Lorenzo Bini Smaghi: Restoring confidence

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, on the panel: "Society, State, Market: a European Answer" at the International Forum Economia e Società Aperta "Uscire della crisi", organised by Bocconi University and Corriere della Sera in cooperation with University Carlos III de Madrid, Madrid, 25 November 2008.

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Since the start of the financial crisis, attempts have been made to frame it within predefined schemes, based on past experiences. Comparisons have been made with previous crises, starting in 1929. Standard terminology has been used, such as recession, stagflation, stagnation, and more recently also deflation, sometimes without fully understanding their meanings.

These exercises risk being not only useless but also counterproductive, to the extent that they lead to policy conclusions that might have been appropriate for the past crises but not necessarily for the current crisis. This crisis is different from the others because it affects confidence, which is at the root of a market economy. What is at stake is confidence in the market. On the other hand – and this can be a decisive factor – confidence in the state has remained high. This can be shown by the fact that banks prefer to buy government bonds rather than lending to each other.

There are two ways to escape this crisis. The first is to replace the market economy with a different system for the allocation of resources, in which the state has a predominant role – some new form of socialism (although there might not be many left who really remember how a socialist economy functions). The risk is that the remaining confidence in public authorities may be lost. The second solution is to rebuild a functioning market economy, which possibly functions better than it did previously. The state has a fundamental role in rebuilding agents' confidence in the market. If confidence is not restored, policy actions may be in vain. And the crisis may get worse.

To escape from the crisis we therefore need intervention from the state, in order to recreate a functioning market economy. However, if we have just get more state and less market we would be worse off. In the following I will try to develop this reasoning.

The crisis of confidence started about a year ago, when financial market participants started to doubt each other's solvency as a result of the undervaluation of risk on toxic assets, the large leverage accumulated over the years and the lack of transparency on reporting accounts. The lack of confidence extended to the entire financial system, and its capacity to appropriately assess the proper value of assets and liabilities. The attempt to reduce risk and leverage resulted in an excess of supply that led to a sharp reduction of asset prices. Some investors tried to move to other markets, such as primary commodities, creating a bubble which, over the summer, brought oil prices to over USD 140 per barrel. An inflationary shock was thereby superimposed on the financial crisis, further weakening the confidence of households and companies. The failure of Lehman Brothers delivered the final blow, with a general contagion to all markets.

The fall of confidence has had a direct impact on agents' behaviour. Consumption and investments have fallen. Portfolio investments are shifted away from any risk, and towards liquid assets. Banks do not lend to each other and the interbank market, which is at the basis of all markets, does not function properly. There is a tendency to reduce bank lending to the real economy.

In such a context, agents tend to be less reactive to incentives and opportunities. For instance, the large fall in fuel prices and other primary commodities since the summer is leading to lower inflation and improving wage purchasing power; indeed, euro area wages are still growing faster than inflation. Nevertheless, the propensity to save has increased and consumption has therefore stagnated. The depreciation of the euro and the improvement in competitiveness should induce firms to invest, especially in the export sector, but, instead, trade is suffering.

The effectiveness of economic policies is impaired. Central banks in advanced economies have drastically reduced policy rates, but bank borrowing rates for final users – households and companies – have come down only marginally. In the United States, where policy rates are lower than 1%, rates for mortgages and companies are in most cases higher than in the euro area, where policy rates are at 3.25%. Fiscal policies have also lost effectiveness. The US stimulus package last spring did not have the expected impact and has not prevented the cyclical deterioration.

There is a risk that the policy action, even when rapid and ample, does not succeed in reversing the trend. There is a risk that policy-makers run out of ammunition too early and remain without a means of escape. As the great spaghetti westerns of our youth have taught us, the "goodies" win if they shoot first. But he also has to hit the target. There is no scene more depressing than those in which the cavalry is surrounded, without any ammunition left.

If the transmission channel of monetary policy does not function, interest rate cuts have little impact on the real economy. They might only help to improve banks' profit and loss accounts, which might be the reason why they are so much in favour of rate cuts. Budget stimulus measures might end in higher savings, and in higher public debt. This was the experience of Japan in the second half of the 1990s.

If economic policy loses effectiveness and margins of manoeuvre, it may also risk losing credibility. This would deal a stinging blow to the feeble confidence of market participants.

Policy actions must give priority to restore confidence, especially with respect to the functioning of financial markets. Markets are currently not working properly for two reasons. The first is the banks' fear of having to face an unexpected withdrawal of funds by their clients. This explains why banks cumulate liquid and riskless assets and sell the illiquid ones, with negative effects on stock prices and on financing flows to the real economy. The second reason is the fear that the counterparty will face difficulty and will not be in a position to reimburse the loan. This explains why, in spite of a high spread of over 100 basis points between the ECB refinancing rate and the three-month interbank rate, the arbitrage opportunity is not exploited. This also explains why banks prefer to deposit their funds with the ECB, at a current rate of 2.75%, rather than lend to another bank. Such behaviour might be justified from the point of view of individual banks which, after having taken too many risks in the past have now become more prudent, even excessively prudent. From a collective viewpoint, if banks stop behaving as banks, i.e. they stop intermediating savings onto investment, there is a risk of implosion with repercussions on the real economy that economic policy would be unable to stop.

Policy action must give priority to making markets function again. Many measures have already been announced, and some have been implemented. I will not dwell too long on those that have been implemented, especially by the ECB, with a view to reassure banks on their sources of financing. In particular, banks can now access financing from the ECB at fixed rates, with a maturity of up to six months, for amounts limited only by the amount of collateral that they have at their disposal. The list of eligible collateral has been expanded to BBB-rated instruments. Lower quality assets can be used for emergency lending assistance operations with national central banks.

European governments have committed not to let any bank fail. Such a commitment, to be credible, must be followed by a programme of bank recapitalisation. Such a programme should be implemented rapidly and in a broad way, to convince market participants that indeed no bank will fail and that it is again safe to buy bank shares and bonds. This will create a virtuous circle of confidence in the markets that will spread to the rest of the economy.

Given the current market stress, the capital injection of the banking system must be abundant and generalised. The private sector alone cannot do the job properly. Previous capital increases have been insufficient and entailed losses, which discourages new potential investors. To achieve a higher capital ratio banks would most probably cut their loans to the private sector, therefore creating a credit crunch. This is why state intervention is needed. Care must be taken, however, and I mention this in particular for those European authorities that are in charge of assessing state aid: such state intervention is not aimed at saving one or a few ailing banks; it is aimed at preserving systemic and macroeconomic stability.

To achieve its goal, recapitalisation should meet the following requirements:

- First, it has to be abundant, going far beyond prudential requirements which are designed for normal times and which should not be modified in the current conjuncture, to avoid being pro-cyclical. I would not dare to give a number but it should create a sufficient buffer to instantaneously restore confidence in the banking system, for instance pushing the Tier 1 capital ratio to a two-digit number. It should be sufficient to further push down balance sheets so that no doubt remains as to where the losses are.
- Second, recapitalisation has to be across the board, and align all banks' capital ratio to the same high level. The functioning of the interbank market requires that participants have no doubt of each other's solvency position. Any fear of a rotten apple can spoil the bunch.
- Third, recapitalisation has to have conditions that make it temporary and sustainable. This requires that the remuneration of the capital injection should be sufficient to compensate the taxpayer and to induce an early repayment, but not punitive so as to penalise private shareholders. An interest rate that is too high on the public injection would encourage banks to pass on these rates to the end-users, who would ultimately be paying the bill. Given the state of the economy, and the difficulty to ensure a high rate of return on investment over the next few years, stock prices would be likely to suffer. It would be paradoxical if the injection of public capital led to a fall in private stock prices.

The ECB has established a scheme for defining an appropriate return on different instruments that could be used for recapitalisation, which has been sent to Member States and the European Commission. We hope that this scheme can be adopted in all Member States, in particular those in the euro area. Indeed, ensuring a level playing-field across banks and countries is essential to foster the return of confidence.

The Japanese experience of the 1990s has shown that the major factor behind the fatal delay in bank restructuring and recapitalisation has been political infighting and the immobility of the private sector. On 12 October, the Heads of State of the euro area countries met in Paris and announced measures aimed at providing financial institutions with additional capital resources so as to continue ensure the proper financing of the economy. The current state of the financial markets does not allow for hesitation. Leadership is required at both the national and European levels to implement the solution which is on the table. A similar, massive action is needed across the Atlantic.

Restoring confidence in markets is the biggest contribution that the state can make to get the economy back on track. It is time to act.

Thank you for your attention.