Overview

European monetary union facing crucial challenges

Monetary union facing severe test

The international financial markets came under considerable tension in the early part of the year as Greece's sovereign debt crisis deteriorated. Over the preceding months, the developments in Greece had ballooned into a crisis of confidence from which the country was unable to liberate itself single-handedly. Given that Greece had breached the European rules for many years prior to the crisis, its plight is not comparable with the fiscal policy problems of other euro-area countries. However, in a market environment characterised by heightened uncertainty about the deterioration of public finances, this resulted in contagion effects and losses of confidence in other euro-area countries as well. This led in early May to an escalation of the situation in the markets for these countries' government bonds. Despite the policy decisions taken at this time to support Greece, the tensions threatened to snowball into an unstoppable avalanche which would have jeopardised the stability of European monetary union and the global financial markets. Against that background, in mid-May the EU finance ministers, after finalising financial assistance for Greece, agreed on extensive additional assistance measures and mechanisms.

The precariousness of the situation necessitated a prompt and far-reaching response. The policy measures taken have nevertheless put a considerable strain on the institutional foundations of monetary union. It is therefore vital that the appropriate lessons from developments over the past few weeks are swiftly

drawn and speedily implemented. However, the tensions in the financial markets are not the cause of the problem but a rather a manifestation of worries about the perceived unsustainability of public finances in some euro-area member states as well as the resultant uncertainty. Therefore, it is primarily the responsibility of the countries concerned to resolutely implement a credible consolidation strategy and to embed this within a macroeconomic reform package with a view to rapidly regaining the confidence that has been lost.

Recent developments have, in addition, revealed weaknesses in the euro area's current fiscal policy rules. Reform in this area is therefore urgently required. Central aspects of the framework must be re-tightened, and incentives for encouraging national responsibility to safeguard sound public finances need to be strengthened significantly. One crucial need is to ensure comprehensive consolidation of public finances and to anchor the fiscal procedures, which do not appear to have had a sufficiently disciplining effect in the past, in a tighter and more automated framework at arm's length from the political bargaining process. Another key requirement, in a potential assistance case, is to increase the responsibility of and incentives for the country concerned to return to a sound budgetary position. The granting of assistance has to be subject to strict conditions which must be closely monitored and scrupulously complied with. In addition, the scenario of a payment default must remain possible and the introduction of a sovereign insolvency procedure seriously considered. Lastly, it is necessary to put in place institutional arrangements ensuring that a member state which draws on an assistance programme implements the measures necessary to safeguard stability and does not, for instance, consciously incur a risk of jeopardising the union's existence. The rapid implementation of such a package of proposals in the context of a reformed regulatory framework would make a crucial contribution to safeguarding monetary union as a community of stability also in a changed underlying setting. To ensure that monetary union is placed on a sound long-term footing, it is vital that policymakers use the current brief respite in order to initiate reforms.

Global economy

Confidence in stable and reliable underlying conditions in the euro area is, moreover, a key basis for underpinning the recovery of the global economy. The real economic environment is currently looking relatively favourable. The worldwide economic upswing has continued to strengthen since the beginning of the year, and the recent rise in uncertainty in the international financial markets has not yet impacted on the real sector. Against this background, numerous international organisations – including the International Monetary Fund – have noticeably revised upwards their forecasts for the growth of the world economy and world trade for this year.

The overall robust global economic momentum, however, is masking perceptible regional differences in growth rates. These disparities had already emerged at the end of last year and persisted throughout the reporting period. The emerging market economies – especially in East Asia – continued to grow

at an impressive pace, with some economies even beginning to show signs of overheating. By contrast, the industrial countries, on the whole, maintained their much more moderate rate of overall economic growth in the first few months of this year. Within this group of countries, Japan and the United States achieved quite strong GDP growth, whereas the euro area's aggregate output expanded only slightly. In some euro-area states, however, the perceptible dampening effects of the unusually cold winter also played a role. The leading indicators for the global economy point to a continuation of the brisk recovery during the second and third quarters, with expectations rising steadily throughout the reporting period.

Financial market environment

In the financial markets, the escalation of the debt crisis in Greece triggered a fundamental reassessment of the risks emanating from public indebtedness in other euro-area countries, too. This increasingly depressed sentiment in the international financial markets, which had still been benign at the beginning of the year – not least against the backdrop of the robust outlook for the real economy.

Eventually, the prices of government bonds in various euro-area countries plummeted drastically and sovereign yield spreads widened to unprecedented levels. In turn, the attendant risks to the stability of the financial systems in the countries concerned dragged down European and global stock markets. The euro's exchange rate likewise came under pressure. Since the root causes of the problem are to be found in the euro area itself, the euro depreciated across a broad front, effectively losing 8½% of its value vis-à-vis the currencies of the euro area's major trading partners since the beginning of the year. The euro's slide against the US dollar during this period was particularly pronounced.

The stabilisation package adopted in mid-May briefly halted the drop in prices in the markets for south European countries' sovereign bonds. It has not yet lastingly eased the tensions on the financial markets, however. This will only occur after credible consolidation measures have been taken to restore confidence in the sustainability of public finances in the countries concerned.

Monetary policy

Macroeconomic recovery in the euro area proceeded merely at a moderate pace, owing in part to weather-related factors. Given the ongoing marked underutilisation of output capacity and muted monetary and credit growth, there was no reason to change the key monetary policy interest rates. However, in the past few months, some marked adjustments were made to the monetary policy operational setting. After continuing to exit from its non-standard monetary policy measures in the first few months of the year amidst the recovery in the money and financial markets observable up to then, the Governing Council of the ECB responded to the resurgence of tension in the financial markets by halting the exit process and actually reversing it in some areas. It thus resumed full allotment for three-month longer-term refinancing operations (LTRO), launched a renewed indexed six-month LTRO in mid-May and reopened a US dollar swap window in response to emerging strains in the supply of foreign

currency-denominated liquidity. Moreover, the Governing Council adopted a reform of its collateral framework, introducing a transition to a graduated haircut regime extending down to a BBB- rating (or equivalent) to take effect on 1 January 2011. This floor was suspended, however, until further notice for marketable debt instruments issued or guaranteed by the Greek government after the Governing Council assessed Greece's consolidation programme as being appropriate.

In the light of the tense situation in the markets for government bonds issued by some euro-area countries, the Governing Council of the ECB also approved, with effect from 10 May 2010, the purchase of private and public debt securities in dysfunctional market segments. This measure harbours substantial stability policy risks. Maximum efforts must be made to minimise these risks in the course of implementing the measures and, in particular, to clearly segregate the spheres of responsibility for monetary policy and fiscal policy.

During the period under review, both monetary and credit growth remained subdued. However, loans to non-financial corporations virtually levelled off following three quarters of sharp falls. This is consistent with the empirical finding of a lagged reaction of this credit component during the business cycle. All in all, the medium-term dynamics of monetary and credit expansion do not indicate any pronounced danger to euro-area price stability.

German economy

The renewed turmoil in the financial markets has so far had no impact on real economic developments in Germany. The German economy's upturn continued into 2010, despite temporary strains, and seems to have accelerated distinctly in spring. In the second quarter, economic output is likely to see strong growth.

In a global economic environment that remains favourable, the German recovery is still being fuelled by exports. Owing not least to the dynamic growth of the emerging market economies and the increasingly entrenched upswing in the United States, the German economy has already reversed half of the decline in exports to non-euro-area countries which resulted from the global economic slump. By contrast, much less progress has been made in the recovery of its exports to its euro-area trading partners. The short-term dampening in the overall economic outlook for numerous euro-area countries that will probably occur owing to the urgent need for fiscal consolidation suggests that this situation is unlikely to change quickly or radically.

The decline in investment in machinery and equipment at the end of last year was cancelled out by a surplus in the first quarter. It has largely stabilised since the significant correction that occurred at the beginning of 2009. This is quite noteworthy from a cyclical perspective considering that output capacity is still being underutilised. Although construction investment was perceptibly squeezed by the cold and snowy winter weather at the beginning of the year, the fall-off was more limited than might have been expected given

the severe weather. In addition, recent data indicate that part of the shortfall might have already been recouped in March.

Apart from some exceptional strains, the underlying trend in private consumption has remained quite stable. Although households curtailed their real consumer spending in the first quarter, this reduction may have been partly attributable to the downturn in car purchases, which lasted into February, following the expiry of the government incentive to replace older vehicles ("environmental premium"). By contrast, retail sales, at least, more or less maintained their pre-quarter level.

One significant factor which might explain the relative robustness of consumption is the continued remarkable resilience of the German labour market. After stripping out seasonal factors, the level of employment remained virtually unchanged. The number of jobs subject to social insurance contributions even picked up slightly, while unemployment was down on the quarter. Although the jobless figures rose slightly after taking labour market support measures into account, the surprisingly muted labour market response to both the severe slump in the real economy and the ongoing underutilisation of capacity remains essentially valid.

In the first quarter of 2010, prices tended to point upwards again at all production and distribution stages. The disinflation process that had been evident since the end of 2008, and which had emanated from commodity prices and subsequently worked through to finished products, has thus come to an end and been superseded by a rising tendency. At the upstream stages of production, energy prices, in particular, rose sharply. This is being reflected in the corresponding components of import prices. At the consumer price level, too, the seasonally adjusted rate of price increases has been appreciably affected by higher energy prices along with weather-related rises in food prices. Domestically induced inflation, by contrast, is likely to remain extremely subdued for the time being.

Germany's economy is thus on a recovery path, the underlying dynamics of which, according to current indicators, do not appear to be at risk. The main momentum propelling the upturn will continue to come from the external sector, especially from non-European sales markets, which are currently recording unbridled growth. In addition, German exports to those markets are benefiting from shifts in international currency parities, although the importance of the price component as a determinant of German exports should not be overstated. The positive sentiment in the manufacturing industry is, moreover, being supported by a regionally broadly based surge in new orders. Demand from the rest of the euro area likewise rose sharply at the beginning of the year. Moreover, the development of credit to non-financial corporations continues to show no indication of any credit crunch. Along with the stable labour market situation, the upbeat mood in the manufacturing sector is also due in part to current household optimism. Given the stable labour market situation, the fear of being laid off does not appear to be a paramount con-

cern at the moment. This gives grounds for hoping that the export-led recovery will be additionally buoyed by domestic demand going forward. On the whole, however, it must be borne in mind that the situation remains fragile and uncertainty in the financial markets is high; these factors represent a strain on, and risk to, such a positive scenario.

Public finances

Despite the stable cyclical outlook, the slump in macroeconomic activity and the fiscal policy response to the slump have left deep scars on German public budgets. The deficit ratio could surge from 3.1% last year to somewhere approaching the 5% mark this year. This development is primarily the result of extensive fiscal policy measures, particularly tax relief and higher public investment spending, not least with a view to stabilising economic momentum.

But on balance, in view of the more favourable macroeconomic setting, the outturn for 2010 could well be more favourable than the projection in the Federal Government's stability programme of January 2010 (deficit ratio of 5½%). Given the very high deficits and a continued rapid rise in indebtedness, a more positive-than-planned development should be used, however, not for relaxing budgetary discipline but instead for faster fiscal consolidation. This is also required by the conditions imposed by the excessive deficit procedure and the continuing need for extensive consolidation at all levels of government.

This concerns not least the central government budget. The associated budget plan presented in March included an extraordinarily high deficit appropriation which in the course of budget implementation is likely to be much lower. For instance, the latest tax estimate projects additional revenue of around €4½ billion compared with the budgeted amount; an additional €4½ billion in revenue from mobile phone licence auctions will also have an impact; and on the expenditure side, too, lower-than-expected spending is foreseeable given the robust labour market situation. The actual central government deficit is likely to be well under €70 billion. The budget plan, however, envisages net borrowing of €80 billion.

The structural deficit, too, will be much lower than estimated (€66½ billion). According to the new debt rule, the 2010 structural deficit will form the basis for the prescribed declining annual borrowing limit in the transitional period up to 2016. The higher this starting level, the greater the leeway for borrowing will be during that period. In order not to endanger the credibility of the new rule, policymakers must resist the temptation to temper and tamper with it prior to its initial implementation by creating loopholes and to delay the necessary consolidation, as has happened so often in the past. The "reduction of the existing deficit" criterion enshrined in the German constitution requires that the budget be based at least on a current estimate of the structural deficit for 2010 rather than the budget target. Moreover, in keeping with the spirit of the new budget rule, one-off grants to social insurance schemes should not be counted against the structural deficit.

The assumption of guarantees in connection with a European Stabilisation Mechanism*

At the end of April, the deteriorating budget and economic situation in Greece ballooned into a crisis of confidence from which the country was unable to liberate itself single-handedly. This was the upshot of developments over many years during which Greece had massively and irresponsibly breached European agreements and rules. Looking back, its budgetary and economic policies stood in stark contrast to the stability requirements of a single currency area. Once the full extent of these failings had come to light, the financial markets began to fundamentally question Greece's ability to continue to meet its debt-servicing and repayment obligations in future without a comprehensive correction of its fiscal and economic policies, in the wake of which Greece found it virtually impossible to raise new funds on the capital markets. In this very fragile situation, a sovereign default by Greece could have triggered a considerable contagion risk for other member states of the euro area. The euro-area finance ministers therefore decided to grant financial assistance to Greece based on strict conditionality, and in Germany this assistance was approved by the Bundestag on 7 May 2010. In its opinion on the relevant draft legislation, the Bundesbank put aside its fundamental reservations and assessed Germany's participation in this assistance package as being justifiable under the exceptional circumstances, despite the high risks involved.

Before the package was definitively approved, the situation in the capital markets worsened further. The aim of containing the threat of contagion emanating from Greece was not attained. Despite the decisions taken, there was a growing danger that the swelling tensions might snowball into an unstoppable avalanche which could have impaired the stability of European monetary union and might also have entailed grave consequences for the entire global economy. This was the unanimous conclusion reached on the weekend of 8-9 May 2010 by numerous international institutions and the major central banks – including the Deutsche Bundesbank. Given this serious and immediate danger, the EU finance ministers adopted a package of stabilisation measures on 10 May 2010. This package finalised the assistance for Greece that had been agreed earlier. The announcement of the support programme was accompanied by a pledge to accelerate the consolidation of public budgets and reform the fiscal rules and by the intention to set up a European financial stabilisation mechanism. There are two purposes to this stabilisation mechanism. One is to enable the EU to provide financial assistance to member states seriously threatened with severe difficulties caused by exceptional occurrences beyond their control. The other is, should the envisaged funds not suffice, to set up a special purpose vehicle, due to expire after three years, which can grant loans to euro-area member states. The necessary resources would be raised in the capital market and guaranteed on a *pro rata* basis by the other euro-area countries. The European Financial Stabilisation Mechanism is to be supplemented by credit lines from the International Monetary Fund.

With regard to the envisaged European Stabilisation Mechanism, it is important that any drawdown of funds be subject to strict economic and fiscal policy conditionality. The intended financial and material involvement of the International Monetary Fund in the agreed assistance programmes, such as in the Greek precedent, is therefore logical. Moreover, it is also important that the granting of assistance be subject to agreement with the guarantors – especially Germany as the largest single contributor. The interest terms must be designed to create a tangible incentive to rapidly regain the confidence of potential donors and resume capital market financing. The terms and conditions of assistance to Greece are a suitable benchmark. It is equally important that the special purpose vehicle which forms the second part of the European Stabilisation Mechanism is a limited-term facility. By contrast, the first part of the mechanism is of unlimited duration and thus, despite its limited volume, opens the door to a permanent arrangement financed by EU borrowing. The provision of such a permanent safety net for countries threatened with insolvency severely strains the underlying principle of monetary union, namely that member states are individually responsible for their own public finances; it is therefore more problematic than the assistance given to Greece, which was *ad hoc* and granted only on very specific terms and conditions, or the temporary assistance offered by the special purpose vehicle. This creates moral hazard both for governments and for holders of government bonds. This moral hazard can be contained by attaching strict conditionality to drawings on these resources and imposing far-reaching consequences for violations of this conditionality

* Opinion expressed by Professor Axel A Weber, President of the Deutsche Bundesbank, at the 19 May 2010 public hearing of the Budget Committee of the German Bundestag on the Draft Act Assuming Guarantees in Connection with a European Stabilisation Mechanism.

on the member state in question. For instance, the mechanism should only be capable of being activated if financial stability is in jeopardy throughout the euro area. The aim must under no circumstances be to mitigate a member state's financing problems on a discretionary basis. On the contrary: strict fiscal and economic policy conditionality should motivate the member state to quickly return to a sound budgetary position and regain access to capital market financing.

All in all, the decisions taken on 10 May 2010 by the EU finance ministers appear justifiable in the light of the risks to the stability of European monetary union and the development of the global economy. The decisions, however, place a severe strain on the foundations of monetary union. Rapid and resolute action is therefore necessary to stabilise and reinforce the weakened foundations of monetary union so that similar escalations can be avoided in future. It is particularly crucial to underpin the rescue measures, as envisaged, with moves to improve statistical reporting and especially to tighten the existing fiscal rules. A major requirement is to attach greater importance to the debt criterion in future. Rules should be laid down for debt ratios in excess of 60% spelling out a timetable for their reduction and the sanctions for non-compliance. The deficit criterion can be strengthened by closing the loopholes introduced by the last reform of the Stability and Growth Pact and attaching greater importance to *ex ante* compliance with the rules. In general, responses to policy aberrations must be expedited and hence the current procedure accelerated. A key need is to improve the hitherto often inadequate implementation of the rules, eg by making the imposition of sanctions less subject to political bargaining and more rule-bound. Another sensible measure would be a commitment to anchor the European fiscal framework – especially the medium-term budgetary objectives – more strongly in national budgetary legislation, as Germany has done with the introduction of a debt brake. In clear cases of misguided policies, increased macroeconomic surveillance at the European level is doubtless also called for. However, in the current framework, not only the independence of monetary policy but also the subsidiarity principle need to be observed. Wholesale moves towards centralisation and fine-tuning would be worryingly dubious. For instance, the relatively broadbrush expansion of deficits and debt in the context of the European Economic Recovery Programme needs to be critically appraised in the light of whether it may, in fact, have helped to worsen the current problems in some countries. Recent calls for a more expansionary fiscal policy and wage increases in Germany likewise give reason to doubt that stronger policy coordination would necessarily contribute to tackling the root causes of the crisis.

If the support measures necessitated by the debt crisis in some countries are not followed up in the foreseeable future by efforts to create a far-reaching, democratically legitimised political union and, instead, member states themselves continue to retain ultimate decision-making authority for their national fiscal and economic policies, monetary union will have to be reinforced as a community of stability by additional reforms that extend beyond tightening the current fiscal framework. A variety of possible measures have already been suggested. Thus, besides moves to strengthen the existing arrangements in the Stability and Growth Pact, the establishment of a sovereign insolvency procedure has also been put forward as a key element of a reformed framework. In addition, further-reaching sanction mechanisms should be considered in the event that a member state which draws on a support programme fails to implement the necessary measures to maintain its stability and thereby consciously jeopardises the union's existence. In the light of the recently agreed decisions, implementation of these proposals would make an important contribution to safeguarding monetary union as a community of stability also in a changed overall environment.

The Eurosystem, with its single monetary policy, will remain committed to the goal of ensuring price stability in the euro area. It is the task of fiscal policy, through sound public finances and a suitable institutional framework, to ensure that monetary policy is appropriately supported in a monetary union that rests on a foundation of stability. Recent developments have revealed weaknesses in the existing fiscal framework and exposed the economic consequences of many years of diverging competitive positions across the euro area. If monetary union is to be placed on a firm long-term footing, it is vital that policymakers use the current brief respite to initiate reforms.

Developments over the past few weeks have once again forcefully driven home the point that the safeguarding of sustainable public finances and the reduction of the high debt levels are crucial prerequisites for the stability of European monetary union. The European fiscal framework is currently being put to its severest test since the launch of monetary union. It will be especially important not only to shore up the damaged institutional foundations but also for those member states which are currently confronted with particularly challenging fiscal problems to live up to their responsibilities and to regain lost confidence. However, German fiscal policymakers, too, should play a prominent role in ensuring that the fiscal framework in the euro area is made truly binding on the member states.