Ewald Nowotny: Achieving financial stability – the role of the EU, the Euro and the ECB

Opening speech by Prof Dr Ewald Nowotny, Governor of the Central Bank of the Republic of Austria, at the Salzburg Global Seminar on "New rules for global finance – which kinds of regulation are useful and which are counterproductive?", hosted by the Central Bank of the Republic of Austria, Vienna, 8 March 2011.

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1. Welcome to the Salzburg seminar:

Ladies and Gentlemen:

It is a great honor for me and the Oesterreichische Nationalbank to host the ***Salzburg Global Seminar*** exceptionally here in ***Vienna***. Let me extend a warm welcome to all of you, in particular the ***high-ranked decision makers*** and ***high-profile experts*** coming from all over the world.

The Salzburg Seminar was ***founded*** in the immediate ***post-war period***, when visions were so badly needed, by three young men from Harvard University as a center for ***intellectual exchange*** in the ***heart of Europe***. More than half a century later, it has developed into one of ***Europe's foremost forums*** for the discussion of ***global issues***. It brings together ***future leaders*** from around the world with ***prominent individuals*** from virtually ***every field of human activity***: politics, economics, social and environmental concerns, the arts and academia.

The **next three days** are devoted to an issue which has ***shaped my life*** at least for the ***last three years***: "***New Rules for Global Finance***: Which kinds of regulation are ***useful*** and which are ***counterproductive***?*"* In order to answer this tricky question, we need to learn the ***lessons*** from the recent ***financial and economic crisis***. But even if the ***financial sector*** is in the core of our considerations, they also go far ***beyond***. It is our ***whole economic model*** which needs to be checked.

Let me present you ***my views*** on some of these topics.

2. Sequencing of the financial and economic crises:

Popular perception of the crisis origins: falling prices in the US housing market led to disturbances on the interbank market and finally to the ***financial crisis***.

Actually, a complex set of ***conditions, causes*** and ***trigger*** factors made the crisis possible:

– First, ***basic conditions: disequilibria*** evolving over the last years:

- ***Global imbalances*** inducing financial flows from emerging to advanced economies;
- Increasing ***weight of the financial industry*** in the economy; in U.S.A. the share doubled since 1980 to reach about 8% of GDP in 2008[1];
- ***Global interest rates*** – arguably at least for some time too low;
- Related trend to household ***indebtedness***, partly fueled by policies expanding homeownership to the poor[2];

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[1] Bank for International Settlements. 2010. BIS Annual Report 2009/10, 28 June. Basel, 75ff.

- Insufficient framework and rules of the international financial system;
- Trend towards income and wealth ***inequality*** within advanced economies[3];
- ***Oil shock*** until mid-2008 seems to have contributed to recession[4].

– Second, more immediate ***causes:*** asset market ***bubbles***:

- Bubbles started with ***financial innovations*** – turning mortgages into liquid assets;
- These innovations led to bubbles that were fostered by a huge, unregulated ***shadow banking sector*** – excessive leverage;
- Intransparent products of "financial industry" attracted ***risk-loving investors***[5];
- False ***management incentives*** favoring short-termism.

– Third, the ***triggering factors*** that helped the bubbles burst:

- Massive defaults in the U.S. ***subprime*** mortgage market;
- In a second step, the bankruptcy of ***Lehman Brothers***.

Preliminary conclusion: Financial crisis has been caused by a ***market failure***, however, the ignorance of its risk is a major ***policy failure***,

– Stemming from inadequate ***regulation and supervision*** of financial (and housing) markets;

– As well as overly loose global ***monetary policy***.

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[2] Rajan R. 2010. How Inequality Fueled the Crisis. Project Syndicate. 9 July. http://www.project-syndicate.org/commentary/rajan7/English

[3] OECD 2008. Growing unequal – Income Distribution and Poverty in OECD Countries. October, Paris.

[4] Hamilton, J. 2009. Causes and Consequences of the Oil Shock of 2007–08. Brooking Papers on Economic Activity. Spring

[5] Sibert, A. 2009. "Why did the bankers behave so badly?". VoxEU.org. 18 May. http://www.voxeu.org/index.php?q=node/3572

The dynamics of the crisis:

Sequencing of Crises

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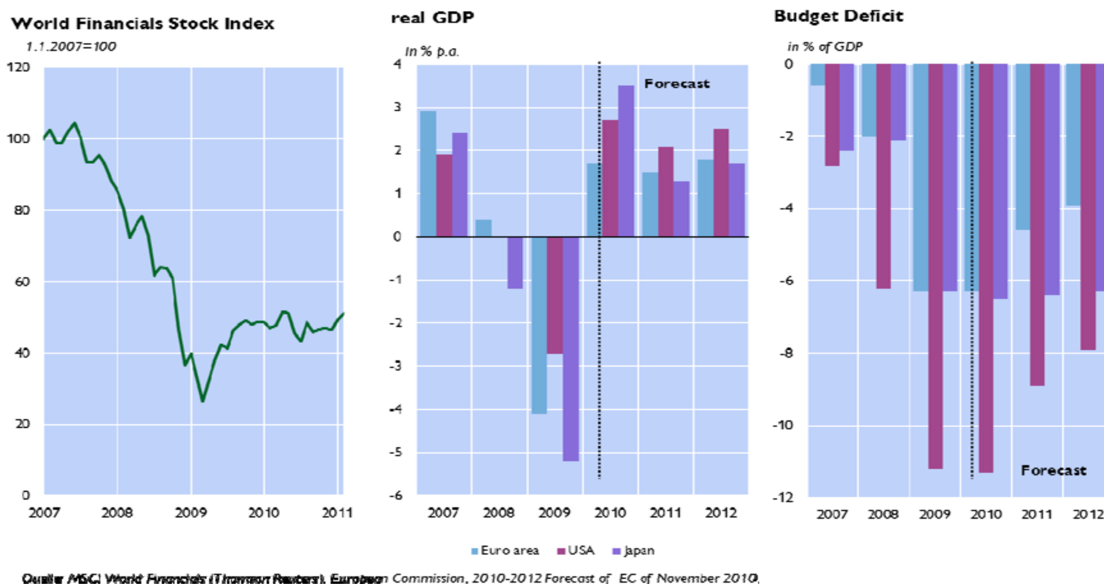
Financial Sector ⇨ *Real Economy* ⇨ *Public Finances*



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– First, ***banking sector*** immediately hit by liquidity shortage:
  - interbank market dried up;
  - Banks refinanced themselves with ***fire sales*** of their assets (asset meltdown).
– Second, the crisis reached the real economy → ***Great Recession***:
  - Dramatic drop in confidence;
  - Plunge of international trade and manufacturing.
– Third, a truly ***global crisis***:
  - No decoupling of emerging economies (however recovery started first their).
– Finally, domino effect – ***entire countries***:
  - Rapid ***deterioration of budgets*** (anticrisis measures & automatic stabilisors);
  - ***Structural vulnerabilities*** of several economies got evident;
  - ***Liquidity problems*** endanger refinancing of public debt;
  - ***Perceived*** risk of sovereign ***insolvency*** by financial markets;
  - ***Overshooting*** of risk premia on bonds interest rates created self-fulfilling prophecy effects.
– ***Greece*** is a case in point, but also a very ***special case***:
  - ***Fraud*** of budgetary statistics – ***loss in confidence***;

- Greece's ***fiscal situation*** worse than any other EU Member State (public debt around 140% of GDP in 2010; deficit now ***improving***: 9.6% in 2010);
- ***Interest rate spreads*** to German 10-year bonds above 900 basis points;
- ***Rescue package*** of EMU MS and IMF (strong conditionality!): 110 bn EUR for 3 years:
  - Eliminated liquidity risk;
  - Bought time to reduce (perceived) sovereign solvency and (derived) financial market risks.

– ***Ireland*** is a different case (10-y spreads above 600 bps)**:**

- Always ***obeyed*** to the ***Stability and Growth Pact***: Fiscal surpluses instead of deficits;
- Problems arouse from ***overextended financial sector*** hit by a housing bubble;
- Mistake in crisis management: ***state guarantee*** of whole banking sector;
- ***Public debt exploded*** fourfold within 3 years (from around 25% in 2007 to almost 100% in 2010);
- Under ***rescue umbrella*** of EU/IMF: 85 bn EUR.

– ***Other countries not comparable*****:** (10-y spreads only around 200 to 400 bps)

- ***Portugal:*** problems less severe and different: competitiveness but no housing bubble! Nevertheless, meager growth prospects and high interest rates make Portugal susceptible to refinancing risks.
- ***Spain:*** low initial debt level (40% of GDP), in 2010: 64% – still below Germany's debt (76%), but strong dynamics; relatively sound banks despite housing bubble;
- ***Italy:*** low liquidity risks, high saving rate, low external debt (but high overall debt).

– ***A euro crisis?***

- ***Misperception:*** crises not euro area origin but ***contagion*** from global crises;
- ***Exaggeration:*** break-up of EMU or ***end of the euro*** no issue! (Too costly for all participants);
- ***Crisis of*** few euro area ***countries not of euro***: Just like California and Illinois – not affecting the US dollar;
- The ***euro remains a success story***!
  - Euro area = ***stability area***: Over the last decade, average ***inflation*** exactly matched ECB's definition of price stability (below but close to 2%), despite heavy oil shock;
  - Euro = at least as ***strong*** a ***currency*** as German mark:

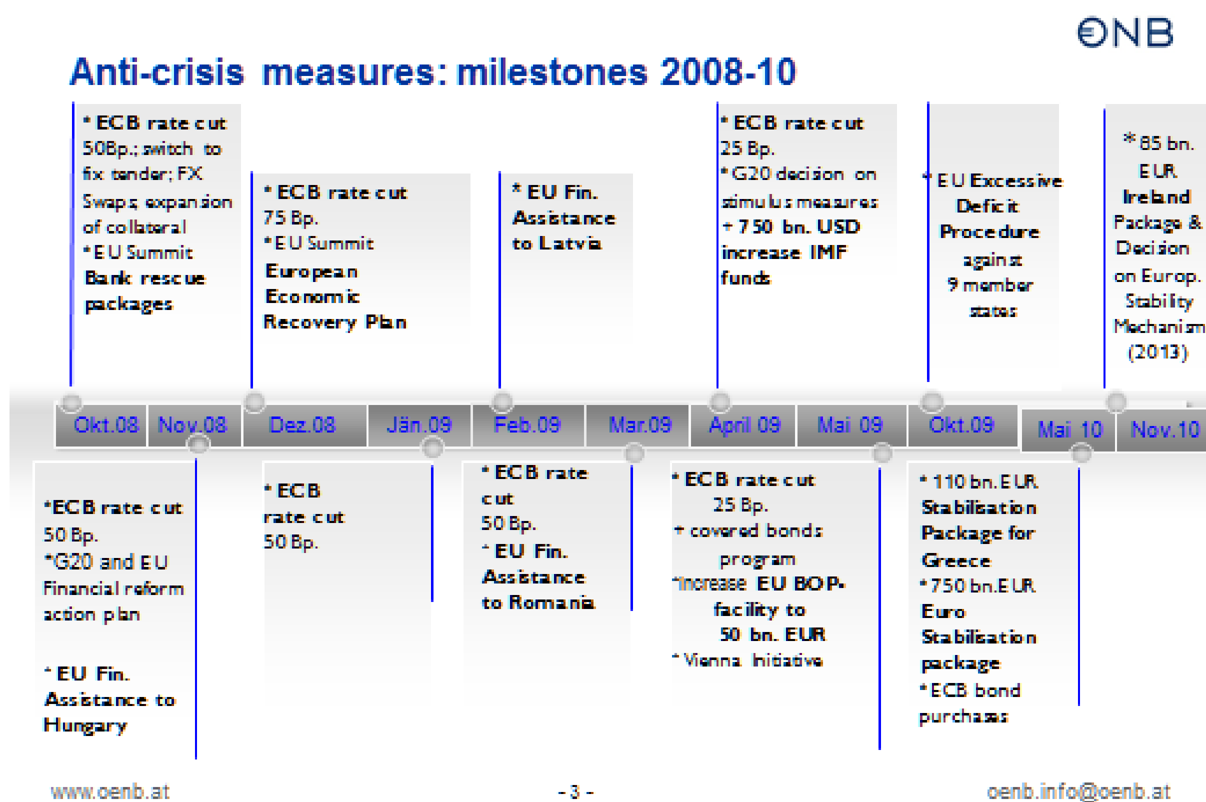
    Against USD stronger than at time of introduction (around 1.18 EUR/USD in 1999);

    Marginal devaluation of effective exchange rate = relief for our exporters, after years of appreciation.
  - With global crisis the euro has ***passed its hardest test***:

Elimination of exchange rate volatility – beneficial for small member states: "in turbulent financial waters it is better to be on a large, solid and steady ship rather than on a small vessel," (ECB President Trichet);

Europe proved its solidarity and ***ability to act*** – (recovery plan, rescue umbrella, reform debate);

ECB ***reacted swiftly*** and effectively – avoiding a collapse of the whole economy:



providing boldly ***liquidity*** to banks:

- ***No inflationary impact*** as long as low credit demand;
- Exit already underway.

Securities Market Programme – temporary purchasing of bonds:

- ***No state financing*** – only to calm markets;
- Temporary, secondary market, very limited amount;

Recovery on its way (but slow and bumpy): 2010: 1.7%; forecasts 2011: around 1,6%);

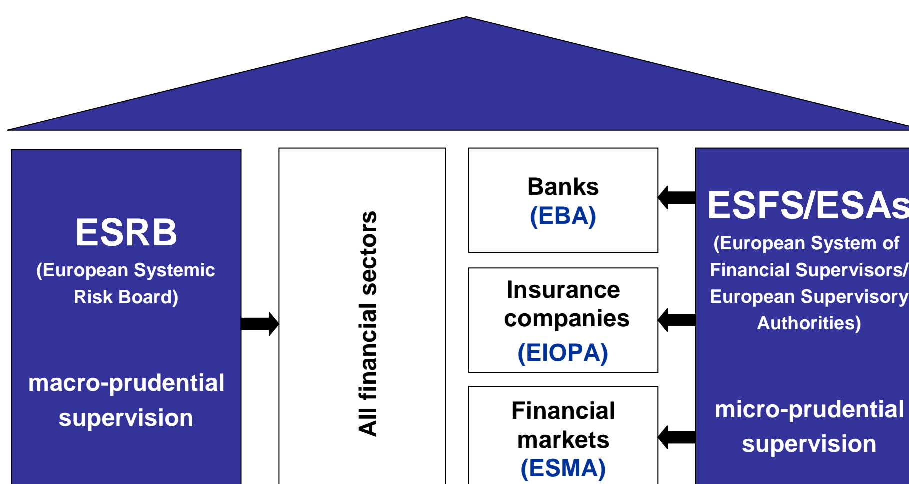
Nevertheless ***national adjustment challenges*** still exist: structural reforms + fiscal discipline.

3. Crisis lessons:

A. Financial sector stability:

- ***Macro-prudential perspective:*** importance of systemic risk, better understanding of interconnectedness in financial system – turbulence can arise from relatively modest initial shocks.
- ***Central banks role in financial stability:*** independence and anchor of stability;
  - ✓ ***Austria: important improvements already in 2008:*** Financial Markets Authority (FMA) and the OeNB have joint responsibility for micro prudential supervision of banks.

Gradual Progress in the Europeanization of Financial Supervision



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- ✓ ***European supervisory architecture.*** European Systemic Risk Board to identify emerging systemic risk, to publish early warnings as well as to make recommendations to the competent authorities;
- ✓ ***Micro-prudential supervision:*** three European supervisory authorities (banks, insurances and securities).
- ✓ ***Various EU directives*** on detailed regulation issues: rating agencies, hedge funds, manager boni, etc;
- ✓ ***Basel III:*** Reducing bank leverage and pro-cyclical risk management;

Examples of macro-prudential policies:

– Austrian authorities active in ***reducing foreign currency loans*** (exchange rate risk)**:**
  - ✓ October 2008: publication of enhanced ***minimum standards*** for foreign currency loans → share of foreign currency loans to private households in Austria has declined since then (to currently 29,5%);
  - ✓ Complementary, launch ***of CESEE foreign currency loan initiative*** applied to Austrian banks activity in the CESEE region.

– ***“Vienna initiative”*** to stabilize CESEE region:

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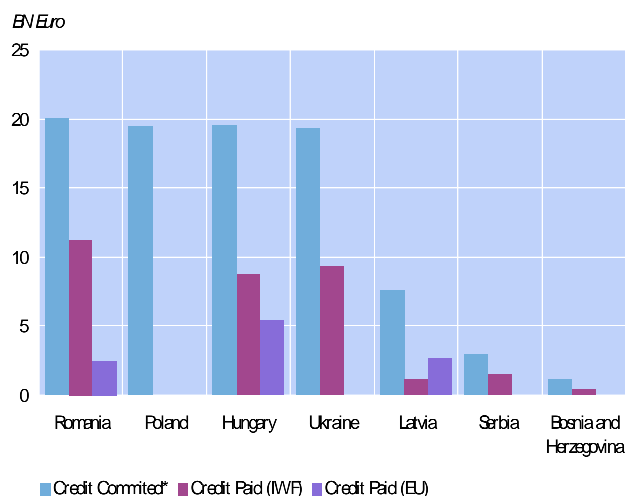
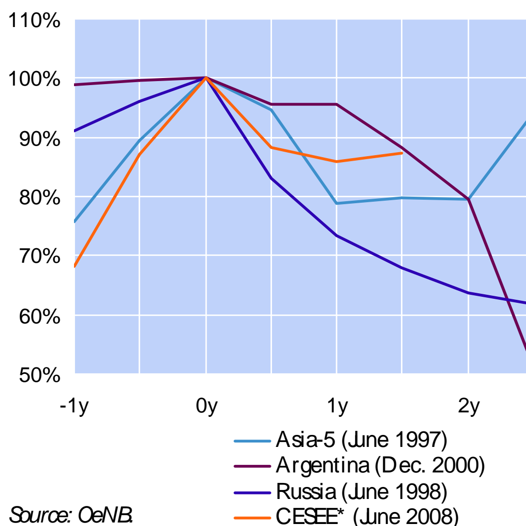
„Vienna Initiative“ Minimized Contagion in CESEE

Support to CESEE



EU banks' exposure in historical crises



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- ✓ Launched during the peak of the global financial crisis in early 2009;
- ✓ Platform for ***cooperation*** between ***home and host country*** supervisors, the European Commission, IMF (and other international financial institutions) and banks;
- ✓ Resulted in stabilizing ***commitment of foreign banks*** in the region;
- ✓ Over the medium term CESEE countries expected to return to ***continued catch-up growth path***, although at a ***lower level*** compared to the pre-crisis period.

– ***Background:*** *The* ***aggregate exposure*** *of Austrian banking groups (domestically owned) to CESEE amounted to around* ***EUR 212bn*** *in the second quarter 2010;*

- ***More than 70% of this exposure in EU Member States;***
- *Claims of Austrian banks to Hungary account for EUR 26.7 bn.*

B. Sound public finances:

– Public finances: ***deteriorated substantially*** during the crisis

- driving factors: shortfalls in profit- and asset-price-related taxes, automatic stabilizers and stimulus measures (figures: deficits an public debt from EC Forecast[6]):

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Development of Public Finances in Selected Countries

Public Finances 2007 and 2010				
	2007		2010	
	Deficit	Public Debt (in % of GDP)	Deficit	Public Debt (in % of GDP)
Euro Area	-0.6%	66%	-6.3%	84.1%
Austria	-0.4%	59.3%	-4.3%	70.4%
Ireland	0.0%	25%	-32.3%	97.4%
Greece	-6.4%	105%	-9.6%	140.2%
Hungary	-5.0%	66.1%	-3.8%	78.5%

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– ***Timing of consolidation*** and structural reforms is crucial:

- In ***some*** countries, concerns for fiscal ***solvency*** – immediate tightening of fiscal policy necessary;
- However, majority of euro area countries: ***delicate balancing act*** avoiding a premature and abrupt fiscal tightening;
- Currently, ***window of opportunity***:
  - Demand side: Relatively **weak euro** and high growth in ***emerging markets***;
  - Supply side: Expected decline in the working-age population not started yet. (In Austria, the decline will start around 2020.)
- Packages for Greece and Ireland and measures ECB to stabilize bond markets have ***bought some time*** to undertake substantial reforms;
- Consolidation measures ***announced as soon as possible*** to convince financial markets.

6 Ratio debt to GDP in bracket.

– Consolidation should focus on ***expenditure side***, especially where fiscal burden is already high (like Austria).

– However, given the size of consolidation needs, supplementary ***tax increases*** necessary in many cases:

- ***Less distortive taxes***, for instance on energy or wealth – to prevent undermining long-term growth potential;
- Reforms of the ***tax structure*** – to enhance growth and labor market participation.

C. *Structural reforms*

Rebalance economies of the euro area.

– ***Greece***, Italy, Portugal and Spain: ***Competitiveness losses*** in the past and/or high fiscal and external deficits.

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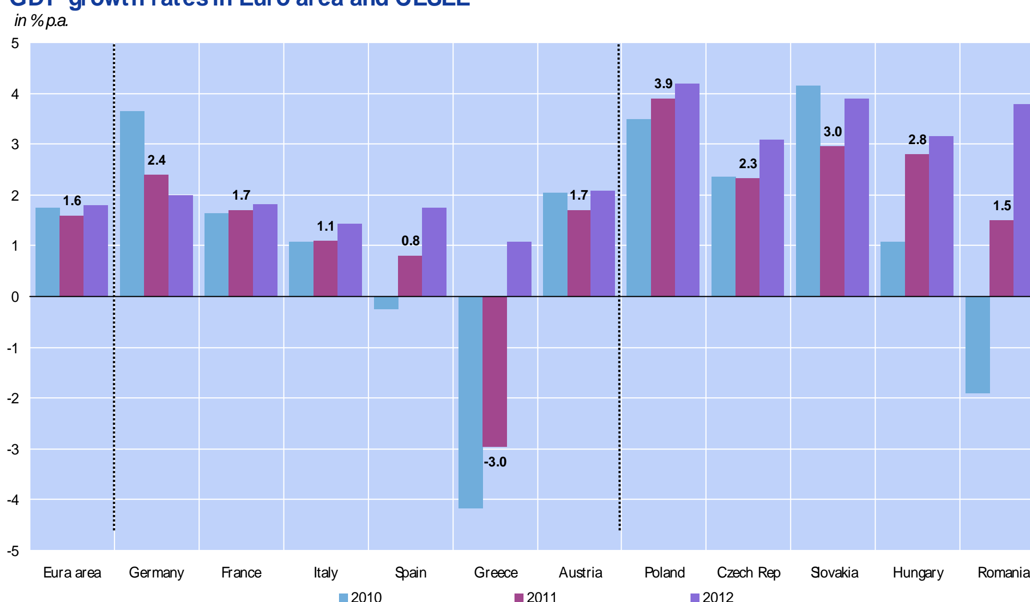
Heterogeneous developments in Europe



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- Significant ***adjustment needs*** on the part of these *periphery countries*:
  - Short run: ***Cost cutting***, wage moderation;
  - Long run: Reforms to strengthen ***productivity*** growth.
- But every ***imbalance has two sides***: Surplus countries (Germany, Netherlands, Austria) should strengthen domestic demand (2 ways):
  - Structural reforms to enhance ***investment*** (ECB/Bundesbank view);
  - Income and tax policy to strengthen ***consumption*** (FT view);

- Otherwise, deflationary drag – could not be compensated by loosening monetary policy (pushing on a rope).

– Crisis lesson: Structural reforms go beyond proper functioning of markets.

- Eliminate ***conditions that favor bubbles***: imbalances, inequality and over-indebtedness;
- Reflected in the new ***EU 2020 strategy***: smart, sustainable and inclusive growth;
- ***Economic Governance Reform*** in the EU to address high degree of economic inter-dependence while preserving national responsibilities.

Van Rompuy Task Force – 5 proposals (accepted by European Council):

1. Greater ***fiscal discipline***:
   - Reinforce ***compliance*** of EU's fiscal rules in euro area countries;
   - ***Preemptive*** part of Stability and Growth Pact;
   - Focus on ***debt*** sustainability.
2. Broadening ***economic surveillance***:
   - ***New mechanism*** for macroeconomic surveillance (annual assessment);
   - ***Alert*** on risks of macroeconomic imbalances and vulnerabilities;
   - *Excessive Imbalance Procedure* with ***sanctions*** (including excessive surpluses?);
   - Indicators to be specified.
3. Deeper and broader ***coordination: European Semester***
4. Robust framework for ***crisis management***:
   - ***European Stability Mechanism*** (ESM) to succeed rescue umbrella from 2013 on.
   - Part of a credible ***crisis resolution*** framework;
   - Details in discussion by European Council.
5. Stronger ***national institutions***:
   - New public institutions to provide independent analysis, assessments and forecasts on domestic fiscal policy matters.

D. Monetary policy:

– ***internal and external stability:***

- Price stability = primary objective;
- = (necessary but insufficient) condition for stable exchange rate and balanced current account.

– ***inflation vs. deflation***

- deflation no immediate concern in the euro area;
- HICP in January 2011: 2.3% (energy, food and taxes); HICP in February 2011 (flash): 2.4%
- Eurosystem forecast (March) for 2011: between 2.0% and 2.6%;

- Inflation expectations firmly anchored: below, but close to 2% over the medium term;
- Risk: commodity prices (wheat, oil, etc.);
- But expansive ***monetary policy not inflationary*** – can easily be reversed!

– ***Crisis lesson:*** monetary policy’s role (Jackson Hole Consensus):

- Preserving both price stability and financial market stability;
- “Leaning against the wind”: difficult in practice;
- However more tools (blurring boundaries between monetary policy and regulation);
- ***Price stability = sine qua non for financial stability*** (but not sufficient).

Increasing Inflation

Country	2009	2010	2011
Euroarea	0.3	1.6	2.2*
EU-27	1.0	2.1	2.5*
Germany	0.2	1.2	2.2*
France	0.1	1.7	2.0*
Italy	0.8	1.6	2.2*
Spain	-0.2	1.8	2.4*
USA	-0.4	1.6	1.1
Japan	-1.4	-0.7	-0.7

Source: *Interim forecast from EC of February 2011, forecast of EC of November 2010.

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4. Conclusion

- Despite criticism, ***reform progress*** has been ***substantial***.
- Enough to ***avoid future crisis***? Certainly ***not***, but hopefully enough to render crisis less severe.
- Remaining ***reform workload is huge***.
- Changes in the regulatory framework are ***not technical matters alone*** implemented by pressing a button by a benevolent social planner.
- ***Resistance from vested interests*** and lobbyists endanger success of reform agenda.
- ***Policy makers need support*** for their ambitious project of securing future economic stability in Europe and elsewhere.

- A ***more balanced development path*** will enable our peoples (Europeans, Americans, Asians and all other world citizens) to ***prosper in a sustainable manner***.