Lorenzo Bini Smaghi: The European debt crisis

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Atlantik-Brücke event, meeting of Regional Group Frankfurt, Frankfurt am Main, 17 October 2011.

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Introduction

It is a great pleasure for me to speak at this Atlantik-Brücke event. In a world that has become so strongly interconnected, the efforts of your association to further promote German-American understanding deserve to be supported and encouraged.

The topic of my talk today is "The European debt crisis", but we should not forget that the current crisis is a global one. Of course, Europe's predicament certainly has some special features, which are not necessarily easy to understand, especially for outside observers.

I would like to contribute to a better understanding by considering four main issues tonight. The first one concerns the challenges that policy-makers in all advanced economies face in addressing the current crisis, in particular as a result of the interaction between the financial markets and the democracies we live in. The second issue relates to the specificities of Europe's situation, which make the crisis significantly more difficult to handle. Third, I will try to explain how these complexities may turn good intentions into bad outcomes. Finally, I will look at the main issues that need to be tackled comprehensively to deal with the current stage of the crisis and will consider how to address the problem of limited public sector resources.

Challenges for policy-makers

The roots of the crisis, which is affecting most advanced economies, lie in the accumulation of excessive debt – both private and public. The solution is to go back to more sustainable – i.e. lower – levels of debts. The key issue is the speed of that adjustment. If, on the one hand, the de-leveraging is too slow, the imbalances at the heart of the crisis will be protracted, reforms delayed and the prospects for recovery will remain fragile – and be certain to disappoint. But on the other hand, if the adjustment is too quick, it may lead to a credit crunch with negative feedback loops on the real economy. Economic history provides us with examples of policy mistakes at both ends of this spectrum.

It is not easy to implement policies which encourage de-leveraging *and* avoid an excessive impact on the economy, particularly in our societies, because those policies have to take into account several constraints. I would like to discuss three of them, taking examples from both sides of the Atlantic.

The first constraint is political. It derives from the fact that taxpayers are not particularly happy to shoulder an ever heavier burden and to find themselves having to support the banking system or the public finances of other countries, some of which triggered the crisis in the first place by mismanaging their investments or their public finances. The taxpayers' unhappiness is understandable. Why should they bail out banks which accumulated too much risk in their balance sheets before the crisis and proceeded to reward their managers handsomely? Why should taxpayers support countries which have lived beyond their means, and even cheated on their accounts? Won't all this money create moral hazard and be an incentive for similarly irresponsible behaviour? Any policy-making institution which is accountable for its decisions has to be able to answer these questions.

These issues were the focus of the political debate in the United States at the start of the crisis. After the US authorities saved Bear Sterns, in spring 2008, the same question arose:

should taxpayers' money be used to bail out other banks? The US presidential election in autumn 2008 encouraged the then US administration to enter the Lehman Brothers' "crisis weekend" with the clear intention not to take taxpayers' money again. We know what happened then. Much more taxpayers' money was ultimately required to prop up the financial system after the collapse of Lehman than would have been needed to rescue it.

This brings me to the second constraint that policy-makers have to work with, which relates to the functioning of financial markets. As the Lehman Brothers case showed, when a major event like the failure of a systemically important bank happens at a time of financial turbulence, markets tend to become completely dysfunctional, contagion spreads throughout the financial system and ultimately the real economy is severely affected. The current sovereign debt crisis in the euro area has shown a similar degree of unpredictability. When a small euro area country got into difficulties, others were gradually affected, according to the depth of correlation between their domestic markets and financial instruments.

Contagion is very difficult to anticipate. At the time of the Lehman Brothers collapse, many observers, and even policy-makers, thought that market participants had had enough time to prepare for such an event. The same applies in Europe, where many analysts still dream that an "orderly" restructuring of the public debt can be achieved. The reaction to the agreement among euro area leaders on 21 July has proved that reality differs from dreams.

Contagion is also difficult to understand, especially for those far away from the immediate chain of events, and who are not immediately affected. For instance, it was difficult for many US citizens and members of Congress to grasp the impact of the Lehman Brothers' failure – as shown by the initial rejection by Congress of the administration's proposal to establish the Troubled Asset Relief Program (TARP). But they understood its impact when the contagion hit the stock market and caused banks to panic. In Europe, the countries with stronger fiscal positions have also had difficulty understanding the potential disruption that contagion from the crisis – unfolding in the periphery – would have on their own economies.

The political and market constraints that a policy-maker faces tend to be contradictory. For example, the best way to deal with contagion is to act quickly, with enormous firepower – the "bazooka" as Hank Paulson used to call it. But it is very difficult to secure a political consensus for having such bazookas, especially if the firepower involves taxpayers' money. It's only possible if taxpayers really feel threatened and are convinced that the risk of not having a bazooka is greater than the risk of having one. They may sense this risk only when contagion is widespread, and markets have become extremely tense, but at that point the so-called bazooka may no longer be sufficient to restore stability. In other words, the less taxpayers' money you spend at the start of the contagion, the more taxpayers' money you may ultimately have to spend to avoid serious financial disruption.

Policy-makers thus face two difficult tasks. They have to weigh the consequences of taking certain actions against the consequences of *not* taking them, and choose the least worst solution. *And*, they have to convince taxpayers, and their representatives, that there is an even worse solution than the least worst option that they have chosen.

The third constraint that policy-makers have to take into account nowadays is the scarcity of resources available to tackle multi-dimensional problems like those posed by the crisis. At the outset, in autumn 2008, European countries were able, for example, to stabilise the situation by providing public guarantees to banks. Ireland was one of the first countries to make such a commitment. In the US the TARP was adopted, with the initial aim being to purchase distressed assets from banks and thus relieve their balance sheets. As the crisis developed, the commitments made to support the financial system led to an overexposure of some sovereigns, which took the form of higher debts and deficits on both sides of the Atlantic. Markets started testing the willingness of taxpayers in the various countries to sustain such an effort.

Some specificities of the euro area

Given these challenges, which are common to most advanced countries, it may be useful to consider some distinctive features which characterise the euro area and may help to explain the situation on this side of the Atlantic. I would briefly like to discuss four of them.

One feature is that monetary and fiscal authorities in the euro area are completely separate. Budgets are the responsibility of the respective countries, within European constraints – which proved however to be rather lax – while monetary policy is the responsibility of the central bank. This means not only that monetary policy is targeted at the euro area as a whole but also that it cannot be used to finance governments. Euro area governments have to finance themselves directly in the market. This is sound and robust, because it avoids monetary financing and the risk of fiscal problems being solved through monetary financing. However, in a crisis, such a constraint can become quite harsh, especially since the Maastricht Treaty did not foresee a situation in which a country would lose market access. Markets have perceived this as a fault line and tried to take advantage of it.

A second feature is that in the Monetary Union the day-to-day supervision remains in the hands of national supervisors, as does the crisis management for banks in difficulty. The stress tests – last year and this year – have highlighted the heterogeneity that exists across countries. Although no systemically important euro area bank has been allowed to fail, and solutions have been found in all cases, the decentralised approach and lack of explicit resolution mechanisms have caused concern in the markets that "tail events" could take place.

A third characteristic is that the decision-making process needed to address the specific crisis situation, notably the creation of a safety net to protect the system against financial contagion, is extremely complex. It is based on inter-governmental agreements which basically require all the Member States to agree. While unanimity may be justified when a new financial mechanism is created, as is the case with institutions in general, it becomes a nightmare when it is needed for each and every decision. In international financial institutions, such as the IMF, majority is the rule. Crises cannot be managed by unanimity.

A fourth difference compared with the US is that society here is on the whole less financially sophisticated. Financial markets developments have a less direct impact on the lives of ordinary European citizens. This is due to many factors, including the smaller role of stock markets in allocating resources, the absence of a single financial centre, and the role of the state in pension systems. As a result, people are less aware of the risks to the financial system in periods of tensions and of the need to act swiftly to avoid contagion effects.

The four factors I have just described are particularly relevant in a situation in which euro area members have decided to maintain their national sovereignty in various domains, such as taxation and public expenditure. It makes it more difficult for taxpayers to understand why they have to help solve the problems created by others, be they the fiscal imprudence of other governments or the reckless behaviour of banks in other countries.

In other words, euro area taxpayers – and their elected representatives – tend to think and act locally, while the euro is a continent-wide currency and has acquired a global dimension in financial markets. This dichotomy has occasionally led to well-meaning actions that in fact have had undesirable consequences.

Well-meaning actions, undesirable consequences

When a debtor cannot repay his debts on time, several solutions are possible. They depend on the balance of power between creditor and debtor and on the legal regime. In a setting where the creditor prevails, he will take the debtor to court and be reimbursed as much as possible, even through the liquidation of existing collateral, if necessary. But in a setting where the debtor prevails, he will pay back only part of the debt and the burden will be on the creditor who made the bad investment decision in the first place. A pragmatic solution is probably for the creditor to assess the ability and willingness of the debtor to pay. If the latter is solvent and has only a liquidity problem, it will be in the creditor's own interest to lengthen the maturity of the loan and eventually grant the debtor conditions that would enable him to repay the loan over time. This pragmatic solution is the one followed internationally – in particular by the IMF – when countries get into trouble and lose market access. It is the solution which was used for Mexico in 1995, for Korea and other Asian countries in 1997, for Brazil in 1998 and in many other cases. Fund conditionality makes it possible to minimise moral hazard, as confirmed by the fact that countries do not relish applying for IMF money.

In the middle of the crisis, Europe started to think about reinventing the wheel, trying to make it easier for debtors – especially states – not to repay their debts and to pin blame on the creditors, especially banks. There are two reasons for this. One is the need to save taxpayers' money. The other is a desire to punish banks which, for many years, made large profits and nicely remunerated their managers even when they made poor investment decisions. If banks are forced to pay for such decisions, they will learn the lessons for next time. If you bail them out, they will make the same mistakes again and again. This is the basic reasoning.

The reasoning seems obvious at first sight. It is also an easy political sell. In fact, it is simplistic and may turn out to produce exactly the opposite result.

The reinvented wheel is known as private sector involvement, which in essence requires any financial assistance that is provided by the public sector to a euro area country to be linked to a parallel reduction in the value of the debt held by private creditors. It is the result of the Deauville agreement of October 2010, which was subsequently endorsed by the European Council in that same month. The ECB has expressed its opposition to this idea on several occasions. This idea has had a major impact on financial markets because it marks a departure – in two ways – from the practice which had guided crisis management since the inception of the IMF. First, it explicitly recognises the possibility of default or debt restructuring by a euro area country, while it was previously considered to be an *ultima ratio* solution, applied under exceptional circumstances to relatively poor countries with limited systemic relevance. Second, it makes financial assistance conditional on an engagement with creditors. In contrast, the IMF doctrine requires countries to engage with creditors *only* if the adjustment programme cannot put a country's debt on a sustainable path. By making PSI automatic, the new approach blurs the distinction between solvency and liquidity crises and thus makes the former much more likely.

After lengthy discussions in which the ECB strongly opposed this form of PSI, the reference to its automatic use was removed, and a reference was explicitly made to standard IMF practice. However, some political authorities are continuing to say that banks should pay for their mistakes and that haircuts on public debt are needed before public money is provided. This unsettles financial markets worldwide. The contagion has spread progressively to the core of the euro area, as concerns about sovereign risk have risen to levels which are hardly justified. Just to quote an example, the credit default swap premia on the sovereign debt of Italy and Spain have risen to approximately the same level as those of Egypt and Lebanon. The CDS for Germany is now higher than that of the UK and about twice the level of the US.[1]

The concept of private sector involvement may please voters, but ends up costing taxpayers much more. I would like to give two reasons for that.

First, experience has shown that penalising banks, and even letting them fail, is not necessarily the best way to make the financial markets work better and assess risk appropriately. Markets remain fundamentally pro-cyclical, and punishing them for past

1 Cut-off date: 14 October 2011.

mistakes may actually increase such pro-cyclicality, especially in the midst of a financial crisis. The first thing that financial institutions do when they realise losses due to their underpricing of risk is to immediately overprice risk and to de-leverage, which tends to fuel a spiral with negative effects on the real economy. Although shareholders and managers should be the first to account for banks' failure to assess risk, experience has also shown that the upcoming generation of bankers has not necessarily learnt from the mistakes made by the previous generation.

So what is to be done?

Appropriate regulation and supervision of the financial system is essential in order to protect taxpayers. This is why regulators and supervisors have to be accountable to taxpayers. I would like to push the argument even further, perhaps somewhat provocatively. Since the regulators and supervisors are accountable to taxpayers, the latter are ultimately also responsible if their financial system is inappropriately regulated and supervised. Taxpayers cannot have their cake and eat it. In other words, they cannot tolerate, or even encourage, lax regulation and supervision – which in turn favours bank profitability, benefits the national financial centre and ultimately contributes to the state's coffers – *and* at the same time refuse to contribute when systemic crises occur as a result of an under-regulated system.

To sum up, the banking system is regulated precisely because of its systemic implications. You don't teach the banking system a lesson by letting it collapse once in a while, but by ensuring proper regulation and supervision, even if some people don't like it.

Similarly, you don't make countries improve their fiscal discipline by making it possible for them to easily get away with restructuring their debts. This may actually create a disincentive, i.e. an incentive *not* to adopt the corrective measures which are needed to reform the economy. This is what actually happened in the case of Greece last spring. As talks of restructuring spread from some euro area capitals, the Greek government started thinking that this could be a nice way to go easy on the adjustment effort and it delayed some of the measures agreed in the programme.

Questioning the signature of the sovereign has very negative effects on the confidence of wholesale and retail investors, both at home and abroad. Since public debt instruments play a key role in domestic financial markets and are an essential means of saving for the population, restructuring has very large wealth effects, with direct repercussions on the economy and also on society and on the democratic system. It is no coincidence that nearly all countries which have restructured their debt in the past were relatively poor and often undemocratic.

As a result, PSI, when applied to states, may end up costing taxpayers even more. In particular, additional financial assistance must be provided to a country which restructures its debt in order to avoid an abrupt interruption in the flow of credit and the collapse of the domestic financial system. Such additional assistance may even be as large as the savings obtained from the restructuring of private sector credits. The 21 July agreement with Greece, for instance, which aimed at saving around €50 billion of debt held by the private sector, required the disbursement of about €20 billion of extra assistance to recapitalise the Greek banking system to avert its collapse and a larger amount to enhance the credit rating of Greek bonds to be used as collateral for refinancing with the Eurosystem.

What's the solution in this case?

To prevent countries from getting again into the same difficulties as they experienced prior to the crisis we need tougher governance, with more stringent rules – not only on fiscal discipline but also on banking supervision – automatic sanctions and greater stringency on domestic decision-making for countries which request financial assistance. The negative experience with the Stability and Growth Pact over the last decade should not undermine efforts to further strengthen the system. It is ultimately the responsibility of each government to ensure not only that it complies with the rules but also that other governments do likewise.

If governments fail to play this role at European level, their taxpayers will bear the costs. Taxpayers should thus hold their representatives accountable for ensuring that the European rules are respected by all.

Stronger governance may require a Treaty change, in particular with a view to giving more power to European authorities over the public finances of a country which asks for assistance. Indeed, looking at the current situation in Greece, it is clear from its balance sheet – its assets and liabilities – that the country would be solvent if it were willing to sell its assets, or pledge them, to repay its debts. Its unwillingness to do so, for local political reasons, and the inability of the European authorities to induce the country to do so, aggravates the situation in the financial markets and tests the political resilience of the creditor countries.

Political leaders are now realising that monetary union *is* a political union. They should act accordingly, instead of passing on the responsibility to financial markets.

Towards a comprehensive solution

We have recently entered a new phase of risk transfer going from sovereign entities to the banking system and back again. Increased risk aversion has progressively spilled across countries. The link between the financial sector and sovereigns has degenerated into a series of negative, rather dangerous feedback loops, which ultimately weigh down on overall confidence and growth, not only in the euro area but also worldwide. Against this background, how can we best avoid investors questioning the sustainability of the overall euro area financial system, as well as the very capability of sovereigns to fully honour their obligations?

Action is required in four main areas.

First, the governance framework should be strengthened to avoid any repetition of the problems which have caused the crisis. The measures adopted recently are a step forward. Further steps are needed, especially to reinforce crisis management, which may require Treaty changes, or a new Treaty among the 17 current members of the euro area. My concern about the current discussions is that while there are several interesting proposals dealing with fiscal policy – aimed in particular at strengthening the Union's ability to constrain the budget of countries requiring assistance – little is being said about financial matters. We have seen that the Irish and Spanish problems, for instance, were not caused by budgetary problems but by an excessive leverage of the banking system. I believe that we need a more tightly integrated regulatory and supervisory structure in the euro area.

Second, given the crisis of confidence in the financial markets, backstops have to be identified to ensure the stability of the financial system, in particular banks. This means that markets – not only supervisors – have to be convinced that banks can withstand a worsening of the situation, both in terms of access to liquidity and in terms of absorbing potential losses through capital. The provision of liquidity is the responsibility of the central bank. Ten days ago we decided to conduct two longer-term refinancing operations with a maturity of about one year, at fixed rate with full allotment. We also decided to continue conducting our main refinancing operations at fixed rates with full allotment against collateral at least until mid-2012. We also launched a new covered bonds purchase programme. However, national treasuries are responsible for ensuring that the banking system is adequately capitalised.

Higher capital is required in particular as a precautionary measure, with a view to reassuring the markets. However, given that the markets are now quite nervous, we should avoid promoting solutions which end up producing the opposite result, in particular having a permanent excess of capital and entrenching the idea that euro area public bonds are unsafe assets. There is also a risk that if banks are given too much time to secure the desired capital ratio, they will achieve it through a de-leveraging and a reduction of their assets, thus triggering a credit crunch. What is needed is a credible backstop for the banking system which can be used quickly to absorb potential losses, if they materialise.

At the current juncture, higher capital in the banking sector could help to reduce the negative feedback loop between the sovereigns and the banks, through several channels. With higher capital buffers banks would be able to withstand larger external shocks, including those stemming from the difficulties of the domestic or a foreign sovereign. In addition, well-capitalised banks would have less of a need to de-leverage and to liquidate their exposure to sovereign debt. Finally, being less vulnerable to systemic risks would mitigate the perceived credit risk of the sovereign itself, and in this way contribute to lowering its financing cost.

The third element of the comprehensive solution is the backstop to the sovereign risk to convince markets that liquidity problems affecting the euro area members will not translate into solvency problems. The European Financial Stability Facility has been put in place. Discussions are ongoing on how to leverage the resources. Various solutions are being studied. I won't go into detail here but will simply say that it is important to realise that the size of the backstop has to be proportional to the systemic risk we may face. The political authorities, and the taxpayers to whom they report, have to understand that if this risk materialises, and the euro area fails to provide a convincing answer, all parts of the Union will be severely affected, even those who currently seem safe. The impact will even spread beyond the euro area, as our G20 partners have repeatedly said. Ensuring the stability of the euro area is thus a responsibility which goes beyond our borders and affects the global economy.

This leads me to the fourth issue, which is the case of Greece. This in itself would require a separate speech. All policy-makers involved, including governments and parliaments, should learn from the experience so far, in particular the fact that apparently easy solutions for taxpayers may turn out to be much more costly. Greece needs an overhaul of its economy, and that will take several years. A long-term solution should be found, bringing about sustainable public finances and a stronger economy. The sustainability of the debt should be ensured over time, looking not only at the level of the debt at a given point in time but also at its trend and interest burden. Pressure should continue to be exerted on the Greek government and parliament to stick with the programme.

Putting wealth to work

The challenges mentioned above raise an additional issue which I would like to address now, namely the shortage of public funds. For several countries, borrowing money to backstop the financial system or to help other countries is unfeasible, given the level of outstanding debt.

What's the solution?

I would like to elaborate on a concept which is often forgotten by analysts, especially those who look at the current situation from the perspective of emerging markets' experiences in the past. In most euro area economies the state itself holds a large amount of wealth, some of which is marketable. According to OECD statistics, in 2010 government financial assets amounted to 33% of GDP in Greece, 43% in Ireland, 34% in Portugal, 26% in Spain, 28% in Italy, 37% in France and in Germany.[2] Before entering into catastrophic scenarios such as those depicted by doomsayers, countries should be able to put their wealth fully to work.

There are various ways of doing this. An obvious and often considered one is the privatisation of some of the state's assets, and using the proceeds to reduce the stock of

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[2] It comprises currency and deposits, loans, securities including shares, financial derivatives, insurance technical reserves and accounts receivable.

government debt. The disposal of government assets has a neutral effect on the fiscal position. But asset sales can significantly contribute to addressing liquidity problems.

One of the concerns generally voiced about the sale of public assets is that valuations can be depressed and that some markets may have completely dried up. Another concern arises from the reluctance to dispose of assets considered to be strategic for the country, given the nature of the companies involved (energy, military, telecoms, etc.).

An alternative way is to leverage the property rights of public assets in such a way that they can be securitised and used to provide protection for bondholders or to guarantee the backstop for the financial sector. Some smart financial engineering is needed, and many ideas are circulating, based also on existing experiences. This is a promising avenue, but much work needs to be done. Better use of existing assets would enable countries to reduce their reliance on additional borrowing in order to finance backstops that are temporary, because linked to the very tense situation of the financial markets. It would thus reduce their fragility in the transition to a more stable situation, in which public finances are on a better footing.

Conclusions

Breaking the spiral of negative feedback loops from a crisis-battered financial sector to sovereign entities – and then back from governments weakened by the financial crisis to the banking system – is crucial to restore confidence in the financial system. Halting that spiral requires a multi-pronged strategy that simultaneously addresses the fiscal and banking systems.

Over the last 18 months European policy-makers have shown that they are able, in the end, to take decisions which safeguard the stability of the euro area financial system and defend the prosperity that we have built over the last 60 years. But they have done it too slowly, under the pressure of the markets, and that has ultimately increased the burden.

A comprehensive, timely solution is needed now. I am confident that Europe’s leaders will find it.