Lucas Papademos: The dual crisis – economic impact, policy response and exit strategy

Speech by Mr Lucas Papademos, Vice-President of the European Central Bank, at the High-Level Panel Debate on "Europe in the Economic and Financial Crisis: How to bring back prosperity for everyone?", organised by the European People's Party, Brussels, 4 May 2009.

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I. Introduction

Let me start by thanking the organisers for inviting me to this policy debate on how to overcome the current economic and financial crisis and bring back prosperity for everyone. This subject remains topical and challenging. Lately, among the generally gloomy reporting on the state of the economy, we have observed some positive signs emanating from market developments and confidence indicators suggesting that the economy is stabilising. Indeed, one indicator that has recently surged is the one measuring the use of pertinent metaphorical expressions: we hear of "green shoots"; "glimmers in the dark"; and, the more traditional, "light at the end of the tunnel". Some indices suggest that the pace of deterioration in the global and European economies is slowing, and equity markets seem to reflect expectations of improving prospects. But it will take some time before our economies fully recover and grow at a robust and sustained rate.

The theme of this debate rightly emphasises two important issues that are relevant for public policy: first, the dual character of the current crisis, which is both financial and economic and, second, the need to also focus on the longer term. The actions of policy makers and market participants should not only aim at overcoming the current difficulties, but should also consider the strategy and measures that will ensure sustained prosperity and that crises such as the current one will not occur again.

Accordingly, in my remarks I will address three issues:

- *first*, the evolving nature of the ongoing crisis and its potential total impact on the European economy;
- *second*, the rationale and the effectiveness of some of the measures being implemented to resolve the problems we are confronted with; and
- *third*, the need to implement reforms and adopt an appropriate exit strategy, from the extraordinary policy interventions, so as to improve the functioning and resilience of the financial system and achieve sustained economic growth in an environment of monetary and financial stability.

II. The evolving nature of the crisis and its economic impact

The nature and scope of the crisis has evolved substantially since it erupted in the summer of 2007. Initially and for a considerable period of time, it was mainly an episode of strong financial turbulence that affected certain segments of the credit market resulting in large writedowns on a class of assets (complex structured products) that affected a relatively limited number of institutions in advanced economies. Progressively, and especially since mid-September 2008, it has evolved into a global crisis affecting advanced, emerging and developing economies; and it has spread across economic sectors. The, more or less, synchronised decline or deceleration of economic activity worldwide has been accompanied by a collapse of world trade that has further depressed global economic activity.

A key feature of the current crisis is the mutually reinforcing interaction between, on the one hand, the weakening of economic activity and the rising unemployment and, on the other hand, the process of deleveraging and repair of banks' balance sheets and the persisting tensions in some financial markets. The weakening of economic activity has been impairing the quality of bank loans thus adversely affecting banks' capital positions and their willingness to extend credit to the private sector. This, in turn, imposes constraints on economic activity and the ability of firms and households to service their debts, increasing the likelihood that banks will suffer further credit losses and tighten their lending standards. Therefore, the main immediate policy challenge is to prevent the emergence of a strong adverse feedback loop between the real economy and the financial sector.

Before examining the effectiveness of the policies being pursued to address this challenge, let me briefly refer to the impact of the crisis on the economy and the financial system of the euro area. Since the financial turmoil deepened and broadened in the autumn of 2008, its impact on the economy has increased substantially. The significant deceleration in real GDP growth in the euro area to 0.8% in 2008, from strong growth rates of 2.7% in 2007 and 3.0% in 2006, reflects the sharp contraction in activity by 1.5% in the fourth quarter of last year. The latest available information suggests that aggregate output recorded a further sizeable decline in the first quarter of this year. The recent forecasts by the IMF paint a gloomy picture for economic activity in the euro area, with real GDP projected to decline by 4.2% in 2009 and by 0.4% in 2010.[1] The European Commission also predicts a significant contraction of euro area GDP this year, by 4.0%, and still slightly negative growth of -0.1% for 2010.[2]

What is behind these forecasts? Two important determinants, among others, that have been adversely affecting private consumption and investment are the perceived unusually high uncertainty surrounding the European and global economic outlook and the exceptionally low confidence in the financial system. Reducing this uncertainty and restoring confidence will be crucial for increasing the effectiveness of the policy measures being implemented and the pace of the recovery.

The estimated total potential impact of the ongoing crisis on the value of assets held by global and European financial intermediaries is very large and has recently been revised upwards. According to the IMF, the total potential writedowns on assets originated in the United States, Europe and Japan could reach USD 4.1 trillion over the period 2007 – 2010, of which USD 2.8 trillion would be borne by banks. The total expected writedowns on assets – both loans and securities – held by European banks are estimated at USD 737 billion. It is useful to distinguish between the actual losses incurred so far, and potential future losses. In Europe, the reported writedowns (on securities and loans) of banks so far[3] amount to almost USD 358 billion (of which euro area banks account for less than USD 173 billion). At the same time, a total of USD 382 billion of fresh capital has been raised by European banks (of which USD 190 billion was raised by euro area banks). Therefore, the newly injected capital into European and euro area banks exceeded the reported writedowns.

Looking forward, the potential further losses of European banks until the end of 2010 are estimated at USD 750 billion.[4] It is important, however, to keep in mind that estimates of the potential future writedowns on assets are based on many underlying assumptions concerning the future path of economic activity, asset market developments and the calculation of impairment charges on loans. These estimates are therefore subject to a substantial margin of error. There is, however, one important point concerning the estimated potential future writedowns of European banks. They mainly reflect expected losses on loans and to a lesser extent further writedowns on securities. This underscores the significance of

[1] See International Monetary Fund, *Word Economic Outlook,* April 2009, released on 16 April 2009.

[2] See European Commission, *Economic Forecast Spring 2009*, released on 4 May 2009.

[3] Data included up until 19 April 2009.

[4] See International Monetary Fund, *Global Financial Stability Report*, released on 21 April 2009.

pursuing policies that can prevent, or at least limit, the negative feedback loop between the banking system and the real economy. And this brings me to the appropriate policy responses.

III. The rationale and effectiveness of policy measures

The nature and scope of the crisis has required the concerted and parallel implementation of three types of policy responses: *(1)* macroeconomic policies to stimulate aggregate demand; *(2)* the provision of liquidity by central banks to ensure the orderly functioning of money markets, contain spillover effects on the financial system and foster the financing of the economy; and *(3)* government measures to repair and strengthen bank balance sheets so as to stabilise the banking system and help restore the provision of credit to the economy.

There are three general points I would like to make at the outset concerning the magnitude and effectiveness of these policy actions. First, the overall effectiveness of the measures depends not only on their design but also on their implementation which must be timely, well targeted and concerted so as to simultaneously address financial market stresses and the weakening of economic activity, thus preventing the development of adverse feedback dynamics between the financial system and the real economy. Second, policy actions must be implemented in a manner that helps achieve the immediate objectives of stabilising the financial system and supporting economic activity, and at the same time, (ensures that the recovery of the economy will be sustained) lays the foundations for sustained growth and prosperity.

The third point concerns the appropriate size of the economic stimulus and the nature of the other measures taken across countries and economic regions. The features of the policy strategies pursued, the precise design, magnitude, and implementation modalities of the relevant policies need not be identical across countries or economic areas, for instance, on both sides of the Atlantic, or – for that matter – on the two sides of the English channel. Some differences in size or scope are warranted by different economic and financial conditions as well as by different institutional structures. Having said that, the general orientation and the overall strategy of the policies being pursued have been similar in all major economies. This commonality derives from our shared analysis of the causes of the crisis, its evolving global character and the lessons that have been drawn about the appropriate policy responses and the need for concerted actions across the globe.

Let me now focus on central bank policy in the euro area. Since the eruption of the financial turmoil, the ECB has acted decisively providing and managing liquidity in the interbank currency market so as to foster its orderly functioning and ensure that banks have adequate access to central bank funding and can continue to finance the economy. The provision of liquidity by the ECB to the euro area banking system has been extraordinary in size and scope. It has involved the implementation of non-standard measures, such as the provision, since last October, of unlimited funding in euro at fixed interest rates over periods up the six months against an expanded list of eligible assets for use as collateral in Eurosystem refinancing operations. In addition, the ECB has supplied liquidity in other currencies, notably US dollars, on the basis of a swap agreement with the Federal Reserve. These money market interventions contributed to the growth in the size of the Eurosystem's balance sheet which has increased since the financial turmoil broke out by around EUR 600 billion, between end of June 2007 and end of April 2009, and had reached EUR 1.51 trillion (or USD 2.01 trillion) by the end of April. This figure is equal to 16.0% of the nominal GDP of the euro area. For comparison, the balance sheet of the Federal Reserve System was USD 2.03 trillion or 14.0% of the US nominal GDP.

The extraordinary expansion of liquidity provision to the euro area banking system has made an important contribution to the financing of the economy because of the dominant role of the banking system in the financing of the private sector in the euro area. More generally, the generous provision of central bank money has ensured that banks' funding constraints and perceived liquidity and counterparty risks have not caused a systemic crisis. Nevertheless, bank lending standards have been tightened and credit growth to the private sector has declined. The latter is partly a consequence of reduced demand for bank loans and partly a result of the deleveraging process in the banking sector and persisting stresses in the bank wholesale funding markets.

As the financial crisis deepened and broadened from mid-September last year, inflationary pressures and risks diminished in the euro area and globally. This was mainly due to the substantial weakening of global economic activity and the accompanying marked decline in commodity prices. Moreover, and despite the huge increase in the provision of central bank liquidity, broad money (M3) growth and the expansion of credit to the private sector decelerated, confirming that the upside risks to price stability were abating. In response, the Governing Council reduced the key ECB interest rates by an unprecedented 300 basis points between October 2008 and April 2009. As a result of the lowering of the key policy rates and the provision and management of liquidity, money market rates have declined even more from the peaks reached in October 2008. For example, the six-month Euribor rate was 1.56 % at the end of April, almost 400 basis points lower than its peak value last October (5.45%) and virtually the same as the corresponding Libor rate (1.51%) in the US dollar money market. Thus, over the past seven months conditions in the euro area money markets have significantly improved and they are virtually the same as, or even better than, those in other major money markets. These favourable money market developments have gradually been reflected in a decline in bank lending rates, especially on short-term credit to the private sector.

Later this week, the Governing Council will assess, on the basis of the latest available information and analysis, the medium-term outlook for and the potential risks to price stability, and, accordingly, will decide on the appropriate monetary policy stance and, possibly, on the implementation of further non-standard measures to foster market functioning. For this reason, I will not elaborate on these issues and will turn next to an assessment of the measures taken by governments to support the banking system and on necessary reforms to strengthen its stability and resilience.

The support that has been provided by governments to the European banks has been substantial. For example, banks in the euro area have received EUR 113 billion of capital injections from governments and EUR 300 billion of government guarantees. Moreover, a number of asset relief schemes, involving the removal of impaired assets from banks' balance sheets on the provision of guarantees to limit the valuation losses of such assets, are in different stages of implementation. The Eurosystem provided advice for the design of these measures, in the form of recommendations, for instance on the pricing of recapitalisation and of government credit guarantees, which aimed at ensuring that such measures would contribute to safeguarding financial stability and restoring an adequate flow of credit to the private sector, while preserving a level playing field within the Single Market to the maximum extent possible.

The implementation of the bank support measures has been gradual over the past few months. In the euro area, only one third of the commitments for capital injections had been used until the end of April and a smaller fraction, less than 18%, of the commitments to guarantee new bank debt have been called for. The use of government credit guarantees varies considerably across countries reflecting several factors. It is still too early to accurately assess the effectiveness of these government measures in improving the longer-term funding of banks and in fostering bank lending to the private sector. The evidence is relatively limited and the positive impact of the bank support measures cannot be easily disentangled from the negative effects of other factors on the bank funding and credit markets, notably of the weakening economic activity.

IV. The need for financial reform and an exit strategy

Overall, the combination of significant macroeconomic stimulus, the provision of unlimited central bank liquidity and the wide range of government measures to strengthen banks' balance sheets will jointly support the economy's recovery and alleviate stress in the financial system. Their impact will become progressively more visible in the coming quarters. The effectiveness of these policies over time will depend on the extent to which other factors reinforce or counteract their positive impacts. There is, therefore, no room for complacency as several risks and uncertainties lie ahead, including the extent and duration of the deleveraging process in the banking systems as well as in the non-financial sectors of a number of countries. Moreover, the pace of recovery will crucially depend on how quickly confidence will be restored in the prospects of the economy and in the soundness and resilience of the financial system.

To this end, it is essential that the revealed weaknesses in the functioning of the financial system and the inadequacies of the regulatory and supervisory framework are effectively and promptly addressed. In particular, there is a growing consensus among policy-makers about the need to strengthen and broaden the regulatory framework and to develop macro-prudential supervision globally and in the European Union.

Even if we agree on the objective, attaining it is undoubtedly a great challenge. There are different views about how to best achieve that goal. At the initiative of the European Commission, the group chaired by Jacques de Larosière undertook a comprehensive review of the EU framework for financial regulation and supervision and proposed, among other innovations, the creation of a European Systemic Risk Council with responsibility for macro-prudential supervision. The ECB welcomes the group's report and broadly supports its recommendations for macro-prudential supervision, as well as the related communication issued by the European Commission. The proposed establishment of the Systemic Risk Council under the auspices of the ECB and the Council's composition are a recognition of the extensive analytical capabilities developed by central banks in the fields of monetary and financial-stability analysis, their relevant expertise, and their closeness to the financial markets.

The development of effective macro-prudential supervision is especially challenging because the institutional framework does not exist. We are therefore called upon to create something entirely new – and the ECB and the entire European System of Central Banks stand ready to assume the macro-prudential supervision tasks envisaged in the report of the de Larosière Group and to provide the necessary analytical and logistical support to the Systemic Risk Council. For the new Council to function effectively, three key requirements will have to be fulfilled. They relate to the input, the output and the institutional foundation of the Council's work:

- *First*, the Systemic Risk Council will need to have a comprehensive and relevant information base that draws on both macro- and micro-prudential supervisory information in order to be able to identify and assess the risks and vulnerabilities in the EU financial system as a whole, to issue risk warnings and to adopt related macro-prudential policy recommendations. Close cooperation and well-functioning information-sharing mechanisms between the new Council, national micro-prudential supervisors and the proposed European System of Financial Supervision will therefore be indispensable.
- *Second*, adequate institutional mechanisms need to be in place to ensure that the risk warnings and the related recommendations issued by the Systemic Risk Council are translated into effective action.
- *Third*, for the Systemic Risk Council to be effective, legitimate and independent in its decision-making, a solid legal basis is essential. Such a basis will also provide legal clarity regarding the tasks to be performed and the access to the necessary EU-

wide macro- and micro-prudential information, subject to adequate confidentiality arrangements.

The development of an effective framework for macro-prudential supervision in the EU is an important policy priority which should be accompanied by the strengthening of the arrangements for micro-prudential supervision. Macro- and micro-prudential supervision are complementary processes and the interplay between them should be smooth and efficient.

V. Conclusion

Let me conclude with a few remarks on another important policy challenge that must be addressed in order to ensure long-term prosperity by adopting an appropriate exit strategy from the extraordinary macroeconomic stimulus and support measures. And I will focus on fiscal policies. It is evident that that the economic downturn, discretionary fiscal measures to stimulate economic activity and government intervention to support the financial sector have had a substantial impact on public finances. The latest information and the Commission's forecast today indicate a serious fiscal deterioration.[5] The current focus of fiscal policy on supporting the economy's recovery is warranted. At the same time, due attention should be paid that current actions do not undermine the integrity of the EU fiscal framework. It is essential to preserve the public's trust in the sustainability of public finances. Therefore, fiscal policy needs to have a credible exit strategy from the current extraordinary circumstances. Governments need to be credibly committed to achieve sound fiscal positions as soon as possible and to fully apply the provisions of the Stability and Growth Pact.

We are living in very challenging times, and bringing back prosperity to everyone – as referred to in the topic of today's debate – is unquestionably key priority. But just as we currently experience a dual crisis – an economic and financial crisis – our response should also be of a dual nature: we should do what is necessary to support economic recovery, while at the same time being mindful of pursuing a credible and sustainable exit strategy from the current extraordinary policy interventions, once conditions normalise again.

Thank you for your attention.

[5] The government deficit for the euro area as a whole is projected to be -5.3% of GDP in 2009, and -6.5% in 2010 – see European Commission Economic Forecast Spring 2009.