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Convergence and Adjustment in the European Monetary Union

Lamfalussy Lectures Conference: "The euro dilemma: inside or outside…"

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Good morning ladies and gentlemen, and thank you to the Magyar Nemzeti Bank for having invited me to participate in this conference in honour of Alexander Lamfalussy. I feel deeply honoured at having been asked to share with you some thoughts on the current situation of European monetary and economic integration. There are two powerful reasons why I accepted the invitation immediately.

Firstly, I sincerely believe that the monetary integration project would have been less vulnerable to the international financial crisis if the pro-Europe momentum of the early European leaders – including most notably Alexandre Lamfalussy – had been maintained. Alexander Lamfalussy as President of the European Monetary Institute (EMI), on which Luis Angel Rojo, the now-departed former governor of the Banco de España, was the Vice president, played a prominent role in making possible such a bold project. In the current critical times, it is more necessary than ever to recover the pro-European spirit and the analytical rigour of the advocates of the European project in order to address and to overcome our current complex problems.

Secondly, I thought I could contribute to this event by sharing with you some thoughts on the economic policy lessons that may be drawn from the experience of the Spanish economy within EMU. Our experience may be of use to other economies aspiring to join the euro.

The creation of the Economic and Monetary Union was one of the most ambitious steps of the European integration project. The introduction of a single currency and a single monetary policy and the institution of the European Central Bank, were true milestones in the project to create an integrated Europe.

At the national level, countries also had to undertake far-reaching changes in their economies to meet the nominal convergence criteria established.

The result of all these efforts was the successful launch of the euro. The first eight years of the euro saw a long phase of very intense growth across all the economies that started from a lower level of per capita income.

The success of the European project was particularly visible in real convergence, which progressed more rapidly than expected. However attention was not paid to the imbalances building up and to the weaknesses in the structure of European governance, which emerged abruptly as the crisis broke. These weaknesses were as follows.

First, national authorities did not take on board the fact that EMU was not a goal, or a final destination, but merely an intermediate stop on the road to a new reality that would require far reaching changes in the rules and in the institutional framework at both national and European levels. Everyone was aware that when EMU was set up, the member countries did not fulfil the characteristics required to be an optimal monetary zone. But it was thought that the functioning of the Union would ultimately generate the incentives to move in that direction. It was expected that the disappearance of monetary policy and the exchange rate as adjustment instruments, would stimulate the introduction of structural reforms that would increase flexibility and adjustment capacity in the participant economies.

But the reality was very different. In most countries there was a lack of ambition regarding ongoing structural reform. And that, against a background of abundant financial capital and underpriced risk across the board, resulted in distortions in resource allocation and in the adoption of inappropriate models of growth.

Second, there were also flaws in EMU governance, which meant that the signs and warnings about the build-up of imbalances and divergences within EMU were ignored. Naive confidence in market mechanisms as the drivers of structural change finally resulted in a framework for the EMU governance with very limited mechanisms of monitoring and lacking of any real coordination.

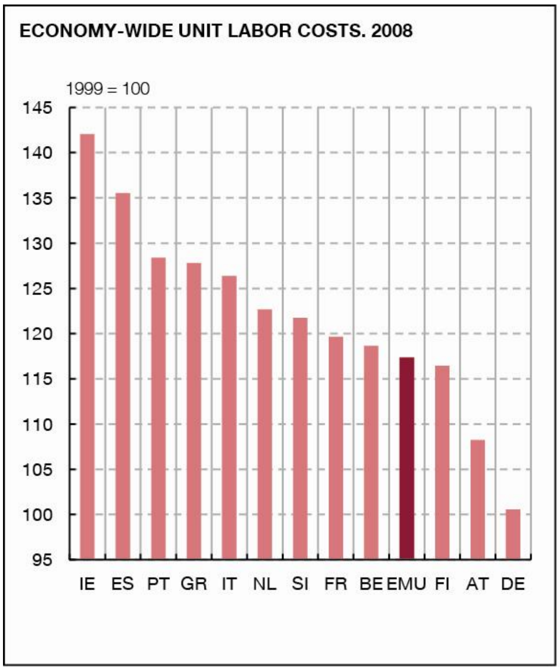
The founding fathers of monetary unification were aware of the destabilising potential that fiscal imbalances posed within EMU. However, the difficulties that might emerge from persistent divergences in spending patterns and from current account imbalances and shortfalls in competitiveness were underestimated. The coordination of structural and macroeconomic policies was organized around a minimalist framework, based on the principle of mutual learning and peer pressure, which ultimately proved to be very ineffective.

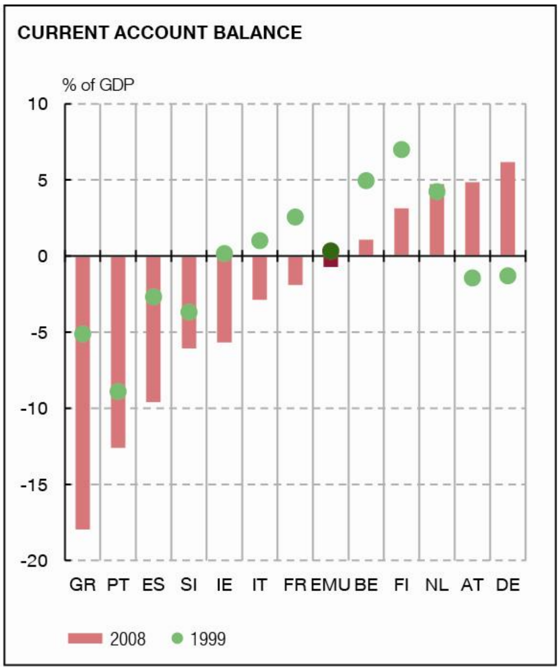
Lastly, the financial markets failed to exert the expected disciplining effect. The global underpricing of risk prevailing during the early years of EMU meant that funds flowed generously and without sufficient discrimination among the different borrowers. Despite the imbalances building up, risk premia remained at historically low levels in all the EMU economies. And also the macroprudential financial regulation and supervision mechanisms were lacking. Once again Baron Lamfalussy, who constantly maintained a degree of scepticism about the functioning of the financial markets, was a pioneer in this area. He was the main architect of the BIS macro-prudential approach to financial stability.

As a result of the foregoing, the euro area countries accumulated imbalances in various areas that left them exposed to a perfect storm following the Lehman Brothers collapse. What began as a financial crisis soon was transformed into a competitiveness and balance of payments crisis in the economies evidencing the biggest structural shortcomings, while it left deep damage to public finances and private-sector balance sheets. Let me focus on each of these aspects.

As regards competitiveness, the reduction in funding costs for certain euro area economies following the creation of the euro and the enhanced expectations of growth boosted an expansion in private spending that was easily financed through external funding, against a background of generalised underpricing of risk. A large portion of these capital flows was not channelled towards productive investment but to financing construction and real estate projects which had a very modest impact on the growth potential of the economy.

In this setting, the excessive expansion of expenditure led to continuing positive inflation differentials and to an increase in unit labour costs relative to the euro area average, as can be seen in the graph on the left hand side. The intensity of these mismatches was accentuated by the weakness of spending and the containment of costs and prices in some of the euro area economies with higher per capita income.

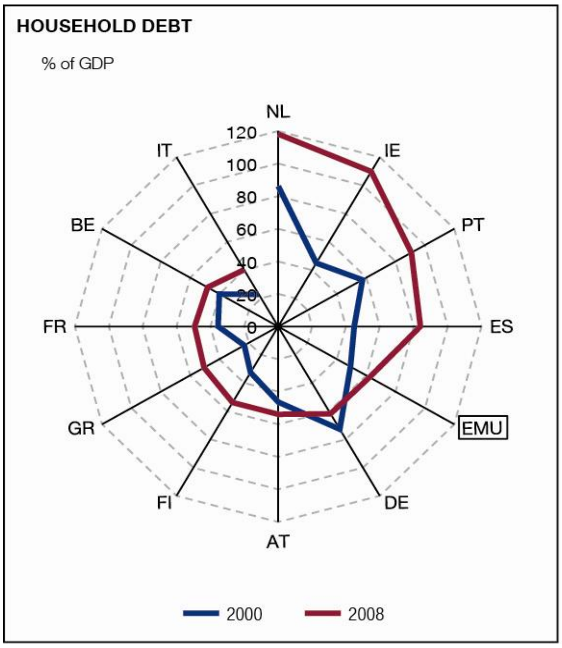


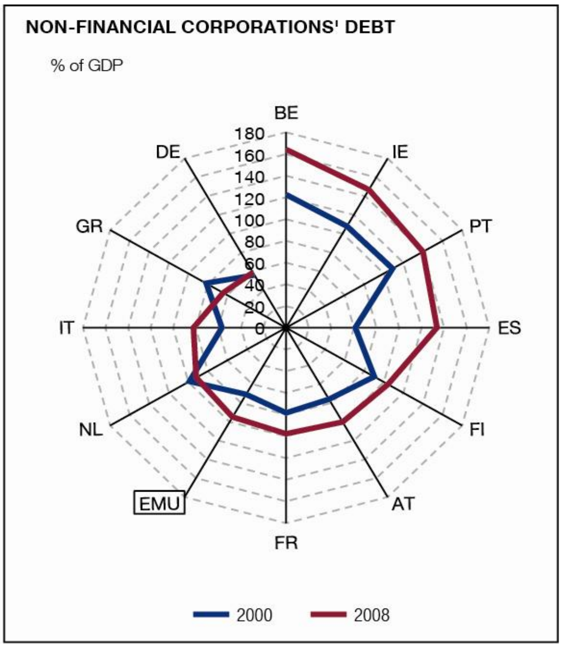


The outcome was notable divergence in the current-account balances, as can be seen on the right. In those economies running deficits –including my own country-, the prevailing interpretation was benign, playing down the importance of these imbalances, and considering them as a natural consequence of headway in real convergence. One example of this was the recurrent use of the Balassa-Samuelson hypothesis to justify the inflation differentials. This interpretation was in contradiction with the weakness of productivity in all these countries.

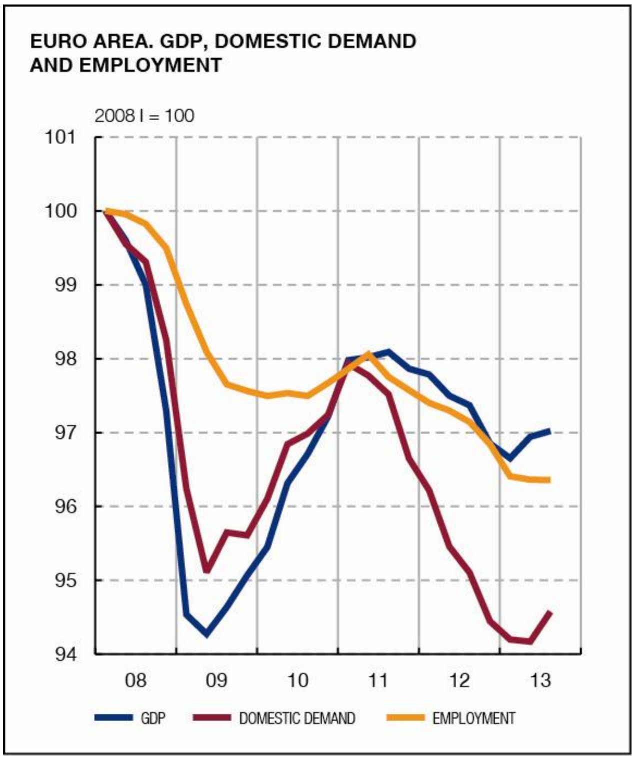
In the fiscal arena, the fiscal rules of the Stability and Growth Pact were absolutely insufficient to ensure the budgetary discipline needed in a monetary union. Most euro area countries did not take advantage of the economic boom years to properly redress public finances. In most cases, debt levels remained far above the reference value of 60% of GDP. And in those countries such as Spain and Ireland, which had low levels of debt in the early years of EMU, the improvements proved to be ephemeral, because they were based on an increase in extraordinary revenue from the real estate boom which was used to increase public spending instead of improving the underlying fiscal position.

Lastly, private-sector debt levels also increased notably as can be seen in these charts.





With the outbreak of the international financial crisis and the shortfall in financing, the high level of indebtedness became an important factor of vulnerability. The correction of the imbalances was urgent but very difficult. Their scale and the inappropriate institutional setting favoured the emergence of negative feedback loops between economic growth and the necessary reduction in high debt levels and the clean-up of the banking system. In particular, the fact that supervision and regulation remained in national hands, meant that governments had to bear individually the restructuring and resolution costs of the financial institutions located within their borders. And that amplified the "diabolical loop" between sovereign and banking risk.



As the chart shows, the adjustment of the imbalances has severely impacted economic activity and unemployment in the Euro Area, and only in recent months has this begun to be reversed. The climate of mistrust led to the fragmentation of financial markets and triggered a balance of payments crisis in countries reliant on external funding. The situation was so serious in mid-2012 that it reached the point of putting into question even the continuity of the euro in its current form and introducing the so called “redenomination risk”.

Against this background, the economic authorities deployed all the tools at their disposal. Specifically, three major packages of measures were launched.

First, the ECB contributed to easing financing conditions both by the use of conventional tools, implementing a gradual reduction in rates down to practically zero and, above all, through the application of a broad set of non conventional measures. From the outset of the crisis, the ECB applied a generous liquidity-provision policy for banks and, in 2012, when circumstances worsened to the extent that the continuity of the euro was in jeopardy, the ECB introduced the possibility of intervening in the public debt markets using Outright Monetary Transactions (OMT). This new instrument proved to be a powerful deterrent against speculative processes and tail risks.

In the absence of mutual insurance mechanisms to repair financial market fragmentation, the ECB had to assume such a heavy responsibility in defending the stability of the single currency. Nevertheless, it should be borne in mind that these measures were not able to tackle the true causes of the crisis and the imbalances; rather, they merely provide some time to be gained in order to allow the activation of the appropriate instruments by national governments and European authorities.

In this respect, European governments have deployed measures across two fronts.

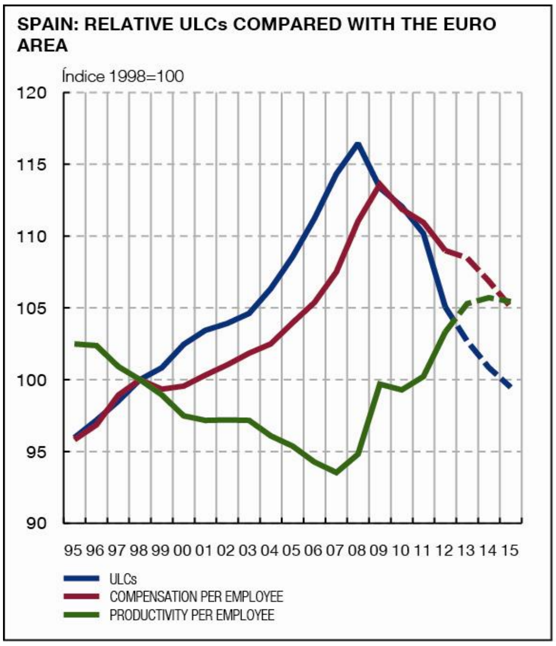
At the euro area level, crisis-management mechanisms have progressively been introduced to provide financial assistance for the countries in most difficulty. The process has been long and complex but the entry into force of the European Stability Mechanism was a milestone in the ongoing design of the new European institutional architecture.

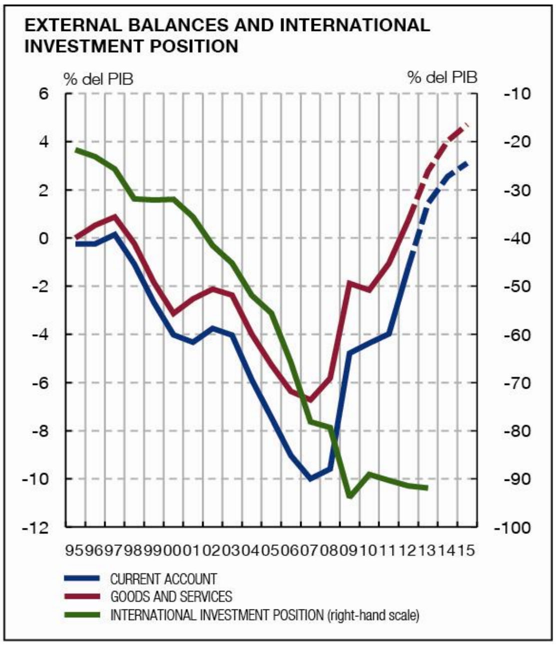
At the same time, European authorities have strengthened economic policy surveillance mechanisms. The key steps here have been: (i) the strengthening of the Stability and Growth Pact, introducing the possibility of imposing sanctions on countries (ii) the widening of the supervision perimeter to encompass macroeconomic imbalances, with the introduction of the Excessive Imbalances Procedure; and (iii) the reform of micro and macroprudential policies, to remedy the flaws that had allowed excessive accumulation of risk.

But perhaps the most important step in order to curtail the negative feedback loops between sovereign and banking risk was the decision taken by the European leaders to address the construction of the Banking Union. The first pillar of this banking union has been the adoption of the Single Supervisory Mechanism, under the roof of the ECB. The SSM will be fully operational in November 2014. The relevant regulation has already been approved, and the ECB is very busy these days with the preparatory work needed. Initial steps have also been taken to establish the Single Resolution Mechanism.

In any event, although making progress towards a more complete economic union at the European level is an important ingredient in the solution of the current problems, governments must be clear that, in a monetary union, national policies must be geared unambiguously to increasing productivity and ensuring the necessary flexibility. And that requires sustaining the public finances consolidation effort and greater ambition regarding the structural reforms needed.

Without the necessary flexibility, the adjustment costs that the correction of the imbalances in a monetary union entails are extremely high. The recent experience of the Spanish economy clearly illustrates this.

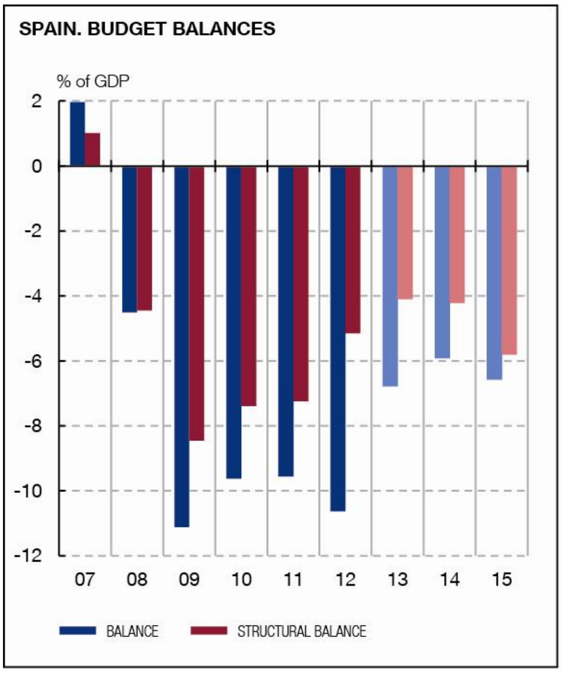


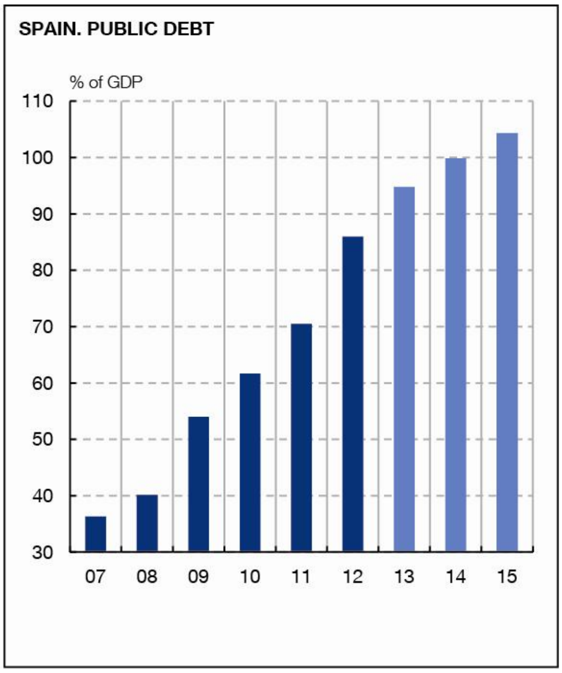


As this slide shows, the Spanish economy is intensively pursuing the correction of its current account and competitiveness imbalances. Real exchange rates, measured by unit labour costs, have shown an improvement that practically offsets the deterioration suffered since the start of EMU, and the current-account balance has run a surplus, after posting deficits of close to 10% of GDP in the years prior to the crisis.

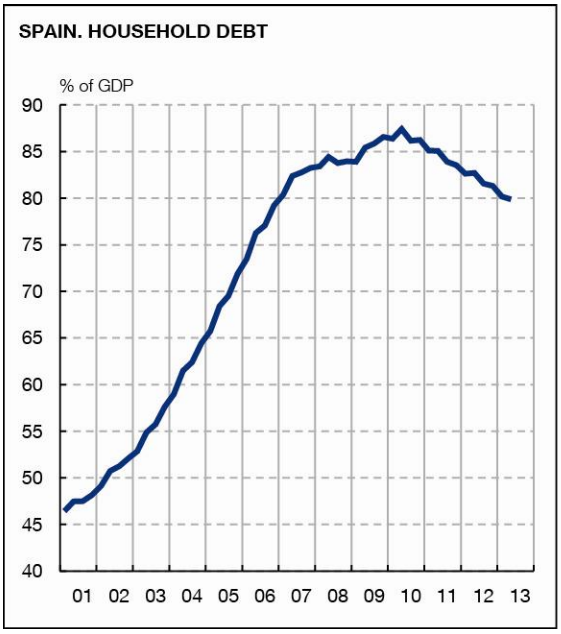
Following an initial phase in which the adjustment was mainly underpinned by a fall in domestic demand, there are visible signs of a genuine readjustment of competitiveness and considerable export buoyancy. Moreover, unlike events in past crisis episodes, when the improvement in competitiveness was based on a readjustment of the nominal exchange rate, the Spanish economy is undergoing an internal devaluation process based on wage and profit margins moderation. That said, the sharp correction in unit labour costs also reflects a pick-up in productivity resulting from ongoing job contraction.

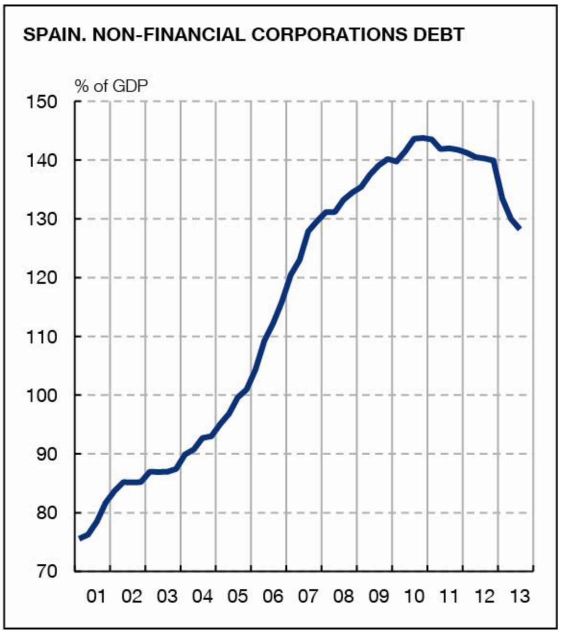
Yet the economy continues to show high levels of external debt, illustrating the challenges ahead in the coming years.





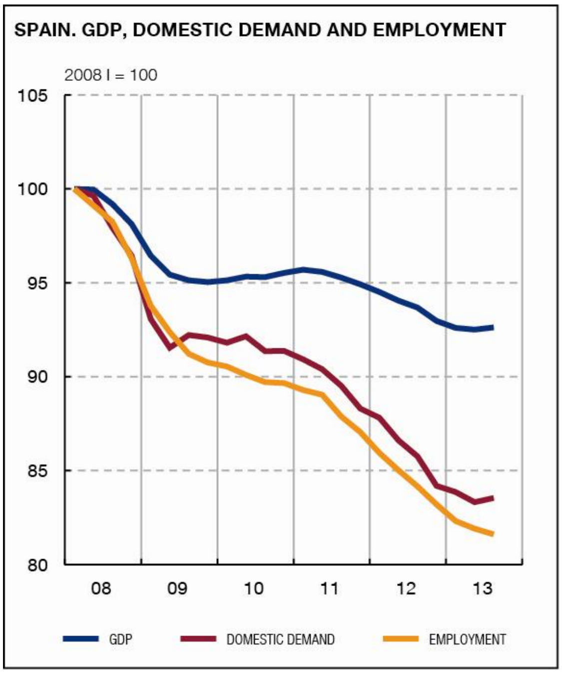
In the case of public finances, this slide depicting the general government balance in structural terms reveals the considerable fiscal consolidation effort made since 2009. Even so, the deficit is still high, and debt levels have risen to over 90% of GDP as a result of the recessionary environment and the recording of the assistance to financial institutions.

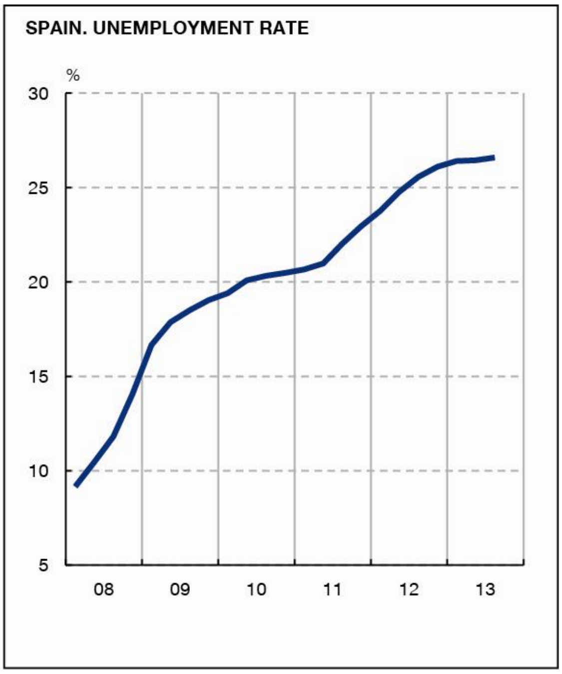




The ongoing deleveraging of the private sector is moving ahead at a moderate pace against a background of weak household and corporate income. A reduction in the real debt burden can be seen but to make progress in the deleveraging process a period of credit contraction seems unavoidable. The clean-up, restructuring and recapitalisation of ailing Spanish banks was tackled under the financial assistance programme requested from the European institutions, which was successfully completed in late 2013. The healing undertook by the Spanish banking system establishes a sound base for the continuity of the required external financing of the economy.

In any case, the significant adjustment made has been achieved at high costs in terms of growth and in terms of unemployment. After an unprecedented double dip recession the level of real GDP is now 7% below the level before the crisis. The level of employment has suffered a contraction of 17% during the crisis and the rate of unemployment has reached 26% of the labour force.





The Spanish experience is very telling. Macroeconomic divergences may have serious consequences if they are not addressed in time.

Accordingly, if, with a view to new monetary union members joining in the future, I had to summarise the lessons learnt in the case of the Spanish economy, I would highlight the following.

Firstly, the importance of a sustained convergence drive, beyond the efforts needed to meet monetary union entry requirements.

Secondly, it is crucial that countries should see the need for more disciplined fiscal policies and to progressively overcome structural rigidities in order to achieve an appropriate level of flexibility and capacity of adjustment.

Finally, the mechanisms being designed for the early detection and correction of imbalances must be rigorously implemented. The difficulties of correcting accumulated stocks of debt and restoring sustained growth underline the need to prevent the situation recurring in the future.

To conclude, I would like to offer you a Lamfalussy quote reflecting his conviction in European integration: "I don't accept the status quo, ... I think it is in Europe's destiny to be unified, and that it will be a good thing for Europeans and also for the rest of the world. It is a fact that is hard to prove, but in any case, it is an act of faith on my part"

(Lamfalussy, 1971)". Hopefully, in the coming years it will be less of an act of faith and start becoming a reality.