EUROPEAN CENTRAL BANK

EUROSYSTEM

The ECB and its Watchers

Frankfurt, 9 July 2010

Imbalances and Sustainability in the euro area

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Up until 6 months ago

The euro was celebrated for its successes

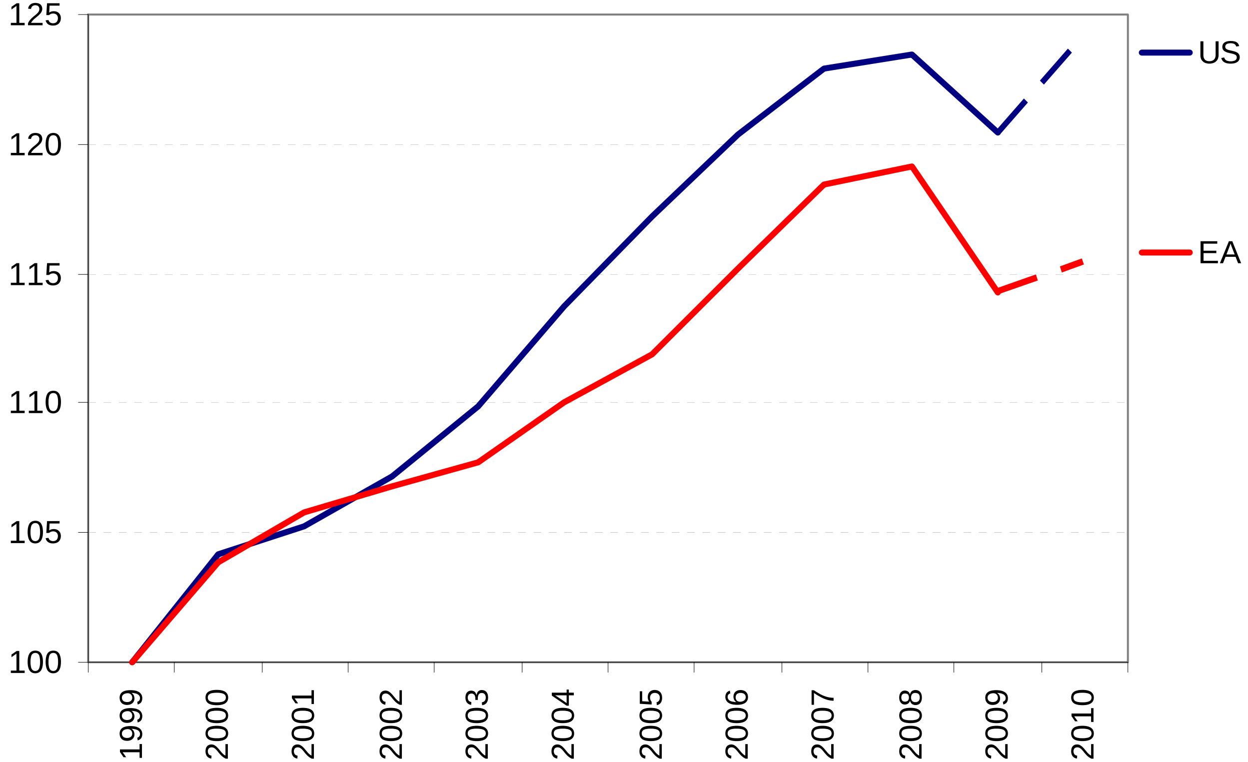
In particular, over its first 11 years and a half

The euro delivered price stability

The average inflation rate has been 1.98%

Euro area growth

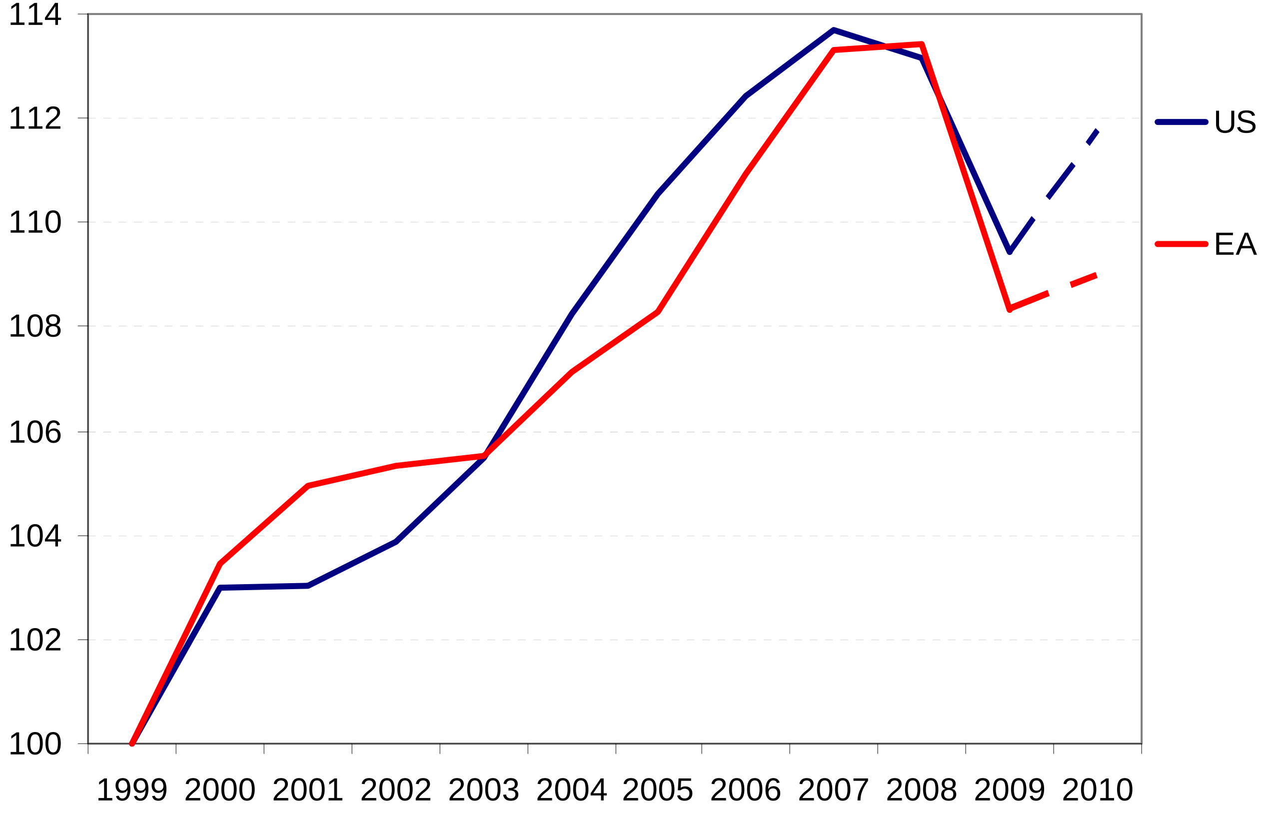
Has been slightly slower than in the US



Real GDP (1999=100). Source: IMF and IMF projections (WEO, April 2010)

But in per capita term

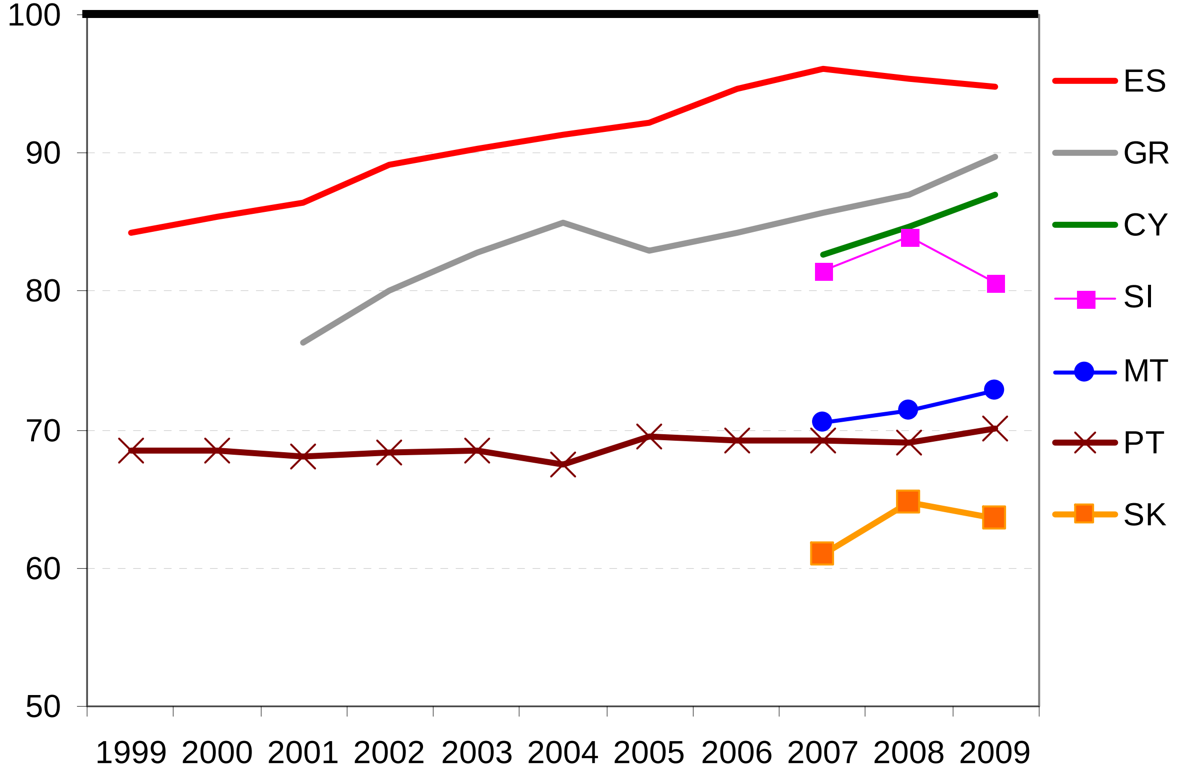
Growth has been similar to the US



Per capita GDP (1999=100). Source: IMF and IMF projections (WEO, April 2010)

Strong convergence

Of most lower income euro area countries



Per capita GDP in PPS (euro area = 100) Source: EC.

But there have been divergences

In the performance of euro area countries

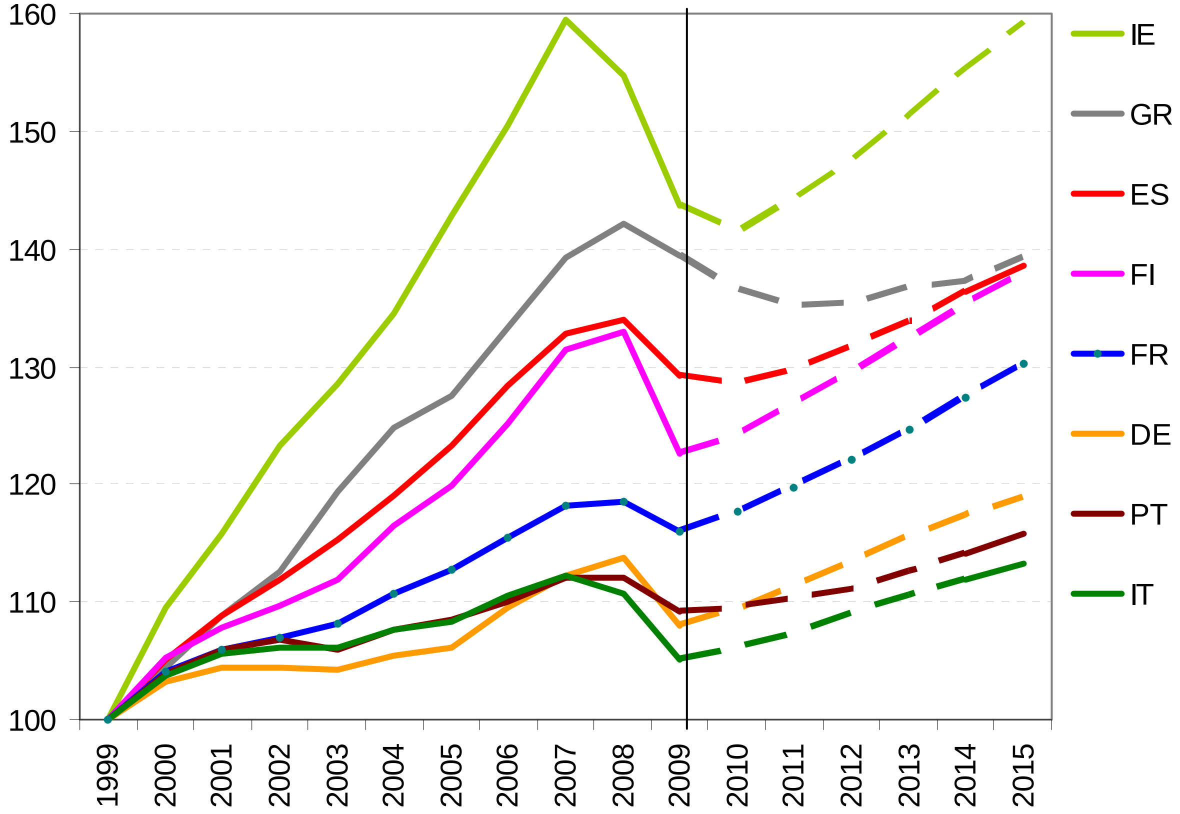
These divergences have been pointed out on various occasions by the ECB

e.g.:
Monthly Bulletin, April 2007, "*Output growth differentials in the euro area: sources and implications*", pages 73 - 86

Monthly Bulletin, November 2008, "*Monitoring labour cost developments in the euro area countries*", pages 76-86

Divergences

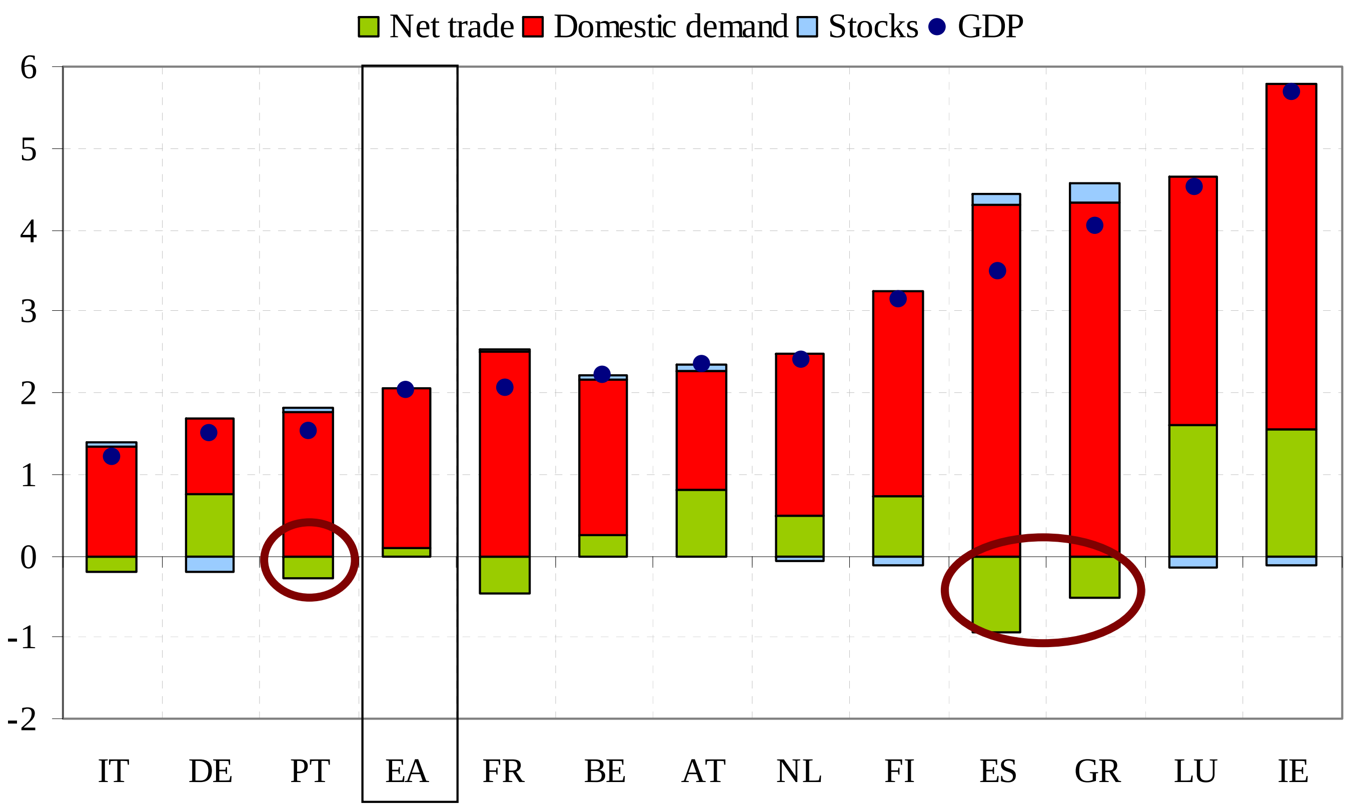
In the rate of growth of GDP



Real GDP Developments (1999=100) Source: IMF and IMF projections (WEO, May 2010) for real GDP.

Which were not aligned with

The rate of growth of domestic demand

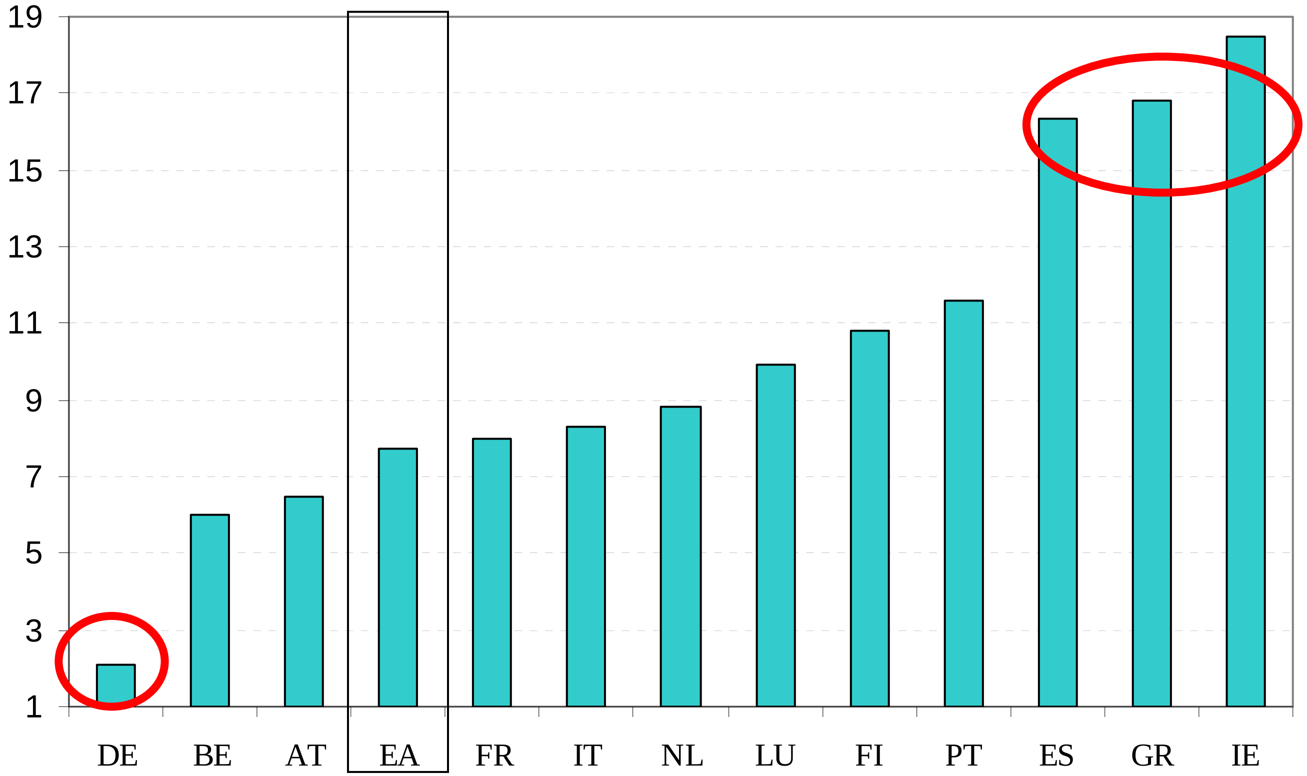


Real GDP and demand composition (average 1999-2008) Source: EC

Notes: countries ranked in ascending order according to real GDP growth.

Fuelled by

Excessive credit growth in some countries…and very slow in others

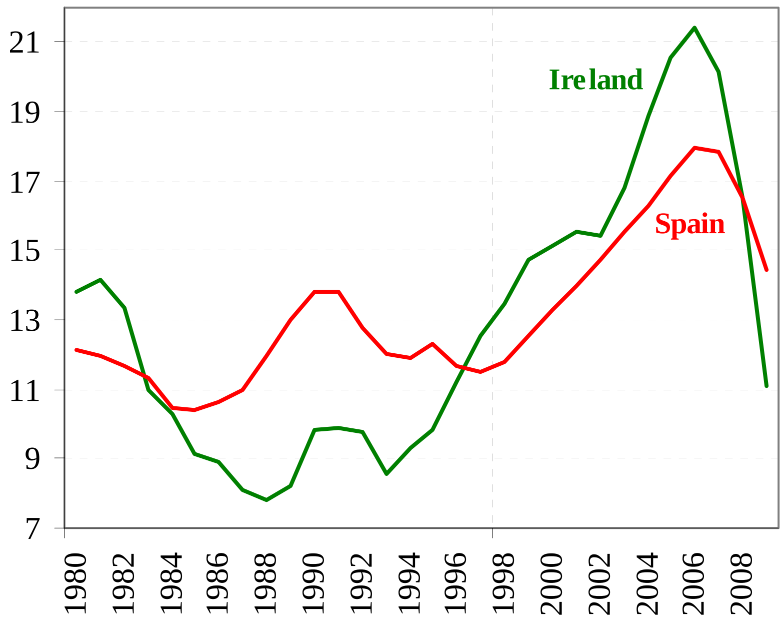


Loans to the private sector (average 1999-2008) Source: ECB

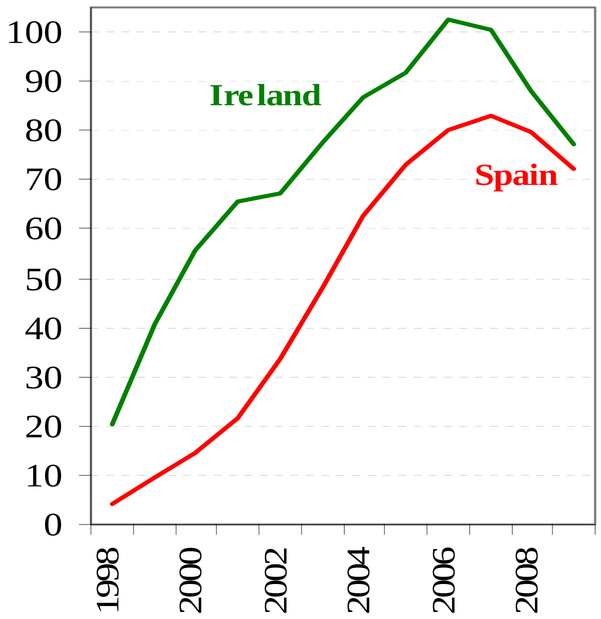
In particular in the housing market

Of some countries

Construction investment in % of GDP



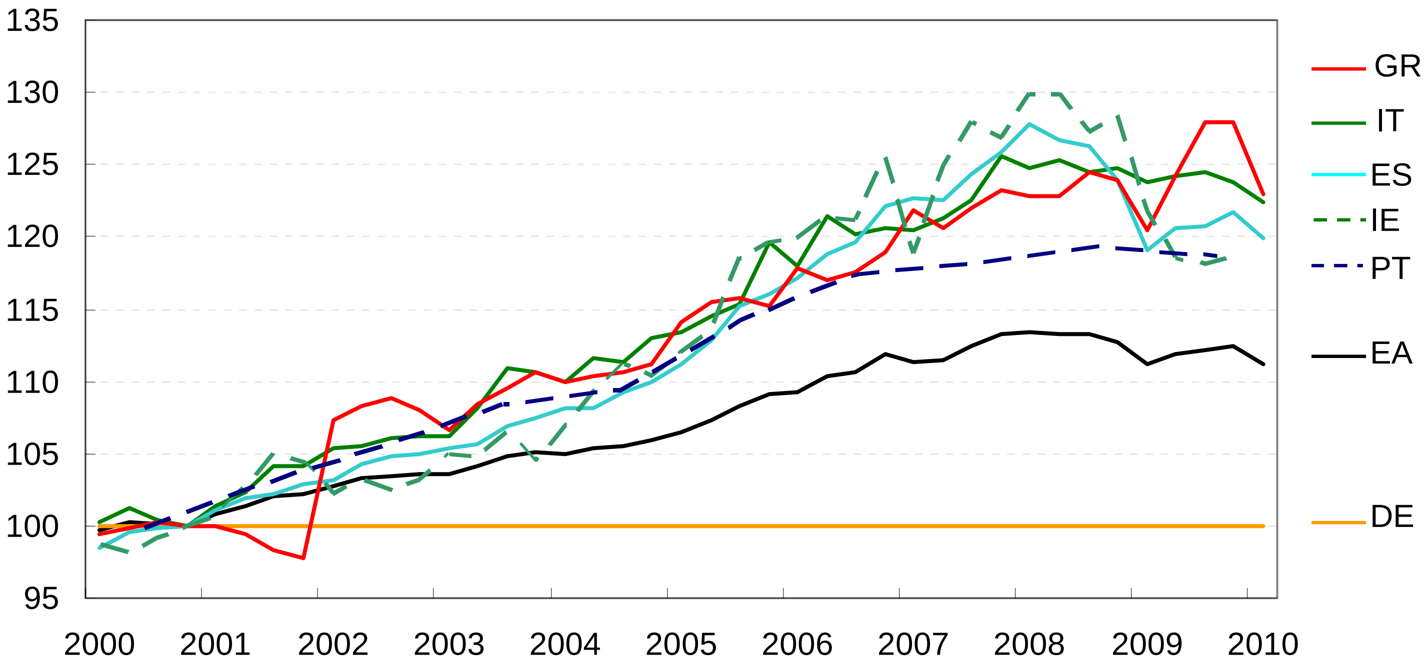
Cumulated changes in real house prices



Source: Own computation on EC, ECB. Real house prices deflated with HICP

And divergences in cost competitiveness

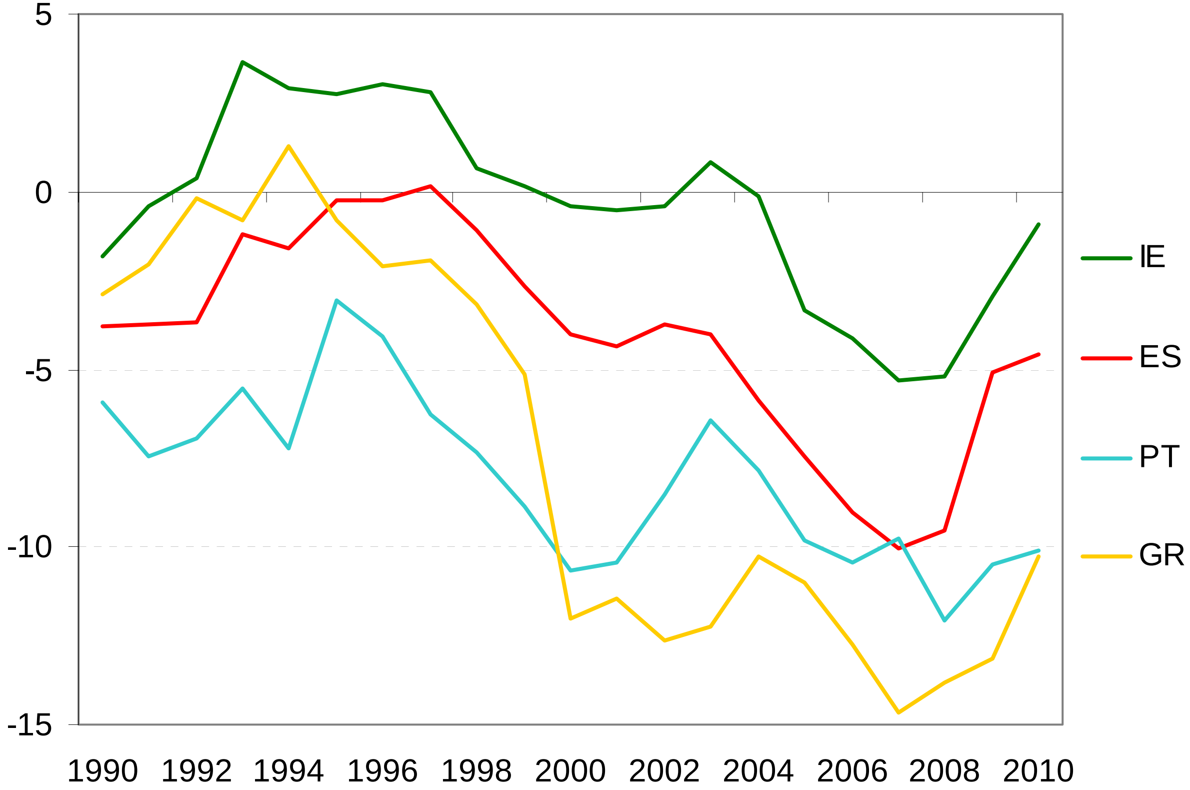
Driven by excess growth of wages with respect to productivity



Competitiveness calculated on the basis of Unit Labour Costs, relative to Germany. 2000Q4= 100 Source: Eurostat.
Note: Quarterly data up to 2010 Q1 for Germany and Spain, 2009Q3 for Ireland and 2009Q4 for the other countries, except for Portugal which is based on annual data (up to 2009). Note: The ULC indices are set to 100 in the last quarter before the euro area accession of Greece. The ULC developments presented for Greece and Portugal might differ from the calculations made by the National Central Banks. The quarterly pattern in Greek ULC is affected by substantial volatility in quarterly compensation of employees figures.

Producing deficits

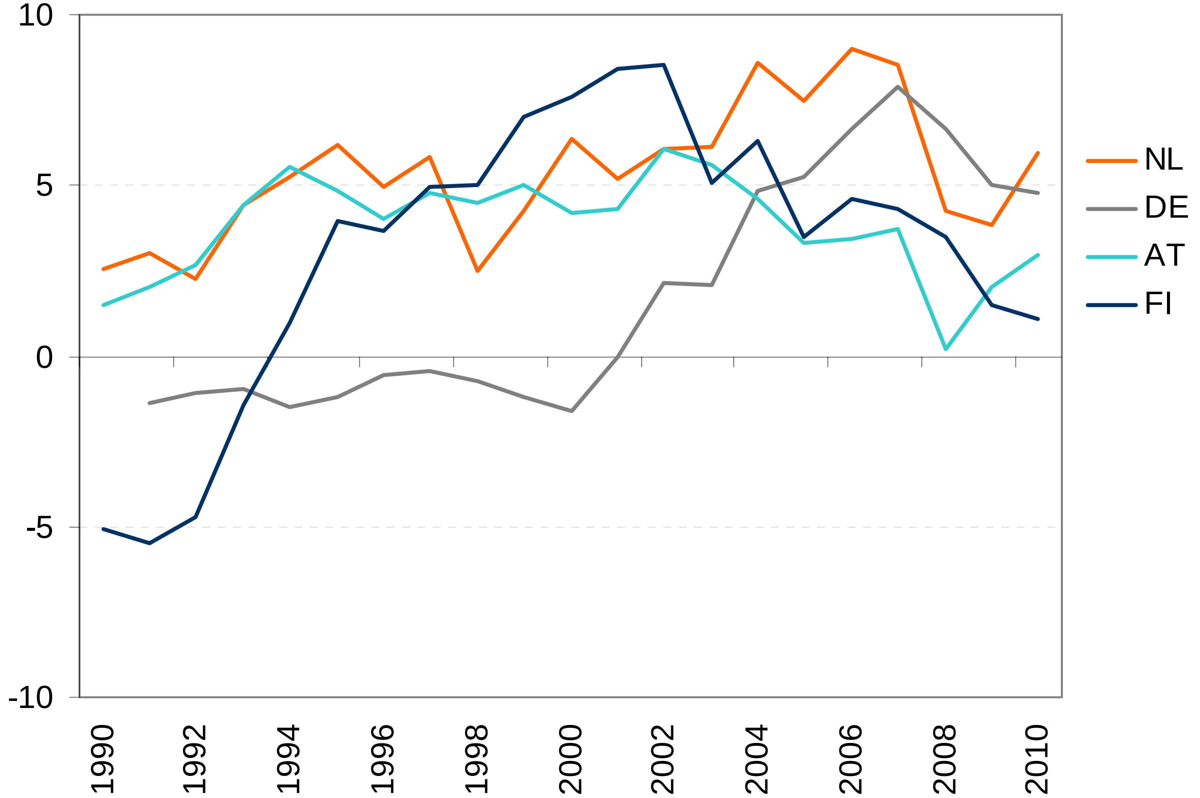
In the current account positions of some countries



Current account in % of GDP. Source: EC. Note: 2010 is forecast (EC May 2010)

And surpluses

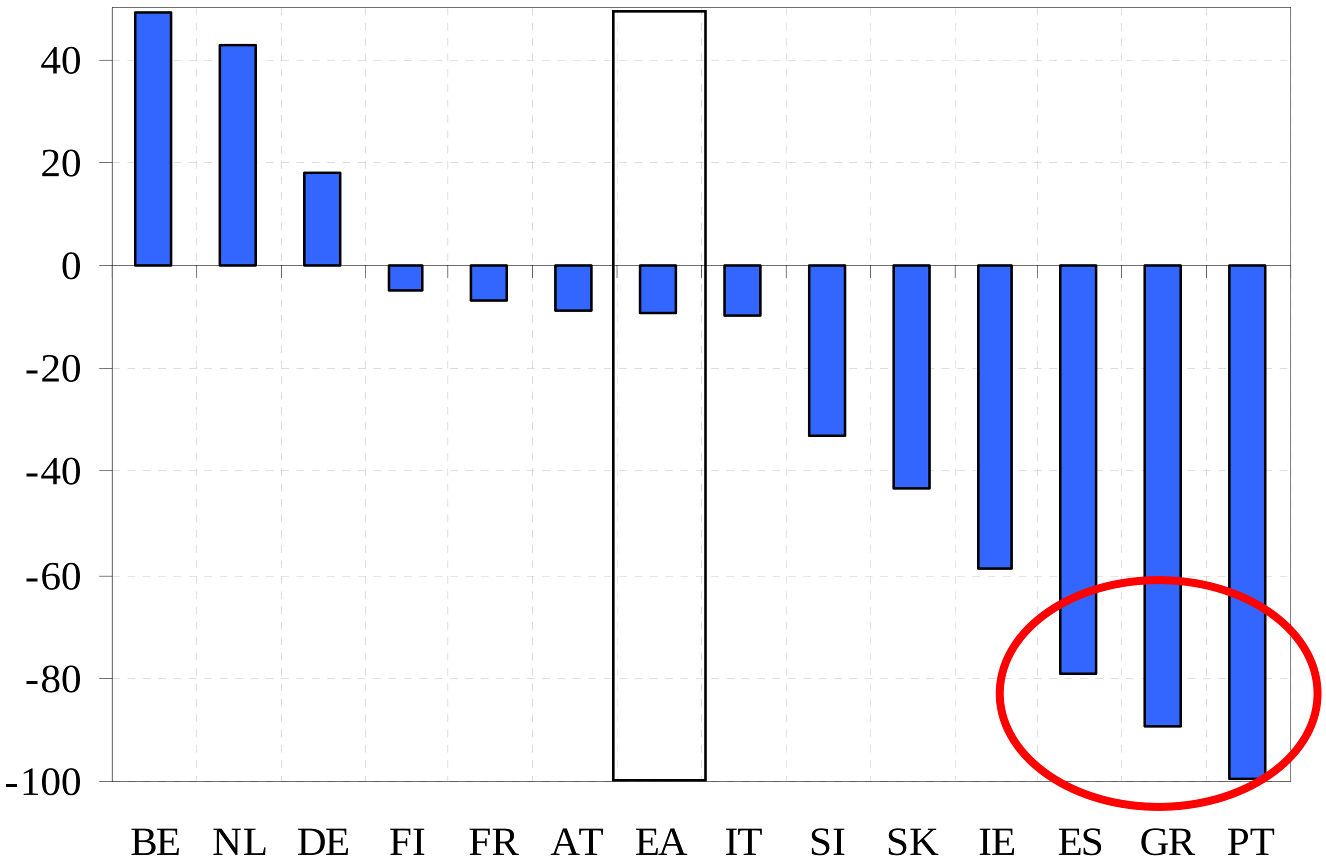
In the current account position of other countries



Current account in % of GDP. Source: EC. Note: 2010 is forecast (EC May 2010)

Producing divergent net asset positions

And significant external indebtedness in persistent deficit countries



Net foreign assets / liabilities in % of GDP (2008). Source: EC.

As a result of the global crisis

The imbalances accumulated within the euro area have given rise to broader divergences, affecting the relative price of various risks prevailing in the member states, in particular sovereign risk but also bank solvency

The challenge going forward

For all euro area countries is to:

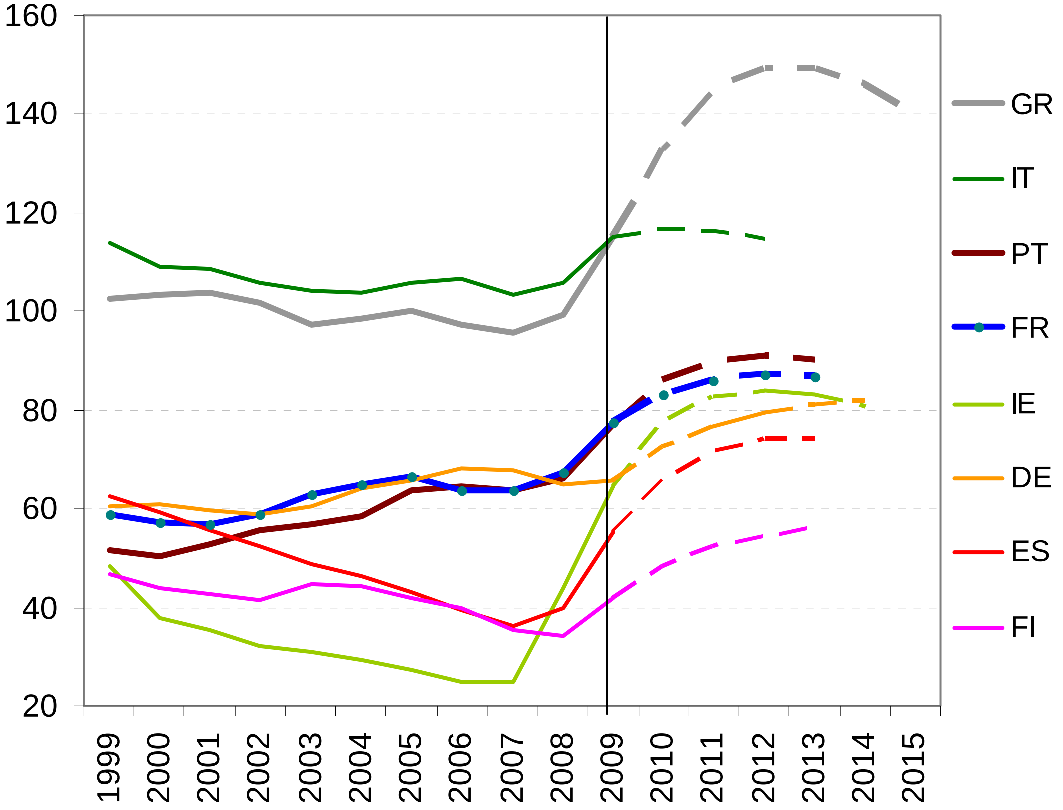
- Regain control over budgetary policy
- Achieve stronger and more balanced growth

For the euro area as a whole:

- Achieve a better institutional framework that ensures a better prevention and crisis management for the future

The fiscal adjustment has started

In all euro area countries

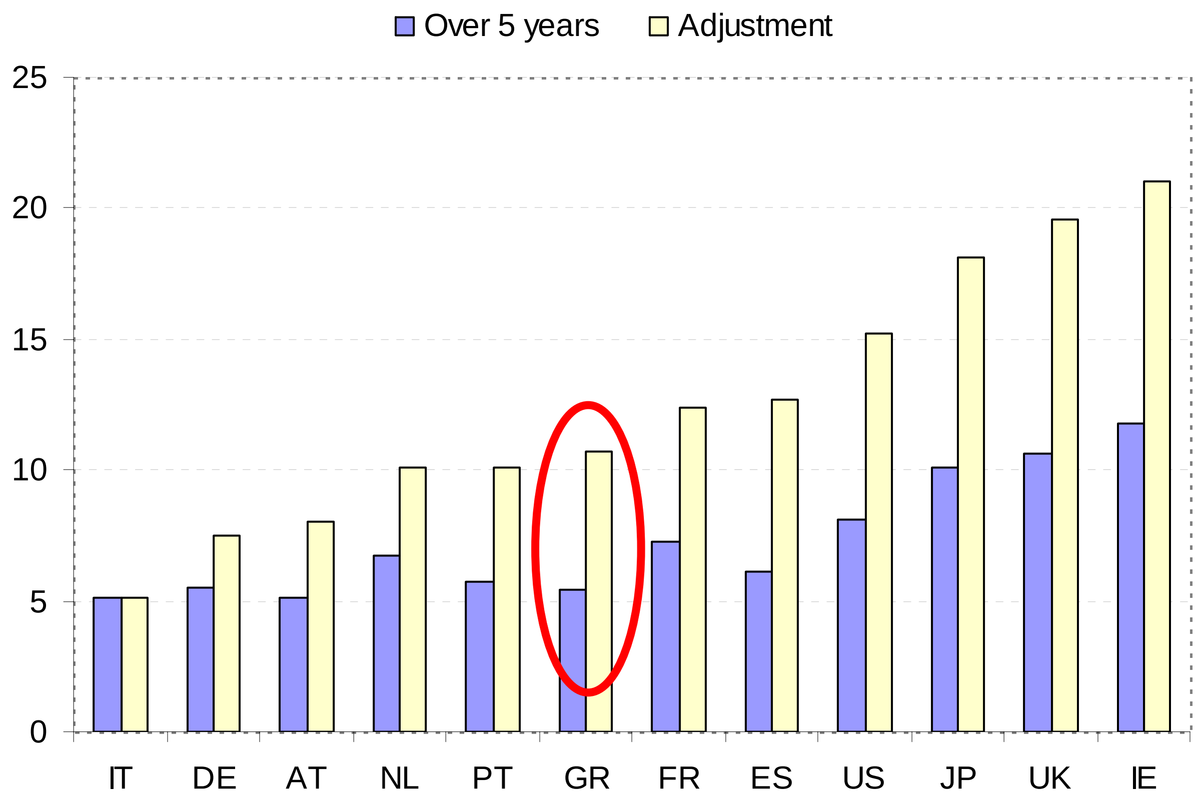


Public Debt in % of GDP

Source: EC and 2010 Stability Programmes targets for Government debt. For IT available up to 2012, for IE up to 2014 and for the remaining countries up to 2013. For GR EC/ECB/IMF programme

The task will be daunting

not only in the euro area….



Adjustment of the primary balance required to stabilise the public debt/GDP ratio at the 2007 level

Source: Cecchetti, Mohanty and Zampolli (2010), "The future of public debt: prospects and implications" BIS working paper n.300. Notes: The purple bars indicate the average primary balance required to stabilise the public debt/GDP ratio at the 2007 level over 5 years. The yellow bars indicate the adjustment from primary balance in 2011 to the target average primary balance. Starting point: 2011; consolidation from 2012.

And can hardly be achieved

Unless euro area (and other) countries implement strategies aimed at stronger and more balanced growth

Given the existing imbalances

The recipe differs across countries

	Low growth	High growth
CA Surplus	**DE**	**FI, LU, NL, BE, AT**
CA Deficit	**IT, PT**	**ES, GR, IE** *(SL,SK,CY)*

Countries with CA deficits

Countries with persistent and deteriorating external deficits should adopt measures to:

1. **Become more competitive**
2. **Increase net private savings**
3. **Rebalance sources of growth towards tradable**

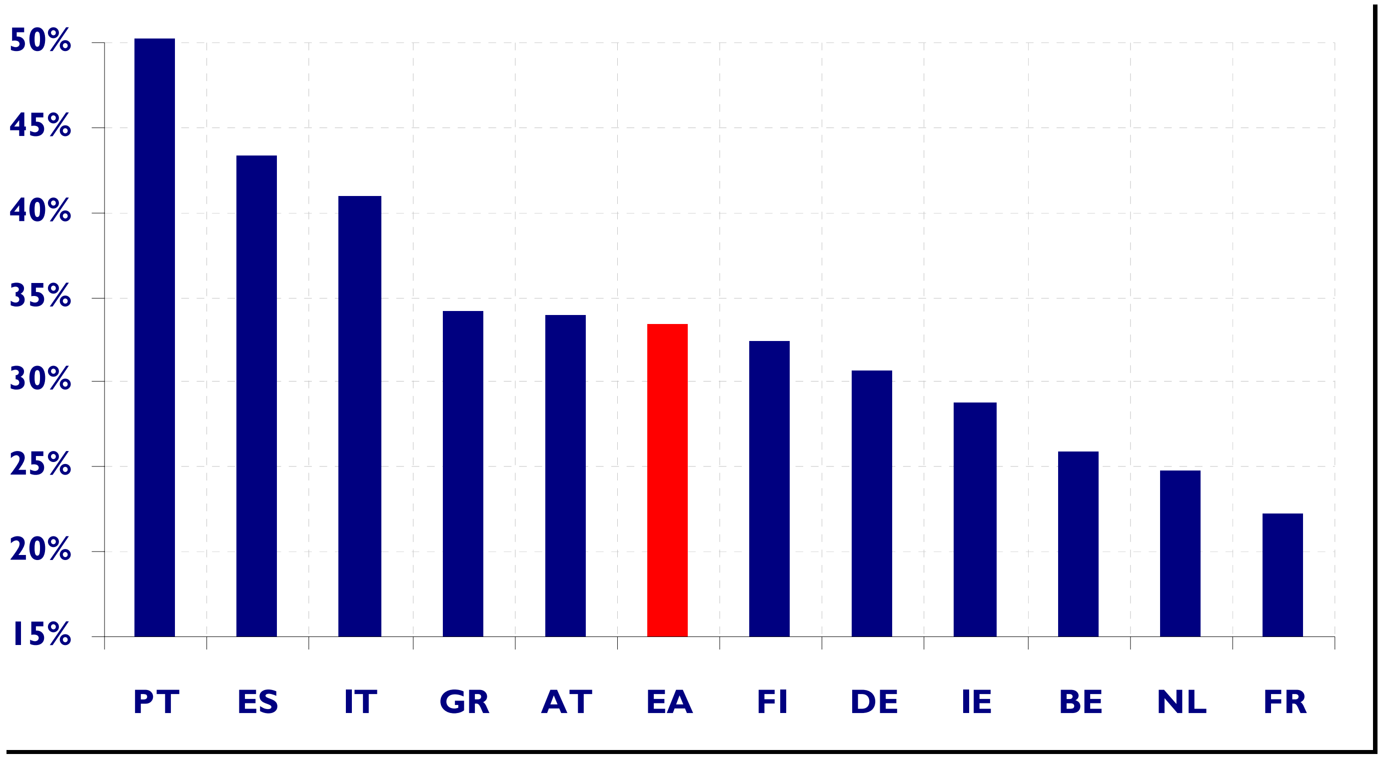
Countries with CA deficits

The strategy requires:

- Wages increasing less than productivity
- Labour market reforms (contracts at firm level)
- Strengthening of the financial sector (to allow for de-leveraging)
- Reallocation of resources to the high productivity growth sectors leading to a change of the structure of the export sector

Countries with CA deficit

Need to upgrade the technological content of exports



Trade structure - Degree of overlap in export specialisation between selected economies and China *(*average overlap over 2005-2008*).* Source: CHELEM and ECB calculations.
Note: The degree of overlap in export specialisation is determined by comparing Balassa Indices for 72 industries.

Countries with CA surplus

For countries with persistent and external surplus, the recipe <u>cannot be</u> doing the opposite of what the countries with CA deficit are expected to do i.e.:

- **Become less competitive**
- **Reduce domestic savings**

Impact of other countries' adjustment

As countries with CA deficit are expected to grow less over the next few years and will aim at regaining competitiveness, there is a risk that demand for net exports for countries with a CA surplus will decrease:

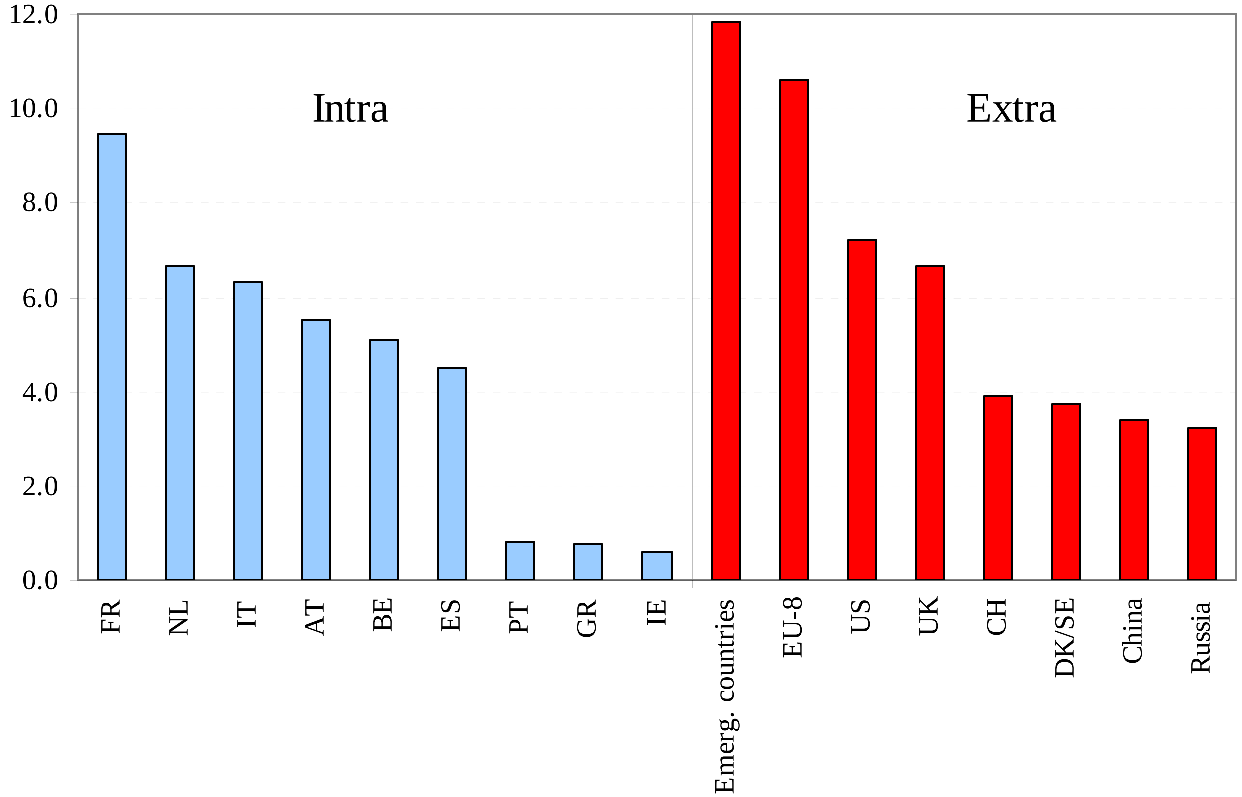
"Germany will be less German if the other euro area countries start behaving like Germany"

However, markets outside the euro area are likely to grow more than within the euro area.

Competitiveness with the rest of the world is essential

Germany - Directions of trade

Growing trade with Emerging economies



German exports towards larger trading partners in % of total exports in 2008. Source: IMF. Emerging and developing countries excludes EU8, China and Russia. It includes other Eastern Europe, other CIS, other developing Asia, Middle East and North Africa, Western Hemisphere.

Countries with CA surplus

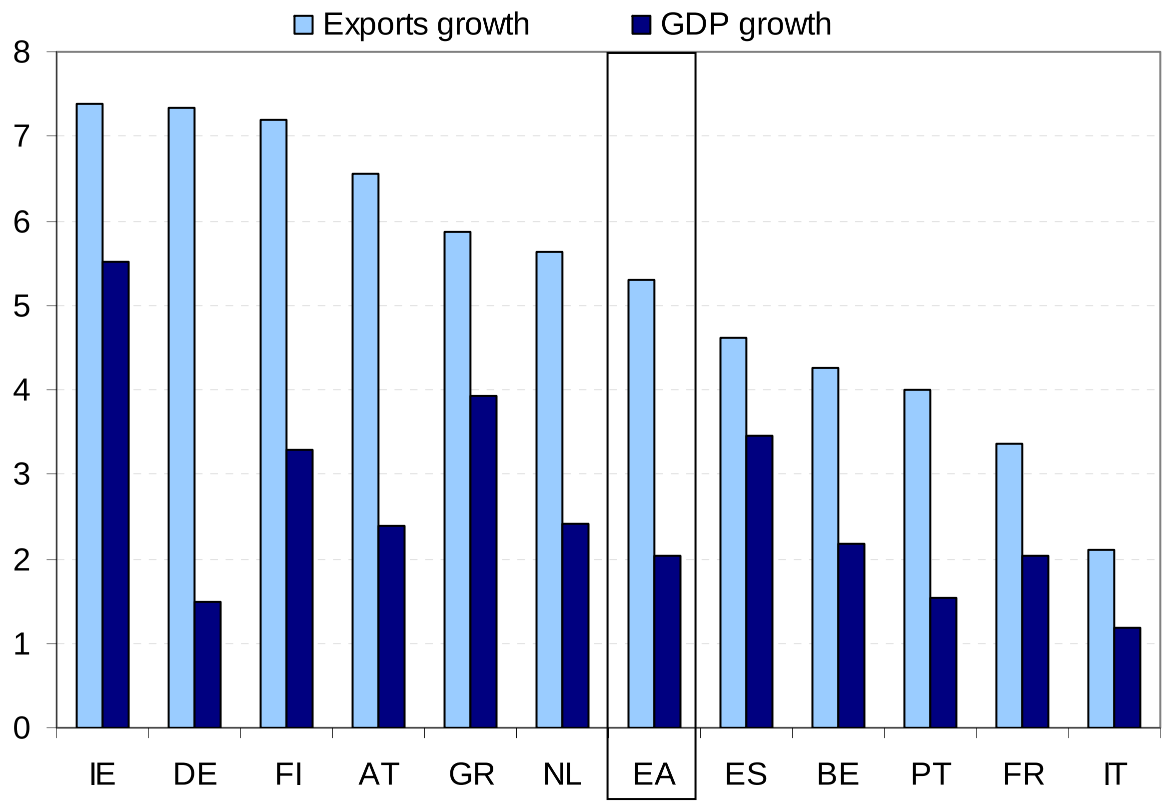
On the other hand, having a successful export sector and a trade surplus is not necessarily a guarantee of high growth of GDP, employment and income

Why?

- The tradable sector might not be sufficiently large to pull the rest of the economy
- The tradable sector absorbs a relatively minor share of employment
- Limited spillovers to the non tradable sector due to excessive regulation/protection in the domestic market
- Lack of incentives for private domestic investment

Strong export growth

Does not necessarily imply strong GDP growth

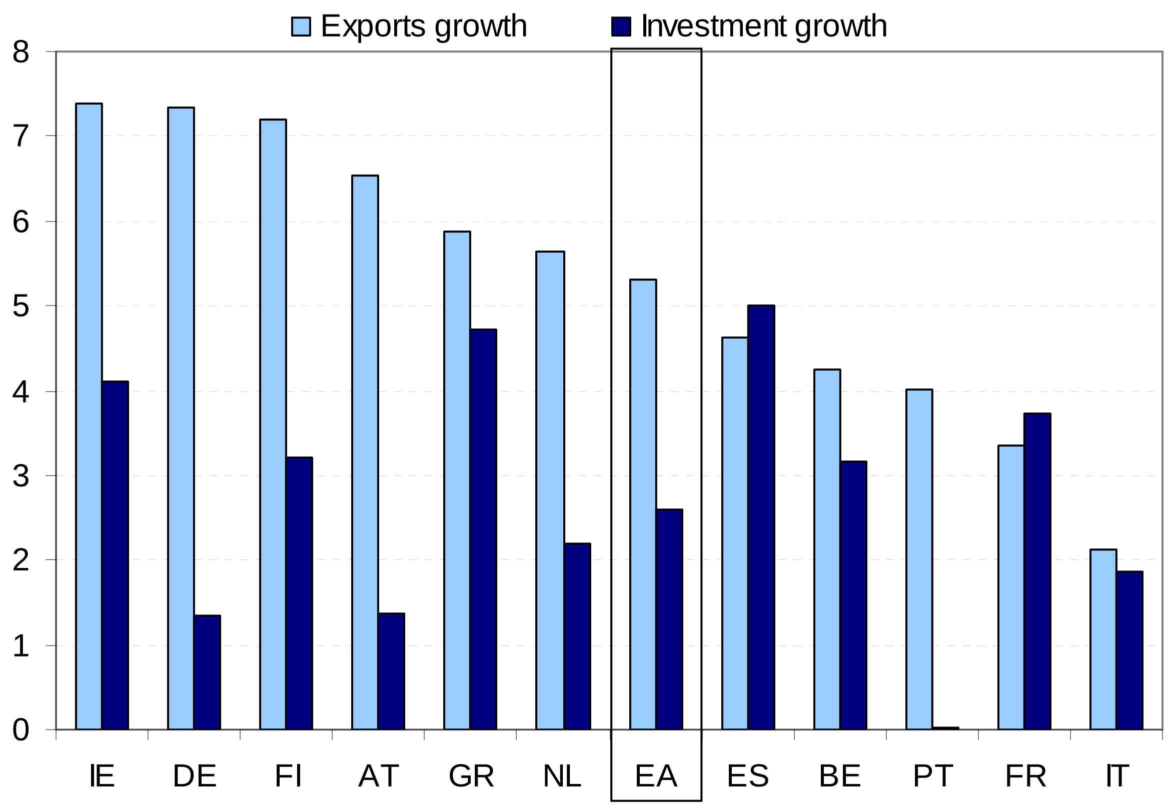


Export and GDP growth (average growth 1999-2008). Source: EC

Notes: countries ranked in ascending order according to exports growth.

Strong export growth

Does not necessarily imply strong investment growth

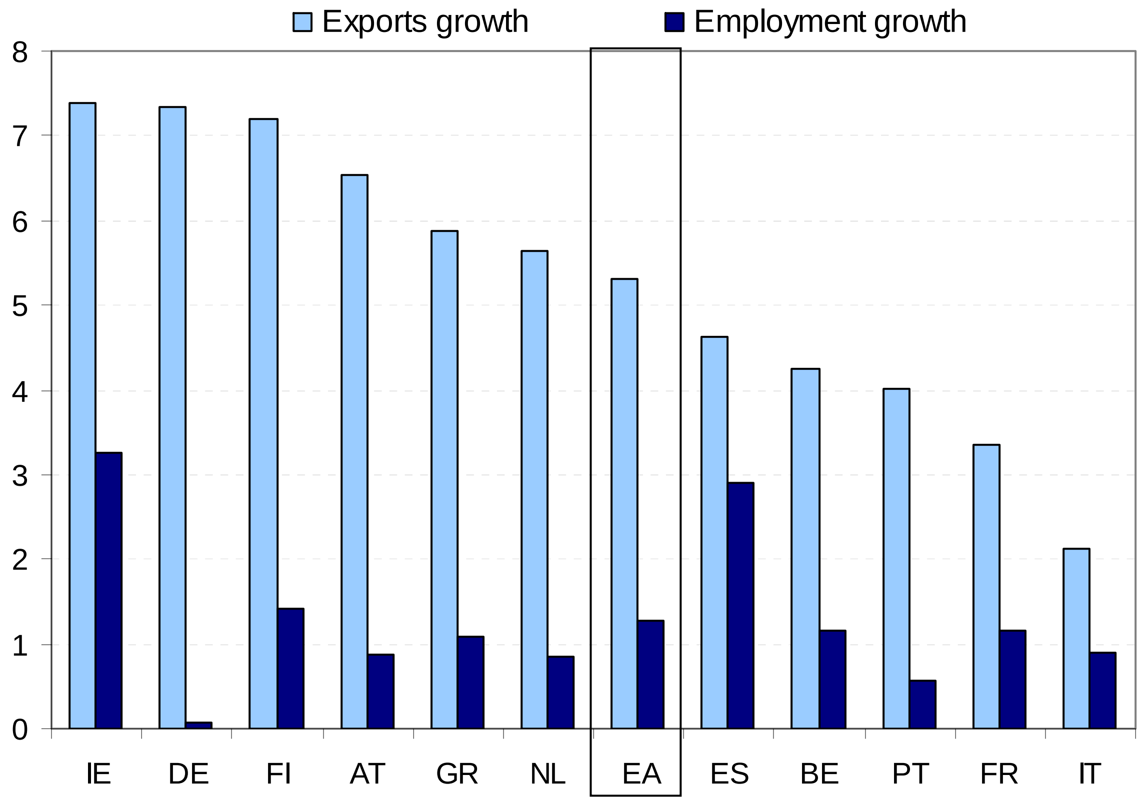


Export and investment growth (average growth 1999-2008). Source: EC

Notes: countries ranked in ascending order according to exports growth.

Strong export growth

Does not necessarily imply strong employment growth

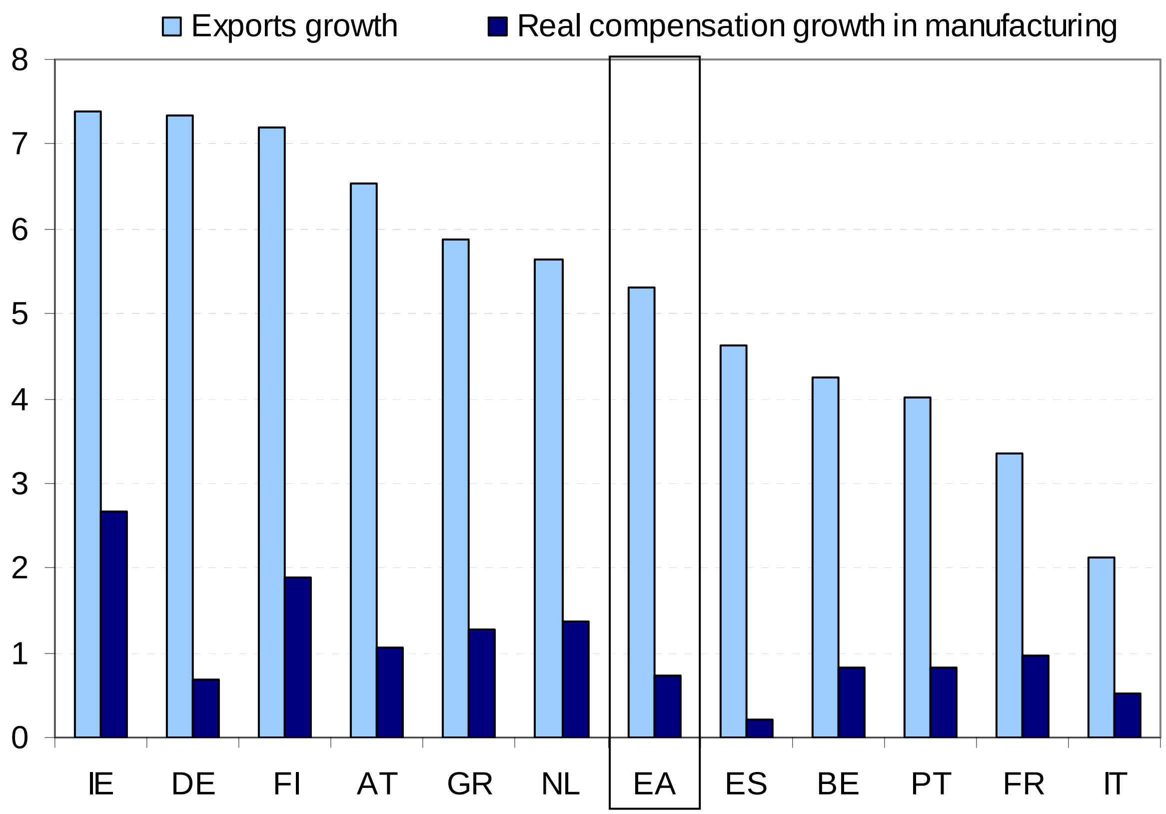


Export and employment growth (average growth 1999-2008). Source: EC

Notes: countries ranked in ascending order according to exports growth.

Strong export growth

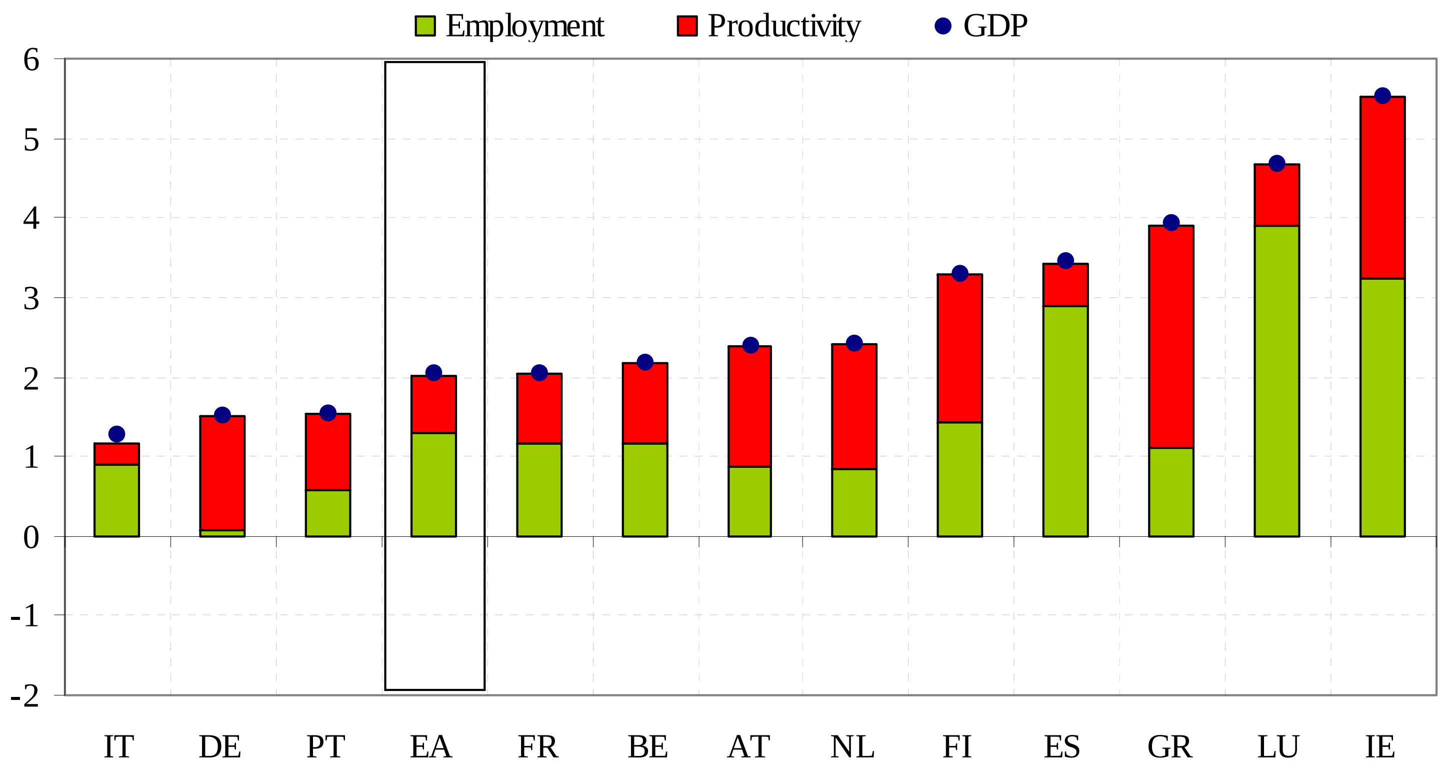
Does not necessarily imply strong income growth



Export and investment growth (average growth 1999-2008). Source: EC Notes: countries ranked in ascending order according to exports growth. Real compensation deflated with HICP. For PT and EA, 1999-2006 average is shown for real compensation growth

Strong export growth

Is achieved through high productivity growth, but is not sufficient to deliver employment growth



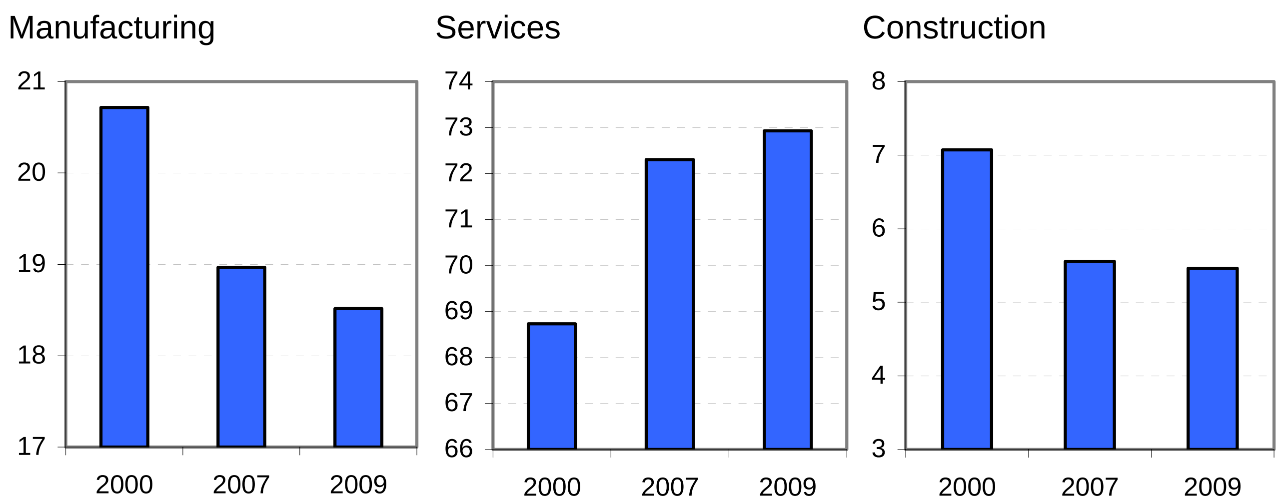
Real GDP and **supply composition** (average growth 1999-2008). Source: EC

Notes: countries ranked in ascending order according to real GDP growth.

Employment

Is bound to grow mainly in the services sector

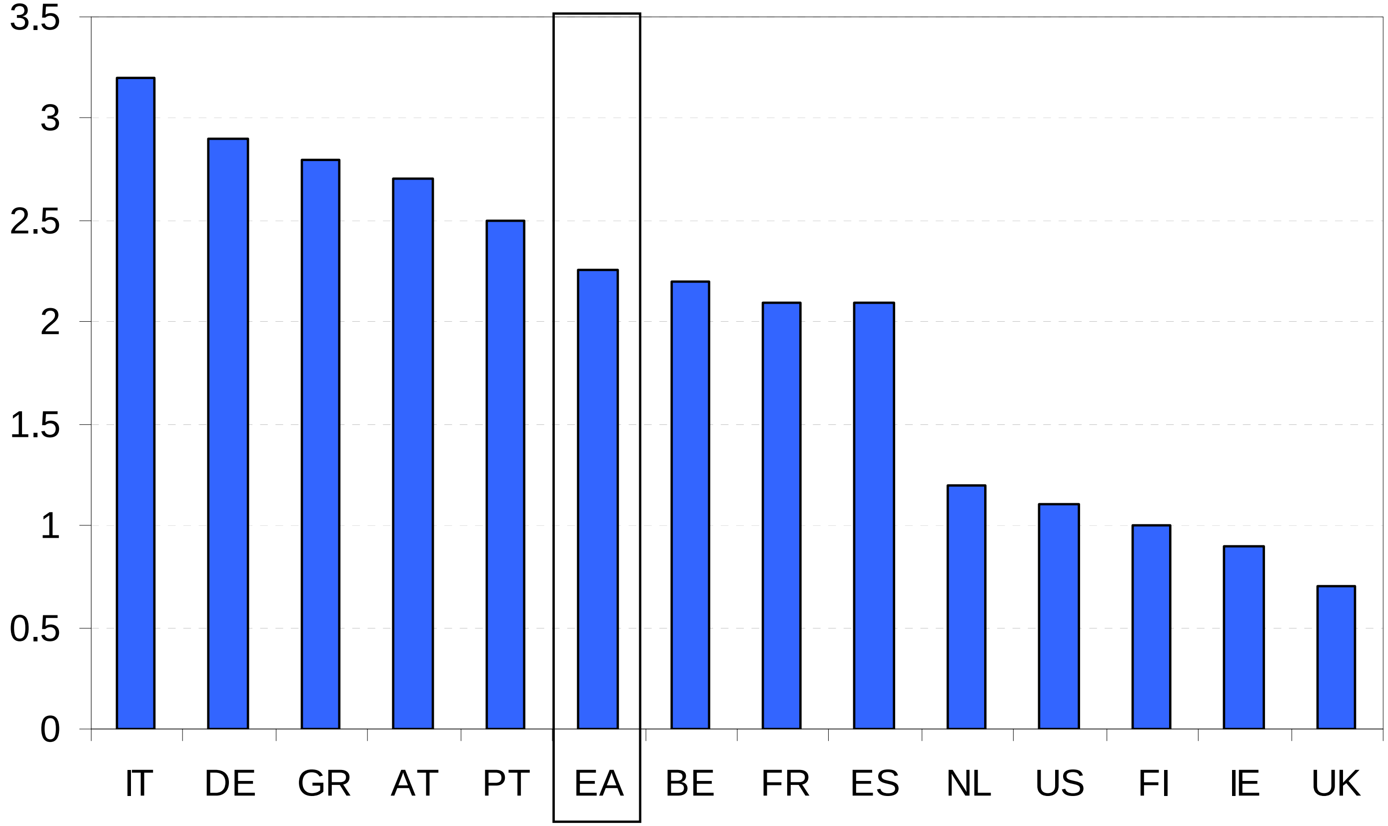
Germany: Sector shares in total employment (in percent)



Source: Eurostat.

But the Service sector

Is highly regulated (professional services)



Product Market Regulation (PMR) index in professional services (the professional services indicators cover entry and conduct regulations in the legal, accounting, engineering, and architecture professions, 2008). Source: OECD . Note: A higher figure means higher regulation. PMR index ranges from 0 to 6.

Countries with CA surplus

Stronger and sustainable growth cannot be achieved only through continuous improvements in the competitiveness of the tradable sector but requires increasing growth potential in the non tradable sector, in particular services

The above tasks

Are mainly the responsibility of the member states, because they involve competences which are still national (taxation policy, labour markets, product markets, education, research and development…)

We should avoid repeating the mistakes of the Lisbon Agenda, which creates EU objectives without providing the EU the instruments to achieve these objectives

But the EU/EA institutional framework needs to be strengthen because problems in some member states may affect the other member states

Principles for reform: "three don't"

1. **Don't assume that all (agents/governments/markets) have learned the lesson from this crisis:**
   → **Stronger surveillance and crisis prevention**

2. **Don't assume that there will be no more crises:**
   → **Crisis management**

3. **Don't assume that there are "easy solutions" to complex problems ("orderly debt restructuring"; "expulsion"…)**

ECB contribution to the Van Rompuy TF:

1. strengthening surveillance over budgetary policies and more effective prevention/correction of excessive deficits and debts

2. improving framework for competitiveness surveillance and the correction of economic imbalances via a traffic light system

3. designing an appropriate euro area framework for crisis management

Differences with Commission proposals

ECB thinks the Commission should go further:

- **Clear and agreed triggers to detect vulnerabilities and define surveillance needs**

    Surveillance missions by COM, ECB

    Adoption of a "corrective policy programme"

- **Strengthening fiscal surveillance**

    Quasi-automatic initiation of EDP procedure

    Independent national fiscal institutions

- **Relying more on incentives and sanctions**

    Reversal of voting majorities in EDP

    Introduce sanctions for persistent imbalances

Strengthen the E of EMU

Complete the Single Market (Monti report):

- Removing barriers to trade and to cross-border activities, especially in the service sector (full implementation of the service directive)

- Accelerating the uptake of new technologies – foster a Digital single market

- Promoting a common energy market (competition, green growth)

- Fostering a single market for capital and financial services

- Eliminating business investment restrictions

A priority: the service directive

The service provisions in the EU is badly fragmented

(only 20% of services provided in the EU have a cross-border dimension)

A full implementation of the services directive would result in an increase in growth potential of 0.6-1.5% of EU GDP

Conclusions

Will it work?

The crisis has triggered a mood for change. Many governments are now embarking on fiscal consolidation strategies

There is awareness that fiscal discipline has to be supported by ambitious programmes of structural reforms to strengthen growth potential

Example (I): labour market reform in Spain

In June 2010, the Spanish government has approved a reform of the labour market:

- **Two main objectives: reduce the large proportion of temporary contracts (so called duality of the labour market) and improve the flexibility of firms' labour conditions to economic circumstances**

Example (II): structural reforms in Greece

- The law on the Financial Stability Fund (FSF) was submitted to Parliament in June. The FSF will contribute to safeguarding financial sector stability by providing equity support to Greek banks should they face solvency problems.

- Newly-created independent Hellenic Statistics Authority (strengthening data reliability)

- Labour market reforms include changes to the framework for wage bargaining, new legislation on minimum wages, reduced severance payments and legislation to increase the flexibility of working hours and part-time work

The experience of the last few months

Shows that

Countries reacted late, and under the pressure of markets

But they reacted

Showing the willingness to do what is needed to overcome the crisis, being full members of the euro area

Indeed

This is not a crisis of the euro, it's a crisis of advanced countries' ability to adapt to a changing global economy

Membership of the euro has for long delayed the recognition of the problem

But the euro exposed countries earlier to the need to adjust

Ultimately

The challenges for advanced countries can be addressed only through:
- budgetary policies
- structural policies

The earlier countries recognize this, the sooner they will implement the right policies

And the stronger they will get out of the crisis

Thank you for your attention

Background slides

Competitiveness surveillance

Traffic light system

Focus: Differentiate intensity of problems and competitiveness surveillance

Elements: Small number of indicators in order to assess which Member States would require

- no specific surveillance (green),
- standard surveillance (yellow) or
- intense surveillance (red)

Fiscal framework (I): Euro area dimension

Enhancing the euro area dimension of fiscal policy surveillance by:

- ***strengthening* ex ante *discussions in the Eurogroup***

(early review of national budgetary plans by Eurogroup; issuance of precise fiscal policy guidelines)

- ***making the Eurogroup the guardian of fiscal sustainability***

(Eurogroup to review how common guidelines have been incorporated into national budgets; deviations from guidelines to engender warnings from Commission, triggering comply-or-explain approach)

Fiscal framework (II): Better implementation

Strengthening the implementation of rules and procedures by:

- ***increasing the quasi-automaticity of the EDP procedures and steps***

(initiation of EDP quasi-automatically once the 3% deficit or the 60% debt criterion are breached: reverses 'burden of proof' - Council needs to decide explicitly to stop escalation of procedure)

- ***the quasi-automatic initiation of sanctions***

(sanctions/means to encourage compliance to be applied earlier, or if country fails to correct excessive deficit by the given deadline)

Fiscal framework (III): Make use of sanctions

Strengthening the implementation of sanctions in case of non-compliance by:

- ***earlier application of sanctions, already under the preventive arm, and in any case for excessive deficits***

(already under the preventive arm, and in any case for excessive deficits; with increasing severity and duration of fiscal imbalance, scale of sanctions to be increased)

- ***broadening the scope of application of sanctions***

(including for excessive debt ratios and in cases where progress towards the medium-term budgetary objective is insufficient)

Fiscal framework (IV): Broader set of sanctions

A wider spectrum of sanctions and creation of new types of means to encourage compliance:

- ***financial sanctions***

(e.g. reduced access to EU funds and transfers)

- ***non-financial sanctions***

(limitation or suspension of voting rights)

- ***procedural sanctions***

(detailed specific adjustment programmes; more stringent reporting requirements; on-site monitoring via special missions by Commission, in liaison with the ECB; requirement to seek prior Council consent for national budgetary measures or borrowing)

Fiscal framework (V): Leaner surveillance

Leaner and more effective fiscal surveillance by:

- ***differentiating the surveillance processes applied to Member States according to their fiscal performance***

(focus on most critical cases; lighter surveillance for well-performers)

- ***assigning greater responsibilities to the Commission in making recommendations/proposals***

(reversal of voting majorities in the Council (e.g. sanction deemed adopted unless opposed by the qualified majority); Commission to make proposals rather than recommendations; strengthening Economics Commissioner inside the *collège*; Commission to assess individual fiscal policy measures and possibly publish assessment)

- ***measures to enhance the quality of statistics***

(enhance powers of Eurostat, e.g. to conduct audits)

Fiscal framework (VI): national link

Enhancing national fiscal frameworks by:

- ***a strengthening of national legislation related to national fiscal rules and institutions***

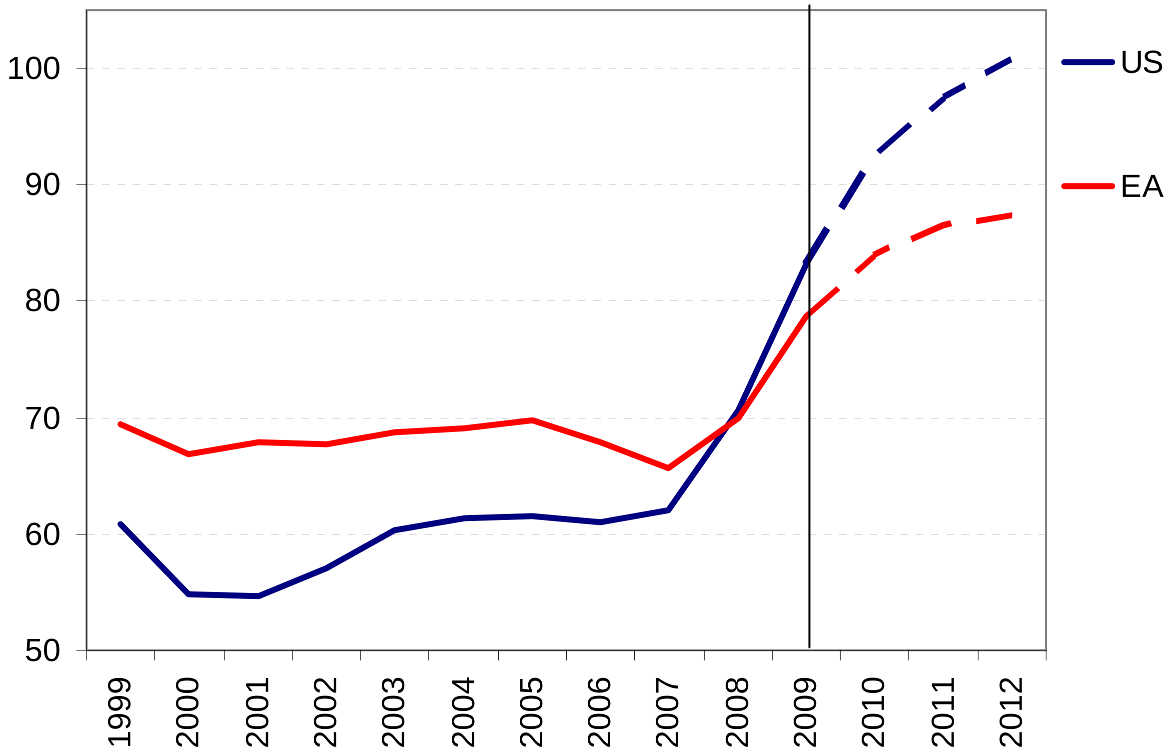
(consistent with the provisions of the EU fiscal framework, to anchor SGP rules in national law)

- ***establishment in all Member States of independent budget offices or fiscal monitoring institutions***

(with the task of monitoring that objectives of SGP and national rules are fully respected)

The euro area has started the adjustment

On the fiscal side



Public debt in % of GDP

Sources: IMF and IMF projections (WEO, April 2010) for US and aggregation of Stability Programmes for EA. The US projections are based on the 2010 administration's budget and the U.S. Congressional Budget Office's budget outlook for 2010–19. These projections include the $787 billion stimulus package under the American Recovery and Reinvestment Act of 2009. They are adjusted for differences in forecasts of (1) macroeconomic and financial variables, (2) the timing of stimulus disbursements, (3) additional costs to support financial institutions and government-sponsored enterprises, and (4) the effect of financial sector support on government-owned financial assets.