Peter Praet: Sound money, sound finances, a competitive economy – principles of a European culture of stability

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the symposium on "Perspectives for a common stability culture in Europe" organised by Konrad-Adenauer-Stiftung, Berlin, 27 February 2012.

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Ladies and gentlemen,

It is an honour for me to have been invited here today to speak about the emergence of a European culture of stability. In Germany, such a culture is the outcome of what is known as *Ordnungspolitik*. It involves the primacy of sound monetary policy, sound finances and solid institutions, as well as ensuring fair competition. *Ordnungspolitik* is firmly entrenched in German governance. Its intellectual roots can be traced all the way back to the Freiburg School of Economics and in particular Walter Eucken. It advocates an institutional framework promoting a free, yet ethically responsible, market economy. Within this framework, economic actors are then free to pursue their own goals.

Speaking at the Konrad Adenauer Stiftung today, let me also pay tribute to the first German Chancellor of the Federal Republic. He firmly believed in a new Germany, inside a peaceful and integrated Europe. He once said, "*Unser Ziel ist es, daß Europa einmal ein großes, gemeinsames Haus für die Europäer wird, ein Haus der Freiheit*" (Our goal is to turn Europe into a large house for Europeans to share, a house of freedom).

Today, I will provide you my reflections about how I see the crisis changing both Europe and Europeans. There are changes in governance, tighter rules, some new institutions have been created to complete the architecture of EMU, and some of the older institutions have tighter mandates and instruments. There is now realism and acceptance of the need for such changes as never before.

My reflections are organised along the subjects of sound money, sound finances and a competitive economy. Some lessons and final thoughts will conclude. Overall, I think there are signs of stabilization that give us confidence about the future.

Sound money

The financial crisis we are experiencing is not a "monetary crisis" in its essence. The ECB has secured price stability. It is also remarkable that inflation expectations have remained anchored throughout the crisis. Looking ahead they remain anchored even in the distant future. Yet, the ECB has to continue earning the confidence it has acquired.

The operational framework of the Eurosystem, through which monetary policy is implemented, has proven to be resilient and effective. The ECB was the first central bank to respond to what was initially called "financial turmoil". A very important part of the ECB's policy responses came in the form of cutting rates and providing liquidity against collateral.

In order to prevent a serious credit-crunch – and preserve the proper transmission of monetary policy – the ECB embarked in a series of exceptional monetary measures. For example, last December the ECB decided to hold two very long-term refinancing operations with a maturity of 3 years against adequate collateral. The first was conducted already in December, and the second is forthcoming. These measures are supporting the liquidity planning of banks, thus allowing the flow of credit from banks to the real economy.

Hence, the ECB has delivered in line with its mandate. However, looking ahead we have to ensure that this will remain so. Risks that monetary policy may be overburdened in the future need to be counteracted. The primacy of sound monetary policy and price stability must be safeguarded. It is our shared asset in the euro area.

In order to safeguard sound money, the other elements of *Ordnungspolitik* also need firming up. I now turn to them.

Sound finances

Sound finances entail two components. The first is sound public finances, while the second is provided by sound financial markets. The crisis has shown that fiscal stability and financial stability are linked. Unfortunately, both have struggled throughout this long, and mutating, financial crisis. Yet, there has been progress on both components.

A point sometime missed is that some of the root causes of the crisis go very far back in time. In many societies there was an excessive build-up of debt in recent decades: both sovereign debt and private sector debt (household & corporate). Warnings were voiced repeatedly, also by the ECB. But, the start of serious debt consolidation was continuously postponed, offloading on future generations. There was too much complacency, although many debt sustainability analyses showed that there was a limited period of time to truly address the problem. The crisis has cut the room for manoeuvre.

The economic downturn that followed the Lehman bankruptcy – which many refer to as the "Great Recession" – changed all this. It has brought the debt problem forward. The crisis and the recession have forced euro area countries to face their responsibilities right away. This entails undertaking very substantial adjustments now. Let me provide you with some reflections about the two main components of sound finances in more detail.

The fiscal component of sound finances

Failings in national governance caused severe fiscal strains in quite a number of euro area countries, while, at the same time, European governance lacked teeth. The Stability and Growth Pact was even weakened in 2003 – at the behest of some of the largest euro area countries – and then reformed in 2005. This was not the only problem. Financial market discipline, another powerful deterrent, was virtually absent until well into the crisis, but came back with a vengeance over recent years. Financial markets became dysfunctional driving sovereign risk premia of a number of euro area countries ever higher. Hence, two important deterrents were missing in the first decade of EMU.

After the bankruptcy of Lehman Brothers, automatic fiscal stabilisers cushioned the impact of the crisis, and many European governments introduced economic stimuli programs. On top of this, the financial recapitalisation required was immense in some countries. As a consequence, deficits soared and governments' indebtedness surged.

The overall public sector deficit in the euro area increased from 1.4% of GDP in 2006 to 6.2% in 2010. At the same time, general government debt in the euro area rose from 68.5% in 2006 to around 85.6% in 2010. However, according to the European Commission's latest forecast, the deficit ratio should gradually decline to below 3% of GDP by 2013, while the aggregate debt ratio in that year is projected to exceed 90% of GDP.

This is a challenging legacy of the crisis. Today, a number of countries have embarked in fiscal consolidation programs, and as you know, Greece, Ireland and Portugal are now implementing ambitious adjustment programs. Hence, fiscal policies are adjusting as a response to the crisis.

But how can public finances be returned to soundness more fundamentally? How can sound fiscal institutions, and therefore sound fiscal governance, be secured in the future? The new

fiscal compact – that is soon to be ratified – is a step in the right direction.[1] It addresses some of the weaknesses of the previous fiscal governance framework.

The fiscal compact has two main elements. The first is the mandatory introduction of a balanced budget rule and a correction mechanism for deviations from balanced budgets at the national level. The second element envisages a strengthening of the excessive deficit procedure within the Stability and Growth Pact.

If effectively implemented, the fiscal compact will help to anchor market expectations on the sustainability of public finances in Europe (and narrow the currently abnormal spreads). Yet, Governments now need to prove their commitment to these new fiscal rules by ensuring a rapid ratification of the new Treaty on Stability, Coordination and Governance in EMU, which includes the fiscal compact, its transposition into national law and by living up to the rules and the spirit of the fiscal compact.

The financial stability component of sound finances

August 2007 saw the start of the financial turmoil with an increasing loss of confidence in the financial markets, a drying-up of liquidity and an increase in both risk premia and counterparty risks. Ever larger volumes of so called AAA-rated privately issued assets became "toxic".

In September 2008, after Lehman's bankruptcy, money markets virtually seized up, financial losses rose rapidly and a process of deleveraging set in. Financial stress spilled over to the real economy with a sudden and very severe impact on trade and growth. This led to the global financial crisis.

How can financial markets be made sound again? This question raises many issues which I have not time to address here today but are fundamental, like:

- how can a better pricing of risk be insured?
- how can asset price bubbles be detected and corrected in time?
- how can procyclicality of financial markets be attenuated? and
- how can the financial system better align with the needs of the real economy?

There have been several institutional developments. A new supervisory framework has been put in place in the EU in order to share information and best practices, foster cooperation and identify sources of systemic financial risks at an early stage. It consists of two pillars. The first covers micro-prudential supervision and comprises the European Banking Authority as well as other supervisory agencies.[2] Supervisory colleges for pan-European banks are also starting to operate. The second pillar is dedicated to macro-prudential supervision and is centred on the European Systemic Risk Board. The ESRB can issue warnings and macro-prudential recommendations whenever necessary. In addition, the new Basel III rules are being implemented to secure adequate capitalization of banks.

What explains the rapid contagion that has characterised the sovereign debt crisis? As I already said, the crisis has revealed weaknesses in the prevention side of economic governance. But, there were also other gaps in the architecture of euro area institutions. This became apparent in early 2010 after the onset of the sovereign debt crisis in Greece. One after the other, fiscally weak euro area countries saw their sovereign risk premia rising and

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[1] A "6-pack" came into force in December 2011, and a "2-pack" is soon to be finalised. They already envisage diverse strengthenings of the Stability and Growth Pact.

[2] Two more supervisory agencies were also created: the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

their rating downgraded. As a consequence, their sovereign spreads soared. An adverse feedback loop set in: a vicious circle by which weak sovereign hurt banks and the need for bank recapitalization and refinancing hurt sovereign. Risk aversion by market participants soared: there was contagion.

The architecture of the Economic and Monetary Union (EMU) had been designed without a proper framework to manage a sovereign debt crisis (and which may have slowed down contagion).

One side of this institutional gap is now being addressed through the establishment of firewalls such as the European Financial Stability Facility (EFSF) – and the forthcoming European Stability Mechanism (ESM) – with their framework for sovereign crisis management and resolution.

Some further steps are still needed. For example, there are only national arrangements for interventions to resolve crises of big pan-European banks. Some account for a large share of national GDP of their home country. Thus, while progress was made on the sovereign side:

- we still lack a European crisis management and resolution framework for systemically important banks;
- there are as yet no funds earmarked or clear provisions to help in the recapitalization of big banks (although the ESFS/ESM might acquire such a mandate as well); and
- the fundamental issue of institutions that are "too big to fail" has only started to be addressed.

Hence, it is fair to say that while a lot has already been achieved, some hard work remains ahead of us in order to secure fundamentally sound finances.

A competitive economy

International competitiveness, i.e. a free, flexible, innovative and open economy, is the third pillar of *Ordnungspolitik*. Economic agents need to fulfil the highest global standards of efficiency. On this front, too, matters in individual euro area countries have not, however, developed as would have been desired since the launch of the euro. There have been persistent economic imbalances in several euro area countries, and slow productivity growth in a number of others. The "Great Recession", the epicentre of which initially seemed to be far away, has exposed and exacerbated these weaknesses.

How could this go on for so long? Diverse national factors played a role: as a result competitiveness changed significantly and heterogeneities build up. Hence, there was also a lack of macro-economic surveillance and too little focus on job creation and improving growth prospects.

Many of these weaknesses are now being addressed by national policies. A number of euro area countries have started serious structural reforms. *But looking ahead, how can the euro area remain competitive more fundamentally?* A new Macroeconomic Imbalance Procedure (MIP) is now in place. A warning system is helping us in identifying risks arising from large and protracted swings in competitiveness as well as sustained budget deficits at an early stage. *How?* By monitoring amongst others, domestic prices, costs of production, wages, unit labour costs, export market shares, and productivity. The MIP complements the fiscal compact.

Hans-Gert Pöttering, the President of the Konrad Adenauer Stiftung and our host today, has put it very clearly: "*Die Durchsetzung umfassender Strukturreformen… kostet in erster Linie Kraft – nicht Geld*" (The implementation of comprehensive structural reforms … calls for great efforts, rather than money).

What have we learned from the crisis?

The speed with which persistent imbalances in EMU can result in systemic risks was not fully understood prior to the crisis. An important lesson is that due to high trade and financial integration in the euro area, the build-up of imbalances in any individual euro area country increasingly affects all others. In other words, there are greater spillover effects on account of increasing interconnectedness. The financial contagion of the sovereign debt crisis is a case in point.

Therefore, substantial risks to fiscal and financial stability can build up if structural reforms, liberalisation and fiscal consolidation are postponed for too long, i.e. in the absence of an effective *Ordnungspolitik*. This leads to stress in our societies. For each euro area country, the pressures for maintaining sound finances and remaining competitive have grown tremendously. At the same time, also the incentives of each euro area country to monitor its peers have grown to virtually the same extent. Hence, my message is that each euro area country is a stakeholder in the success of the others.

Some final thoughts

The global financial crisis has been a traumatic event in the still short history of the euro area. Yet, it has also been a wake-up call. In my view it has been a catalytic event that is changing both Europe and Europeans. The contours of a shared European culture of stability are gradually emerging. It is a culture of respect of rules and institutions and transparency. This will support the economic growth that is indispensable to heal the legacy of the crisis. But let us be modest and bear in mind that solutions to the crisis are only good:

- if they are thought through carefully,
- if they are widely accepted and shared by European citizens, and
- if they are widely implemented across euro area countries and, when needed, improved and strengthened as necessary.

As Konrad Adenauer put it many years ago, "*Die Einheit Europas war ein Traum Weniger. Sie wurde eine Hoffnung für viele. Sie ist heute eine Notwendigkeit für alle*" (The unification of Europe was the dream of a few. It became a hope for many. Today, it is indispensable for all).