

Europe 2020 strategy: Macroeconomic Context and Perspectives

Speech by

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It is a great honour and pleasure to be here today. My intervention will be on the difficult policy options and the economic reforms that are needed to preserve Europe's stability and avoid another European crisis while enhancing economic growth and social cohesion.

I will make reference to the Euro area, although many of my considerations could equally apply to the whole of the European Union or a possibly enlarged Euro area in the future.

The unprecedented economic and political crisis has brought some good and bad news for the Euro area. On the positive side, the crisis has highlighted the advantages of a single currency and demonstrated the benefits of deepening Euro-area policy coordination. Thanks to the successful first decade of Economic and Monetary Union (EMU), the Euro area and its Member States are today in a better position to manage these challenging times than in the past. The euro has limited the impact of the crisis in Europe and provided stability in a number of ways.

First, it has eliminated the exchange rate and interest rate turbulences among the Euro-area Member States that were common during periods of financial stress in the past. Second, the Euro area's stability-oriented macroeconomic framework has reduced the level and volatility of inflation and interest rates. Third, the consolidation of budgetary deficits in most Member States in recent years, even though imperfect, has created room for fiscal policy to play an important stabilising function during the crisis in some countries. Fourth, since the start of financial turmoil in 2007, the ECB has adopted an accommodative monetary policy stance and has managed liquidity smoothly. This policy has helped ease conditions in the interbank market and anchor inflation expectations throughout this period of uncertainty. Finally, the governance structure of EMU, while far from being perfect, has facilitated policy coordination across the Euro area and the European Union as a whole. The close interaction of all actors involved in the Eurogroup and in the Ecofin Council has encouraged a fast and bold policy response to the global economic and financial crisis.

Imagine for a moment how the crisis might have unfolded in the Euro area without the euro. Coordination problems would have been daunting. Sixteen European central banks would have had to struggle to coordinate liquidity provisions while trying to stabilise exchange rates and inflation expectations.

However, the crisis has also revealed important weaknesses in the Euro area created before the crisis. These include, in particular, the vulnerability of Member States affected by significant macroeconomic imbalances, and important shortcomings in the European regulatory and supervisory frameworks.

The accumulation of large current account imbalances and divergent competitiveness developments have made some Euro-area Member States particularly vulnerable to the crisis. Partly favoured by low real interest rates, the Euro area has experienced substantial growth differentials among Member States over the past ten years. Growth differentials

should pose no major problem for a monetary union if they are part of a normal catching-up process or a reflection of differentials in population growth. However, they can become a problem if they are due to more enduring competitiveness gaps. As demonstrated by the evolution of intra-Euro-area current accounts and real effective exchange rates, there was substantial divergence in competitiveness within the Euro area at the start of the crisis. Recent research done by the European Commission¹ identifies three groups of countries: (i) those with large current account deficits and significantly overvalued real effective exchange rates (notably Spain, Greece, and Portugal); (ii) countries with large current account surpluses and various degrees of real exchange rate undervaluation (Germany, the Netherlands, Finland, Luxembourg, and Austria); and (iii) countries with falling export market shares (Belgium, Ireland, France, and Italy). Whereas Germany since 1999 has continuously improved its price competitiveness with respect to the Euro area average, the relative competitiveness of the initial boom economies, including Spain, Portugal, Greece, and also Ireland, has increasingly deteriorated.

This tendency towards persistent divergences between Euro-area Member States has been due to a lack of responsiveness of prices and wages, which have not adjusted smoothly across products, sectors and regions, and has led to accumulated competitiveness losses and large external imbalances. At the same time, while the progressive enlargement of the Euro area will add dynamism to its economy, it will also increase the diversity of the EMU, making stronger demands on its adjustment capacity.

Some commentators have raised the question of whether the Euro area has successfully helped navigate the storm or whether, given existing structural imbalances, it has further facilitated the spread of the crisis in Europe. Others have even expressed doubts about the very survival of the EMU.

What did go wrong in the currency area?

Let's see the need for adjustments from a theoretical point of view. The EMU is the most important example of a recently established currency union and the one to which the Optimum Currency Area (OCA) theory has been most frequently applied. The European experience is, in some sense, an open laboratory in which each OCA property can be assessed. Various developments in economic theory and econometrics have made it possible to progress from the 'early OCA theory' to a 'new OCA theory'. The balance of judgements has shifted in favour of monetary union: it is currently expected to generate fewer costs and greater benefits than previously thought.

According to the so-called new 'endogenous OCA theory', we should look forward to a happy ending for the Euro area, regardless of whether individual OCA properties are respected or not. It has been argued in fact that the creation of the EMU itself would moderate the risk of painful adjustment by increasing flexibility and by making economies more similar, even though greater specialisation would tend to increase structural differences. According to this line of thought, the currency area would therefore become optimal through this endogenous process².

¹ European Commission (2010).

² Frankel and Rose (1998).

This reasoning is based on two components. First, the fact that a number of countries decide to form a monetary union activates a cycle of more intense economic integration. The use of a common currency reduces transaction costs and price transparency increases, leading to greater integration. Second, integration, in turn, further reduces the degree of divergence among the member countries. These two components ensure that the countries, by forming a monetary union, move toward the OCA-zone, which they will eventually reach one day. Thus, there is a self-fulfilling dimension to the optimality of a monetary union. By the mere fact of establishing a monetary union, the countries involved will be pushed to create the conditions that make the union optimal.

In addition, there may be institutional forces at play, increasing the flexibility of the economies involved in the currency union. More specifically, the existence of the monetary union and its coordination framework might foster ongoing structural reforms, including product and labour market reforms. As far as the latter help to absorb shocks more rapidly, the propagation of shocks across countries might become more symmetrical, constituting another potential source of endogeneity of OCA.

On the other hand, there are basic economic mechanisms that can undermine these virtuous cycles, and it is important for policy makers to be aware of these forces.

First, an alternative view³ argues in favour of less synchronisation due to higher specialisation among countries, favouring asymmetric, sector specific shocks. If clustering effects occur among the members of the Euro area, integration would not make them more alike, but instead more different from each other. Economic integration would make their economic structures increasingly dissimilar, with different countries specialising in the production of different goods and services. As a result, higher integration of the Euro area would lead to greater divergences among its members. As a consequence, more asymmetric shocks would occur, rather than less. Up to now, economic integration in Europe does not seem to have produced large agglomeration effects, but the enlargement of the European Union may create the potential of large movements of capital towards Central Europe, causing industrial shifting and leading to large asymmetric developments in the business cycles between East and West.

In addition, going back to the old OCA theory, many academics have remained rather sceptical about the euro's prospects since the integration process has started. Most of them find the Euro area is still lacking the textbook criteria for a successful currency union, such as highly flexible labour markets and a centralised fiscal stabilisation scheme. The fact that member states have retained control over a good number of important economic policy instruments creates a potential for economic divergence. For example, wage policies and labour market institutions are completely in national hands, leading to very wide divergences within the union. The divergent movements of competitive positions within the Euro area are partially the result of divergent national wage policies and institutions, but also by varying degree of speed of structural reform processes.

All this generates a potential for divergent movements in employment and output— asymmetric shocks—within the Euro area which will necessitate adjustments in the future. As these adjustments are likely to be painful, they are bound to lead to tensions in a

³ Krugman (1993).

monetary union. It is likely that these problems will become even more pronounced in an enlarged Euro area. Countries will retain their full control over national economic instruments, creating dynamics of divergence that will be difficult to contain.

So the question is: What policies can be used to tackle imbalances, given that the nominal exchange rate is not available, to avoid such a potential unhappy ending?

There is a significantly slower speed of adjustment of real wages to economic shocks in continental Europe. Unemployment eventually puts some downward pressure on real wages, but a large share of the adjustment is borne by employment. Low wage flexibility is explained mostly by the functioning of specific labour market institutions. Low wage flexibility also contributes to the lack of price flexibility. Labour market integration has also been analysed in terms of geographical and occupational mobility. Several studies have found that geographical mobility is two to three times higher in the US than in Europe⁴. The OECD reports that only 5.5 million European Union citizens reside in another Member State out of 370 million (or about 1.5% of the population, representing only half of the number of non-EU citizens residing in the EU). The variation of unemployment in Europe is also considerably higher than in the US. Differences in relative unemployment rates between regions are more persistent in Europe than in the US.

The diagnosis of the causes of structural rigidities in product and labour markets and low financial integration gives us reasons to worry. Some economists⁵ have clearly illustrated how rigid labour market institutions, when the economy is hit by adverse shocks, generate structural unemployment. This helps to explain the persistence of European unemployment and the high share of the long-term unemployed.

Product market regulations have also been examined in many studies. Price flexibility is hampered, albeit by different degrees across the Euro area, by the slow implementation of the Single Market Programme and by a slow dismantling of some non-tariff internal and external trade barriers. Work on a set of product and labour market indicators—first pioneered by the OECD—has provided a remarkable impulse to these studies.

On top of these reforms, there are automatic adjustment processes in a currency union, such as the competitiveness channel. Countries that have lost price competitiveness will eventually experience recessionary forces that help re-establish competitiveness via lower inflation/costs. That being said, the functioning of the competitiveness channel may be slow and delayed considerably, as long as endogenous financing of balance of payment needs is available. However, the cost of having accumulated large external liabilities may suddenly increase if the risk appetite of international investors drops. Then a crisis would develop.

The lags and costs associated with the automatic adjustment process are a good reason to take corrective and timely policy measures in case of large current account deficits by effectively mimicking devaluation through an internal route.

⁴ OECD (1999).

⁵ Blanchard and Wolfers (2000).

An internal devaluation, i.e. a real devaluation by reducing labour costs at home relative to trading partners, can be realised in different ways. One instrument that has been used is that of lowering social security contributions, financed by increasing VAT rates (thus switching the weight of tax bases). This policy, implemented in Germany in 2006, has apparently been a success, although it has probably further amplified divergence with respect to other European countries.

Labour costs can also be contained by reducing the indexation of wages to inflation as such indexation tends to perpetuate a situation of high wage growth and high inflation, destroying competitiveness in a currency union. If, for political reasons, indexation cannot be reduced, one option could be to use the average inflation of the currency union as a peg for wage growth. However, while this may help to stabilise competitiveness, it may not be sufficient to regain lost competitiveness, depending on the magnitude of the differential in productivity growth. Amending other wage impacting policies could also be of help: minimum wage growth and public wage growth could be moderated and unemployment benefits reassessed.

The context of the EMU and the need to gain in flexibility and adaptability should provide an added incentive for structural reforms aimed at improving the functioning of labour and product markets, thus helping to strengthen the competitiveness channel as well. This would make adjustment faster and smoother and limit the risk of the real interest rate channel kicking in as a source of short-run macroeconomic instability. Finally, it would pay a double dividend by also helping to raise potential economic growth.

Let's see whether there are other policy options.

The divergent movements of competitive positions within the Euro area are also the result of structural reform processes characterised by varying degrees of speed within the monetary area. Beyond the internal devaluation option, the full set of policy measures includes: fiscal adjustment, productivity-enhancing policies, especially in the non-tradable sector, and regulatory financial policies.

Fiscal policy is perhaps the most important macroeconomic policy tool, especially where monetary policy is centralised. Fiscal consolidation seems particularly appropriate if public saving is too low or monetary policy too lax. It will remain crucial going forward to reverse the extensive use of fiscal stimuli and automatic stabilisers during the crisis, to lower the public debt and reduce domestic demand pressure. Policies that may previously have been distorting private saving and investment decisions, e.g. mortgage interest relief and favourable tax treatment of debt, should also be reduced or eliminated.

Structural policies to improve productivity growth, including in the non-tradable sector, are crucial to regain competitiveness. Productivity growth depends on capital investment, education, innovation, product market regulation, labour market flexibility, and the business environment. Productivity growth is not only important in the tradable sector but also in the non-tradable sector as it feeds into the costs of the tradable sector. Although their impact may be of a more medium-run nature, productivity-enhancing reforms are crucial to establishing future competitiveness and achieving a higher standard of living. Structural reforms, especially in product markets, should also lead to lower inflation, if but temporarily.

Regulatory financial policies are also important. The boom in some countries was accompanied by a rapid growth of private sector credit, with an accumulation of risks in financial assets as average loan quality declined. By improving financial supervision and making provisioning more stringent in booms, central banks can limit the growth of private credit growth and the accumulation of loans of dubious quality.

Other policy options are available, but they involve radical social and economic changes that are hardly feasible or, in some cases, desirable.

So the next question is: How can Europe 2020 help?

The crisis has shown the ability of the Euro area, and the EU more broadly, to act decisively and in a coherent manner when necessary. Despite some initial hesitation, concrete policy initiatives such as the European Economic Recovery Plan revealed political will and recognition of joint responsibility. The crisis underlines a key lesson on the importance of policy coordination and the need to take full account of the intensified interdependencies and spillovers within the Euro area. An important concrete step forwards is the envisaged strengthening of the EU-wide supervisory framework. With regard to fiscal policy, the prevailing setup appears to be capable of delivering the necessary degree of coordination while maintaining its country-specific dimension and accountability.

In recent years the political economy of structural reforms—and the debate on whether the EMU may encourage or hinder product and labour market reforms—has received considerable attention. Thus far no consensus has emerged. One optimistic view is that the EMU strengthens the incentives for structural reforms simply because ‘There Is No Alternative’⁶: having lost direct control over national monetary policy, Euro area countries have to strengthen market-based adjustment mechanisms in order to cope with adverse shocks. Europe 2020 could provide further help by encouraging a virtuous cycle of reforms to fully develop.

There is wide agreement that the sequence of reform also matters. Structural reforms may start with product market reforms, possibly because they are less affected by EMU coordination problems than labour market reforms. Some⁷ argue that such reforms should aim at increasing the intensity of product market competition. Overall, prices would then tend to be lower and real wages would tend to be higher. Profits would also tend to be lower. The consequence of this shift could easily be a short-term increase in real expenditure, because the short-term propensity to spend is probably more a result of wages than of profits. Therefore, output and employment may well rise even without any relaxation of monetary policy.

Most Euro area countries still need to counter pervasive price rigidities and reduce imperfect competition in several important sectors, particularly regulated sectors and network industries. Moreover, significant reforms to enhance labour market flexibility are still needed in several Euro area countries. The Europe 2020 strategy might provide an important impulse in this respect. The strategy aims at transforming the EU into a smart, sustainable and inclusive economy with high levels of employment, productivity and social

⁶ Hence the TINA acronym.

⁷ Nickell (2006).

cohesion, while adapting to the new economic realities and thereby addressing various challenges. It is of paramount importance for the success of the Europe 2020 strategy that short-term economic recovery conjugates with longer-term objectives such as higher productivity and innovation gains, larger and better investments in the green economy, better focus on education and skills, revitalisation of the single market and, last but not least, improved welfare and social inclusion.

In order to address all these important challenges, the role of social partners will be key in mastering the implementation of ambitious reforms while maintaining social cohesion over the coming years.

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