Overview

Background

Macroeconomic imbalances built up after the euro was introduced

In the years following the introduction of the euro, considerable macroeconomic imbalances accumulated in some euro-area member states. Although the type and extent vary from one country to the next, these imbalances have much in common. A sharp drop in price competitiveness and a significant rise in current account deficits were manifestations of these imbalances. In most cases, they were spurred by relatively strong growth of domestic demand and, in several cases, a real-estate boom. The result was a constant diversion of factors of production towards domestically oriented sectors. As the macroeconomic growth, which took place in an environment of favourable financing conditions, was accompanied by very strong credit growth, households' and enterprises' indebtedness rose. A large portion of the funding was raised through the individual banking systems, the balance sheets of which grew, in some cases considerably. On the whole, the sustainability of economic growth, the readiness of production structures for the future, the income outlook going forward and the recoverability of many assets were gravely overstated. The state of government finances was likewise assessed overoptimistically: public authorities benefited greatly from imbalances driven by domestic demand, and the additional latitude offered by lower funding costs was often not used for thorough consolidation; instead, in many instances government spending expanded considerably.

Growing weight of domestic activity, rising indebtedness

Outbreak of the crisis and adjustment processes

Crisis led to fundamental reassessment of risks

The outbreak of the financial and economic crisis in 2007-08 brought the expansion process of the previous years, which had generally not been sustainable, to an abrupt halt. The outlook for growth and, in the same context, the creditworthiness of households, enterprises, financial institutions and also general government were fundamentally reassessed. The outbreak of the debt crisis in spring 2010 represented the most severe test of the resilience of the monetary union in its entire history. Not only the regulatory framework of monetary union, resting on the pillars of member states' individual responsibility and the primacy of a stability-oriented monetary policy, but also the economies of many member states came under massive pressure: Greece, Ireland, Portugal and, most recently, Cyprus, needed considerable financial assistance from the other member states and, in return, agreed to implement comprehensive macroeconomic adjustment programmes; Spain likewise received conditional financial assistance to prop up its financial system.

Fiscal and monetary policy countermeasures enabled a gentler adjustment process

In order to grant such conditional assistance, the ultimate goal of which was to avert threats to the financial stability of the euro area as a whole, bilateral aid for Greece was followed up initially by the creation of the European Financial Stability Facility (EFSF) and the European Financial Stabilisation mechanism (EFSM), which was then succeeded by the European Stability Mechanism (ESM). In addition, the Eurosystem once again stepped up the quantity and quality of the extensive non-standard measures it had already taken during the financial and economic crisis. The primary beneficiaries were the countries particularly affected by the crisis and their banking systems, which received access to additional liquidity at favourable terms and conditions and at reduced collateral requirements. The higher risk premiums demanded by the capital markets were therefore not fully passed through to borrowers. In the end, outflows or reduced inflows of private sector funds were made up for, and a gentler process of macroeconomic adjustment was made possible – for instance, with regard to

the financing of still-extant current account deficits.

Member states' efforts to correct undesirable developments, …

At the same time, the affected member states went to, at times, considerable lengths to assist in efforts to correct undesirable developments in their economies and to safeguard or restore confidence in enduring economic growth, financial system stability and sustainable government finances. The necessary adjustment process taking place in the real economy, the financial sector and among governments is still in full swing. Various articles in this issue of the Monthly Report discuss individual elements of this process and identify key future challenges.

… in the face of numerous challenges

Those countries which were jolted by particularly severe losses in confidence are now facing numerous difficult tasks, the urgency of which varies from one country to the next: reducing high current account deficits and high net external debt, consolidating government budgets, restructuring financial systems and reducing households' and non-financial corporations' debt in an orderly fashion. The performance of these economies needs to be boosted in order to restore sustainable growth which can create sufficient employment, and thereby drive the very high unemployment back down. This will require not only thoroughgoing reforms in labour and product markets, along with public sector agencies and legal systems, but also a reliable outlook that these measures will be decisively implemented and that the authorities will stay the course with regard to reforms.

Tangible progress in the adjustment process

Despite some progress, further efforts and patience needed

In this light, a comparison between the current situation and development tendencies of the affected countries, on the one hand, with the situation at the onset of the crisis, on the other, shows that major gains have already been achieved, but that considerable further adjustment remains necessary. Given the need for reform which has come to light, it should come as no surprise that only part of the long road to reform has been travelled. Such adjustments will take time in order to become effective. Policymakers should not be expected to come up with panaceas capable of almost instantly eliminating the deep-rooted problems exposed by the crisis. This is especially true as the affected countries in the monetary union no longer have the nominal exchange rate at their disposal as an adjustment instrument for country-specific problems and monetary policy makers need to maintain a stability orientation for the euro area as a whole.

Macroeconomic adjustment process is under way, …

On a positive initial note, the macroeconomic adjustment process has already made considerable progress in some countries: current account deficits have been largely eliminated, and most countries are now seeing their exports rise perceptibly, along with sharply falling imports. This turnaround is probably due largely not only to weak economic activity and domestic demand, but also to the fact that most countries have seen improvements in their price and cost competitiveness, and efforts to tap new foreign markets have been clearly on the rise. The economic outlook brightened somewhat over the course of the previous year, driven primarily by exports. Even the rise in unemployment, dramatic in some places, seems to be levelling off, yet at a worryingly high level. Efforts, in some cases considerable, have been taken to stabilise the financial system, with additional burdens or losses in the banking system often being assumed by the government sector.

… structural reform measures taken, …

During this adjustment process, a raft of structural reforms have been tackled. These reforms were comparatively far-reaching on the labour market, especially with regard to job protection, unemployment benefits and collective bargaining law. Although it usually takes a certain time-lag for the positive effects of the reforms to materialise, initial signs are possibly already emerging in those countries in

which the economic outlook has recently brightened.

… budget deficits reduced …

By implementing consolidation measures on the revenue and expenditure sides, fiscal policy makers, too, have succeeded in reducing new borrowing, which had ballooned at the beginning of the crisis; despite all the uncertainty involved in factoring out cyclical influences, precisely in such periods of upheaval, the structural deficits, in particular, have gone back down significantly. The massive rise in government debt, however, also indicates that governments, partly with the help of assistance programmes, have made a considerable contribution to stabilisation and, among other things, have propped up the financial system and offset its losses. The fact that Ireland successfully completed the assistance programme at the end of last year and that the programme focused on Spain's financial sector expired in January 2014 are testimony to the progress made in the adjustment process.

… and, overall, improved framework conditions for sustainable growth

To sum up, in many of the countries which were hit hardest by the crisis, the conditions for sustainable growth are better than before the crisis as a result of the processes and reforms initiated, though this is currently being obscured by the high unemployment resulting from the difficult adjustments. It must be emphasised, moreover, that investors are now more aware of the risks of their investments. Market responses to policy measures or entrepreneurial decisions therefore have a more disciplining effect than prior to the crisis and can thus keep policymakers more firmly anchored to the path of reform upon which they had embarked.

Dealing with root causes remains a challenge

High private sector debt weighing on growth

Despite the progress made in addressing the causes of the crisis, a battery of challenges still lie ahead. The need for additional corrections to the balance sheets of the private and public sectors is weighing on the short-term economic outlook. It is true that progress has been made in private-sector deleveraging, and that such progress is becoming recognisable, especially considering that debt ratios were understated before the crisis by the unsustainably high level of economic output, whereas in the current slump the exact opposite effect is occurring. Historical experience of private-sector debt overhang, however, shows that not only do the adjustment processes for reducing overindebtedness generally dampen consumption and investment, but that foot-dragging on balance sheet adjustment can also impair the necessary adjustment processes in the individual enterprises, stunt structural change and maintain an atmosphere of heightened uncertainty about the future. This can have a permanently damaging effect on economic growth.

Very high level of government debt

Despite the efforts taken and the deficit reductions achieved thus far beginning from around the year 2010, fiscal policy consolidation has frequently fallen short of the original plans and standards – to a major degree also because the underlying macroeconomic problems had been underestimated. There has been a further marked increase in the government debt ratios of the countries particularly affected by the crisis; some of these ratios have now reached very high levels of well over 100% of nominal gross domestic product. On the whole, public finances therefore remain vulnerable to negative shocks. This is all the more so for two reasons. One is that initially precious time was squandered following the outbreak of the financial and economic crisis: in many instances, decisive reforms to fiscal and economic policy were not tackled until confidence in the sustainability of public finances had already come under direct threat, and were then often too little, too late. Another is that, in some countries, implementation of adopted measures has been uneven, the reform process and confidence-building are being impeded by political instability, or there has been mounting

Risks to the reform process

political pressure to depart from the path of consolidation and reform.

Solving problems within the existing regulatory framework is member states' task

Although relatively comprehensive assistance and coordination mechanisms have been created, the regulatory framework for monetary union continues to rest on the primacy of individual national responsibility; no European fiscal union with extensive European powers of intervention in national economic and financial policy has been adopted. The problems therefore still have to be primarily resolved at the national level. The crisis is also, and above all, a debt crisis, and one of the central challenges is to reduce the high levels of private and public debt. General government, households, enterprises and economies as a whole need to be able once again to reliably service their debt obligations.

Departure from the consolidation path would be the wrong move

What this means for fiscal policy makers is not to stray from the path of consolidation. For one thing, the aforementioned extraordinarily expansionary fiscal policy at the beginning of the crisis and the, in some cases, drastic rise in government debt need to be taken into account. Although the deficit reduction now necessary may have a more contractionary effect than in normal times, no self-neutralising consolidation owing to short-term growth losses is to be expected. Another factor to be noted is that the countries particularly affected by the crisis have either not yet restored lost confidence in the capital markets, or have only just now restored confidence. It is of paramount importance that government deficits be quickly reduced to European target levels so that a certain latitude is opened up for use as and when necessary if, for instance, national financial systems require further support. General government's ability and willingness to service its debt obligations is a key part of winning investors' confidence and – particularly bearing the programme countries in mind – the solidarity of the other member states, which have explicitly or implicitly assumed a considerable portion of the liabilities – in the Greek case, even the vast majority of liabilities.

Improve locational conditions, …

Efficient product and labour markets and competitive economic structures are indispensable preconditions for household and corporate deleveraging, as sufficient current income and earnings are necessary in order to service outstanding debt. To further improve price-based and non-price-based locational factors, the product and labour market reforms need to be continued, and the nature and scope of government activity also need to be subjected to a critical review with a view to creating efficient administrative structures and legal systems which support the economic process.

… review the nature and scope of private-sector deleveraging …

Moreover, clarity should be achieved as quickly as possible on how to deal with high private debt levels. It must be examined on a case-by-case basis whether existing debt can be repaid under realistic assumptions or, if not, whether it can be rolled over or, *in extremis,* written off. On the one hand, it would be wrong to simply renounce the repayment of debt, as this would increase the incentive for misbehaviour, and future credit relationships would involve large risk premiums. On the other hand, bad debt should be removed from the books as soon as possible, and it is the task of policymakers to adjust modalities which stand in the way of such cleansing; potential growth will be stunted if unsustainable economic structures are preserved and uncertainty as to where potentially looming losses will strike is permitted to fester.

… and use balance sheet assessment to put banking systems on a sound basis; …

Such cleansing of bad debt or non-performing loans is likely to weigh on bank balance sheets, in particular. The decision to create a banking union represents an integration step which, in principle, is important and can make the institutional framework of monetary union more resilient to future crises. However, the preparatory work for Europeanising banking supervision can also contribute to solving today's problems: in the banking sector, the forthcoming balance sheet assessment of those institutions which will be subject to joint direct supervision in future is intended to provide greater clarity about the size of balance sheet impair-

ments and to help put banks' balance sheets back on a sound and reliable footing. For this to succeed, the assessment needs to be conducted according to uniformly high standards with conservative valuations, and any impairments identified must be rectified quickly and sustainably – primarily by strengthening the capital base through own funds or funds obtained in the capital market, alternatively by bailing in creditors, resorting to funding from the member state's public sector in a pinch only after all other options have been exhausted. Moreover, a successful balance sheet assessment is likely to make a key contribution to reducing the dependence of banks in the peripheral countries on Eurosystem refinancing and to thus reducing the risks in the central bank balances and in their mirror image, the TARGET2 balances.

… however, deleveraging not an end in itself, especially given the costs and side-effects

However, avoiding dragging out the necessary balance sheet corrections does not mean imposing increased private-sector deleveraging in the individual countries across the board. Portfolio adjustments, such as through debt restructuring or insolvency, ultimately redistribute wealth – within the household, enterprise and banking sectors, but also from one of these groups to another and, depending on the circumstances, away from general government or foreign creditors. The urgency of such adjustments, their feasibility, where they have to be applied, in particular, or also their side-effects, vary from one country to the next. Above and beyond the incentive effects mentioned earlier, key restrictions of a speedy deleveraging process include the robustness of public finances, potential contagion effects abroad if certain creditors had to swallow particularly severe losses, or the consequences with regard to the confidence of foreign investors and thus to the possibility of once again covering external funding requirements primarily through private capital inflows.

Although the single monetary policy is making a considerable contribution to combating the crisis – by supporting efforts to overcome the general macroeconomic malaise through its expansionary orientation, given the low price pressures, and through its non-standard monetary policy measures, from which the banking systems in the countries particularly affected by the crisis have derived particular benefit – it is not the job of European monetary policy, however, to ensure the solvency of national banking systems or governments, and it cannot take the place of the necessary adjustments in the real economy and balance sheet cleansing.

Stable economic foundation for the single currency is a task for all member states

For the countries particularly affected by the crisis, it is ultimately about arranging their economic and fiscal policy affairs in such a manner that they can meet the requirements of the monetary union and its shared, stability-oriented monetary policy once again under their own power and on a long-term basis. Each member state has to confront, on its own, the task of attaining such readiness; therefore, looking at the crisis countries' need for adjustment also forces the other member states to "look in the mirror". Although greater risk sensitivity among investors and the regulatory framework of monetary union, with its reformed rulebook, can give important guidance to policymakers, each and every member state is ultimately responsible for, and should have a vested interest in, doing what it takes to secure the stability and the success of the single currency.