Lucas Papademos: Tackling the financial crisis – policies for stability and recovery

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the Annual Dinner of the Society of Business Economists, London, 11 February 2009.

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I. Introduction

When I accepted your kind invitation to address the Annual Dinner of the Society of Business Economists – for which I thank you – I knew I would be coming to the City of London at a time when the general economic sentiment, especially in the financial markets and the banking sector, might be matching the weather conditions: not exactly sunny and occasionally frosty. I also knew that I would be speaking to members of your Society at a very challenging time for economists. Over the past year and a half, and especially since last September, the assessment of the state of our economies, the forecast of the economic outlook and the formulation of economic policy have become particularly challenging because of the extraordinary uncertainty characterising the behaviour of consumers and firms and the functioning of markets. Long gone are the days when economics and economists were described with indifference or even in unflattering terms. According to the Oxford English Dictionary:

"in the 19th century, economics was the hobby of gentlemen of leisure and the vocation of a few academics" and *"economists wrote about economic policy but were rarely consulted before decisions were made."*

Those days are gone. We are now in *"'the age of economists', when the demand for their services seems insatiable."* And this is even more so in the midst of the financial crisis that we have been experiencing for some time now, and the associated fallout on the real economy.

At the present juncture, economists in business and policy-making institutions continue to face a mountain of thorny and complex issues. To address these, it is necessary to use not only our knowledge and experience, but also some "mountaineering" skills. I find it intriguing that the Society of Business Economists was founded in the year 1953, which was marked by a groundbreaking mountaineering achievement: it is the year in which Sir Edmund Hillary and Tenzing Norgay climbed Mount Everest for the first time. Our experience with the ongoing financial crisis sometimes reminds us of those mountaineers: like them, we have been facing constantly changing and often stormy conditions, and we have had to march through uncharted territory. As monetary policy-makers, we have found it necessary to adapt our equipment – our instruments and operating procedures – to changing circumstances. And we have been equally determined to master the challenges that lie ahead. But in order to do so successfully, it is essential that we have clear objectives, that we pursue an appropriate strategy and that we adhere to solid principles guiding us towards achieving our policy goals.

So what further steps and actions should be taken in order to successfully "climb that mountain" and reach our policy objectives? What course should we take in order to steer clear of the precipices of plunging markets, to prevent financial and economic hypothermia, and to ensure that our policy equipment, that is, our policy tools, remain effective? In my remarks tonight, I would like to address two specific questions:

- *First,* what are the necessary policy actions that can preserve price and financial stability, restore confidence and foster economic recovery?
- *Second,* what macroprudential supervisory policies and institutional and regulatory reforms should be pursued in order to avoid the emergence of market excesses and

financial imbalances in the future and minimise the likelihood of another financial crisis in the long run?

II. Policies to preserve stability, restore confidence and foster economic recovery

Over the past five months, since the financial turmoil intensified and economic conditions deteriorated substantially, central banks and governments have taken *unprecedented* measures to preserve stability and cushion the impact of the financial crisis on the economy:

- *unprecedented* have been the measures taken by the major central banks since the eruption of the crisis, as judged *(i) by* the size and frequency of money market operations to provide liquidity; *(ii)* by the enlargement of the pool of eligible collateral and the expansion of their balance sheets; *(iii)* by the speed and magnitude of monetary policy easing since October 2008; and *(iv)* – in some cases – by the use of unconventional or non-standard policy tools;
- *unprecedented* have been the measures taken or announced by governments *(i)* to support the banking sector through recapitalisations, government guarantees on bank debt, and asset-relief schemes; and *(ii)* to stimulate aggregate demand through fiscal packages.

The policies implemented so far have helped to stabilise the banking system and to mitigate the effects of the financial turbulence on the economy. Nevertheless, financial stresses remain and economic conditions are deteriorating in Europe and throughout the world. According to the latest forecasts of the IMF and the European Commission, global economic activity is expected to increase only slightly by 0.5% and the euro area economy is likely to contract at an average annual rate of about 2% this year.[1] Moreover, there are concerns that a negative feedback loop between the financial sector and the real economy may emerge in some countries, which may result in a prolonged period of weakness in economic activity and entail deflation risks.

The inflation outlook for the euro area

The preservation of price stability over the medium term is the overriding policy objective for the ECB. By achieving this objective, we contribute to financial stability and support sustainable growth. Since mid-2008, annual (HICP) inflation in the euro area declined steadily from 4% in July 2008 to 1.1% in January 2009 (according to Eurostat's flash estimate). This decline in headline inflation reflects largely the substantial fall in global commodity prices and associated "pipeline" price pressures over this period. Annual inflation rates are projected to decline further in the coming months, mainly due to expected lower commodity prices and base effects stemming from past energy prices, but also owing to diminishing domestic inflationary pressures in an environment of subdued economic activity. Around the middle of this year, annual inflation may reach very low levels, but then it is expected to increase again and be in line with our definition of price stability, that is, inflation rates of below, but close to, 2%. Several available indicators of medium-term inflation expectations support this assessment.

This likely time profile of inflation should be seen against the background of an extended period of significant economic downturn in the euro area and all other advanced economies.

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[1] The European Commission, in its January 2009 interim forecasts sees a contraction of the EU economy of -1.8% and of the euro area economy of -1.9%. The most recent IMF projections (January 2009 World Economic Outlook) forecast a contraction of the euro area economy by -2.0%, and only marginal positive growth for the world economy of +0.5%.

Further unexpected declines in energy prices owing to weak global demand and a sharper or more protracted slowdown in economic activity could reduce price pressures further. Therefore it cannot be excluded that euro area inflation may reach a level close to zero for a short period of time. Such a possibility, however, does not imply the emergence of deflation risks because it is likely to be short-lived and should not affect medium-term inflation expectations. Indeed, the ECB is committed to keeping inflation expectations firmly anchored in line with our definition of price stability. Moreover, although underlying domestic pressures are likely to moderate in the coming quarters, wage and price-setting behaviour is characterised by considerable inertia. It is also possible that domestic cost pressures may turn out to be stronger than expected – a prospect that is supported by recent developments in wage and unit labour cost growth.[2] For all these reasons, our current assessment is that the risk of deflation in the euro area remains remote despite the expected weakness in economic activity this year.

The prospects for economic growth

The latest data and survey indicators point to a substantial decline of real GDP in the fourth quarter of 2008 and to a continued weakness in economic activity in the euro area in the first half of this year. Confidence is at historically low levels, world trade has sharply declined and financing conditions remain tight. All these factors are adversely affecting aggregate demand. Recently, some survey indicators showed signs of stabilisation. It is too early to declare that we may be reaching the bottom of the downturn on the basis of these signals. Other indicators point to a less encouraging, if not gloomier, outlook. In other words, what we see flashing amid the clouds that cover the economic landscape right now could either be a silver lining and a first ray of light, or the harbinger of stormier weather conditions.

The risks to economic growth remain on the downside. Among the factors that may adversely affect economic activity is the prospect of growing protectionism. Economic nationalism is an emerging threat to global economic recovery and should be avoided. Another risk is the possibility that the financial crisis may have a greater negative impact on the real economy than currently expected. This could be the outcome of the mutually reinforcing effects of weak economic activity, deteriorating bank asset quality and constraints on the supply of bank credit.

The intensification and broadening of the financial market turmoil since September has significantly affected the pace of broad money growth and the expansion of bank credit to the private sector. The flow of bank loans to the private sector has decelerated steadily in recent months, and in December it turned negative for the first time since the outbreak of the financial turbulence. At the same time, there are some positive developments. The substantial reduction in ECB interest rates since last October is being passed through to lower bank lending rates, thus easing financing conditions for companies and households. I also find it encouraging that money market conditions have improved gradually but steadily. Money market spreads have progressively narrowed, even though they remain at elevated levels and the turnover in unsecured money market remains rather low. The evidence, however, also suggests that financial institutions pursue the deleveraging process mainly by tightening credit standards and curbing new lending.

Monetary policy

Against this background of rapid disinflation, weak economic activity and persisting financial market stresses, the ECB will continue to face the twin challenge of securing price stability and contributing to financial stability in the euro area. To meet this challenge, the conduct of

[2] Unit labour costs in the euro area rose by 3.6% in the third quarter of 2008 compared with 3.2% in the second quarter, despite the decline in GDP growth occurred over that period.

monetary policy by the ECB has been based on its medium-term oriented strategy and a fundamental principle: the separation of the monetary policy from liquidity management. The monetary policy stance is defined by the level of the key ECB interest rates and is determined with a view to achieving the primary objective of preserving price stability over the medium term. Liquidity management aims at ensuring the orderly functioning of money markets which is necessary for the efficient transmission of monetary policy and for the mitigation of financial stability risks. The separation principle implies that the policy interest rate is not employed to alleviate stresses in the financial system if upside risks to price stability prevail. If the preservation of price stability is secured over the medium term and will not be jeopardised by a change in the monetary policy stance, the interest rate can be adjusted to mitigate the impact of financial market stresses on the economy, including their potential effect on medium-term price developments.

For more than a year since the outbreak of the financial turmoil in August 2007, the ECB did not reduce its key policy rates in view of significant medium-term inflation risks, but intervened in a decisive manner in the money markets, by taking "unprecedented" measures to provide liquidity so as to maintain orderly market conditions and contain the spillover effects of financial market tensions on the real economy. Since October 2008, following the intensification and broadening of the financial crisis and in view of the significant change in the balance of risks to price stability, the ECB responded in a timely manner both with an unprecedented – in terms of speed and magnitude – easing of monetary policy (having reduced its policy rate by 225 basis points in a period of three months) and by taking unprecedented – and indeed "unconventional" or "non-standard" measures – in the money markets by providing unlimited funding in euro (but also in other currencies) over periods of up to six months against an expanded range of eligible collateral. As a result, the size of the Eurosystem's balance sheet increased by 37% during the fourth quarter of 2008 to a total of just over €2 trillion at the end of last year. This simultaneous easing of monetary policy and liquidity provision was fully consistent with the separation principle and the medium-term orientation of our strategy because of the new constellation of risks to price stability and financial stability.

The unprecedented reduction in the ECB's policy rates and the extraordinary increase of liquidity in the money market have been helping to mitigate the impact of the processes of disinflation and deleveraging on the real economy. Consequently, they have been containing the possible emergence of "endogenous" risks to price and financial stability. At the same time, we continue to be confronted with exceptionally high uncertainty. The transmission mechanism of monetary policy has been affected by the strains in the money market and the ongoing adjustment of banks' balance sheets as well as by the increased risk aversion and reduced confidence of consumers, firms and investors. Accordingly, we will continue to monitor closely all relevant developments. In early March, with the benefit of additional information and the ECB staff macroeconomic projections, we will assess the medium-term outlook for price stability and the associated potential risks. If inflationary pressures are diminishing and risks to price stability are assessed to be on the downside, a further easing of monetary policy may be appropriate in order to maintain inflation over the medium term at a level consistent with price stability, that is, below, but close to, 2% and keep inflation expectations firmly anchored in line with this objective.

An important issue which has been discussed extensively recently is whether the persisting strains in the money market and the significant tightening of credit conditions – and the possible emergence of supply constraints – in the bank credit market require further measures to be taken by central banks and governments in order to preserve financial stability and support the recovery of the economy. Such measures have been taken or pledged in the past in the United States, the UK and the euro area. And yesterday, the US government announced an extensive new package of measures to "stabilise and repair the financial system, and support the flow of credit necessary for recovery."[3] In the euro area, as I previously noted, the ECB has already taken non-standard measures in the past by changing aspects of its operational framework to provide unlimited liquidity to financial institutions at a fixed interest rate against an expanded list of collateral. Are these measures sufficient? Or are additional measures necessary to secure price stability and preserve financial stability under the current circumstances? Let me make three pertinent points:

- *First*, the purpose of such measures is to improve the functioning of markets and the transmission of monetary policy when these are impaired by exceptionally high uncertainty and elevated risk perception.[4] Clearly, the dysfunctioning of markets because of increased uncertainty and risk cannot be addressed by a change in the stance of monetary policy.
- *Second*, any measures that may be deemed appropriate to improve the functioning of markets and help stabilise the financial system may be taken independently of the level of policy rates. This is what the ECB has done in the past when it took "non-standard" measures. Put differently, I do not see a dependence, or necessary sequence, between the level or path of policy rates and the possible adoption of "non-standard" measures aimed at improving the functioning of markets and preserving the stability of the banking system. Indeed, a possible implementation of such measures can be seen as an application of the "separation principle" I previously mentioned between interest rate decisions and other central bank operations.
- *Third*, as always, we will do whatever we judge to be necessary and appropriate to maintain price stability and contribute to the preservation of financial stability.

Other policies to tackle the crisis

Having said that, it should also be clear that we cannot rely solely on central bank policies to address all the consequences of the financial crisis and its fall-out on the economy. Other policies and measures are required to tackle the challenges we are facing in the financial sector, in the real economy and in the complex interaction between the two. After all, Hillary and Tenzing also did not conquer the world's highest mountain by themselves; they were helped by a large team that was part of their expedition. In fact, as they were ascending towards the summit, they reached levels of altitude where further safe progress was possible only with the support of additional oxygen equipment. I am stretching the metaphor here, but dealing with the problems faced by some banks, and facilitating the provision of credit to the economy, may require the supply of "additional oxygen" in the form of government measures aimed at strengthening the banks' balance sheets, both on the liability and the asset sides.

Since last autumn, governments have provided, or pledged, a substantial amount in guarantees for new debt issuance by banks and have recapitalised a number of financial institutions. The latest figures (end-January 2009) show that the stock of guaranteed bank bonds globally will soon reach a level of €300 billion, of which one quarter concerns euro area banks. These are substantial figures, though we should bear in mind that it takes some time for the measures to be completely implemented and to show their full effects.

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[3] Remarks by US Treasury Secretary Timothy Geithner, "Introducing the Financial Stability Plan", 10 February 2009.

[4] The tensions in the money markets reflect the reluctance of banks to lend to each other because of persisting concerns about the creditworthiness of their counterparts and uncertainty about their own liquidity needs. And the tighter credit standards and conditions reflect, *inter alia*, banks' concerns about asset quality and credit risk.

Additional measures to support the asset side of banks' balance sheets

It may be necessary, however, in order to safeguard banking sector stability and restore an adequate flow of credit to the economy,, that these measures, which were aimed at supporting the liability side of banks' balance sheets be complemented in certain cases by additional measures designed to support the *asset* side. Various approaches have been considered, ranging notably from *(i)* asset removal schemes involving the removal of the "problem" assets from the balance sheets, through direct government purchases or by transferring them to "bad banks" or asset management vehicles; to *(ii)* asset insurance schemes that limit the valuation losses of impaired assets by invoking a government guarantee while keeping them on the balance sheets of institutions concerned, and *(iii)* including various hybrid schemes that combine features of asset insurance and asset removal.

The appropriate design and the effective implementation of asset support measures require addressing a number of complex issues. Past experience and the assessment of alternative schemes on the basis of a number of criteria, suggest that there is no single approach that would be uniformly superior independently of the circumstances of the financial institutions concerned. Rather, the measures would need to be designed on a case-by-case basis and in a pragmatic manner. In fact, hybrid schemes have often been chosen as the most appropriate. The chosen scheme should aim to achieve a number of objectives: *(i)* it should safeguard financial stability and effectively restore the flow of credit to the private sector; *(ii)* it should also ensure that a level playing-field in the EU financial market is maintained to the maximum extent possible; and *(iii)* it should contain the impact on public finances and limit moral hazard. At the current juncture, we see the financial stability objective and the restoration of an adequate flow of credit to the economy as the overriding concern. But the other objectives must also be met.

Bearing in mind these objectives, the European Commission, in cooperation with the ECB, has developed a list of guiding principles for the design and implementation of asset support schemes in order to address the most critical issues, which concern the eligibility of institutions and assets, the valuation of assets and the risk-sharing mechanism, to create the right incentives and minimize the impact of the measures on public finances. What we need in the EU is a common consistent framework that will help ensure the attainment of the three objectives in an efficient and effective manner.

Fiscal policies

While such schemes, as well as the government guarantees and recapitalisations, should assist in restoring a degree of normality to the functioning of the financial system, mitigating the fallout of the crisis on the real economy calls for a different set of policy tools, notably fiscal policy. In other words, if banks need some "additional oxygen", so does the macroeconomy. As always, the content and quality of the remedy, and the dose to be administered, are crucial. Specifically, the various ingredients of the fiscal stimulus packages need to be carefully chosen, in order to ensure that the measures taken will be effective in supporting the economic recovery in a timely manner and that taxpayers' money is appropriately and efficiently spent, that is, it generates real economic benefits and is not wasted. We therefore call for prudence in the design of fiscal stimulus packages: they should be timely, targeted and temporary. Needless to say, the appropriate dose of fiscal stimulus will depend not only on the particular economic situation in each country, but also on its fiscal position. It is crucial that the confidence of the public in the soundness of public finances is not undermined. The stimulus packages should therefore contain a credible exit strategy, so that the desired support of economic activity in the short term is not jeopardised by the long-term negative effects associated with unsustainable public finances.

III. Policies to reduce the procyclicality and safeguard the stability of the financial system

Any seasoned mountaineer also gives some thought to whether his gear has served him well during an expedition, and what devices may need to be exchanged or rearranged to make sure he is well-equipped for the next climb. Likewise, policy-makers around the world are assessing whether – and to what extent – certain features of the financial system encouraged market excesses and the build-up of large financial imbalances. And they are considering what changes should be made to the financial system and to the regulatory and supervisory framework to reduce the pro-cyclical behaviour of financial markets.

In my view, the past two years have demonstrated a number of weaknesses of the financial system. It is imperative for policy-makers – and market participants – to address these weaknesses so as to avoid the recurrence of similar excesses and imbalances in the future. For us as central bankers, it is essential for an additional reason: even if tackling the structural weaknesses is a task for the longer term, we need to start now in order to contribute to the restoration of confidence also in the short term. The markets need to see that serious and concerted efforts are undertaken to safeguard financial stability in a sustained manner. Several important activities are underway in this respect. At the global level, under the aegis of the G-20 and the Financial Stability Forum, and in Europe, on the basis of the ECOFIN Council's roadmaps. The various measures being discussed and agreed in these fora aim at addressing the inherent procyclicality of the financial system. The focus of the work is on: *(i)* regulatory aspects, and notably capital requirements; *(ii)* fair-value accounting and provisioning regimes; *(iii)* incentive schemes; and *(iv)* transparency and disclosure rules. Moreover, steps are being taken to strengthen the regulatory and supervisory framework in Europe in order to enhance both crisis prevention and crisis management. There is no time on this occasion to go into details on all of these issues, but let me comment on three: *(1) accounting standards*; *(2) capital requirements* – and the complex interrelation between the two – and *(3)* the need to strengthen the *macroprudential supervision* of financial markets and institutions.

Let me start with *accounting standards*. Finance and accounting have close and powerful links. The current fair-value accounting rules have been identified as having contributed to financial market dynamics. The *"self-reinforcing downward spiral of higher haircuts, forced sales, lower prices, higher volatility and still lower prices"*[5] has become an all too frequent phenomenon in financial markets. When markets are dysfunctional or illiquid, I have doubts whether marking-to-market provides accurate or useful information, especially from a medium or longer-term perspective. Moreover, the current impairment rules have not allowed banks to have forward-looking provisions or dynamic provisioning, so that they would build up provisions in good times and draw them down when the cycle turns and defaults surface.

This should make us think again. Accounting standards do not exist in a vacuum – they have an impact on financial stability and ultimately on the real economy. We should therefore reflect on how we can dampen or correct the procyclical impact of fair-value accounting and provisioning regimes, without compromising the provision of accurate and useful information or a "true and fair view" to investors.

Second, *capital requirements*. The current framework based on Basel II involves greater risk sensitivity, because it links required capital to the perceived riskiness of assets which is likely to change in the course of the economic cycle. What the capital regime should do – but is not doing at present – is to promote the creation of capital buffers and restrain the build-up of excessive risk-taking during the upswing of the economic cycle while containing the costs of financial distress in the downturn. In order to achieve this, authorities are currently discussing

[5] Remarks by the President of the Federal Reserve Bank of New York, Timothy Geithner, before the US Senate Banking Committee, 21 November 2008.

whether the capital requirements could be supplemented by a measure to help contain leverage.

Macroprudential supervision and the role of central banks

The final point I would like to make concerns the financial stability framework in Europe and the role of central banks in it. One of the key lessons from the crisis is that in an increasingly market-based and interconnected financial system, disturbances are likely to affect core market mechanisms, such as the distribution of liquidity; they have cross-border implications; and they are likely to propagate in a more unpredictable manner. An adequate appreciation of these dynamics requires a *systemic* perspective for the analysis of financial stability which normally lies with the central banks, but requires also a close interaction between them and prudential supervisors.

Central banks can make an important contribution to financial stability by performing several tasks that can strengthen the "macroprudential supervision" of the financial system. The precise content of the term is not always clearly and precisely defined. In general terms, macroprudential supervision – rather than concentrating on the health and performance of individual financial institutions – aims to limit system-wide distress by calibrating prudential controls accordingly. Financial stability risk depends on the collective behaviour of institutions – it is "endogenous" – because, collectively, financial institutions can influence asset prices, which can significantly affect the health of the economy as a whole. This, in turn, can produce powerful feed-back effects on the soundness of the institutions. In concrete terms, macro-prudential supervision should involve financial stability monitoring and analysis, the development of early warning indictors; macro-stress testing to verify the resilience of the system, the definition of reporting and disclosure requirements to ensure the availability of relevant information, as well as macro-prudential regulation, aimed at countering the potential procyclicality of regulatory requirements and avoiding excessive leverage, risk concentration and liquidity mismatch in the financial system.

Given the increasing financial integration in Europe, and especially within the euro area, and notably the growing number and systemic relevance of cross-border banking groups, central banks in general, and the ECB and the Eurosystem in particular, are well placed to assume the tasks of macro-prudential supervision. Key requirements for an effective implementation of this task are *(i)* access to relevant supervisory information on large cross-border financial institutions and *(ii)* the establishment of mechanisms and procedures that would ensure that the assessment and advice concerning corrective actions that aim at containing risks and vulnerabilities is duly reflected in the actions of national supervisory authorities.

IV. Concluding remarks

Will appropriate macroeconomic policies and a strengthened regulatory and supervisory framework be able to prevent future financial crises? Can we design a "crisis-proof financial system"? Thinking about these questions, I am reminded of an episode during a visit of Mahatma Gandhi to London, before Indian independence. He was then asked by a reporter: *"What do you think of European civilisation?"* Gandhi answered: *"I think it would be a good idea."* A crisis-proof financial system would indeed be a "good idea". It would, however, be foolhardy to presume that better regulation, more effective supervision and longer-term stability-oriented macroeconomic policy would suffice to eliminate the cyclical features of the financial system and the build-up of financial imbalances in the future. Market participants have an important role to play – and a self-interest – in addressing some of the revealed weakness in the financial system, and in strengthening market discipline. What we, policy-makers, can do, and should aim at, is to ensure that the macroeconomic policies we pursue and the regulatory framework we design do not exacerbate cyclical fluctuations, and that, when financial imbalances and market excesses emerge and are identified, we have the appropriate tools to address them in an effective manner.

Thank you very much for your attention.