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Has adjustment and recovery in the Euro Area been too slow?

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Dear colleagues, as a preamble to my presentation and our discussion about the current crisis, I would like to share some thoughts on my decades-long experience dealing with macroeconomic policy and international coordination. During my career, I have witnessed multiple transatlantic disagreements regarding the best use of economic policy tools. Divergent viewpoints about the role of fiscal and monetary stimulus have been the norm since, at least, the eighties.

Interestingly, despite significant philosophical disagreements, if one uses real GDP per capita as a measure of how countries welfare has developed overtime, there is negligible difference in outcomes.

So far, recovery has been weak across the board. At the current juncture, most advanced economies - but also China - are facing very low or negative inflation rates. This is the case not only in the Euro Area, but also in Japan, the United Kingdom (UK) and the United States (US), where Central Banks have more forcefully intervened and nominal growth is more robust.

When compared with the performance of the United States, the recovery in the Euro Area since 2009, and in particular in the periphery, has been disappointing thus far. However, Spain, Ireland and Portugal, countries who received financial support, are set to be the top economic performers this year (as the beneficial effects of their reform agenda emerge). Of course, we cannot view the performance of Greece (complicated by non-abating political uncertainties) as successful so far.

Too slow or too fast? Against this background, I have been requested by the round table organizers to discuss whether the observed path of adjustment and recovery in the Euro Area has been too slow.

As I will detail in what follows, **I do not think there is a simple answer**. Let me start by describing what I think are the different roots of the problems that required different policy mixes in the advanced world and discussing whether Euro Area policies were, in my view, correct. I will then discuss, given the required policies, the speed of the adjustment.

Recovery in the midst of secular stagnation. There are two different theories of why economic growth has slowed down globally. On the one hand, Larry Summers argues that secular stagnation is the result of a lack of demand and, thus, calls for fiscal and monetary stimulus. On the other,

Robert Gordon and others argue that the main problem is the dismal behaviour of productivity, which is on a downward trend for which there seems to be no reversal in the medium term. According to the latter view, the problem is on the supply side of the economy.

This distinction in diagnosis is well reflected in the divergent policy reactions to the crisis. The UK and U.S. have relied heavily on fiscal and monetary stimulus (to close the output gap). Instead, the European policy mix placed more emphasis on achieving structural reforms (aimed at increasing productivity and potential output) and fiscal adjustment. Euro Area countries, especially those requiring official support, are undergoing significant reforms aimed at improving labour and product market efficiency. On the fiscal side, Euro Area countries now have stronger control mechanisms in place to avoid an excessive accumulation of government debt. It would seem that Brussels reads Gordon while London and Washington are more in tune with Summers.

It is unlikely that past drivers of economic growth, such as trade liberalisation and increased female participation rates in the labour force, will be replicable. Against this background, and given the unfavourable demographic projections in the Euro Area, Total Factor Productivity (TFP) will be the primary driver of potential GDP growth.

Importantly, the different policy prescriptions are also the result of the different structures and shocks faced. As I have argued elsewhere, while the world faced a large (global) financial shock in 2008-2009, to which the authorities reacted by massively deploying fiscal and monetary policies, the Euro Area was confronted with an additional (euro area specific) shock.

In the Eurozone, during the first decade of the EMU, large imbalances, reflected in large increases in domestic and external indebtedness and in sizeable fiscal deficits (in some cases), had been accumulating. The combination of the global financial shock with its underlying imbalances and vulnerabilities resulted in a cross-border funding shock. This led to financial re-fragmentation and exposed the accumulated imbalances.

Structural reforms are key, not only for the promotion of long run growth, but also for the efficient functioning of the currency union. The academic literature shows that structural and fiscal distortions, such as sector specific taxes, and labour and product market regulations, interfere with the efficient sectorial allocation of production factors, thereby generating very different aggregate TFP levels across countries.[1] Given the structural disparities within the area, Europe has rightly

[1] See, for instance, Restuccia (2004).

placed much emphasis on structural reforms.

This combination of factors forced Euro Area policy makers to devise a broader strategy, focused on a longer horizon. During 2008 and 2009, coordinated fiscal and monetary policies were deployed, globally and in Europe, to contain the financial crisis. Then, after the shocks started to affect the Euro area, policies had to be re-designed to bring about an elimination of excesses, both financial and fiscal, and correct the sources of the imbalances.

The implementation of difficult reforms and the necessary fiscal consolidation have contributed to the unsatisfactory short-term growth performance of some European economies in recent years. These reforms, however, will bring great future benefits, and they will make the currency union more stable by reducing structural disparities among its members.

Given all the considerations above, has the path of adjustment and recovery been to slow?

On the fiscal front, the debate suggests the opposite is true. Fiscal imbalances have adjusted relatively rapidly, allowing program countries to halt their explosive debt trajectories. The same holds true for the current account and external imbalances. Reputed academics like Professor Wren–Lewis, and even the International Monetary Fund, have argued that the process of fiscal consolidation has proceeded too fast. According to that logic, the excessive withdrawal of the public sector at a time of deep recession had a multiplicative effect on activity.

While I am a strong supporter of countercyclical fiscal policy in a crisis like the one faced in 2008-2009, I do not believe that structural fiscal deficits are to be cherished. Although understanding the effect of fiscal policy on economic activity (the so-called fiscal multipliers) is of utmost importance, I believe that in focusing the discussion on whether the (hard to accurately measure) multipliers are larger or smaller, we risk missing the broader picture. A fundamental limiting factor for fiscal room of manoeuvre is the amount of external financing that is available. In fact, in the absence of the extraordinarily large and cheap European official support, the fiscal retrenchment would have been more pronounced, which could have sent damaged economies into even deeper slumps. I can only wonder where Greece could have found additional financing beyond the 240 billion euro it has obtained so far. Disagreements regarding the size of the fiscal multipliers or the speed of the adjustment, however valid, must take a back seat when faced with such harsh realities.

Structural reform is advancing rapidly and its benefits are already starting to show up. Widely recognized structural reform indicators, such as those prepared by the World Bank or the OECD, illustrate the extent of the effort made by European economies. This is especially true for those countries under a financial program. As documented by these institutions, the reforms have

translated into lower nominal labour costs and more efficient product market regulations. Countries like Ireland and Spain already see the benefits of their reforms in terms of higher economic growth.

According to the OECD, all program countries could have higher growth in the coming decades if its reform efforts continue. Supply side reforms will assist in making the most productive use of the spare capacity accumulated during the prolonged downturn.

On the financial deleveraging front, the process seems to be taking more time than hoped. This slow progress is rooted in many factors.

First, there are very different legal framework for insolvency and bankruptcy laws across the euro area. Widespread repossessions and bankruptcies in societies unaccustomed to these practices (unlike the U.S.) would make the task of striking a balance between growth and reform politically challenging.

Second, there are differences in the incentives provided by the supervisory system for banks to restructure dubious loans. This supervisory problem was further complicated by the fact that the Euro Area countries needed to harmonize their legal systems, a process that could not happen overnight.

Thirdly, differences in the ability of the private sector to obtain funding from a variety of sources also matter. It is well known that euro area firms are much more reliant on bank-funding than their US counterparts. This more readily available market financing allowed for the necessary bank deleveraging, without forcing the large drops in net borrowing by the private sector witnessed in the euro area.

Underlying these factors there has been the need to proceed with the deleveraging in an environment in which banks are still recovering from the financial crisis and in which the necessary structural reforms are proving to be a short-term drag. To accelerate the bank healing process, reduce the level of fragmentation and minimize the possibility that future-banking crises become fiscally unsurmountable; the euro area has equipped itself with a Banking Union, and a capital markets union is under development.

Let me close by saying that, beyond the speed of the adjustment, the key issue is the long-term growth prospects. I am confident that, in the medium to long-term, the combination of structural and fiscal reforms and the creation of the banking union will deliver sizeable benefits. The multi-layered Euro Area policy approach, which relies on using fiscal and monetary policies to help the

economy accommodate structural changes, while allowing for a less abrupt (and damaging) elimination of imbalances and underlying structural mismatches, is creating a sound basis for sustained medium-term growth.