



# **Experiences with the economic adjustment in euro area crisis Member States**

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**Athens, 21 April 2016**

# Key factors influencing the adjustment process

## *1. The economic starting conditions:*

- Macroeconomic and fiscal situation
- Health of the financial system
- Flexibility of markets

## *2. The design of the adjustment strategy*

## *3. The framework conditions for implementing the adjustment strategy*

## *4. The external dimension*

## 1. The economic starting conditions: fiscal, macroeconomic and financial

	<b>Fiscal balance, % of GDP (just before programme)</b>	<b>Gross public debt, % of GDP (just before the programme)</b>	<b>Current account balance, % of GDP (just before programme)</b>	<b>Financial sector</b>
<b>Greece</b>	-15.2% (2009)	126.7% (2009)	-12.7% (2009)	Held high amount of GGBs
<b>Ireland</b>	-32.3% (2010) (-11,1 excl. bank supp.)	86.8% (2010)	-0.8% (2010)	Very high real estate exposure
<b>Portugal</b>	-11.2% (2010)	96.2% (2010)	-10.3% (2010)	Exposed to macroeconomic imbalances
<b>Spain</b>	-9.5% (2011)	69.5% (2011)	-3.3% (2011)	High real estate exposure
<b>Cyprus</b>	-5.8% (2012)	79.3% (2012)	-5.1% (2012)	Held high amount of GGBs

## 1. The economic starting conditions: market functioning

	<b>Regulatory barriers to product market competition (OECD 2008)</b>	<b>Strictness of employment protection regulation – Regular contracts (OECD 2010)</b>	<b>Business environment (World Bank rank "Ease of doing business", Nov. 2010)</b>
<b>Greece</b>	2.2	2.8	109
<b>Ireland</b>	1.4	1.3	9
<b>Portugal</b>	1.7	4.1	31
<b>Spain</b>	1.6	2.4	49
<b>Cyprus</b>	n.a.	n.a.	37

## 2. The design of the adjustment strategy

- *The adjustment strategy needs to be tailored to the economic weaknesses of the country concerned*
- *Targets should be ambitious but achievable (scope for virtuous cycle)*
- *Challenging issue of sequencing of measures*
- *In the face of uncertainty, the programme financial envelope needs to be sufficiently high to credibly be able to absorb headwinds*
- *There are trade-offs concerning the length of a programme:*
  - *A longer adjustment period allows in principle a smoother fiscal consolidation and gives more time for structural reforms to show their effects*
  - *A longer programme is likely to require more programme financing*
  - *Political and public support for reforms erodes over time*
  - *Frontloading the implementation reforms enhances the credibility of the adjustment strategy*

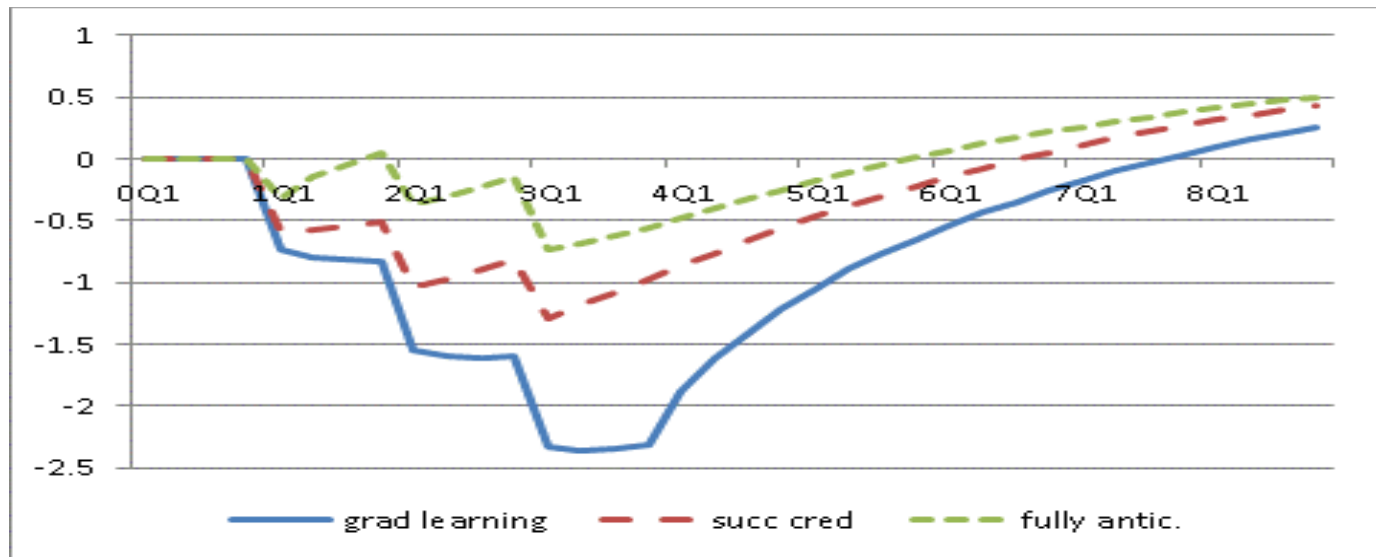
### 3. Framework conditions for implementing the adjustment strategy are crucial

	<b>Quality of institutions (WB 2010 ranking 1-100) (1)</b>	<b>National programme ownership</b>	<b>Credibility of the adjustment strategy (2)</b>
<b>Greece</b>	68.3	Patchy	97
<b>Ireland</b>	93.2	Strong (cross-party)	34
<b>Portugal</b>	81.9	Initially strong (cross-party)	37
<b>Spain</b>	81.8	Strong	1
<b>Cyprus</b>	85.8	Initially strong	n.a.

*(1) Average of: government effectiveness; regulatory quality; rule of law; control of corruption*

*(2) Approximated by the number of weeks after the start of the programme during which spreads continued to increase*

## Credibility matters: illustrative QUEST simulations of the GDP impact of three year successive consolidations of 1% of GDP



- **Gradual learning:** consolidation measures and their benefits are not anticipated at the outset to be fully permanent; full credibility only after three years
- **Successive credibility:** each successive consolidation round is fully credible, but future rounds are not yet anticipated in the first quarter
- **Fully anticipated:** the sequence of consolidation measures over three years is fully anticipated in the first quarter of the simulation

## 4. The external dimension

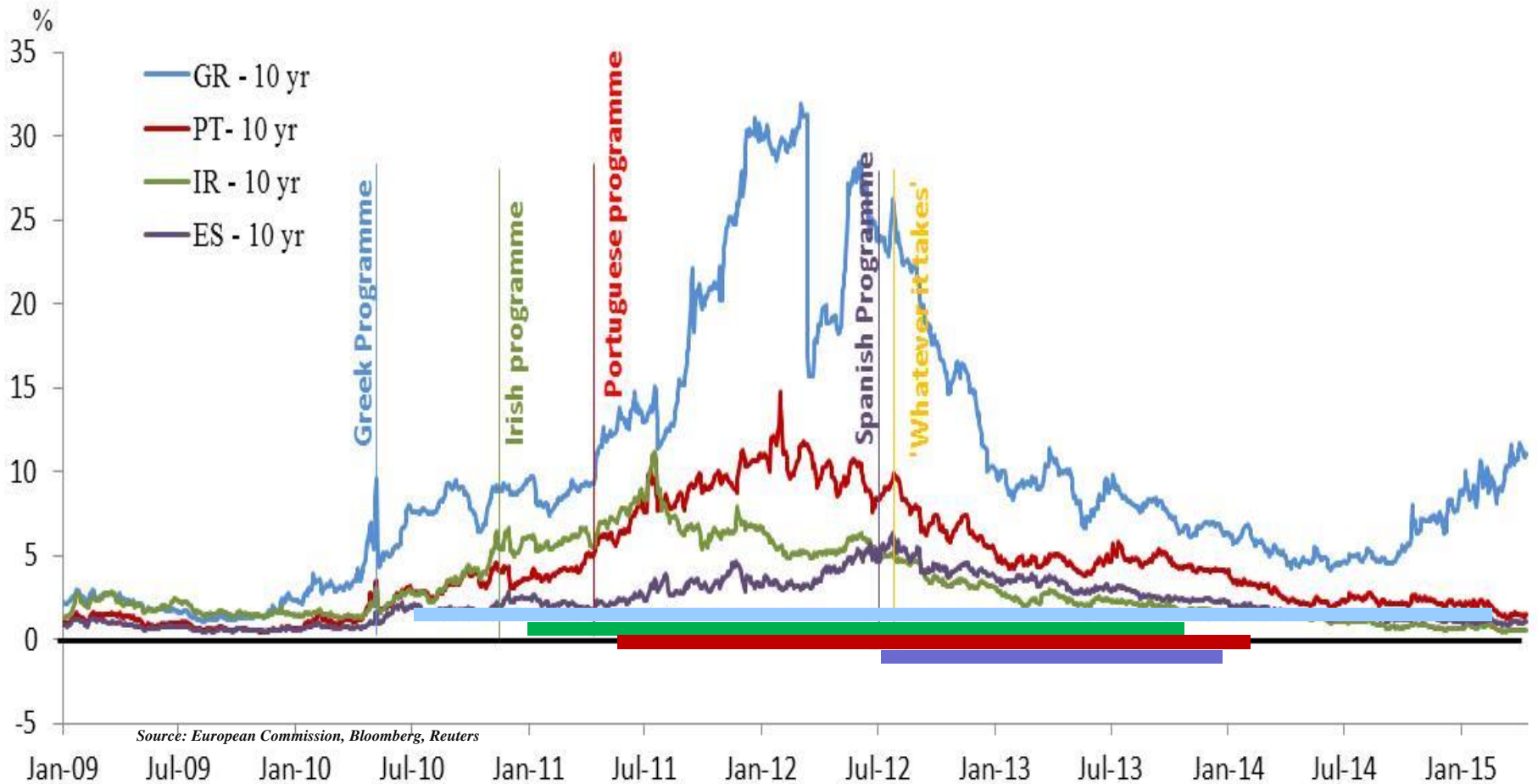
*External financing in the context of an economic or financial sector adjustment programme can smoothen the adjustment process*

*The external environment can facilitate or complicate the adjustment process, e.g. via:*

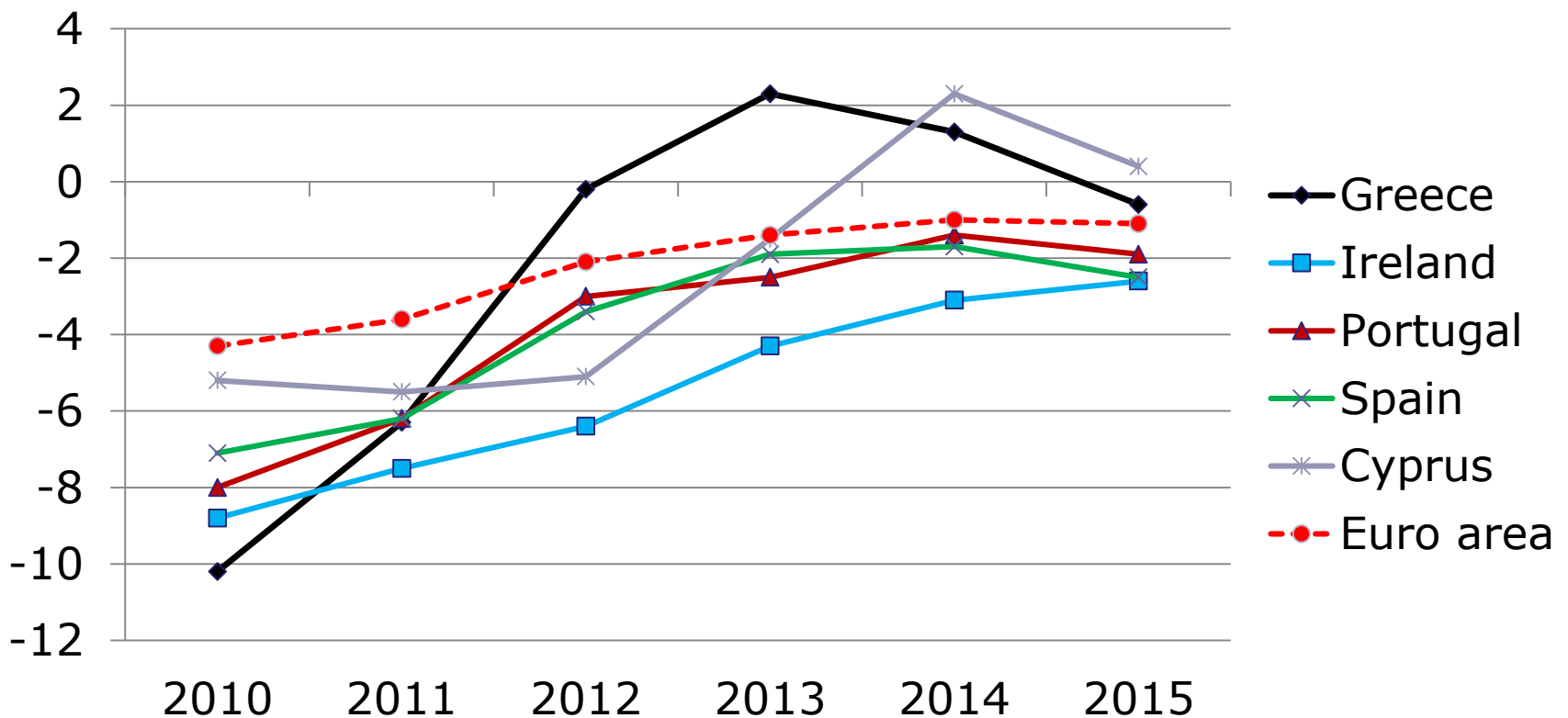
- export demand*
- financial market contagion*
- monetary policy*
- EU/EA level policy decisions*



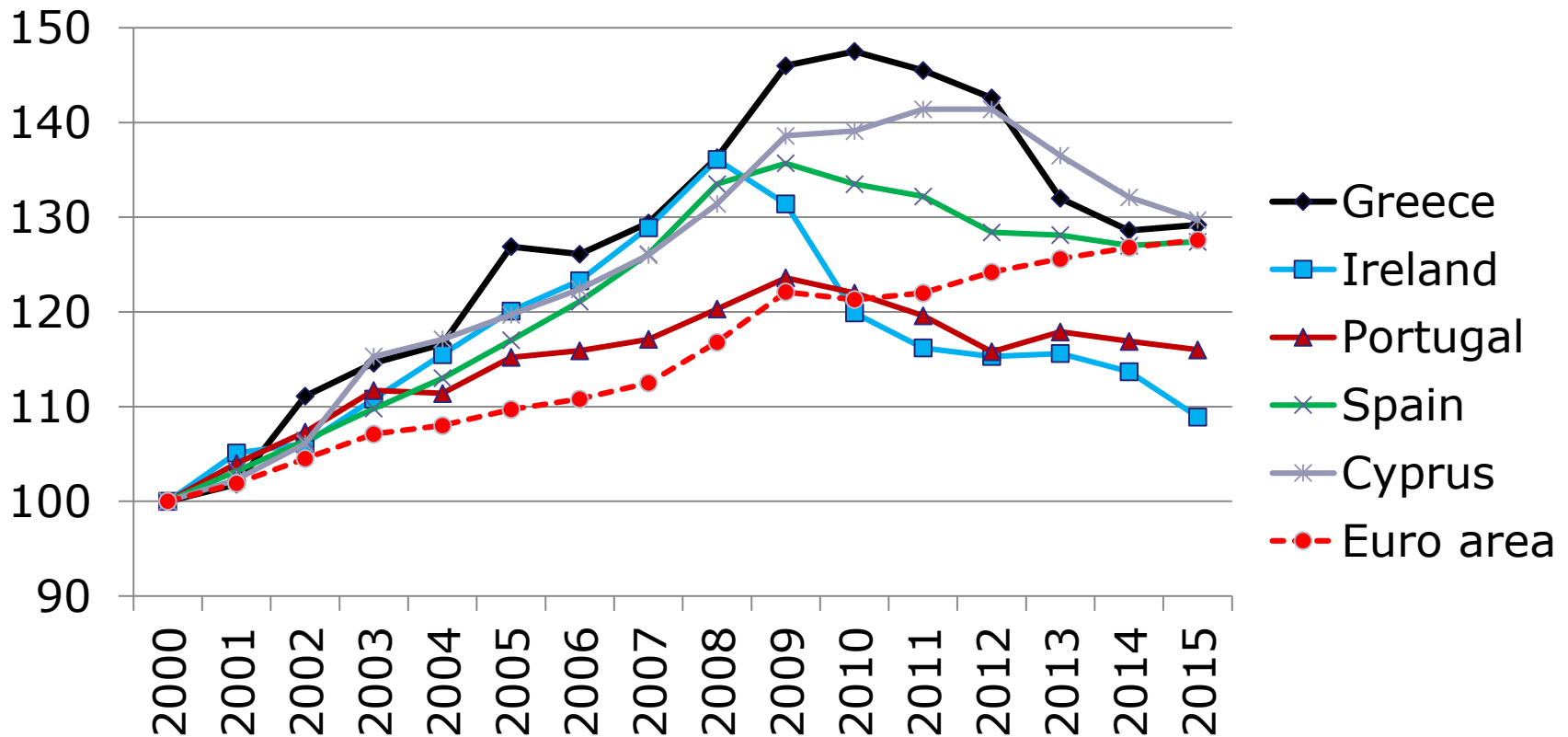
# 10-year sovereign bond spreads versus Bund



## Achievements: general government structural balance

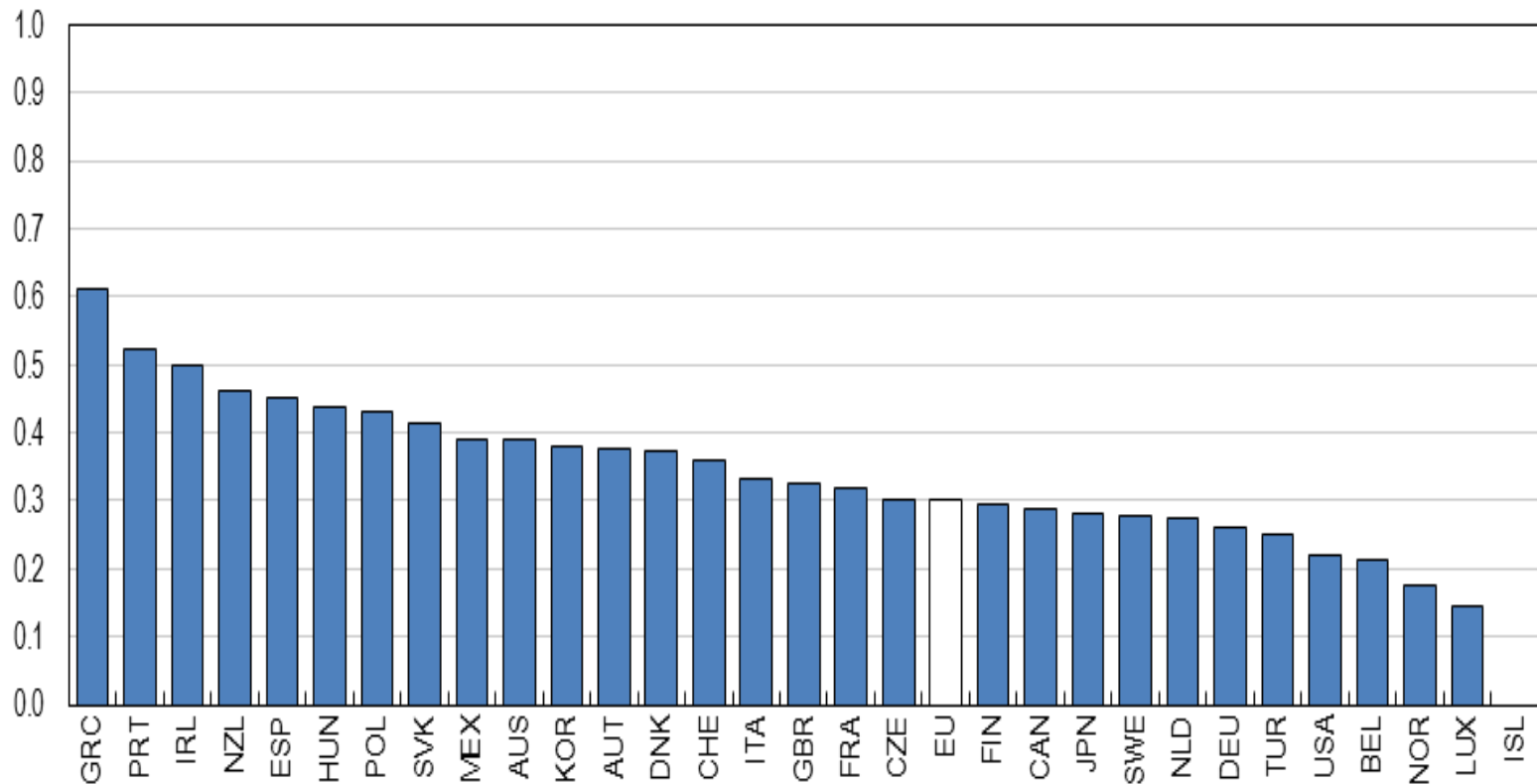


## Achievements: evolution in nominal unit labour costs (total economy; 2000=100)

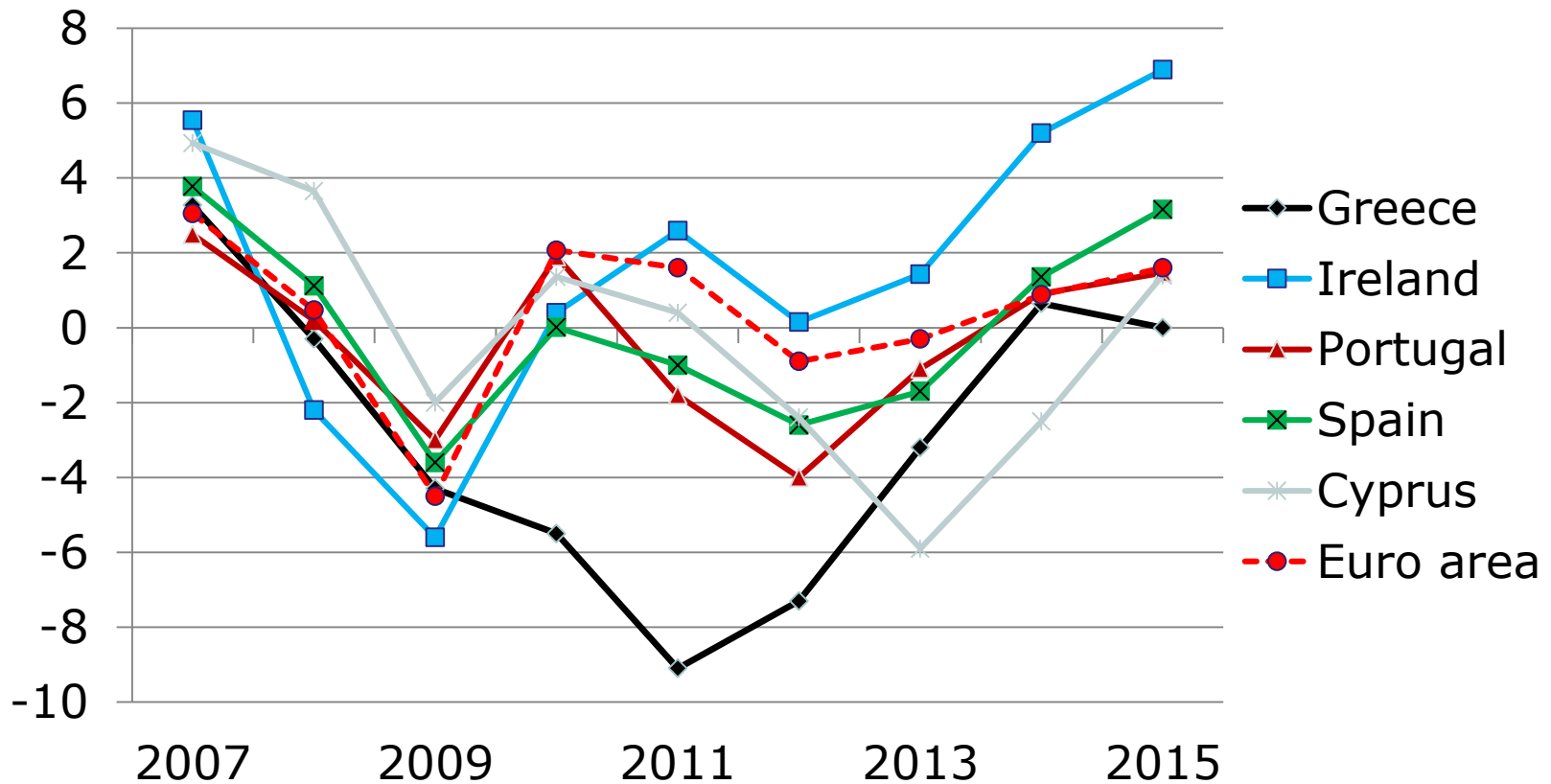


# Overall reform responsiveness (OECD)

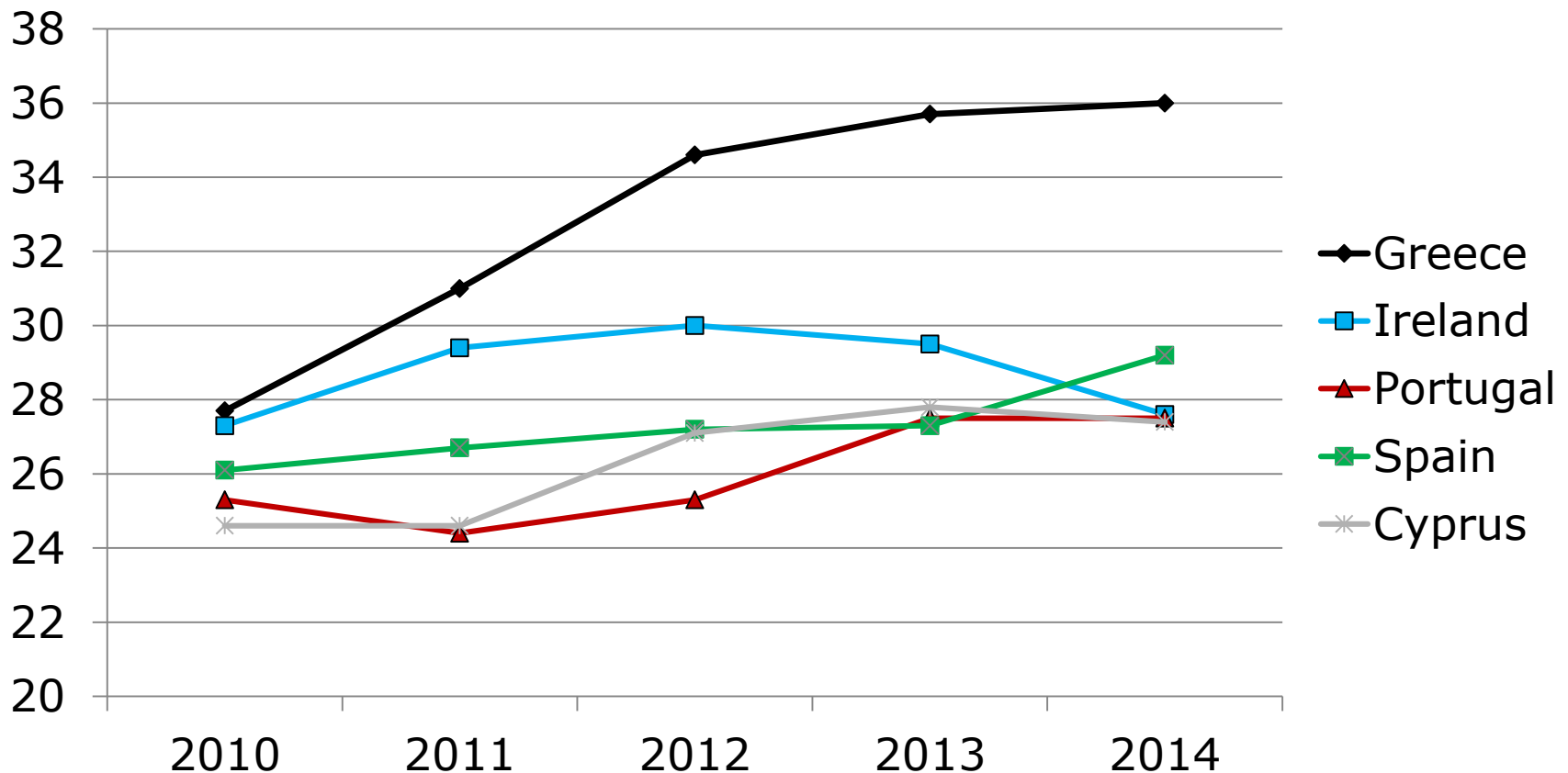
## B. Overall reform responsiveness over the period 2007-14



## Developments in GDP (percentage change)



## Social developments: percent of people at risk of poverty or social exclusion



## Some tentative conclusions from the experience with adjustment programmes so far

- *Adjustment through "internal devaluation" often takes longer than expected*
- *There is clear evidence of "reform fatigue" after about two years of adjustment programme or even reform reversals afterwards*
- *Frontloaded fiscal adjustment allows the brunt of the impact to be introduced when the importance of adjustment is well understood and helps underpin market confidence*
- *Governance reforms tend to lose momentum when the immediate pressure eases*
- *While all programmes de facto took distributional aspects into account, a more explicit treatment is desirable*
- *"Soft factors", like national ownership and institutional quality, are of crucial importance*
- *Credibility of the adjustment strategy depends on both domestic and external factors*
- *Better communicating the need for adjustment and the reasons for particular reforms could help preserving public support*