"The structure of the euro area recovery" - speech by Rolf Strauch

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16/10/2017
Speeches
Washington, DC

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The structure of the euro area recovery
J.P. Morgan Investor Seminar
Washington, 14 October 2017

(*Please check against delivery*)

Ladies and gentlemen,

Of all the annual IMF meetings since the crisis, the outlook for the euro area recovery this year is certainly the most bullish we have seen for years. The euro area has embarked on a robust, broad-based recovery, driven by domestic demand but importantly also by the strength of the global economy. This reflects the fact the euro area has remained the most open major economy during the crisis, and consistently improved its competitiveness. The euro area's way out of the crisis also offers some good lessons how to embrace globalisation.

Europe was hit hard by not one, but two crises at the beginning of the decade. The resulting damage has now largely been repaired. Job creation, and the positive effects it has on consumption, has regained its strength as a driver of growth, and so has business investment. This will support longer-term growth. Divergences that had emerged among euro area countries over the crisis are diminishing. Growth and inflation in euro area countries are now better synchronised, which provides a more homogeneous basis for any monetary policy normalisation by the ECB.

The euro area should now use its regained strength to become more robust and remain successful in the global economy, by further strengthening resilience and competitiveness. A number of concrete steps to do exactly that are now in the political agenda. Recent national elections across Europe have confirmed the continent's commitment to multilateralism, which bodes well for this agenda.

Let me walk you through this reform agenda step by step. First, I will give you some evidence to show that Europe is the most globalised of the world's large economies. Second, I will show how the euro area economy has benefited from this, and from the comprehensive policy response that Europe put in place to fight the euro crisis. I will dedicate my remarks thirdly to pointing out some areas where the euro area could still improve.

I. Euro area benefits from recovering world trade

The euro area is the most open major economy of the world. There are various ways to show how deeply the euro area is integrated into the global economy. The size of exports plus imports of goods and services or euro area economies expressed as a percentage of the total economy stood above 80% in 2016. That is by far the biggest share of any major economy. In the U.S., the percentage is only 25%, and in Japan it is roughly a third. In 1995, the ratio in Europe was only 50%, while it remained largely stable for the U.S. over the same period. So Europe has really strengthened its openness to trade over that period, but the U.S. has not significantly done the same.

Another way to look at the numbers is by measuring the market share in global exports. This confirms the euro area's relevance in global trade. While the euro area only represents about 16% of global GDP, a full 25% of exports in the world originate in the 19 countries of the euro area. This is the highest share for any large economy in the world. And this is the case despite the rapid rise in recent years of fast-growing economies such as China. In China, the number stands at only 13%. Other economies trail well behind that, with the U.S. at 9%, and Japan at just 4%.

Moreover, the euro area exploited the diversity of its economies. The euro area sectoral structure and its export portfolio is extraordinarily diverse, with different countries specialising in different products. It is not all about German cars: Italy and Portugal have a high share of manufactured products, Ireland specialises in chemicals products, while Greece and Cyprus had a relatively high share of mineral fuels and related products.

Current forecasts envisage a marked rebound of world trade and in particular of the trading activities of advanced economies. Euro area growth expectations have been revised upward on the back of strong export growth adding to robust domestic demand. According to the European Commission, export growth is expected to reach about 4% this year and next year. Recent data on sentiment in the manufacturing sector and new orders, which are indicative for the trading sector, confirm these strong prospects. Based on these indicators, the outlook for the major euro area economies is very favourable, more so even than in major emerging market economies.

II. Euro area crisis response – overcoming imbalances

The role of the euro area and in the global economy, as well as its recovery on the back of a strengthened world economy have been helped by a set crisis responses over the past decade. These policy initiatives have helped to deepen integration, overcome imbalances and make the euro area more competitive.

The euro area experienced two major financial crises in the past decade. First, the global financial crisis hit us like it did the rest of the world. As you know, it originated in the subprime mortgage market in the U.S. And just as the U.S. started to recover, Europe was hit by a second crisis, which was of our own making. A number of countries lost access to refinancing markets. It was something that had not be foreseen when monetary union was set up, and there was no immediate rescue plan. Without taking action, there was a very real risk that the euro could have fragmented.

That is why the euro area put up a spirited defence. In the first place, countries have worked hard to reduce the macroeconomic imbalances that were at the heart of the crisis. Current account imbalances and fiscal deficits have now narrowed considerably.

These national policies were supported at the central level by a tightening of the fiscal rules, such as the Stability and Growth Pact, and through setting up the

Macroeconomic Imbalances Procedure, which gives the European Commission the capacity to warn and take action if it sees a renewed build-up of the same macroeconomic problems as those that caused the crisis.

Euro area countries continued to liberalise their product markets and reduce barriers to entrepreneurship. Countries undergoing an ESM programme implemented such reforms particularly strongly. As a consequence of these efforts, euro area economies have among the most competitive business climates in the world. According to the World Economic Forum, one third of the most competitive 25 economies are located in the euro area. In some aspects competitiveness, such as insolvency laws and trading, even half of the best performers are euro area countries.

The loss in price competitiveness experienced during the first decade of EMU could be reversed by a great deal of restraint in unit labour costs, above all in ESM programme countries. The real effective exchange rate based on unit labour costs declined significantly compared to the pre-crisis period. By comparison, the labour costs-based exchange rate of the U.S. and China have increase by 10 percentage points or 30 percentage points respectively. This takes into account the recent appreciation of the euro, which reflects the regained growth prospects and the expected monetary policy adjustment by the ECB. This appreciation has only partly undone earlier improvement in competitiveness.

III. The recovery: inclusive growth and recouping business investment

The results of these initiatives is that the euro area economy is now growing above potential. Per-capita growth is also back at the same level as that in the U.S. That used to always be the case, but the relationship was interrupted during the crisis. This shows that Europe is able to generate the same amount of wealth for its citizens as the U.S. economy, when abstracting from poor demographics.

European growth has been more inclusive in two respects than in other countries. Growth in the euro area has put people back to work. Growth was driven strongly by employment prior to the crisis. Obviously the crisis presented a drastic rupture, especially in those countries where the construction sector broke down. However, the employment rate in Europe has been rising since then, and is now higher than it was in 2000. In the U.S., the employment rate is still well below its 2000 level. In other words, more people in Europe are benefiting from the upswing. Increasingly, we are also seeing the positive effects in a reduction of youth unemployment, despite the fact it still remains intolerably high in some countries.

Secondly, euro area income distribution is much better than in the rest of the world. This can for instance be measured by the GINI coefficient which ranges from 0 to 100, with the lower bound expressing perfect equality. In the U.S., it stands at 41, but in France and Germany around 30. Inequality in disposable income of high income earners and the lowest income bracket continued to increase in the U.S during the last decade but remained broadly stable in Europe. Rising inequality is a problem throughout Western societies, but Europe’s starting position and track record are simply far better.

This is particularly important, given the rising criticism of globalisation and the negative side-effects it brings for some. The loss of employment among blue collar workers in the US is one of the plausible explanations put forward for the resentment towards globalisation. Fortunately, European societies have offered much more of a helping hand. This is one of the reasons why centrifugal populist forces in the euro area have not prevailed.

Finally, the robust recovery goes hand in hand with a strengthening of investment activity. It is true that overall investment has not yet reached pre-crisis levels. However, business investment is back on track and the drop in investment activity experienced over the crisis has been overcome. Public investment and residential investment are still lagging behind. It has to be taken into account that residential investment prior to the crisis was driven by the housing bubble, and therefore reflected an unproductive allocation of capital, which should not repeat itself. On that account, current investment activity is reflecting long-term trends and also a pattern of healthy growth prior to the crisis.

As a consequence of the structural improvements achieved during the recovery – especially the strong rebalancing of countries with an ESM programme – euro area economies have converged cyclically. Countries hit most by the crisis are recovering faster. This brings all countries closer to a position where the output gap and other gaps relevant for monetary policy are closed. Correspondingly, the dispersion of inflation across euro area countries has declined, and is now at the lowest level since the start of EMU. This is highly relevant for monetary policy as it creates a fairly harmonized setting across euro area countries, where monetary policy should fit all countries.

IV. Further steps to make the euro more robust

Europe’s regained strength should not lead us to overlook weak spots. There are steps that the EU and the monetary union could - and should - take to make its economy more resilient. These can built directly on what was already achieved over the crisis.

Europe should strengthen further its growth potential. Our poor demographics are a clear long-term restraint, and growth will have to come from investment and productivity gains. But productivity has fallen behind as a driver of growth in the recent recovery. Structural reforms need to continue in all countries, not just in those who received an ESM assistance programme. Strengthening production factors is important for the long-term convergence of the euro area economies. There is good evidence that this requires functioning product markets, high quality education systems, flexible labour market, and strong financial supervision. These are also the conditions to tackle the legacies of the crisis – in particular unemployment and non-performing loans in banks, which lower bank profitability and restrict lending activity. Structural reforms are an important area where European countries must work hard – but without giving up on the social aspects of the European model which have allowed a more equal income distribution and support those affected by the changes of globalisation.

Another gap that the euro area needs to fill is economic risk-sharing. The comparison with the US is telling. It shows that euro area countries are to a much lesser extent able to smoothen economic downturns than the US. Moreover, important channels of risk-sharing are less developed. For US states, capital market flows help to weather economic fluctuations. In turn, financial integration in the euro area has declined during the crisis.

The data show that financial integration quickly rose after the euro was introduced, as one would expect. It then crashed during the crisis, and while it has recovered since then, it is still well below its peak. But we see also that there is more fiscal risk-sharing complementing market mechanisms in the US, and in other federations, such as Germany. In short, this means that budget resources are used to stabilise the economies.

There are a few policy steps which can be taken at the European level to improve these channels of risk sharing. First, Banking Union needs to be completed. Banking Union was launched during the crisis with the creation of a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM). The Single Resolution Fund needs a financial backstop to make it more credible. This is a role that the ESM could take on. Europe also needs a common deposit insurance. This can happen only after legacy issues at banks in a number of countries have been tackled.

Secondly, the euro area should harmonise bankruptcy, tax and corporate law and move towards more a more harmonised capital market supervision, a project known as Capital Markets Union. This would ease the way for cross-border equity investments and open up new ways of funding for companies. It would also reduce their heavy reliance on bank funding, one of the reasons that Europe's banking sector is so large in comparison to the size of the economy. Finishing the Banking Union and setting up the Capital Markets Union would be a big help in increasing risk-sharing in the monetary union.

There is also now a political debate about simplifying the European Union fiscal rules. Initially laid out in the Maastricht Treaty and the Stability and Growth Pact, the rules have been tightened since the crisis. But they are now too complex. So I welcome the debate on how to make them more effective. Better rules would help to create the fiscal space needed in future recessions.
Finally, the fiscal instruments available at the European level should be completed. During the crisis the ESM as a powerful crisis resolution mechanism was set up. Now a limited euro area budget is also under discussion. It could support the fiscal risk-sharing we see more strongly in federal countries. In my view, we have a real need in the monetary union to create a facility that deals with asymmetric economic shocks. A country hit by an asymmetric shock would receive money during a crisis, but would need to repay it once it recovers. This is possible without permanent transfers between countries, or debt mutualisation.

We certainly do not need a fully-fledged fiscal and political union in monetary union, not are these political possibilities. But significant further steps are being discussed and I expect to see results from these pragmatic initiatives towards deeper political integration.

Ladies and gentlemen, I have tried to clarify that the euro area recovery is to a significant extent the consequence of past reform efforts on the one hand, and the euro area's embrace of globalisation, and economic openness on the other. I have also mentioned a few steps that Europe is considering to take to make its economy more resilient and monetary union more robust. It is very welcome to see that citizens seem again to have become more cognizant of the benefits of monetary union. This creates the political energy to pursue further integration.

Thank you for your attention.

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