Lucas Papademos: How to deal with the global financial crisis and promote the economy's recovery and sustained growth

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the 7th European Business Summit organised by the European Business Forum, Brussels, 26 March 2009.

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I. Introduction

The European and global economies are experiencing the most severe and prolonged financial crisis since the 1930s. A few facts and figures highlight the magnitude and nature of the challenge we face. Since the beginning of the financial turbulence in 2007, the total reported write-downs and losses of banks globally have exceeded 888 billion dollars. Some estimates of the overall expected losses by banks and other financial institutions are in the range of 2.2 trillion dollars.[1] Asset prices have plummeted worldwide, though the extent differs across countries and market segments. In the EU, the value of equity has fallen by 6 trillion euro,[2] a decline of more than 50% from the peak reached in summer 2007. Economic activity decelerated sharply during 2008, especially in the last quarter; it is projected to contract significantly in the EU this year and to recover very moderately and gradually in the course of 2010. Importantly, the economic outlook is surrounded by exceptionally high uncertainty reflecting, among other factors, the low level of consumer and business confidence as well as the ongoing deleveraging of banks and other financial institutions.

The economic and financial situation and prospects are characterised by two features: first, a synchronised decline or deceleration in economic activity in all economies which is associated with a collapse in world trade; and, second, growing signs of an adverse feedback loop between the real economy and the financial sector. Although the sharp drop in the value of toxic assets has weakened many banks' balance sheets, the weakening of economic activity has been impairing the quality of bank loans, adversely affecting their capital positions and their willingness to extend credit to the private sector. This, in turn, constrains the pace of economic activity and the ability of the private sector to service its debts, entailing a risk of a vicious circle.

II. Policies for economic recovery and sustained growth

These observations have two general implications for economic policy. First, the economy's recovery requires the simultaneous implementation of macroeconomic policies to stimulate aggregate demand and of measures that will help repair banks' balance sheets and encourage the provision of credit to the economy. In this way, a potential vicious circle can be prevented. Second, concerted policy efforts in all economies, especially the large ones, are necessary so that world trade can be revitalised and financial capital flows stabilised. This will help support the emerging market economies and global growth. The policy strategies pursued need not be identical across countries and regions and the required size of the economic stimulus and the nature of the other measures taken need not – and should not – be the same, as structural and conjunctural conditions differ. Nevertheless, a similar orientation and consistency is warranted.

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[1] See International Monetary Fund, Global Financial Stability Report Market Update, 28 January 2009, p.2.

[2] Based on data available up for January 2009.

Since the intensification of the financial crisis in September 2008, central banks and governments globally have acted in a decisive and concerted manner to contain the adverse effect of the financial crisis on the real economy and promote its recovery. In the euro area, the actions taken by the ECB and the Eurosystem are unprecedented in size and scope. Government support for financial institutions in the form of recapitalisations, guarantees on bank debt and, more recently, asset relief schemes, have been significant and the pertinent measures are progressively being implemented. And the fiscal stimulus packages of euro area governments are substantial, amounting to a total of about 2% of euro area GDP over this year and the next.

The immediate priority of macroeconomic policies and bank support schemes is to promote the economy's recovery and preserve price and financial stability. Yet, a fundamental policy objective should be that the recovery of activity and the repair of the financial system have to be achieved in a manner that will ensure a sustained growth performance and will prevent the recurrence of episodes of financial imbalances and market excesses that can threaten again financial stability and economic welfare. Put differently, it is important that the policies and reforms pursued today lay the foundations for sustained growth. Let me now elaborate on these issues by focusing on the role and contribution of central bank policy and of financial system reform.

Central bank policy

The ECB's monetary policy and provision of liquidity have played a key role in containing the downside risks to price stability, supporting economic activity and stabilising the financial system. The extent of the monetary policy easing since last October has been unprecedented, with key ECB policy interest rates having been reduced by 275 basis points. At the same time, money market rates have declined even more from the peaks reached in October 2008 as a result of the reduction in the policy rates and the provision of unlimited liquidity to banks at a fixed interest rate (against an expanded range of eligible collateral) since last October. At present, Euribor rates of maturities up to three months are below or very close to the main refinancing rate (MRO) of the ECB and at historically low levels – ranging between 0.93% (overnight) and 1.56% (3 months).[3] And these levels are comparable to the corresponding Libor rates in the US dollar and Pound sterling money markets.[4] Thus, over the past six months, conditions in the euro area money markets have significantly improved and effectively are similar to – or even better than – those in other major money markets.

In addition, the provision of liquidity by the ECB to the euro area banking system has been extraordinary in size and scope. The size of Eurosystem's balance sheet in mid-February had reached 1.53 trillion euro (or 1.96 trillion US dollars), compared with 0.91 trillion euro before the eruption of the crisis. The expansion of the Eurosystem's balance sheet by about 70% over this period reflects the various non-standard measures implemented by the ECB, including the provision of unlimited funding in euro at fixed interest rates over periods up to six months as well as the supply of liquidity in other currencies, notably US dollars, on the basis of a swap agreement with the Federal Reserve. The reduction in the policy rates and the increased supply of reserves were fully in line with the ECB's primary objective of preserving price stability over the medium term, as inflation pressures eased and inflation risks diminished, and helped to alleviate pressures in the credit market and mitigate financial stability risks.

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[3] Euribor rates for longer maturities (on 25 January 2009) are following: 6 months: 1.71%; 9 months: 1.78%; 1 year: 1.86%.

[4] US Dollar 3-months Libor on 25 January 2009 were 1.48%; and Sterling 3-months Libor 1.79%.

Nevertheless, and although bank lending rates have been gradually falling, bank credit standards on new loans have been tightened and credit growth to the private sector has been decelerating. This partly reflects the impact of the decline in economic activity on the demand for bank loans, but it is also a consequence of the ongoing deleveraging process in the banking system and continued stresses in the funding markets.

Government support for the banking system

Since last autumn, governments have supported the banking system through various measures: by injecting new capital, by providing guarantees on new bank debt issuance and, more recently, through asset relief schemes (involving the removal of impaired assets from the banks' balance sheets or the provision of guarantees to limit the valuation losses of such assets). These measures have succeeded in stabilising the banking system, by reducing systemic risks and strengthening confidence. The support provided has been substantial, for example banks in the euro area have received 115 billion euro of capital injection from governments (of which 75 billion euro were provided to the major banking groups) and 217 billion euro of funding guarantees. However, these bank support measures are taking some time to implement. So far, only one third of the commitments for capital injections have been used and a smaller fraction – about 12% – of the commitments to guarantee new bank debt have been called upon. The participation of banks in the debt guarantee schemes is voluntary, and the very limited use of these guarantees may reflect a decline in the demand for credit and/or the desire of the banks to continue deleveraging their balance sheets. It is, however, important to ensure that other constraining factors are addressed, for example that the disincentives associated with the provision or pricing of these debt guarantees are promptly addressed, so as to help banks finance additional lending to the private sector.

Possible further measures

A relevant question is whether the tight financing conditions and the continuing stresses on the banking system require further measures by governments and central banks in order to help revive the extension of bank credit to the economy. The answer regarding the need and the nature of potential further measures depends on the causes or determinants of the prevailing financing conditions and on the structure of the financial system. To the extent that (i) financial market stresses, (ii) the deleveraging process, (iii) uncertainty about the economic outlook and about potential further bank losses, and (iv) low confidence impair the functioning of the credit and bank funding markets and the transmission of the effects of monetary policy, "non-standard" measures aimed at reducing funding uncertainty and enhancing the functioning of the credit market and, consequently, the monetary policy transmission mechanism, may represent possible courses of action. In the euro area, because the banking system has a more dominant role in the financing of the private sector than the capital market, compared with other economies, the implementation of such measures would be more focused on the banking system. Potential measures could include an extension of the maturity of the central bank liquidity provided to banks and purchases of private debt securities in the secondary market in order to improve its liquidity and reduce the cost of funding of the real economy, thus helping its recovery.

Could a further easing of monetary policy contribute to containing potential disinflation risks and provide further support to economic activity? I would like to make two general remarks concerning the role of monetary policy in fostering the economy's recovery and sustained growth at this juncture and more generally. First, as we have emphasised in the past, the ECB's monetary policy should ensure that inflation expectations over the medium to longer term remain firmly anchored in line with the Governing Council's aim to keeping inflation below, but close to, 2%. This anchoring of inflation expectations supports sustainable growth, employment creation and contributes to financial stability. Second, the monetary policy stance should be determined so as to also contribute to a smooth exit strategy from the current exceptional circumstances of historically low rates and unlimited provision of central

bank money to the banking system. Consequently, a monetary policy that aims to address potential disinflation risks and maintain medium-term price stability must be implemented in a manner that also ensures the preservation of price stability over the longer term.

Financial system reform

And this brings me to two final points concerning two other essential conditions for sustainable growth: financial system reform and sound fiscal policy. It is by now generally agreed that there is both a great and urgent need to introduce reforms that prevent the recurrence of episodes of financial market excesses and corrections and that will make the global financial system more resilient to shocks. An extensive and impressive amount of work has been undertaken by national authorities and international bodies, under the auspices of the Financial Stability Forum and, more recently, the G20 process. Concrete proposals have been formulated – and others are currently being elaborated – on how to reduce the cyclicality of the financial system through various measures and reforms, including the enhancement of the scope and effectiveness of financial regulation and supervision. In the EU, the report of the de Larosière Group is a valuable contribution to this end. The forthcoming summit meeting of the Group of 20 in London can mark a further important step in the effective pursuit of this reform agenda globally. The prompt implementation of the proposed financial reforms will not only foster sustainable growth and financial stability in the long run, but it should also contribute to boosting confidence in the financial system in the short run, thus promoting economic recovery.

Fiscal policy

Last, and definitely not least, it is also essential for sustainable growth and prosperity that confidence in the long-term soundness of public finances is maintained. Government deficits and public debts are rising substantially in most countries as a result of the economic downturn, discretionary measures to stimulate the economy, and the funding of the bank support schemes. This is partly inevitable – due to the downturn – and partly necessary – to help stabilise the economy and the financial system – in the short run. But it is also imperative that fiscal policies are designed and implemented in a manner that strikes the right balance between the need to support the economy's recovery and the need to preserve the confidence in the soundness and sustainability of public finances which is key for the long-term performance of the economy.

III. Conclusion

I have used the word "confidence" several times. The severity and duration of the current economic and financial crisis is partly a consequence of the reduced confidence in the prospects of the economy and the soundness of the financial system. The recovery of the economy also hinges on the restoration of consumer and business confidence that can contribute to the revival of spending and investment, and the return to normality in financial markets and the banking system. The rebuilding of trust will depend on our ability to appropriately combine the policy actions needed to address the immediate challenges with the necessary reforms for establishing an economic, financial and institutional environment that is conducive to sustainable long-term growth.

Thank you very much for your attention.