George Provopoulos: Key challenges for South East Europe inlight of the crisis

Opening address by Mr George Provopoulos, Governor of the Bank of Greece, at the Conference of Bank of Greece & Oxford University: “Challenges and Prospects of South East European Economies in the Wake of the Financial Crisis”, Athens, 16 October 2009.

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I am very pleased to welcome you to the Bank of Greece for this conference, co-sponsored by the Bank of Greece and the University of Oxford through the latter’s program on South East European Studies. The focus of this conference is the policy responses to the most severe economic and financial crisis that the world has faced since the Great Depression and the key challenges that lie ahead for South East Europe in light of the crisis.

This morning, I would like to share with you some thoughts about policy responses to the crisis. I will also provide some observations on the challenges that lie ahead. I will have more to say about the major challenges facing the economies of South East Europe during this afternoon’s panel discussion. My remarks about policy will deal with three broad issues: first, the response of the Governing Council of the European Central Bank to the crisis; second, the pace at which the extraordinary monetary and fiscal stimuli now being provided should be withdrawn; and, third, the need to develop a macro-prudential approach to financial regulation.

Monetary policy

Exceptional times call for exceptional measures. The policy response of the ECB to the crisis has been rapid, bold and frequently unconventional.

With the intensification and broadening of the crisis, beginning in October 2008 the ECB Governing Council reduced its key policy rate from 4.25 per cent to 1.00 per cent in a period of only seven months. This was an extraordinary response for a central bank that had, until that time, moved at a measured pace in changing rates, abiding by the principle that a certain degree of persistence in policy-rate changes increases the effectiveness of rate adjustments.[1]

Interest-rate reductions may not be very effective, however, during times of extreme stress when conventional channels of monetary-policy transmission are blocked or impaired. In the aftermath of the collapse of Lehman Brothers, financial markets froze and credit intermediation collapsed. Uncertainty pervaded the markets, counterparties were viewed with suspicion, and the flow of credit all-but halted. In these circumstances, the ECB undertook a number of non-standard measures to enhance the flow of credit and support the functioning of the money market. Our approach consists of five broad elements.

- First, the full accommodation of banks’ liquidity needs at a fixed rate.
- Second, the expansion of the list of assets used as collateral.
- Third, the lengthening of the maturities of long-term refinancing operations.
- Fourth, the provision of liquidity in foreign currencies.

[1] See Jean-Claude Trichet, “Credit Alertness Revisited”, paper presented at the symposium on “Financial stability and macroeconomic policy”, sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 22 August 2009.

- Fifth, purchases of covered bonds in order to stimulate a market that has been traditionally an important source of funding for banks.

In addition to this exceptional support to domestic financial markets, the ECB has also provided assistance to non-euro-area financial markets. For, example, we have entered into either swap or repo arrangements with Denmark, Sweden, Hungary, and Poland. Moreover, E.U. countries have strongly supported recent measures to increase IMF resources through, among other vehicles, bilateral loans to the Fund, an SDR allocation, IMF gold sales, and a quota increase. In turn, the Fund has responded to the crisis with a record lending commitment, which includes programs to Belarus, Bosnia-Herzegovina, Hungary, Iceland, Latvia, Poland, Romania, Serbia, and the Ukraine.

In addition to the foregoing actions by the ECB, euro-area governments launched major fiscal-stimulus programs while supporting banks with guarantees and capital injections. Together, these measures reduced uncertainty and increased confidence, contributing to an improvement in economic and financial conditions.

Exit strategy

With the recovery in the euro area in its initial stages, and with economic activity still far below pre-crisis levels, it is too soon to begin a withdrawal of the stimulus measures. Nevertheless, the development of a medium-term macroeconomic framework for the post-crisis period will be crucial. It will help facilitate the achievement and maintenance of a sound fiscal position and the ability of the monetary authorities to deliver price stability. It will also help foster financial stability. The challenge will be to choose the correct timing of the withdrawal so as to avoid: first, a premature unwinding of public interventions; second, jeopardizing the achievements in stabilizing economic and financial conditions; third, letting these measures continue for too long, with risks of distorting incentives and damaging public balance sheets. Among the factors that will shape the ECB's approach to exiting the non-standard measures are the following:

- First, we will act with the aim of securing price stability in the medium-term. By implication, any non-standard measure that may pose a threat to price stability will be promptly withdrawn. If no such risk exists, a measure can be maintained in case of significant financial-market tensions.
- Second, we have built a degree of phasing out into the exit process through the design of our measures. In the absence of new policy decisions, several of these measures will unwind naturally, for example, through pre-determined termination dates.
- Third, the ECB's operational framework comprises a broad set of instruments so that the exit strategy can be formulated in a flexible way. For example, the interest-rate corridor allows short-term interest rates to be changed while keeping some non-standard measures in place should the need arise. Therefore, the Governing Council can choose the way in which interest-rate action is combined with the unwinding of the non-standard measures.

Let me turn to the issue of the exit from expansionary fiscal policies. In my view, an important medium-term risk to sustained recovery revolves around deteriorating fiscal positions. The large increases in fiscal deficits and public debt incurred to provide stimulus to the economy have already raised concerns in financial markets, as suggested by the widening sovereign spreads relative to pre-crisis levels, for economies with large fiscal burdens. If the recovery were to stall, followed by a prolonged period of very-low growth, deficits and debt could swell to difficult-to-sustain levels. Governments will, therefore, need to start addressing mounting long-run fiscal challenges by committing to large reductions in deficits once the recovery is on a solid footing and advancing reforms that will put public finances on a more sustainable path. I need to add that Greece is among the euro-area countries for which the challenge of medium-term fiscal viability is especially urgent.

Financial sector regulation

The best way to manage a crisis is to prevent it happening. At the root of the market failure that led to the crisis was optimism bred by a long period of high growth, low real interest rates, and policy failures. One such failure was that financial regulation was not equipped to address the risk concentrations and distorted incentives underlying the financial innovations.

This circumstance raises another medium-run challenge. The present crisis has revealed that macro-prudential factors play an important role in determining the size, nature, and propagation of systemic risk. Therefore, it is essential to establish an effective framework for macro-prudential supervision that will ensure a systematic analysis of risks, as well as the formulation of policies to address such risks.

Let me say a few words about the framework for macro-prudential supervision envisaged for the E.U. Following the publication of the Report of the de Larosiére Group in February 2009, the Commission issued a package of draft legislation in late September with the aim of creating a European Systemic Risk Board – or ESRB. The main task of the ESRB will be to identify and assess risks to the stability of the EU financial system and issue risk warnings when the identified risks appear significant. Several features of the proposed framework are important.

- First, the European System of Central Banks will play a key role in the functioning of the ESRB. The voting members of the ESRB's General Board will include the 27 governors of the EU's national central banks and the President and Vice President of the ECB.
- Second, the ECB will be assigned the task of ensuring sufficient human and financial resources for the ESRB's Secretariat.
- Third, the ESRB will *not* be responsible for the *implementation* of macro-prudential policies. That responsibility will remain with national authorities and national supervisors.
- Fourth, since the ESRB will not implement macro-prudential policies, the effective monitoring of the follow-up to its warnings and recommendations and the consistent and timely implementation of the recommendations will be crucial for the performance and the credibility of the new macro-prudential supervisory framework.

The creation of the ESRB will, in my view, constitute a historic step forward, putting in place an important building bloc of an EU financial-stability framework that is consistent with the objectives of creating a single market.

Challenges for Southeastern Europe

Some of the policy challenges facing the euro area also need to be addressed by the countries in Southeastern Europe. Moreover, many of the countries in Southeastern Europe are confronted by additional challenges. Let me mention some of these challenges, as well as some questions that we may wish to consider during the course of this conference.

- First, prior to the crisis many countries in the region ran large current-account deficits underpinned by capital inflows. As the crisis demonstrated, however, capital flows can be subject to abrupt and sharp reversals. What policy measures can be used to deal with surges of capital inflows and their sudden reversals?

- Second, much of lending in the economies concerned has been denominated in foreign currencies. This situation can lead to corrosive feedback loops between banking crises and foreign-exchange crises, compounding the effects of each. What policies can be taken to safeguard domestic banking systems from exposure to foreign-currency borrowing?
- Third, some banking systems of euro-area countries have relatively-high exposures in the countries of South East Europe. In addition to the measures, including bilateral MOUs among some national central banks, that have already been taken, what other actions would help minimize the risks that may arise from strong financial linkages?
- Fourth, many of the economies in Southeastern Europe tend to be relatively closed. Moreover, the trade linkages among the countries of Southeastern Europe themselves are quite limited. In other words, the shares of the exports of each country in Southeastern Europe to the rest of the region tend to be relatively small, given the geographical proximity of our countries. These shares are typically in the range of 15 per cent to 30 per cent. What accounts for this circumstance and how can we boost both the level of trade in goods and services, and intra-regional trade among our economies, thus helping to generate a virtuous cycle of growth?

These are some of the issues that perhaps can be addressed.

I look forward to a lively discussion.

Thank you for your attention.