

Research Fellowship Programme - Future of the EMU

Essay on Country adjustment in EMU: complementarity and trade-offs between adjustment mechanisms and policies

Background

Empirical evidence shows that the creation of the euro area and, in particular, the decline in spreads observed in a range of Member States during that period, was at the origin of a significant increase in domestic expenditure and in public and private sectors borrowing, in the concerned Member States, leading to high levels of public, private and external debt. The recent crisis and, in particular, the tension in sovereign markets, made also clear the need for those euro area Member States to address these imbalances by implementing strict fiscal consolidation measures, featuring significant private sector deleveraging and restoring external balance. In fact, these euro area countries face now the hard challenge to regain competitiveness and spur economic growth while simultaneously correcting significant levels of public and private sector debt. The need to deleverage in both sectors (public and private), although leading to healthier financial positions over the medium term, raises additional challenges to policy making given the significant impact that this deleveraging process may have on economic growth in the short term. The speed of the adjustment and the interaction between the adjustment itself and the policies to be adopted by these countries becomes crucial, in this context, to guarantee a path towards a "virtuous equilibrium".

Aims of the essay and key questions to be tackled

As a starting point, the essay should assess the pace of the deleveraging process needed to correct the imbalances built up before the crisis in the countries concerned and the expected impact of this process on economic growth, both in the short and medium term, taking into account the trade-off between the underlying decrease in credit supply and domestic demand and the potential positive confidence effect this deleveraging process may bring to these economies. The essay should then assess, in the context of the EMU, the interaction between the adjustment process and the policies that can be adopted to address those imbalances (e.g., fiscal policy), to promote an orderly deleveraging process and financial stability (e.g., enhancement of crisis management schemes), and to spur competitiveness and economic growth (e.g., product and labour market reforms), identifying, in particular, the policies, or the sequence of policies, that will most likely avoid, or at least attenuate, a persistent low growth and a disorderly deleveraging process.

Important questions to be addressed include, inter alia:

- What should be the adjustment capacity of the concerned euro area Member States to guarantee a smooth deleveraging process to correct the macroeconomic imbalances and, at the same time, create an environment favourable to economic growth?
- What kind of policy measures should be implemented in order to correct the imbalances and, at the same time, avoid a credit crunch or a misallocation of credit and a disorderly deleveraging in these economies? How to facilitate the deleveraging in both the financial and non-financial sectors taking into account the existing interaction between them, the

interconnectedness of financial sectors across euro area Member States and, therefore, the risk of financial vulnerabilities exacerbation during the adjustment process?

- What is the role of structural reforms in this context, and their interaction with policies targeted to correct the imbalances, such as the fiscal consolidation measures that are now being implemented? In particular, what does the evidence tell us about the impact of policies that aim to increase flexibility in the economy (namely, in the product and labour markets) on the countries' adjustment capacity when a deleveraging process is taking place both in the private and public sector? When these reforms have not been implemented before the adjustment process, what are the crucial sequential issues that should be taken into account when defining the policies to be implemented both to correct the imbalances and to strengthen competitiveness and promote economic growth?