George Provopoulos: Reflections on the economic and financial crisis

Speech by Mr George Provopoulos, Governor of the Bank of Greece, at the 17th Meeting of the Economic and Environmental Forum of the OSCE, Athens, 18 May 2009.

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I am delighted for the opportunity to address this meeting of the Economic and Environmental Forum of the OSCE. As the history of this Organization clearly demonstrates, the management and resolution of security crises call for forceful and well-articulated policy responses. My presentation – reflecting my comparative advantage as a central banker – will deal with a crisis of a different kind – the economic and financial crisis that has engulfed the global economy for almost two years. My remarks will deal with four broad issues – the origins of the crisis, the policy responses taken so far, the prospects for an economic recovery during the next year, and the policy challenges that remain to be addressed. Although I will touch upon global developments in the course of my presentation, my main focus will be the euro-area economy and, to a lesser extent, the Greek economy.

The origins

For four years, through the summer of 2007, the global economy boomed. Global economic growth rose at an average rate of 5 per cent a year, its highest sustained growth rate since the early 1960s, while inflation remained generally contained. To some analysts, it began to look as if the global economy had entered a new phase – which some characterized as "The Great Moderation" – robust growth without the ups and downs of the normal business cycle.

That picture changed dramatically with the eruption of the financial crisis in August 2007, following the collapse of the U.S. subprime mortgage market. What were the factors that led to that crisis? The seeds of this crisis were planted over a number of years and relate mainly to changes that took place in the financial industry.

During the past ten years or so, a dramatic shift took place in the financial sectors of many economies. The management of economic risk, aimed at facilitating trade and investment, became less of a core activity of international finance. In its place, the financial industry came to be dominated by the risk inherent in arbitrage and deliberate exposure to asset price changes. In other words, the financial system increasingly moved away from activities geared to hedging existing economic risks – activities that promote trade within and among nations – and toward activities aimed at creating and promoting new risks.

Clearly, the liberalization of financial markets and innovations in those markets have made important contributions to economic welfare, providing substantial improvements in the productivity of our economies. However, as the demand for finance increased, financial institutions began to increasingly rely on innovative funding techniques. For example, the securitization of assets – that is, the transformation of, say, mortgages into tradable financial instruments – has the potential to facilitate the diversification of risk. Yet, securitization also meant that banks were able to sell their credit – for example, their mortgage loans – immediately after they had been extended.

Such innovative financial techniques had several consequences. First, they enabled lenders to expand the volume of their operations and conserve on capital. Second, they weakened lenders' incentives for prudent screening. The resulting decline in lending oversight contributed to rapid credit growth, helping to underpin asset price bubbles in some markets, including the housing market in the United States. Third, the complex structure of many structured products made it difficult for the ultimate holders to assess the quality and price of the underlying instrument.

Another contributing factor to the crisis is important to mention. For most of the past ten years, a chronic shortage of savings in some of the world's most advanced economies – especially the United States – was funded by savings from emerging market economies, particularly those in Asia. For example, during the period 1999 to 2006, the U.S. current account deficit – a measure of that economy's shortage of savings – doubled as a share of gross domestic product, rising from 3 per cent to 6 per cent. In turn, Asian emerging market economies, especially China, recorded huge current account surpluses and accumulated enormous foreign-exchange reserves, mainly denominated in U.S. dollars. Effectively, the United Stated paid for its deficits – or shortage of savings – by supplying dollars to the rest of the world, contributing to the creation of excess global liquidity and asset-price bubbles.

Feedback loops

All of this came to a head in August 2007 with the outbreak of the U.S. subprime crisis. Although that crisis produced a substantial slowdown in U.S. economic growth, initially much of the remainder of the global economy, including the euro area, was largely unaffected. The global economy bent, but it did not break.

Financial wounds continued to ferment, however, despite the efforts by policy-makers to sustain market liquidity and capitalization. Concerns about losses from bad assets raised questions about the solvency and funding of some key financial institutions. The situation deteriorated rapidly in September 2008, following the default of Lehman Brothers, the large U.S. investment bank, and the rescue of A.I.G., the largest U.S. insurance company. These events prompted a huge increase in perceived counterparty risk as banks faced large write-downs. Moreover, the solvency of some of the most established financial firms came into question, market volatility surged, and liquidity dried up. In effect, the entire U.S. financial system was put under severe strain.

The impact of these events was felt across the global economic and financial systems, and the world economy entered its sharpest downturn since the Great Depression of the 1930s. A striking feature of this crisis has been the successive revisions – all in a downward direction – of global growth forecasts. To give an example, one year ago the IMF forecasted that global growth in 2009 would be 3.8 per cent. In October of last year – that is, shortly after the events of Lehman Brothers and A.I.G. – the IMF reduced its global growth projection for 2009 to 3.0 per cent, lower, to be sure, than the earlier forecast, but still a fairly robust rate. In January of this year, the IMF again reduced its growth forecast for 2009, this time to 0.5 per cent. Several weeks ago, the IMF released a new forecast. The IMF now projects that global growth will turn negative – on the order of 1.3 per cent – this year.

What happened to produce such a dramatic turnaround? Because the banking system was at the epicenter of the crisis, the ramifications were quickly transmitted to all sectors in all countries of the global economy, and were magnified by a collapse in business and consumer confidence. Historical evidence confirms that financial crises are more likely to be followed by severe economic downturns when they are centered in the banking system and occur in the context of rapid build-ups of credit and house prices – characteristics that were features of the present crisis. Adding to the strains, the turbulence exposed long-simmering internal vulnerabilities within some emerging economies, focusing investors' attention on currency mismatches on borrower's balance sheets and excessive credit growth in those economies. Moreover, the severity of the crisis has been exacerbated by a corrosive feedback loop between the financial and the real sectors of the economy, which has, to some extent, undermined policy-makers' efforts to address the situation. Specifically, a disfunctioning of financial markets has reduced economic activity while the weakening of activity has, in turn, impacted on the capital position of the financial sector and, thus, its ability to provide credit to enterprises and households.

Policy responses

The policy responses, in both advanced and emerging-market economies, to the crisis have been rapid, bold, and unprecedented. Central bankers around the world have been on the front lines to sustain demand in the face of the financial-market disruptions. In what follows, I will focus my remarks on monetary-policy and fiscal actions in the euro area and the responses of the international community.

What did the Governing Council of the ECB do in response to the crisis and why did it do it? Broadly speaking, the Governing Council's responses took place in two stages – the first stage corresponds to the outbreak of the crisis and the second stage to its intensification.

Upon the first signs of financial-market turbulence, in August 2007, the Governing Council moved to ensure the functioning of the money market. The so-called "wholesale" money market plays a key role in the economy because it is the market in which banks borrow and lend to each other. In times of distress, however, banks and other financial institutions seek to reduce their exposure to risk. To do so, they move to reduce their illiquid investments, including some loans, and increase their liquidity. This process is what is known as "deleveraging". If a large number of banks do this at the same time, it can lead to large reduction of loans to corporations and consumers, inflicting damage on the economy.

Because banks were concerned about both the amount of liquidity they could obtain and the length of time for which they could hold on to the liquidity, in August 2007 the ECB provided liquidity at long time horizons as a way to insure banks against future liquidity shortfalls. This action helped increase public confidence that banks would be able to meet their obligations.

Since the intensification of the crisis this past fall, the Governing Council's actions entered a second stage. The Council has reduced its key policy interest rate from 4.25 per cent to 1.00 per cent. Such a large reduction in such a short period of time has been unprecedented in the euro area. As a result of this reduction, we are providing unlimited funding to banks at a rate of 1.00 per cent. In addition, sound and creditworthy banks can secure overnight funds in the interbank market at a rate that is between the 1.00 per cent main policy rate and the deposit rate, the latter of which is only 0.25 per cent. Moreover, we have taken several measures that are not standard in order to encourage banks to extend new credit or to continue to roll over maturing loans to firms. These measures include fixed-rate, full-allotment tenders which grant eligible banks access to unlimited funding for up to six months at our main policy rate, and the expansion of the list of eligible assets that can be used as collateral. I should also mention that ECB President Jean-Claude Trichet recently announced that additional non-standard measures will be implemented in the next few months.

As concerns about the extent of the downturn have mounted, euro-area governments have also turned to fiscal policy to support demand. Fiscal policy is providing support through automatic stabilizers and the use of government balance sheets to shore up the financial system, including capital injections to banks. In addition, many euro-area governments have taken discretionary measures to stimulate their economies.

While discretionary fiscal measures can help bolster aggregate demand and limit the impact of the financial crisis on the real economy, the room for such measures is subject to a number of important limitations.

- First, the use of fiscal policies will need to take account of the sustainability of public finances. While global developments have played a role in the widening of euro-area sovereign-interest-rate differentials since last fall, country-specific factors, including projected debt levels, have also played an important role.
- Second, a clear and credible commitment to long-run fiscal consolidation is more essential than ever in present circumstances. Any loss of market confidence could raise long-term real interest rates and debt-service costs, offsetting the expansionary effects of measures already taken and adding to financing costs. Therefore, fiscal

support measures should be accompanied by a plan to withdraw the stimulus as the crisis abates.

- Third, to attain such a credible commitment, it is crucial that euro-area countries respect fully the provisions of the Stability and Growth Pact. This will provide the necessary medium-term framework with which to preserve the public's trust in the sustainability of the public finances.
- Fourth, as growth is a key factor in restoring debt sustainability, directing expenditures toward productive areas – such as government investment in transportation, infrastructure, and education – would be beneficial. A similar argument applies for tax reforms that reduce distortions.
- Fifth, as indicated by the foregoing remarks, for some countries there is no room for discretionary fiscal expansion. I might add that, reflecting past choices, Greece is one of those countries. It would be possible, however, to boost public investment in Greece without any significant budgetary effects if the advance payments of Community funds are used for the financing of infrastructure projects.

Let me say a few words about the policy response to the crisis at the international level. The IMF has been the main vehicle for coordinated action by the international community. The Fund's resources have been greatly expanded and actions have been initiated to further increase the Fund's resources through, among other vehicles, a quota increase and an SDR allocation. In turn, the Fund has responded with a record lending commitment totaling some $157 billion. A number of European countries – including Belarus, Hungary, Iceland, Latvia, Romania, Serbia, and the Ukraine – have undertaken adjustment programs supported, in part, by financial assistance by the Fund. These programs have helped increase confidence and have reduced pressure on capital outflows.

Prospects for recovery

The picture that I have described thus far is of a global economic downturn that is by far the deepest since the Great Depression of the 1930s and of a policy response, including monetary and fiscal actions, and support measures for banking systems, that are unprecedented in both breadth and magnitude. It is important to point out that this policy response is very different from that which took place during the Great Depression. During the 1930s, many large economies did not pursue expansionary monetary or fiscal policies. In the early years of the Great Depression, some countries, including the United States, operating under the rules of the gold standard, implemented tight monetary policies in order to stem gold outflows. With regard to fiscal policies, the conventional wisdom of that earlier period was that budgets should not be expansionary, even during depressions. That wisdom did not begin to change until 1936, the year in which Keynes published a book that ushered in the Keynesian Revolution. Moreover, during the 1930s there was no IMF to provide support for countries facing balance-of-payments' difficulties. Instead, many countries implemented extensive trade protectionism to deal with balance-of-payments problems.

In terms of policy responses, therefore, we are in a better position at the present juncture than was the case in the 1930s. Nevertheless, there are also some differences between the 1930s and the present situation that are not so favorable to the latter situation.

- First, in 1929, when global stock markets crashed, the U.S. banking system was in a relatively-healthy condition. It took three years of deep depression to wreck havoc on U.S. banks. The response of the U.S. policy-makers – including their introduction of deposit insurance – quickly got the U.S. banking system up and running again. In the present situation, the U.S. banking system has been the epicenter of the problem from the start, and the issue of pricing toxic assets has yet to be resolved.

- Second, there is some concern that the fiscal response to the present crisis may, in some countries, be overly aggressive. The largest fiscal deficit of the United States, for example, during the Great Depression was less than 6 per cent of GDP. In contrast, the deficit in the U.S. is expected to exceed 13 per cent of GDP this year and be close to 10 per cent of GDP next year. Other countries will also be running up huge deficits. The IMF projects that the aggregate fiscal deficit of the euro area will rise from 1.8 per cent of GDP in 2008, to over 6 per cent of GDP in 2010. These deficits could put upward pressures on long-term interest rates, helping to abort a recovery. This situation underscores the concern that I expressed earlier about the need to formulate clear exit strategies at an early stage.

Based on what I have said so far, the key factor determining the course and speed of a recovery will be the rate of progress toward returning the financial sector to health. History shows, however, that recoveries from financial crises, especially when they are global in nature, are significantly slower than recoveries from other types of shocks, such as shocks to oil prices. Moreover, recovery from the present situation is made especially difficult in light of the complexities involved in dealing with bad assets and restoring confidence among banks.

These factors underlie the IMF's projection – to which I referred earlier – of a 1.3 per cent contraction in global output this year. The euro area is projected to experience an even steeper decline in economic activity than the rest of the global economy. Both the IMF and the European Commission project that the euro area economy will contract by about 4 per cent this year. This contraction reflects an expected sharp contraction in euro-area export markets along with the effects of financial stress and housing corrections on domestic demand.

The IMF also projects that global growth will re-emerge in 2010, but at 1.9 per cent it would be sluggish compared with past recoveries. With regard to the euro area, the ECB Governing Council expects that economic activity will be very weak for the remainder of this year before gradually recovering in the course of 2010.

Recently, there have been some positive signs in the euro area economy, mainly reflecting financial-market developments and confidence indicators. Those so-called "green shoots" suggest that the economy may be stabilizing. It is important to keep in mind, however, that, if stabilization is indeed taking place, it is at a very low level of activity. It will take some time before our economies fully recover and grow at a robust pace.

Allow me to say a few words about the Greek economy. As a result of the crisis, I expect that growth will slow from almost 3 per cent last year, to zero per cent this year, perhaps even moving into negative territory. Moreover, several fundamental problems beset the Greek economy, including low international competitiveness, reflected in very-large current-account imbalances, a large fiscal deficit, and a very-high debt level. To restore competitiveness and correct the fiscal imbalances, bold and wide-ranging reforms in the public sector, and structural reforms to enhance productivity and raise the employment rate, are required. The Bank of Greece's Annual Report, published last month, provides a roadmap for the implementation of a credible medium-term strategy aimed at addressing the economy's problems. Clearly, we have reached decision-time in Greece. It is now time to move forward and there is no room for delay.

The international financial crisis has had a more limited impact on the Greek banking system than on many others and the fundamentals of the Greek banking system remain sound. To a significant extent, this is a consequence of the very limited exposure of Greek banks to toxic assets and their relatively-strong liquidity positions, which reflects the fact that Greek banks are largely deposit-based. Nevertheless, the weakening of economic activity will affect the ability of individuals and companies to service debts, and reduce profits. In its supervisory role, the Bank of Greece has been closely monitoring the banking system, tightening credit standards and supervisory controls, to ensure continued soundness. As you may know, Greek banks have been large investors in other economies of Southeastern Europe. With the sharp weakening of economic activity in the region, the Bank of Greece has called on banks to be prudent in their assessments of economic conditions in those economies so as to limit risk exposure. Finally, in line with all EU governments, the Greek government has been implementing a plan for enhancing liquidity and strengthening banks' capital base. The Bank of Greece has been encouraging banks to make use of the plan.

The challenges ahead

The recovery from this crisis may be slow, but there will be a recovery. What, then, are the policy challenges that lie ahead? I believe that there are two main types of challenges that need to be addressed.

The first challenge concerns macroeconomic policies. Clearly, the short-term effectiveness of these policies will depend on their medium-term credibility. As I have emphasized, to retain their credibility, exit strategies will be needed to convert fiscal and monetary policies from extraordinary short-term support to sustainable medium-term frameworks.

With regard to the euro area, monetary policy is formulated in a medium-term context, with the aim of ensuring price stability. Measures of price expectations show that our policy is highly credible.

The second challenge concerns financial sector reform. The pace of the recovery will crucially depend on how quickly confidence can be restored in the soundness 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 frameworks 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.

There are different views about how to best achieve that goal. At the initiative of the European Commission, a group chaired by Jacques de Larosière undertook a comprehensive review of the EU framework for financial regulation and supervision.

The group proposes to establish a European System of Financial Supervisors, bringing together the national supervisors with three independent supranational "Authorities" (for banking, insurance, and securities markets), accountable to the EU institutions. These Authorities would oversee the work of, and resolve disputes among, national supervisors, who would retain responsibility for the conduct of supervision. Cross-border institutions would be supervised by colleges of home and host supervisors. To bridge the gap between macro- and micro-prudential oversights, the group proposes creating a European Systemic Risk Council linked to the European Central Bank. This council would comprise the Governors of the European System of Central Banks, the heads of the Authorities, and the European Commission. The group advocates the establishment of "a truly harmonized set of core rules" harmonized and prefunded deposit insurance schemes, and more detailed criteria for burden sharing.

If implemented, the approach would constitute a historic step forward, putting in place important building blocks of an EU financial stability framework that is consistent with the objective of creating a single financial market.

Conclusion

The key priority among policy makers is to bring back economic growth and help bring about prosperity for everyone. The crisis that we presently face is a dual one – a financial crisis and an economic crisis. As I have stressed, our policy response should also be of a dual nature, one part of which involves a short-run response and the second part of which involves a medium-term response. In the short run, we should do whatever is feasible to support economic recovery. In the medium term, we should be prepared to pursue a credible exit strategy from the extraordinary policy interventions while developing an effective framework for financial supervision at the EU level. The former, short-term, response will help pave the way to recovery. The second, medium-term, response will help ensure that we do not experience a similar crisis in the future.

Ladies and gentlemen, thank you for your attention.