nominal exchange rate.

What is less well known is that we have also seen cost adjustments in surplus countries. In Germany, ULC growth relative to the euro area has accelerated strongly in recent years, on the back of more robust wage growth and slowing productivity. That has translated into a small correction in its cost position relative to its euro area partners. However, thanks to the depreciation of the euro exchange rate, Germany’s competitive position relative to the rest of the world has also improved during the crisis.

Stable rebalancing

Still, all this does not mean that the rebalancing process has reached its steady state, for two reasons.

First, the fact that rebalancing has been achieved, to some extent, by falling potential growth is hardly satisfactory. We cannot have a situation where rebalancing only holds if potential growth remains low and unemployment high. Remember that, despite the notable improvements since 2013, in several stressed countries employment is still more than 10% below 2008 levels. Any external rebalancing that does not generate jobs is not one that will last.

Achieving both external rebalancing and high employment requires a better reallocation of available resources, which means shifting resources to the tradable sector and, more generally, to the most productive firms operating within each sector of the economy. This would

[3] See ECB (2014), “To what extent has the current account adjustment in the stressed euro area countries been cyclical or structural?”, box in the *Monthly Bulletin*, January (**https://www.ecb.europa.eu/pub/pdf/other-/mb201401_focus05.en.pdf**). See also IMF (2015), *External Sector Report 2015* (**https://www.imf.-org/external/np/pp/eng/2015/062615.pdf**), and European Commission (2015), “Rebalancing in the euro area: an update”, box 1.3 in the *European Economic Forecast*, Spring (**http://ec.europa.eu/-economy_finance/eu/forecasts/2015_spring/box3_en.pdf**).

boost total factor productivity and, therefore, potential output on a long-lasting basis, and also make the necessary adjustment in relative costs more sustainable.[4]

Many countries still have a way to go in this regard. Admittedly, in many crisis countries ULCs have fallen and relative prices between the tradable and non-tradable sectors have adjusted. Yet sectoral labour flows show that, in the early phase of the crisis, there was no reallocation of jobs to the tradable sector. Rather, employment declined across all sectors in a context of collapsing domestic demand.[5] More recently, although some countries have added jobs in the tradable sector, by far the largest sectoral contributor to employment gains has been the services sector, which in many countries is largely non-tradable.[6]

What is more, preliminary evidence shows that there is still a lot of progress to be made in the reallocation of resources *within* sectors. This plays an even more important role for total factor productivity growth in mature economies such as those in the euro area.[7]

All this points to a need for further internal adjustments. But it also highlights the continuing importance of product market reforms, such as completing the single market, which open up services markets to competition. This would encourage intra-sector reallocation among the most productive firms. And by making services more tradable, it would mean that employment growth in that sector would also contribute to rebalancing.

Second, despite the flow improvements, external imbalances in stock terms remain high. The net international investment position (NIIP) of most countries with large net foreign liabilities has stabilised, thanks to current account improvements. But it has not yet fallen towards safer levels. All five (former) programme countries still have a negative NIIP in excess of 90% of GDP, and in some cases much greater. The NIIP of major surplus countries, such as Germany and the Netherlands, has also continued to grow.

That suggests further adjustment is still needed to achieve a sustainable external position. European Commission projections suggest that the NIIPs of Greece, Spain, Cyprus and Portugal will remain at levels associated with substantial external vulnerabilities over the next decade.[8] To meet the threshold specified in the Macroeconomic Imbalances Procedure – which is an NIIP/GDP ratio of –35% over a 10-year period – each would have to make substantial improvements.

It is also important to note that internal debt levels – the debt a country owes to itself – remain high as well in several countries. For example, in Spain more than 60% of public debt and 80% of private sector debt is held by Spanish residents. This may not contribute to net external liabilities, but it contributes to the general debt overhang, which holds back credit and investment. Internal debt, therefore, also needs to be tackled to achieve a sustainable internal rebalancing.

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4 For a description of how current account adjustment takes place at the extensive margin (creation of new goods and services), rather than at the internal margin (increased trade in existing goods and services), see Corsetti, G., Martin, P. and Pesenti, P. (2013), "Varieties and the transfer problem", *Journal of International Economics*, Vol. 89, pp. 1–12.

5 See Tressel, T. and Wang, S. (2014), "Rebalancing in the Euro Area and Cyclicality of Current Account Adjustments", IMF WP 14/130.

6 See ECB (2015), "What is behind the recent rebound in euro area employment?", article in the Economic Bulletin, Issue 8: https://www.ecb.europa.eu/pub/pdf/other/eb201508_article01.en.pdf?07f79a90715d-214297004b476b416430.

7 For the importance of within-sector resource reallocation to foster sector and aggregate productivity growth see, for example, Krizan, C.J., Foster, L. and Haltiwanger, J.C. (2006), "Market selection, Reallocation, and Restructuring in the U.S. Retail Trade Sector in the 1990s", *The Review of Economics and Statistics*, MIT Press, Vol. 88(4), pp. 748–758, November.

8 See http://ec.europa.eu/economy_finance/eu/forecasts/2015_spring/box3_en.pdf.

Structural rebalancing

In short, former deficit countries still face twin challenges to achieve sustainability: they need to further lower their net external liabilities, while continuing to rebalance their economies internally. The difficulty is how to do this without the one objective cancelling out the other. Let me explain.

In terms of addressing the external position, there are two, admittedly stylised, ways in which countries can do this: they can *pay down debt* or they can *grow out of debt*. Yet given the size of the net liabilities involved, each option taken in isolation has challenges.

Paying down external debt would require very large surpluses coupled with sizeable nominal adjustments. As rebalancing towards the tradable sector has not yet been completed, it is difficult to see how this could happen without depressing incomes and employment. Further still, the scale of the required adjustment would create prolonged disinflationary expectations, which would raise expectations of future real interest rates, depress demand and hinder internal rebalancing.[9]

At the same time, growing out of debt through boosting nominal GDP – a so-called "beautiful deleveraging" – is also not feasible on its own. Reducing NIIPs solely through the denominator would require unrealistically high rates of growth, beyond even the most heroic assumptions for structural reforms and/or fiscal and monetary stimulus. What is more, a large growth spurt without structural change might simply suck in imports and lead to new external imbalances emerging.

Incidentally, a third option would be to aim to change the composition of net external liabilities – that is, to replace debt with equity and foreign direct investment. This would not alter the level of NIIPs, but it would reduce vulnerabilities by improving risk sharing. In this context, the Capital Markets Union project could be powerful. However, this has to be considered a longer-term goal.

The only way ahead over the medium term, then, is for crisis-hit countries to find a combination of current account surpluses and nominal GDP growth that can produce both external and internal balance. So how can that be achieved?

Further action on the nominal side is clearly necessary, in particular to support employment and resource reallocation. And, within limits, that would not necessarily be inimical to growth: a recent modelling exercise by the IMF shows that wage moderation may have a positive economic effect on crisis-hit countries, especially if accompanied by more dynamic wage growth in surplus countries.[10] The structural reforms undertaken since the crisis would also allow such adjustments to be made more quickly and with less employment cost than in the past.

However, at some point nominal adjustment leads to a change in dynamics – that is, the positive substitution effects of relative price changes are dominated by the negative effects on incomes and real rates. That is why any effective adjustment strategy also has to be based around productivity growth. Productivity growth both lowers ULCs, supporting exports, and lifts permanent income and potential output, supporting debt reduction through real GDP growth. And though this might lead to higher investment, that would not necessarily be contrary to current account adjustment. If new investment occurs in the tradable sector it should lead to a stronger exporting base in the future.

Another factor in favour of focusing on productivity is that the types of reforms that will deliver productivity growth are likely to have less negative effects when monetary policy is at the lower

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[9] See Cœuré, B. (2014), "Structural reforms: learning the right lessons from the crisis", keynote speech at the Economic conference, Latvijas Banka, Riga, 17 October.

[10] See https://www.imf.org/external/pubs/ft/sdn/2015/sdn1522.pdf.

bound. That is because they act more on fixed costs than marginal costs, and hence have less impact on prices and real rates. For example, measures such as judicial reform or opening up closed professions are likely to primarily boost investment – and hence productivity – with little disinflationary effect.

For all these reasons, and as I have said on several occasions[11], seeing rebalancing as all about cutting costs – which is what policymakers often think of as "competitiveness" – is misguided. Productivity growth is central to competitiveness and to growing out of debt. This is confirmed by the IMF exercise I just mentioned: the benefits of wage moderation diminish as more countries engage in it, whereas if all countries engage in structural reforms to raise productivity the benefits are large and uniform.

Among the structural reforms that reduce fixed costs, one that is likely to have the strongest impact in the current environment is improving insolvency regimes. This would help tackle the debt overhang for viable firms by reducing the costs of debt workout. And it would also allow non-viable firms to fail faster, supporting reallocation to more productive ones. This is the message of a recent analysis from the European Commission, which finds that a good insolvency framework is associated with speedier adjustment of non-performing loan ratios.[12]

Symmetrical rebalancing

That said, it is also clear that sustainable rebalancing cannot only involve measures in crisis-hit countries. Rebalancing has to be somewhat symmetrical, i.e. surplus countries also have a contribution to make.

Such a contribution is partially about strengthening domestic demand, though we know that spillovers to crisis-hit countries through higher imports are likely to be small.[13] But what is more important, in my view, is the role of surplus countries in supporting *euro area price stability* – i.e. an inflation rate of below but close to 2%. This would allow the remaining relative price changes within the euro area to take place against a higher nominal bar. And that would in turn avoid deflationary nominal adjustments that raise real interest rates.[14]

So how could this be achieved?

As I already mentioned, wages have been rising more robustly in surplus countries, which is welcome and consistent with rebalancing. Yet some argue that more is still needed in terms of demand-side policies. Such measures would no doubt support euro area price stability. But they would have very limited impact on potential output and the permanent income of households. One can therefore question how much they would, in isolation, contribute to a sustainable rebalancing over the medium term.

The situation may be different, however, if growth is boosted by a combination of higher public investment and structural reforms creating incentives for higher private investment, which will induce a rise in permanent income. This could be a major confidence boost to the economy

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[11] See Cœuré, B. (2015), "Paradigm lost: Rethinking international adjustments", Egon and Joan von Kashnitz Lecture, Clausen Center for International Business and Policy, Berkeley, 21 November.

[12] See Carcea, M.C., Ciriaci, D., Cuerpo, C., Lorenzani, D. and Pontuch, P. (2015), "The economic impact of rescue and recovery frameworks in the EU", *EC Discussion Paper*, No 004, September.

[13] See https://www.bundesbank.de/Redaktion/EN/Reden/2014/2014_03_17_weidmann.html.

[14] This line of thinking has been formalised in a recent paper by Olivier Blanchard and co-authors which looks at the effect of higher government spending and inflation in core countries on those in the periphery. They find that, in normal times, the benefits for periphery countries are minimal as terms-of-trade gains are offset by the central bank raising rates. In a liquidity trap situation, however, the effects are markedly different. Crucially, if monetary policy is expected to not raise rates for a couple of years or more – as it is the case today – the stimulus for the periphery can be large. See Blanchard, O., Erceg, C.J. and Lindé, J. (2015), "Jump starting the euro area recovery: would a rise in core fiscal spending help the periphery? ", NBER WP 21426.

resulting in a surge in investment expenditure and a corresponding endogenous increase in inflation. But at a later stage, when the real effects of structural reforms show through, supply would catch up and inflation pressures would abate.

For surplus countries this would, in my view, be a win-win outcome, thus setting the right *domestic* incentives to adjust. In some surplus countries the output gap is currently closing in the presence of low potential growth and a significant savings-investment imbalance. With the policy measures I have mentioned, they would instead be able to move towards a new, win-win equilibrium. An equilibrium that would not only be consistent with the external balance, but also tackle the interrelated domestic challenges of weak private and public investment and low potential growth. At the same time, this adjustment would be "self-limiting", in the sense that upward pressure on inflation would be temporary and would not fundamentally undermine the country's external competitiveness.

How rebalancing plays out between surplus and deficit countries will determine the role of the euro area in global growth. As crisis-hit countries need to run continued surpluses to reduce their net liabilities, the euro area as whole will continue, unless the surpluses of other countries fall, to run a large surplus with the rest of the world. With weakening demand in emerging markets, this essentially puts the burden of generating global growth squarely on the shoulders of the United States. That may be asking a lot, especially if the secular stagnation hypothesis is to be believed.

Indeed, as I pointed out in a recent speech in Berkeley, export-led strategies risk a fallacy of composition: they may be relevant for one economy, but in the aggregate they risk leading the global economy into a high saving, low real interest rate trap. It is vital that all major economic areas contribute to global growth to avoid a descent into beggar-thy-neighbour policies.[15]

The alternative risk is that, if adjustment in the euro area is too asymmetric, it may ultimately stall in crisis-hit countries. Pre-crisis imbalances would then not be fully reversed. That might contribute to a reduction in the euro area current account surplus, but at the cost of creating new risks down the line. That is neither in the interest of the euro area nor the global economy.

Conclusion

Let me conclude.

Euro area countries have made substantial progress with rebalancing in recent years. But many still have a way to go to make rebalancing sustainable. Doing so is not only essential for their own stability and growth. It is also key to creating the conditions for completing monetary union in a way that will prevent imbalances from emerging again.

The full potential of using the Macroeconomic Imbalance Procedure to strengthen euro area surveillance has so far not been realised, neither for preventing nor for correcting imbalances. From now on, it is important that its corrective arm is used forcefully and without exception as soon as excessive imbalances which endanger the smooth functioning of EMU are identified.

The roadmap to a complete monetary union is there: it was laid out in the recent Five Presidents' Report. But the political will to enact it will not exist unless economic divergences are first ironed out. It is clear that monetary union cannot now be built from behind the veil of ignorance. But all countries can take measures to make their economic policies converge and reduce foreseeable risks, which is what makes mutual insurance possible.

Ultimately, it is economic divergence that fuels political divergence, and this is what makes the euro area so fragile. Sustainable rebalancing is the first step towards avoiding such divergence.

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[15] See Cœuré, B. (2015), op. cit.