DEUTSCHE BUNDESBANK
EUROSYSTEM

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European Monetary Union and the Financial Crisis: Lessons for Economic Policy

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1 Introduction

Ladies and gentlemen

First, I would like to thank you for the invitation; it is a pleasure to be here at the Foreign Policy Association. We are living in a world that is marked by ever-growing interconnectedness and complexity. Consequently, the association's objective of inspiring the American public to learn more about the world is gaining in importance. And I am happy to be able to contribute to this objective today.

Given the current circumstances, the natural topic of discussion for a central banker is the financial crisis. Now, having already entered the fourth year of the crisis, the time has come to consider the lessons we have learnt. In my speech, I will look at the lessons for economic policy, with a particular focus on the situation in Europe. Having been hit hard by the financial crisis, the European economy as a whole is now on a stable path towards recovery, albeit at a moderate pace and with a significant degree of heterogeneity across the member states. The Greek crisis in spring clearly demonstrated that a smooth recovery cannot be taken for granted, but I am confident that the danger of sliding back into recession is negligible.

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As a result of the events we have witnessed over the past three years, two issues have come to the fore of public debate in Europe: the problem of macroeconomic imbalances in Economic and Monetary Union (EMU) and the role of fiscal policy in securing macroeconomic stability. Let me begin with a short discussion of the macroeconomic imbalances in EMU.

2 Macroeconomic imbalances as a challenge for EMU

The public debate on imbalances within EMU focuses on the current account positions of the member states. This issue should not be confused with the debate on global imbalances, since the current account of the euro area is roughly balanced. Intra-EMU imbalances in current account positions, however, are not a new phenomenon. In fact, they have existed since the beginning of monetary union. Some member states, such as Germany, Austria or the Netherlands, consistently post current account surpluses. Other countries, such as Portugal, Spain, Greece or Ireland, persistently record current account deficits.

In principle, a current account surplus or deficit reflects saving or borrowing at the national level. And, as for individuals, there is no reason why an economy as a whole should not be a net saver or borrower, even for an extended period of time. Consider the following examples: countries with a prospectively ageing population save more than they invest, as they face declining domestic investment opportunities. Hence, they have temporary current account surpluses. At the same time, countries that are catching up on economic development usually invest more than they save, as they have ample investment opportunities but are usually short of capital. As a consequence, they run temporary current account deficits. The common feature in both of these cases is that the current account

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serves to smooth consumption over time, and thereby raises welfare: like individuals, economies are better off if their consumption profile is less volatile.

As a result of these relationships, capital flows from countries with relatively large savings to countries with relatively high investment. In EMU this flow of capital increased with the introduction of the euro. There were two reasons for this. First, exchange rate risk was eliminated, making cross-border investments less risky. Second, country default risks were increasingly perceived as converging towards a relatively low level. According to the reasoning I have just outlined, the intra-EMU capital flows should reverse once investments in deficit countries start to pay off. In reality, however, diverging current account positions might also reflect underlying distortions – and this was the case in EMU.

The main problem for member states with persistent current account deficits was that the inflow of capital was not always allocated efficiently. In Spain and Ireland it went into booming real estate markets, in Greece it funded high government deficits and in Portugal it supported private consumption. This allocation spurred domestic demand and, owing to inflexible labour markets, wages increased more than productivity. This, in turn, reduced the price competitiveness of the countries in question. As a result, imports increased, exports dwindled and the current account deficit grew further.

Although these imbalances have domestic roots, the associated problems are not confined to the national level. Given spillover effects in the closely integrated euro-area financial markets, they are also a problem for other member states and for monetary union as a whole. The debt crisis in the first half of this year was a case in point. Consequently, the problem of imbalances within EMU has to be addressed.

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A major dispute regarding relevant policy options is the question of which group of countries should be the one to adjust. As the deeper causes of the imbalances are domestic factors within the deficit countries, it is mainly incumbent on them to take action. A number of structural reforms are needed to enhance the competitiveness of domestic companies by increasing productivity and keeping costs in check. At the same time, the deficit countries have to increase labour market flexibility and consolidate government budgets. In the end, domestic absorption will have to return to a sustainable level. This may sound harsh, but it is an inevitable adjustment for economies that have lived beyond their means.

But there are also voices demanding that surplus countries should adjust. These voices are certainly right – at least at this rather general level of abstraction. They are right in the sense that once import demand from deficit countries declines, surplus countries will have to reallocate some resources towards satisfying domestic demand. However, they are wrong in claiming that economic policy in surplus countries should actively boost domestic demand and, consequently, imports by using fiscal policy stimulus or an expansionary wage policy, instead of allowing market forces to make the adjustment. In this context, it should be noted that the situation of surplus economies in EMU is not comparable to that of some emerging markets where market adjustments are hampered by policy interventions. To put it more bluntly: analogies between Germany and China may be fashionable, but are grossly misleading. Let me explain in some more detail why I believe that the reasoning behind the proposals for actively stimulating domestic demand in EMU surplus economies is flawed.

To demand measures that would boost imports neglects the fact that trade flows are highly diversified. Thus, an increase in the imports of surplus countries would improve the current account balance in deficit countries only by a small margin. Given the current trade structure, an increase of 10% in German imports would improve the current account balance in Spain, Portugal and Greece by a mere 0.25 percentage point. The current account

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balance in Ireland would improve by 1 percentage point. The proposal of raising wages to support domestic demand and reduce competitiveness not only neglects the fact that wages are not a political control variable; simulation studies also show that the effects would be confined almost entirely to the home economy in the form of changes in employment. Finally, the argument that fiscal policy should be used to stimulate internal demand and imports overlooks the fact that public finances in surplus countries are also strained and that ambitious consolidation efforts are required in these economies as well. The role and course of fiscal policy in EMU is indeed one of the most challenging and pressing topics that Europe faces today.

3 The role of fiscal policy in securing stability

In the financial crisis, fiscal policy proved to be an important stabilising factor. Various support measures for the financial sector and the real economy helped to mitigate the negative effects of the crisis. Nevertheless, these measures placed a large burden on the national budgets of EMU member states. And in spring 2010 sovereign risk came to the fore, turning into a major downside risk for recovery in Europe. Within a short period of time fiscal problems in Greece and other member states turned into an imminent danger to the stability of the financial system and EMU. Thus, in May member states and the EU decided to implement far-reaching measures to support the countries in question. These fiscal measures were justifiable given the risks associated with inaction. Nevertheless, they still placed a serious strain on the foundations of EMU. Therefore, these measures cannot be a long-term solution – they only bought us some time, and it is crucial to regain lost confidence in member states' public finances by restoring sustainability.

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This is a twofold task that entails a credible consolidation of government budgets as well as a strengthening of the fiscal framework within EMU. Regarding consolidation, Greece and other affected member states have taken important initial steps; now it is important to maintain the momentum. The common argument that such fiscal tightening might have a dampening effect on the real economy does not speak against such policies. Policy priorities have to shift towards austerity when the sustainability of public finances, let alone the solvency of governments, is questioned by the markets. Given the current worries of investors and market participants about the state of public finances, the dampening effect of fiscal consolidation could be significantly reduced. Moreover, in the longer term immediate consolidation prevents a negative spillover from public finances to growth. In other words, credible fiscal consolidation could serve as a possible anchor in the current uncertain environment.

To guarantee sound public finances in the long term, it is also necessary to strengthen the fiscal framework of EMU. The centrepiece of this framework is the Stability and Growth Pact (SGP), which was devised to ensure the fiscal discipline of national budgets. Member states are obliged to keep the budget deficit below a threshold of 3 % of GDP and the level of debt below 60 % of GDP. Although the rules of the SGP are generally appropriate, it is necessary to improve compliance. The main problem is that any violation of the provisions is followed by a political decision on sanctions. Experience has shown that this arrangement adds an undesirable degree of flexibility to the rules. It would therefore be advisable to install a system of automatic sanctions. In addition, it is not sufficient to focus on the budget deficit alone, as was done in the past; it is also necessary to place more emphasis on the level of national debt.

These adjustments would definitely improve fiscal discipline. Still, they might not always be sufficient to safeguard macroeconomic stability, since imbalances do not necessarily

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emanate from the public sector. Hence, a further and broader surveillance of macroeconomic developments may be helpful. This is not to imply that we should conduct macroeconomic fine-tuning at the EU level, quite the opposite. Any procedures and, in particular, sanctions should only be taken into consideration when there is clear evidence of imbalances with significant negative spillover effects on other member states.

Although an enhanced SGP and better macroeconomic surveillance would improve stability, future crises can never be ruled out. As a result, we need rules for an effective crisis management. The relevant provisions have to be designed in a way that distorts incentives as little as possible. It is therefore imperative to reinvigorate the “no-bail-out” principle. For this purpose, the discipline imposed by the financial markets is welcome and should be utilised: Private investors have to bear and therefore internalise the risks of unsound fiscal policy. This could be achieved by creating a framework for the orderly restructuring of sovereign debt. Against this background, financial support to member states has to remain a last resort that should only be implemented when there is a clear danger of contagion. And when granted it has to be tied to strict conditions.

4 Conclusion

Ladies and gentlemen, let me conclude my speech by summing up the main points. Regarding the problem of macroeconomic imbalances within EMU, it is necessary for those countries with current account deficits to undertake structural reforms. Additional measures by surplus countries would do little to ease the adjustment burdens of deficit countries. In this regard, the analogy that is often drawn between China and the surplus countries in EMU, such as Germany, obscures more than it explains.

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Regarding fiscal policy, the most urgent task is to consolidate the national budgets within EMU. At the same time, it is necessary to strengthen the fiscal framework. Relevant proposals have been put forward by a task force led by the President of the European Council, Herman van Rompuy. This discussion is ongoing and a number of details still have to be worked out. The Bundesbank welcomes the fact that Europe is willing to revise the relevant rules. However, it is important that the relevant players do not relent in their efforts as external pressure decreases.

Thank you for your attention!

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