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Macroeconomic imbalances and structural reforms

ECB Central Banking Seminar

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Cross-country developments since the start of EMU

1999 – 2007	• Significant divergences of competitiveness and current account balances among EA countries; • unsustainable boom in domestic demand, excessive credit growth and accumulation of debt in some euro area countries up until 2007;
2008 – 2009	• Financial crisis and recession unmasked accumulated imbalances. Resulting in a costly process of rebalancing;
2010 – 2013	• Sovereign crisis; • Financial assistance programmes: 5 countries entered into a EU (and IMF) financial assistance (GR, IE, PT, CY, ES); • New Macroeconomic Imbalance Procedure (Nov. 2011), also targeting a rebalancing of current account surplus positions
2014 – 2019H1	• Programme exits in IE, ES (fin. sector progr.), PT, CY, GR; • Economic recovery/expansion; • Have vulnerabilities been overcome? How to make the euro area more resilient? • Are current account surplus positions too high?

- Euro area rebalancing objective included in the EU economic governance framework

  - Macroeconomic Imbalances Procedure envisages symmetry of adjustment in the monetary union (REGULATION (EU) No 1176/2011):

    "Given vulnerabilities and the magnitude of the adjustment required, the need for policy action is particularly pressing in Member States showing persistently high current-account deficits and competitiveness losses."

    "Furthermore, in Member States that accumulate large current-account surpluses, policies should aim to identify and implement measures that help strengthen their domestic demand and growth potential."

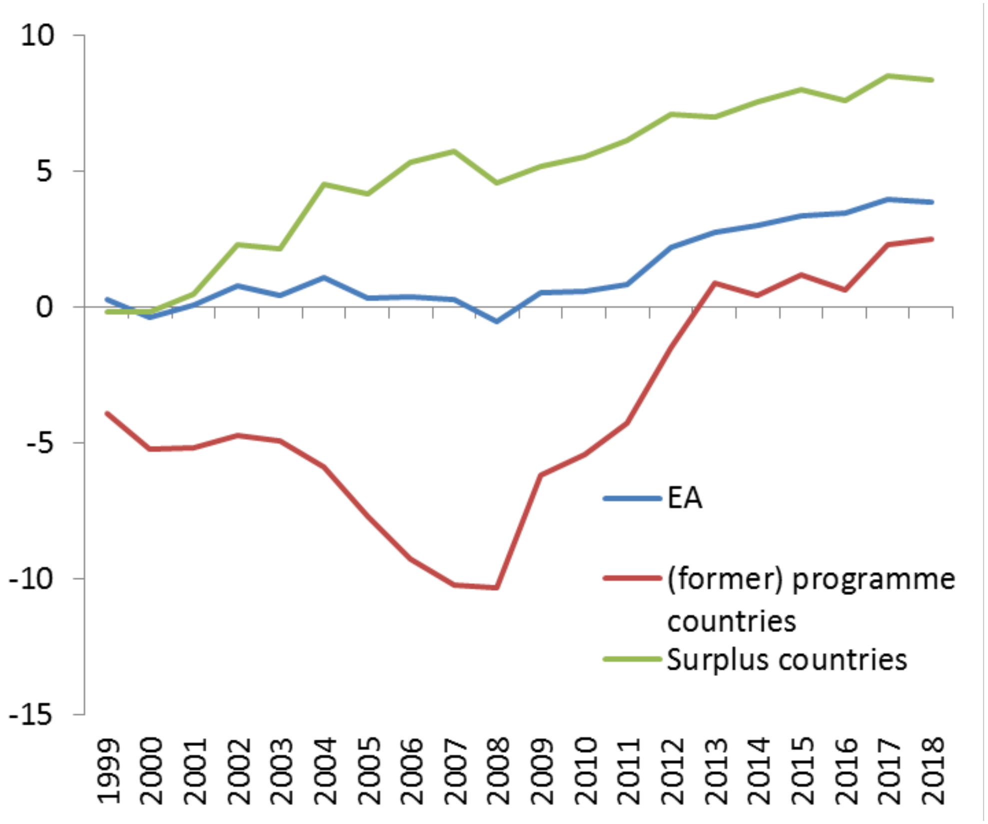
- Global imbalances

  - IMF Article IV on the euro area identifies a (mild) external imbalance (June 2019):
    "The euro area current account surplus has narrowed slightly, but it is still assessed by IMF staff to be moderately stronger than warranted by fundamentals."

Overview

...remarkable in (former) programme countries, in particular in terms of external rebalancing & relative cost competitiveness.

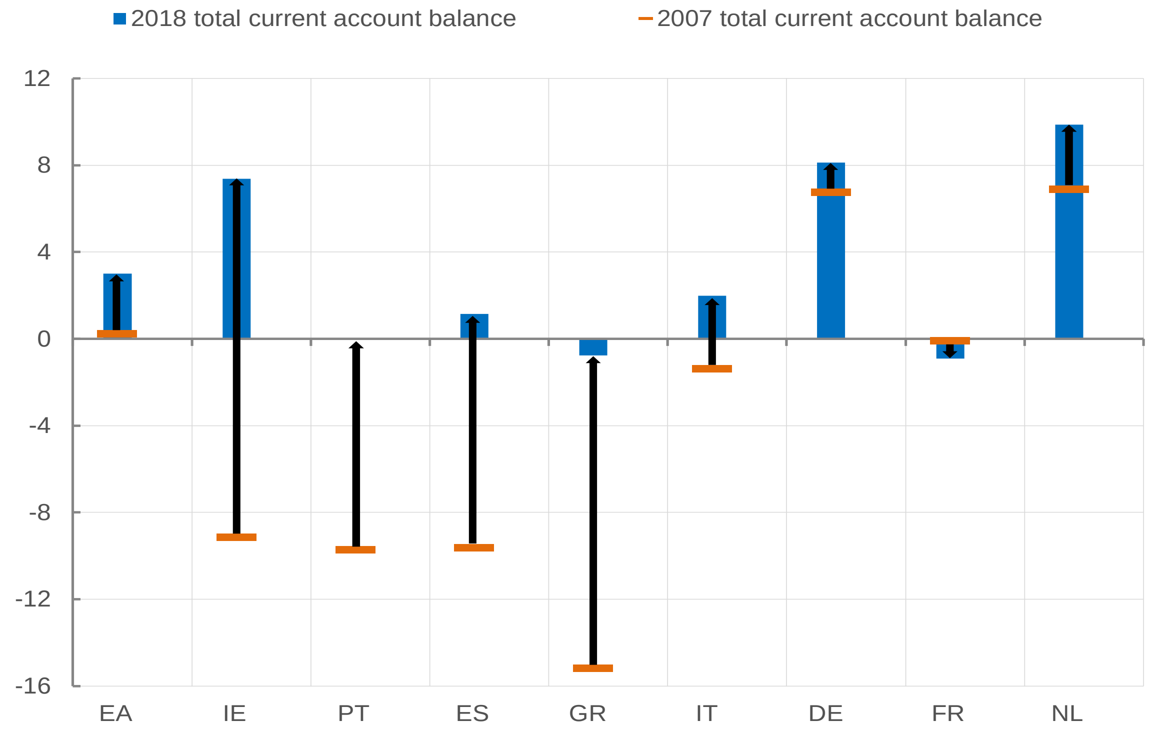
Current account *(in % of GDP)*



Sources: EC and ECB computations. Programme countries include: GR, IE, CY, PT and ES.
Note: GDP-weighted average within each group.

Current account adjustments in the euro area and selected euro area countries

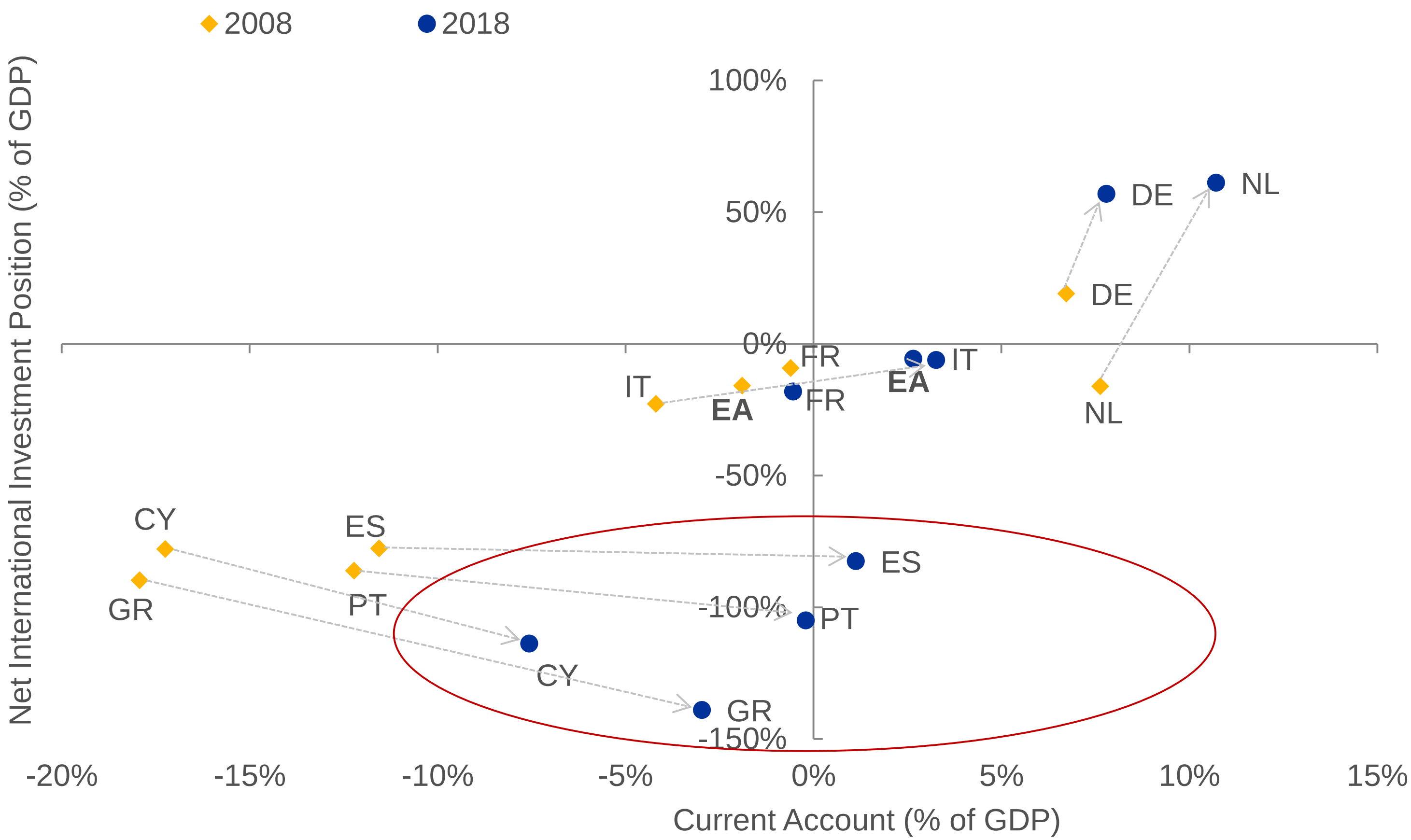
(total changes from 2007 to 2018, in % of GDP)



Source: ECB.

NIIP positions remain sizable and negative in some countries

Countries with still high external debt still require CA adjustment.



Source: ECB. Note: LHS: Four quarter moving averages. Last observation is Q3 2018.

Overview

Accumulation of imbalances driven by, among others…

- **Overly-optimistic expectations** about future income streams;

- **Significant structural rigidities, partly weak institutions** and lack of competition leading to a misallocation of resources;

- **Shortcomings in national supervisory policies** (e.g. excessive risk taking by banks on the asset and funding side; insufficient capital buffers) and **under-appreciation of risks by financial markets and rating agencies** (e.g. compression of sovereign bond spreads);

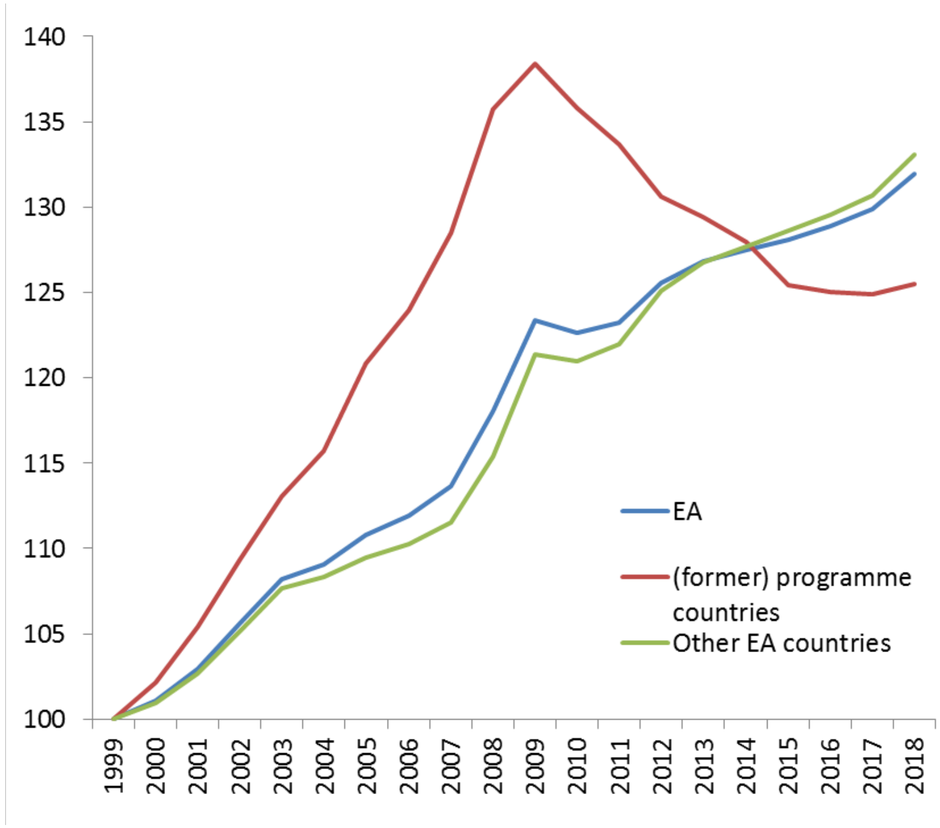
- **Lack of counteracting national policies** to prevent the build-up of imbalances and erosion of competitiveness (e.g. unsustainable pro-cyclical fiscal policies; lack of structural reforms).

- **Current account surplus positions since 2009 driven by government and non-financial sector savings**

Caveat: These drivers overall characterise the accumulation of imbalances, but there has been significant cross-country heterogeneity as to their respective importance.

...remarkable in (former) programme countries, in particular in terms of relative cost competitiveness.

Unit labour cost *(1999=100)*

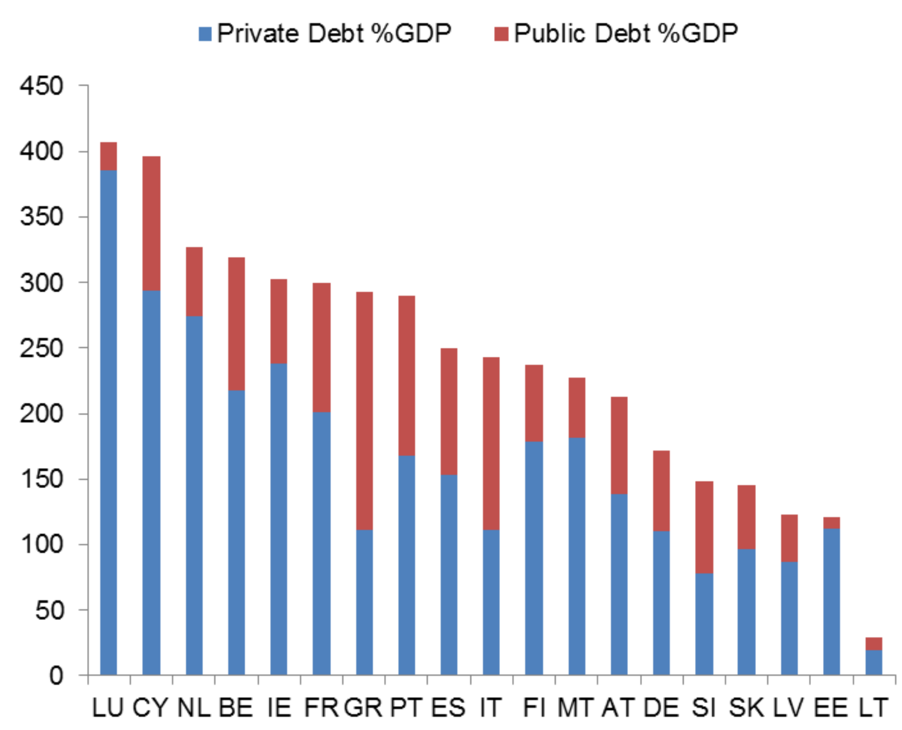


Sources: EC and ECB computations. Programme countries include: GR, IE, CY, PT and ES. Note: GDP-weighted average within each group.

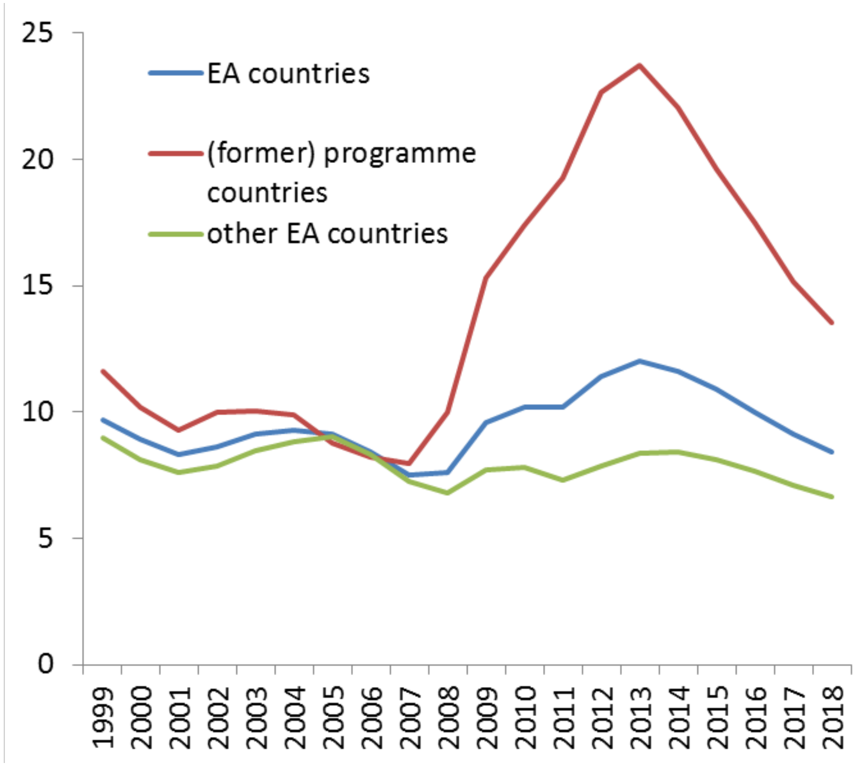
But vulnerabilities remain severe in many countries…

…in particular as regards legacy debt and high unemployment

Private (non-consolidated) **and public sector debt** *(in % of GDP)* ***Q4 2018***



Unemployment rate *(in % of LF)*

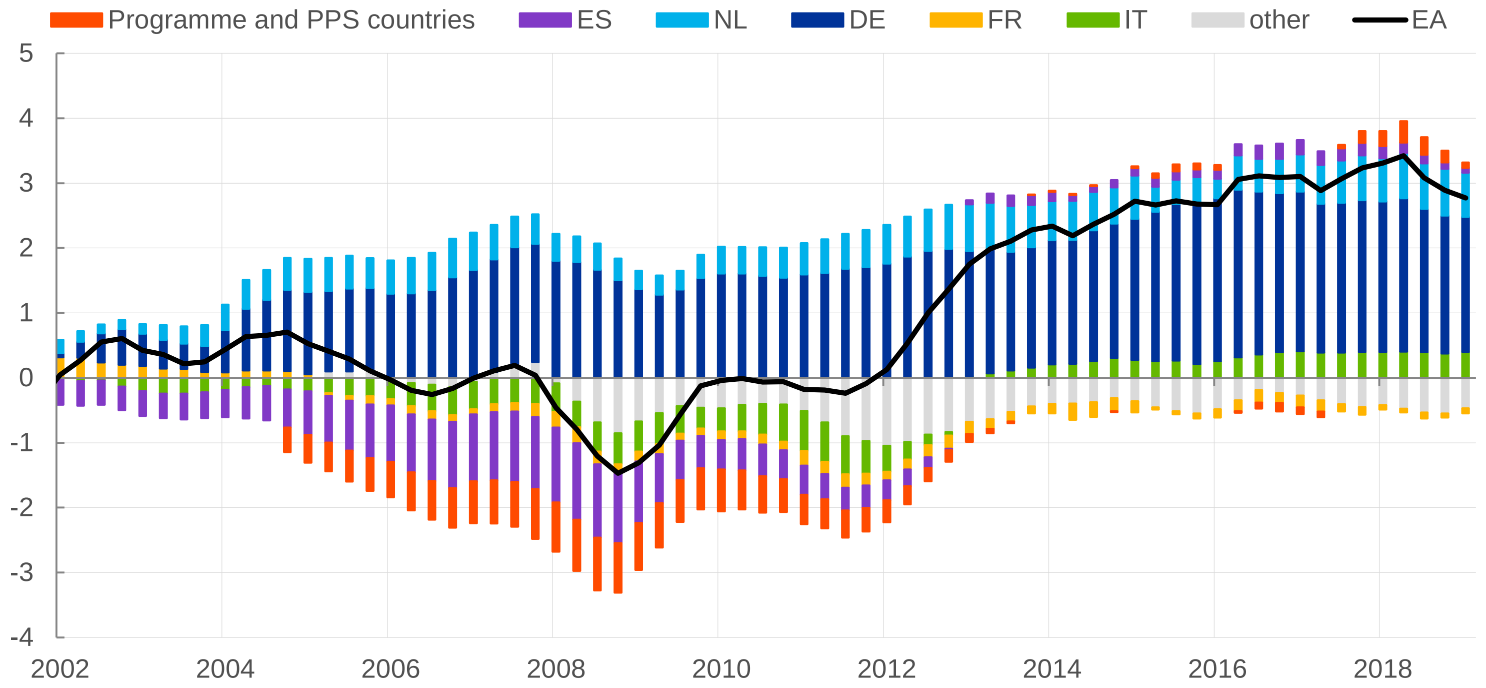


Sources: Eurostat, ECB

Symmetry of adjustment: Surplus countries

Euro area current account balance by country

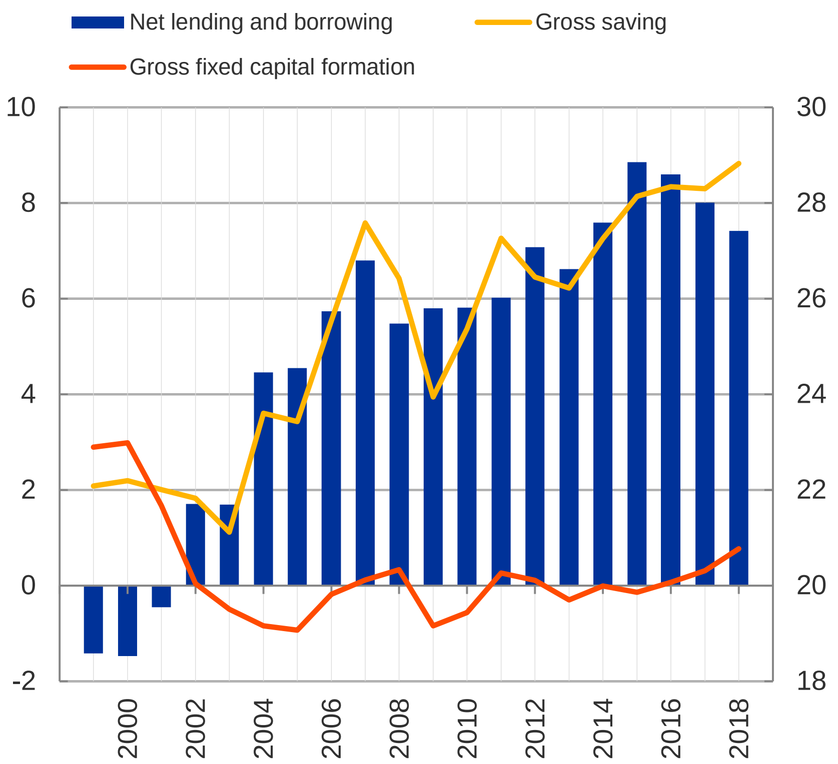
(percentage of GDP, 4-quarter moving sum)



Sources: ECB and Eurostat

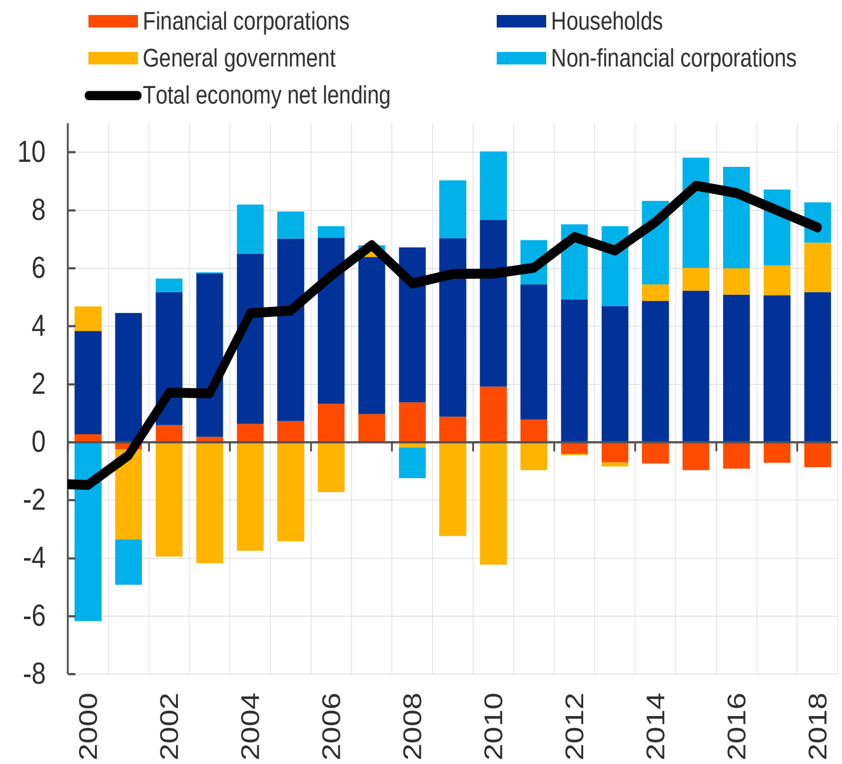
Notes: Programme and PPS countries: PT, IE, GR and CY. Last observation: 2019Q1 (for IE 2018Q4 figure is assumed).

Germany: saving, investment and net lending/borrowing
(percentage of GDP)



Source: European Commission.
Notes: Last observation: 2018Q4.

Germany net lending by sectors
(net lending/borrowing by sector, % of GDP)

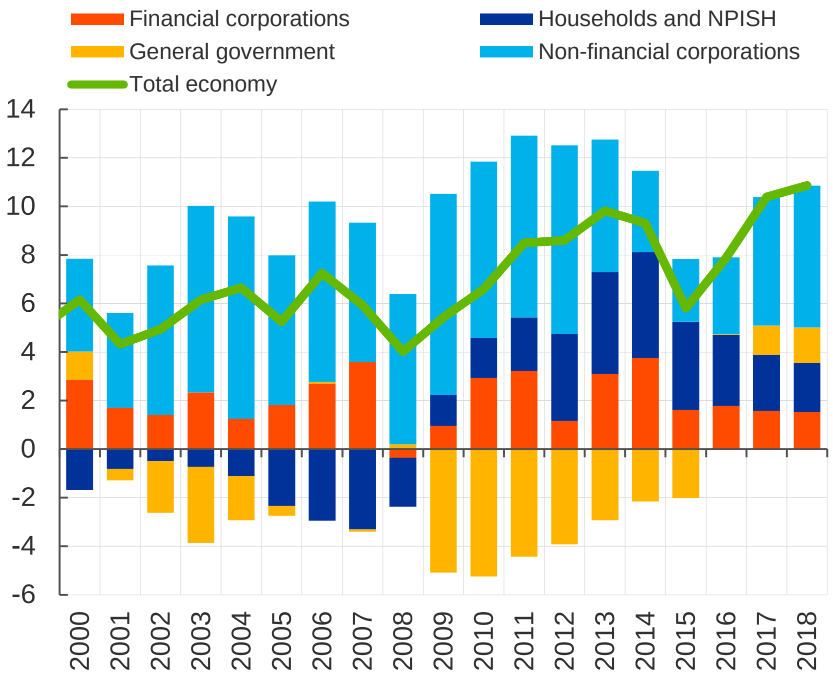


Source: European Commission.
Notes: Last observation: 2018Q4.

The Netherlands and Spain: Net lending by sectors

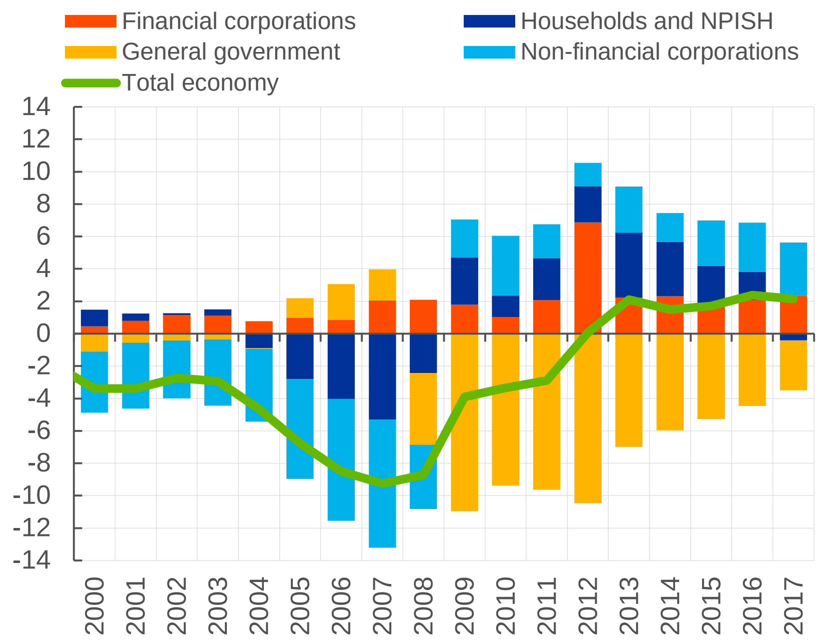
The Netherlands

(net lending/borrowing by sector, % of GDP)



Spain

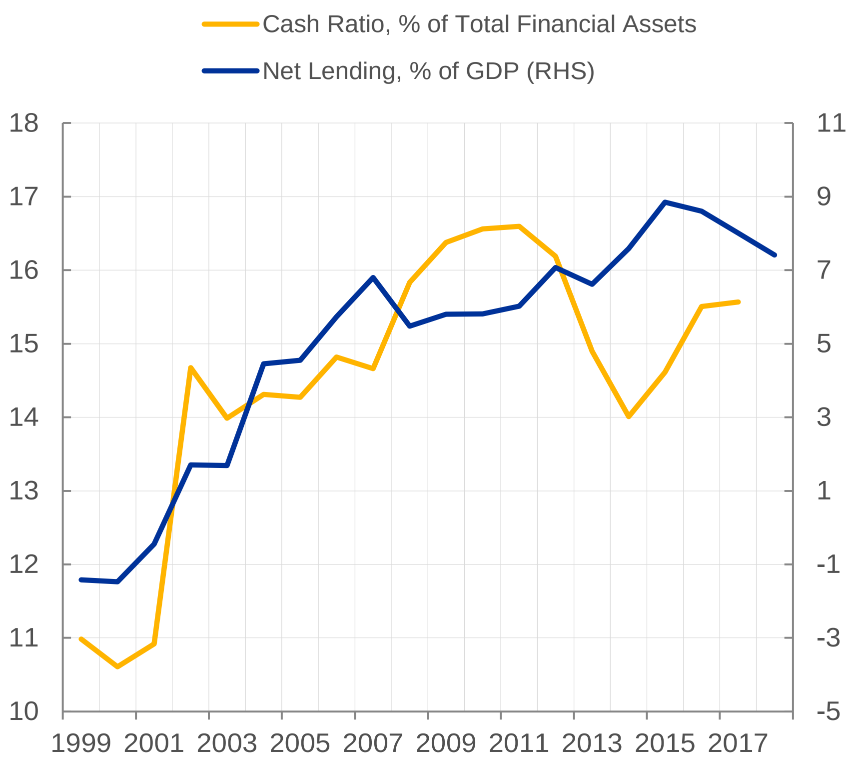
(net lending/borrowing by sector, % of GDP)



Source: European Commission.
Last observation: 2017 (Spain) and 2018 (The Netherlands).

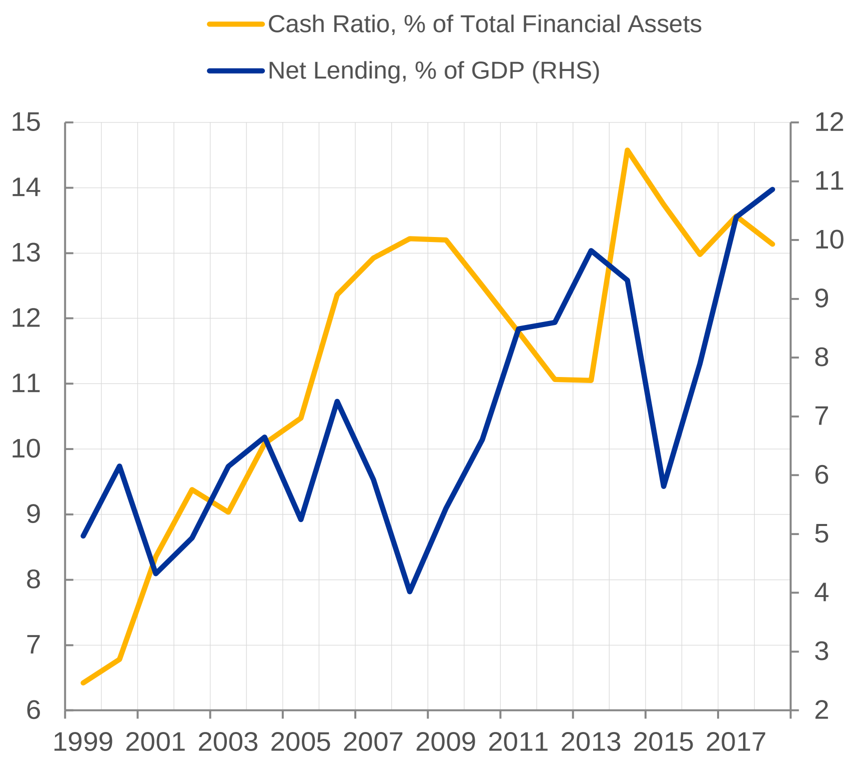
NFC net lending and cash holdings

Germany



Source: ECB, Eurostat and National Statistics Office
Notes: Last observation 2017 (Cash Ratio) and 2018 (Net Lending).

Netherlands



Source: ECB, Eurostat and National Statistics Office
Notes: Last observation 2018.

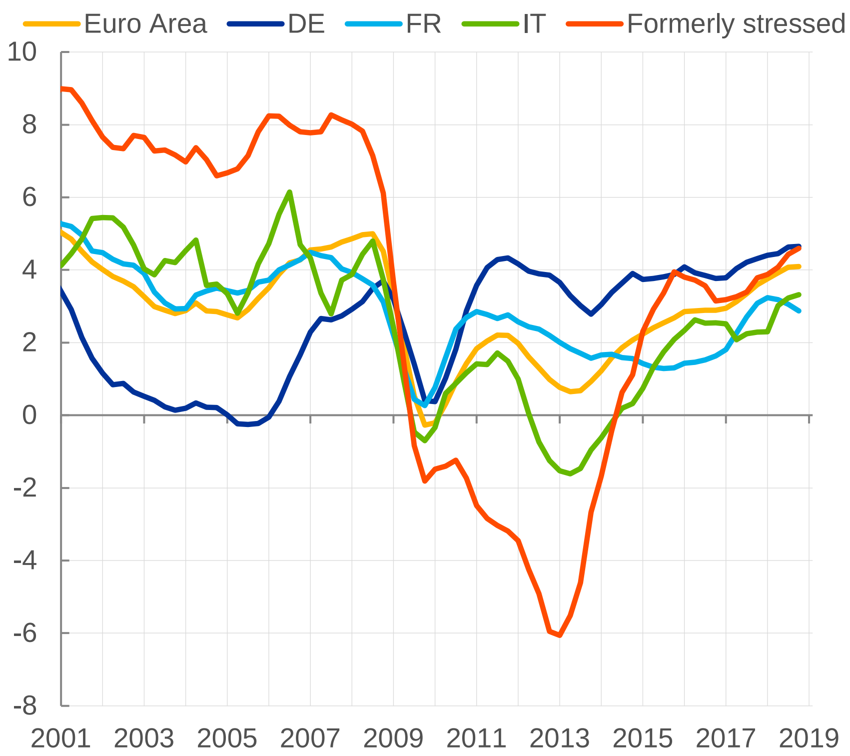
Germany: Hypotheses for corporate net lending and the CA

Hypothesis	Rationale
Financial Friction Hypothesis Fiore and Uhlig (2015)	Shortfall of available funds at low interest rates due to soaring risk premiums
Wage Moderation and Labor Market Reforms Berger and Wolff (2017), Dustmann et al. (2014)	Wage moderation due to outsourcing and labour market deregulation
World Demand and German Exports Schuknecht (2014)	Boom in global economy and higher demand for German export products

	Horizon	CA/GDP	CS/CINV
Labor Market Shock	Impact	12.96	8.87
		(2.21, 29.80)	(1.52, 25.24)
	1 Year	12.78	7.69
		(3.84, 25.33)	(1.88, 19.93)
	4 Years	9.61	6.84
		(4.41, 17.69)	(3.13, 13.33)
Financial Friction Shock	Impact	5.04	16.39
		(0.41, 19.76)	(3.87, 36.95)
	1 Year	7.82	26.26
		(1.90, 22.13)	(13.46, 41.38)
	4 Years	9.89	22.16
		(3.84, 20.38)	(12.51, 34.17)
World Demand Shock	Impact	19.54	6.80
		(4.94, 40.69)	(0.52, 22.82)
	1 Year	19.88	7.76
		(7.02, 37.20)	(2.50, 20.34)
	4 Years	16.04	7.91
		(7.12, 28.04)	(3.37, 15.44)

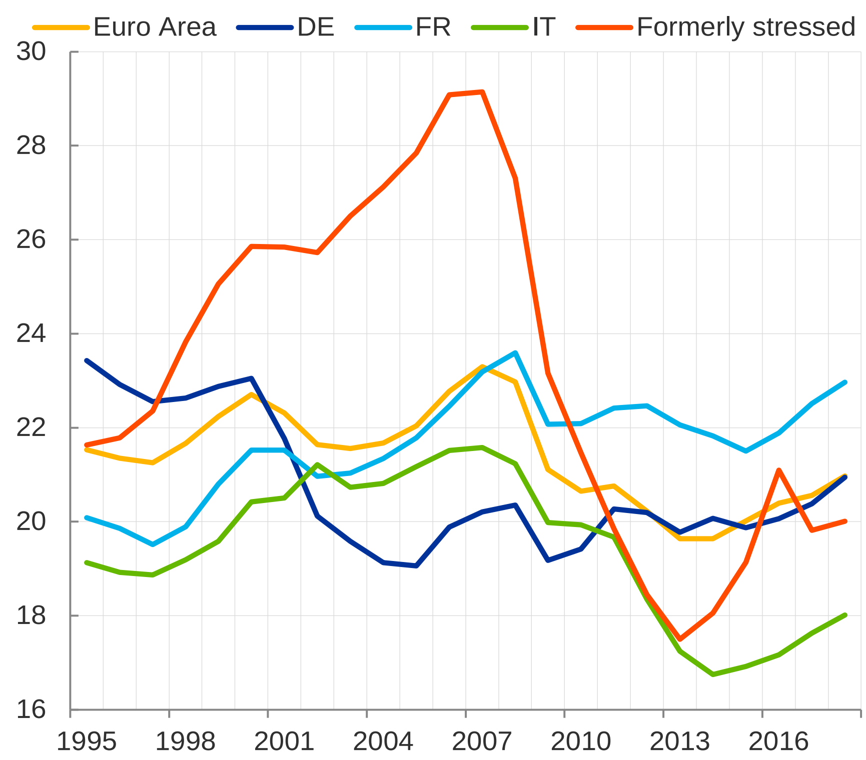
Source: Thorsten Klug & Eric Mayer & Tobias Schuler, 2018. "The Corporate Saving Glut and the Current Account in Germany," ifo Working Paper Series No. 280.
Note: Results of the forecast error variance decomposition (RHS) are in % and 68% credible sets are in brackets. CA: Current Account, CS: Corporate Savings, CINV: Corporate Investements.

Compensation of employees
(annual % changes)



Sources: Eurostat and ECB calculations.
Notes: Figures are NSA, 4Q moving average. Formerly stressed economies report GDP-weighted average of PT, GR, IE, ES and CY. Latest observation: 2018Q4.

Total investment
(Gross fixed capital formation in % of GDP)



Source: Eurostat and ECB calculations.
Note: Formerly stressed economies include: PT, GR, IE, ES and CY. Total investment in intellectual property products in 2016 in Ireland doubled in 2015 related to shifts of intellectual property product assets from other countries to Ireland by large firms. EIB Investment Report 2017/2018 (2017).

Overview

Bottom line so far:

1. Remarkable external and fiscal adjustment in former programme countries, but still need to build buffer;

2. Structural rigidities have delayed the nominal adjustment and made the real adjustment more costly (high unemployment);

Where sustainable growth can come from?

1. Higher flexibility in product and labour markets;

2. Efficient use of public spending and growth-friendly tax system;

3. Better institutions and more efficient framework conditions (competition framework, judicial system, etc);

4. Further rebalancing of cost/price competitiveness needed in some cases;

→ Role of structural reforms is key

(see among others Masuch et al 2018, Structural Policies in the Euro Area, ECB Occasional Paper, No 210)

Excerpt from the June 2019 introductory statement at the press conference

"(…) In order to reap the full benefits from our monetary policy measures, other policy areas must contribute more decisively to ***raising the longer-term growth potential and reducing vulnerabilities.***

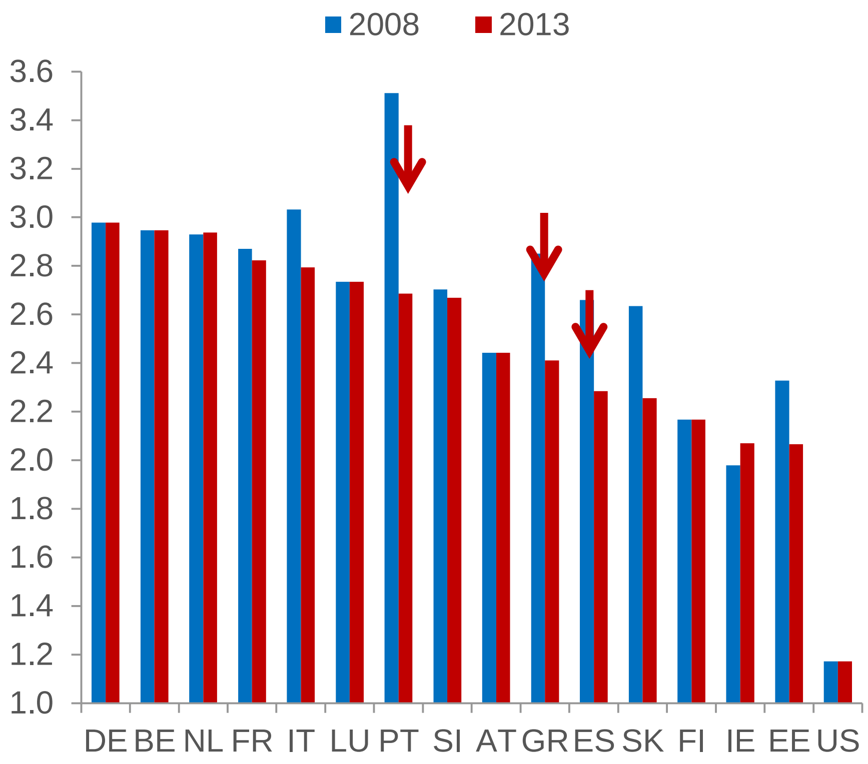
"The ***implementation of structural reforms in euro area countries needs to be substantially stepped up*** *to increase resilience, reduce structural unemployment and boost euro area productivity and growth potential. The 2019 country-specific recommendations should serve as the relevant signpost."*

"(…) ***Improving the functioning of Economic and Monetary Union remains a priority****. The Governing Council welcomes the ongoing work and urges further specific and decisive steps to complete the banking union and the capital markets union."*

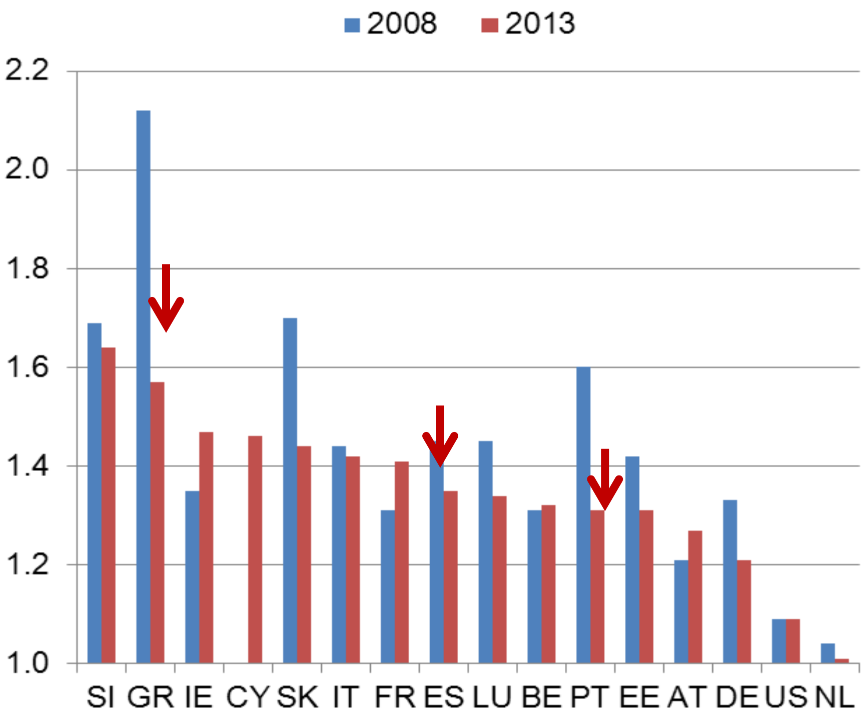
Remarkable reforms undertaken in programme countries...

Employment-, competition- and productivity-enhancing reforms.

Employment protection legislation
(overall strictness for individual and collective dismissals)



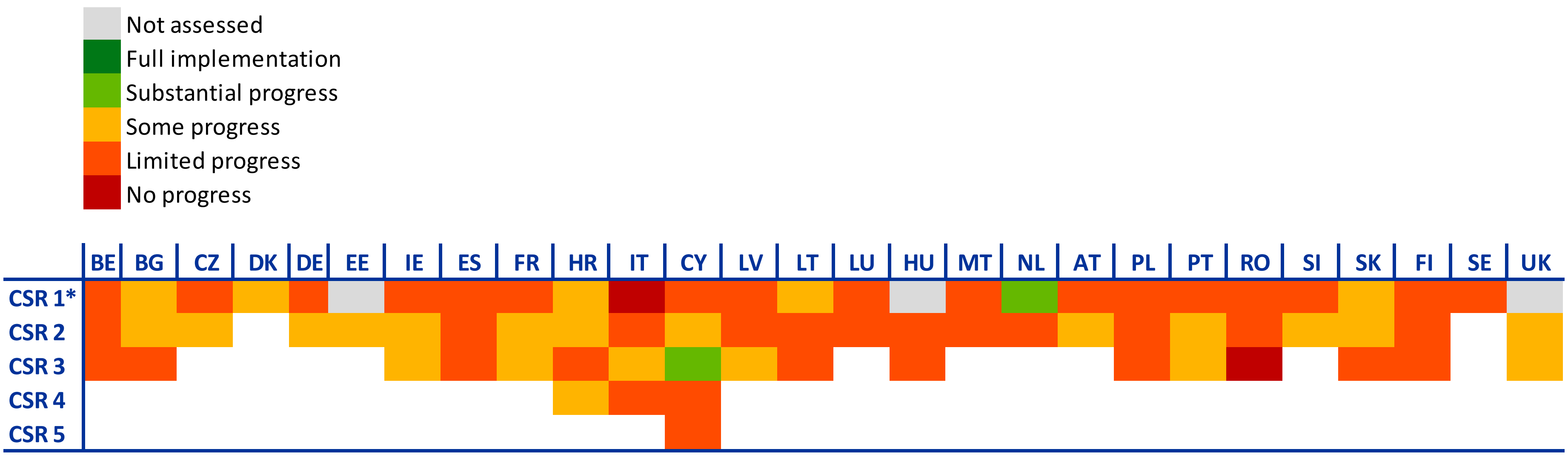
Product market regulation index



Source: OECD

Only two of all 2018 EU country-specific reform recommendations have been substantially implemented.

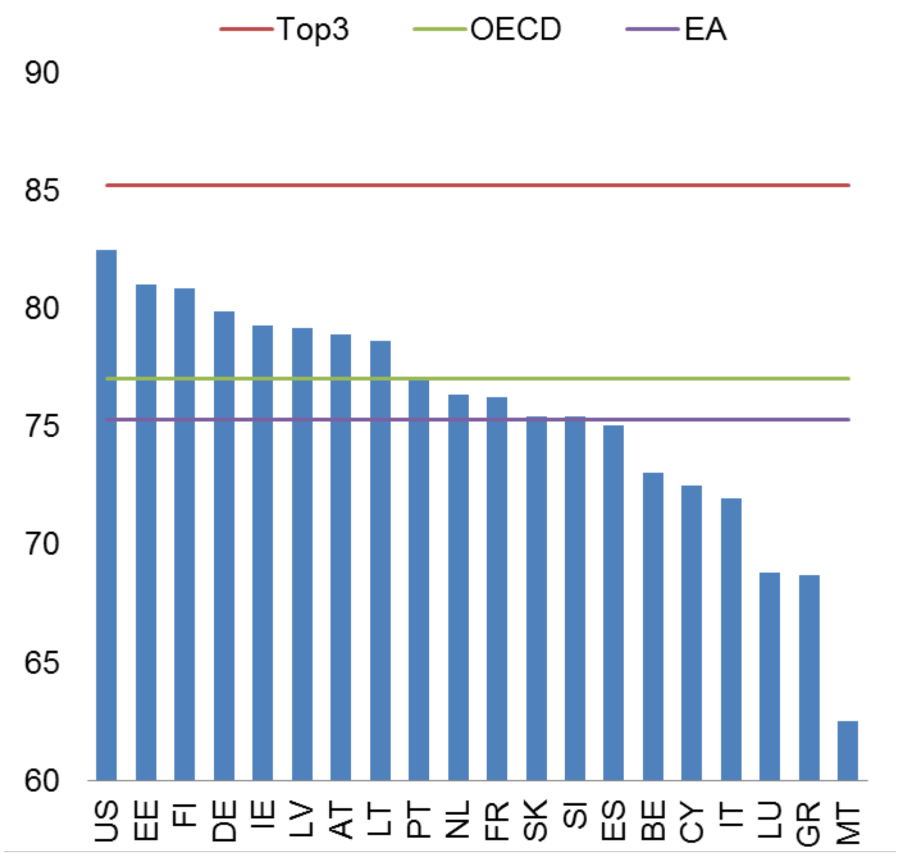
Implementation of 2018 country-specific recommendations (CSRs) by EU Member States



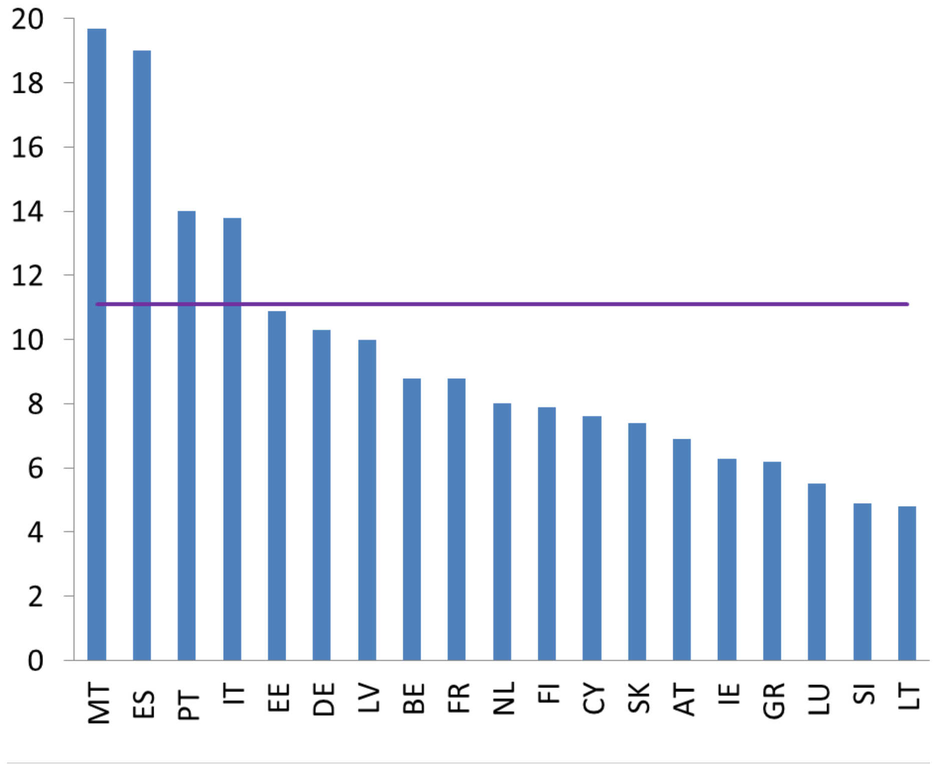
Sources: European Commission. Countries under a macroeconomic adjustment programme don't receive CSRs. * CSR1 is only partly assessed as it refers to the SGP requirements assessed only in May.

Economic structures do not function equally well across EA

The ease of Doing Business indicator
(*distance to best practice*)



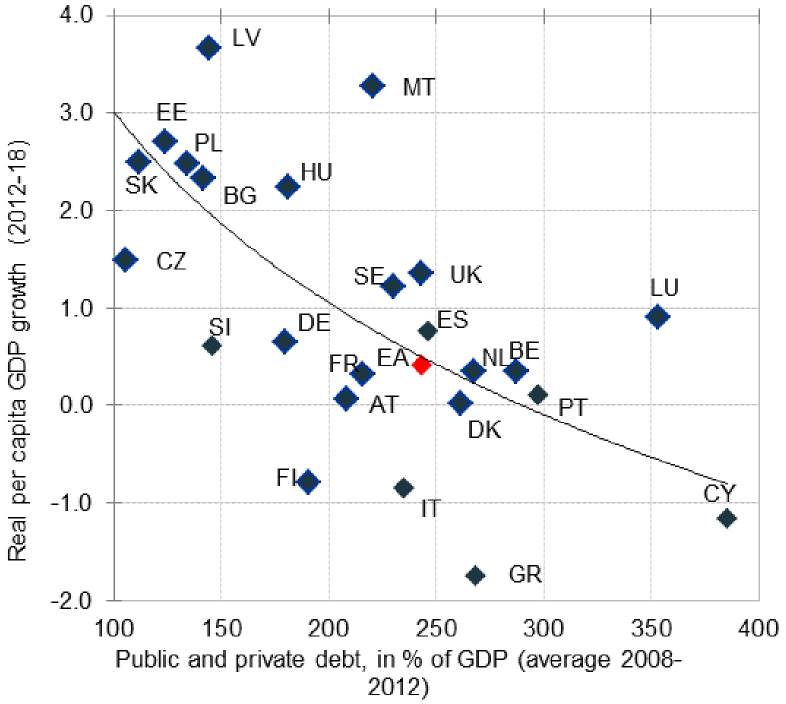
Early school leavers
(*in % of population 18-24*)



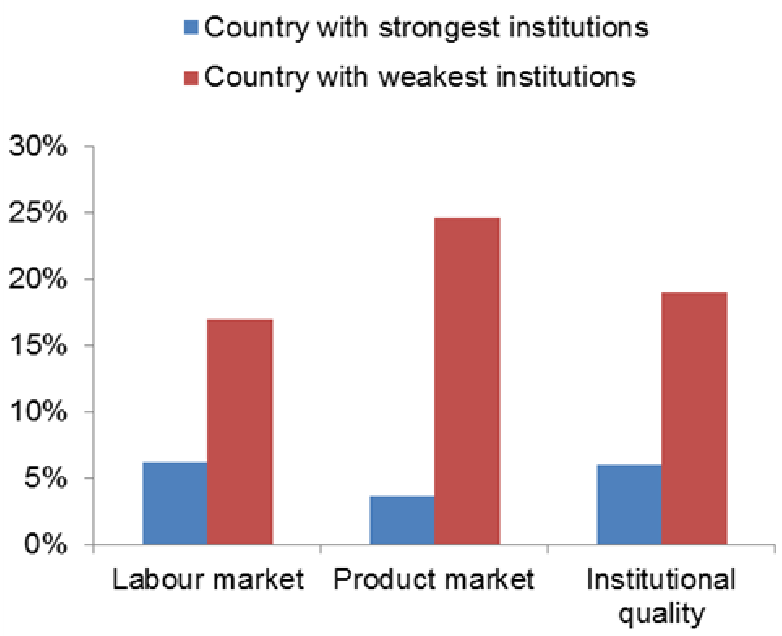
Source: World Bank (left chart) and Heritage Foundation (right chart).
Notes: Doing Business covers areas such as costs/time related to starting a business, construction permits, getting credit, enforcing contracts etc.. The Economic Freedom indictor covers four areas including (i) rule of law (property rights, corruption), (ii) government size (fiscal freedom, government spending), (iii) regulatory efficiency (business freedom, labour freedom), (iv) market openness (trade freedom, investment freedom, financial freedom).

Vulnerabilities/rigidities limit growth and resilience to shocks

Lower debt associated with higher economic growth



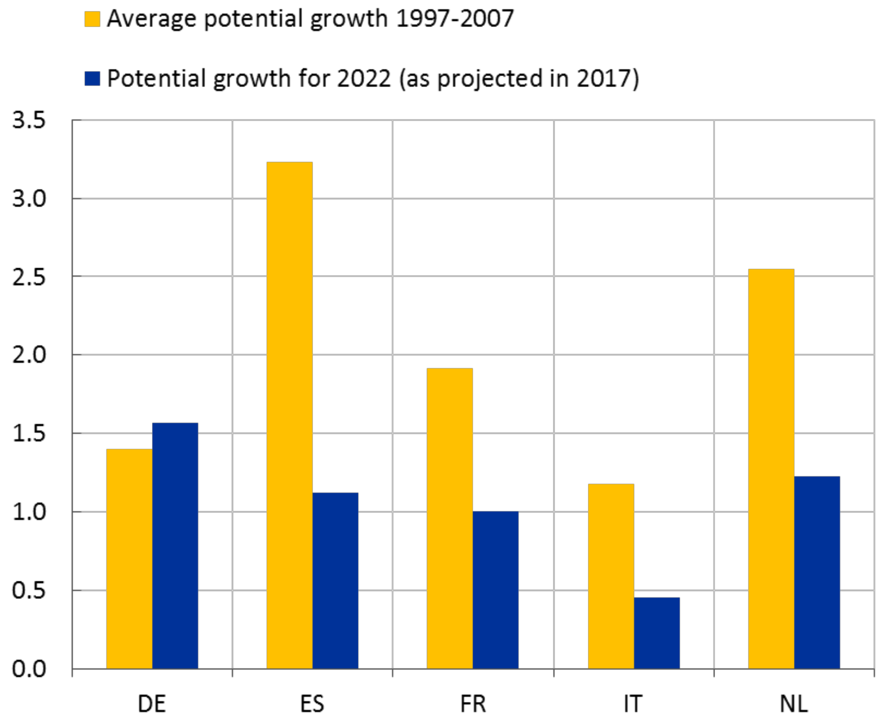
Stronger institutions reduce crisis incidents



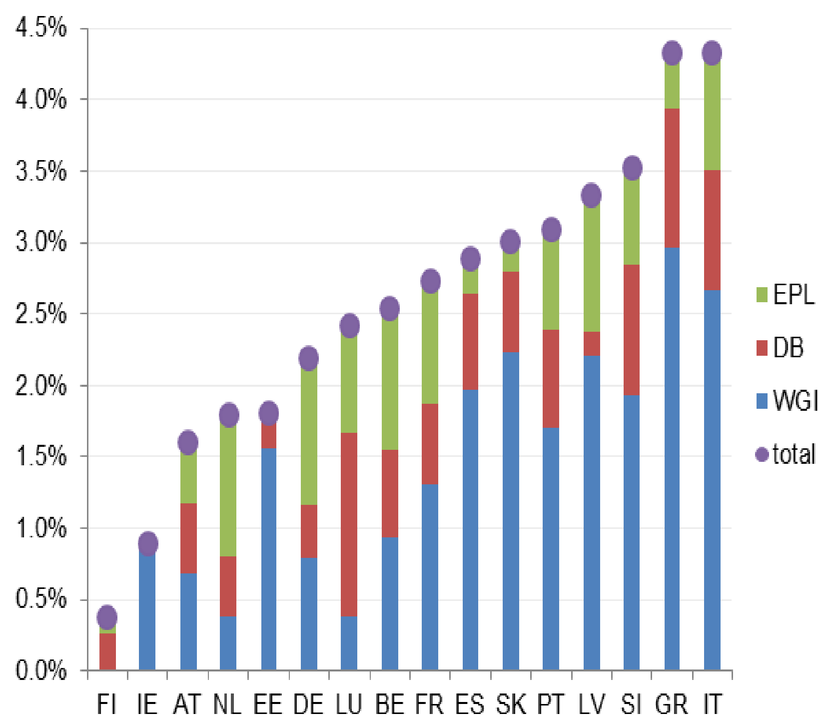
Source: LHS, ECB and Commission; RHS: Sondermann (2018), Towards more resilient economies: The role of well-functioning economic structures, Journal of Policy Modeling, Vol 40(1), 97-117. Notes: right hand chart: *p<0.1; **p<0.05; ***p<0.001. Robust standard errors in brackets. The table shows the result of a probit model where the probability of crisis is computed on the extremes of institutional variables, i.e. the lowest and the highest institutional values across countries, while control variables are assumed to be average.

Improving institutions would support weak projected growth

Potential output growth estimations
(average 2016-20)



Increase in TFP achievable by moving the structural and institutional indicators towards best performers



Sources: Eurostat, EC, IMF, ECB. Notes right hand chart: Best performers are: Ireland on doing business, Finland on governance, Estonia on employment protection

Objective: prevent the emergence of harmful imbalances and correct imbalances already in place.

November (year t-1)

Alert Mechanism Review (EC):

I. Scoreboard indicators
II. **Identifying** countries which require further analysis

No further analysis needed: **FI, BE, HU, RO, UK, AT, DK, LU, LT, LV, EE, CZ, MT, PL, SI, SK**

March (year t)

In-depth reviews (EC):

I. Based on wider indicators than scoreboard and assessment of previous year's recommendations
II. Surveillance missions

March-June (year t)

- EC decides whether to open or not the **Excessive Imbalance Procedure (EIP)**
- Council adopts final **country specific recommendations**

No problem Procedure stops	**Imbalances**	**A: Excessive imbalances** **B: Excessive imbalance procedure**
2019 MIP: --	**BG, DE, IE, ES, FR, HR, NL, PT, RO, SE**	**A: GR, IT, CY** **B: --**

Can the current framework be further improved to facilitate better reform implementation?

A. Main avenues proposed in the *"Five Presidents' Report"* (2015):

- **More traction of MIP**: as a rule apply the EIP when imbalances are excessive;
- Create **National Productivity Boards** that raise awareness for reform needs;
- Contemplate on **financial incentives for structural reforms**
- Initiate a "**binding convergence process towards more resilient economic structures"**, among others by identifying best practice structural reforms

B. Various proposals published recently take up some of those suggestions:

- e.g. European Commission's May 2018 package, e.g. on a "reform delivery tool", current discussion on a euro area budgetary instrument (BICC)

Overview

Conclusions

- **Macroeconomic imbalances** (e.g. current account balances, labour costs, or credit growth) **have started to adjust** since the beginning of the crisis
- However, the **adjustment remains somewhat asymmetric**, with still relatively high current account surplus positions in some countries.
- Despite the adjustment, **vulnerabilities remain high** (legacy debt, unemployment or remaining rigidities), **limiting resilience to shocks and growth potential**
- Credible and decisive **structural reforms are crucial** to change this.
- **Significant reform progress achieved by vulnerable EA countries during programme,** but it has weakened over the past two years.
- **Overall insufficient reform progress in EA countries**, also in the largest countries, **is concerning**