Peter Praet: The role of the central bank and euro area governments in times of crisis

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the German Federal Ministry of Finance, Berlin, 19 April 2012.

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Introduction

Since 2007, we have constantly been confronted with exceptionally tense financial and economic conditions. When the tensions in the financial markets first emerged in the summer of 2007, they were perceived as a liquidity shock. However, the collapse of Lehman Brothers in September 2008 – the first climax of the crisis – revealed more fundamental fragilities in the global financial system.

The accumulated credit excesses, paired with the complex cross-country linkages in the financial markets, quickly exacerbated the financial market tensions on the other side of the Atlantic, transforming them into a crisis of global dimensions.

The resulting Great Recession of 2009 affected virtually all industrialised countries and caused other weaknesses in the economic and financial system to be crystallised. Specifically, the severe economic contraction worsened the fiscal positions in many countries around the world, particularly in those that already had sustained public or private debt imbalances before the crisis.

The subsequent tensions in some sovereign debt markets have spilled back into the financial markets. As safe assets, sovereign bonds play a key role in financial systems. The weakening of this status of being a safe asset in some countries added renewed fragility to financial institutions.

Five years into the crisis, there remain manifold challenges to global financial and economic stability. The situation continues to be extraordinarily complex, and there are no easy solutions on offer.

The exceptional dimension of the crisis – the real threat it presents for the prosperity of the people in Europe and around the world – requires a forceful response by national and international authorities. However, several factors are limiting the capacity of authorities to react around to world. Most importantly, the weak fiscal positions of many countries are placing severe constraints on the capacity of governments to – somehow – spend their way out of the crisis.

In some cases, this has led to calls on monetary authorities to act more. In addressing the crisis, we should not forget that policy responses shape future expectations. We cannot afford to take measures that entail the risk of adverse economic consequences, such as moral hazard in fiscal policies or an unanchoring of inflation expectations.

In my remarks, I will focus on the euro area's framework for economic governance and on the crisis resolution measures taken in there. In view of enormous challenges that had to be dealt with, both the ECB and the euro area governments have taken important policy measures.

The euro area economic governance framework and the crisis

Let me first briefly review the economic governance of the euro area at the outset.

The most distinctive feature of EMU is that it combines a single monetary policy with largely decentralised fiscal and economic policies. In such a framework, a key challenge is to ensure a high degree of self-responsibility or, expressed in other words, to ensure that unsound national policies do not even materialise and do not, in any event, undermine the stability of the common currency.

These challenges were abundantly clear to the founding fathers of EMU: rules on fiscal spending were laid down in the Maastricht Treaty, and supplemented by systems for the coordination of economic policy. Together, they are now generally referred to as the European economic governance framework.

The fiscal constraints in EMU – given the two reference values, namely the ceilings of 3% of GDP on budget deficits and of 60% of GDP on government debt – are probably the best known elements of the fiscal framework. But the framework was, in fact, far more comprehensive, even before the recent reform of economic governance. A set of rules imposed preventive limits on government borrowing, requiring Member States to achieve close-to-balance budgets over the business cycle. These rules were meant to place debt on a sustainable footing and, at the same time, to create fiscal room for manoeuvre for "rainy days".

A surveillance procedure was also put in place to verify that all the parties involved complied with the agreed fiscal targets. And in the case of non-compliance, a "corrective arm" was envisaged, starting with warnings and ultimately culminating in sanctions, in order to ensure that governments would quickly reduce any excessive deficit through progressive corrective steps.

The fiscal rules were complemented by additional elements, such as the Broad Economic Policy Guidelines, which were introduced as a tool to ensure a convergence of economic policies and performance across Member States and to foster economic growth and employment, as well as to attain the ambitious goals set in the "Lisbon Agenda".

How has the European framework for economic governance been applied and how well has it served Europe?

It is true that the euro area has fared reasonably well in macroeconomic terms. For instance, real GDP growth per capita in the euro area has not lagged behind that in the United States. Over the same period under review, more jobs were created in the euro area than in the United States.

However, the European governance framework was unable to ensure fiscal soundness and macroeconomic stability in all euro area Member States. Some Member States had already accumulated large fiscal imbalances in good times. The fiscal policy framework suffered from weak implementation, in particular after the reform of the Stability and Growth Pact (SGP) in 2005.

Other macroeconomic imbalances, particularly divergences in competitiveness, were also allowed to develop over a number of years prior to the crisis. In some Member States, wage increases significantly exceeded productivity gains and this, in turn, caused unit labour costs to rise substantially.

When the global financial crisis hit the real economy in 2009, the budgetary effects of automatic stabilisers in the tax and benefit systems, the fiscal stimulus packages introduced by governments and the support provided to the financial sector led to a sharp deterioration in the fiscal positions of all euro area countries. External and domestic imbalances mounted, especially in weaker euro area countries. This led to severe tensions in financial markets and to the emergence of risks of adverse spillovers to the rest of the euro area.

One could divide into four categories the ways in which countries could have addressed sovereign debt problems in the past. First, and most naturally, governments pursue a course of fiscal consolidation. Second, as tended to be the case in some countries, central banks can monetise public debt, i.e. finance government debt and deficits by issuing additional money. Third, governments can decide not to honour their obligations and simply default on their outstanding debt. Finally, as occurred in a few exceptional cases, third parties can decide to assume the debt and deficits of their vulnerable counterparts, thus typically transferring resources from economically stronger to weaker entities.

European Union legislation clearly rules out the monetisation and bail-out options. Article 123 of the Treaty on the Functioning of the European Union prohibits any form of monetary financing of public debt or deficits; Article 124 forbids privileged access to financial institutions by the public sector; and the "no-bail-out clause" in Article 125 precludes that one Member State becomes liable for the liabilities of another Member State.

These articles are based on sound economic principles. Monetisation would inevitably lead to higher inflation, with the well-known costs to economic prosperity. Transfers between euro area Member States would – particularly in the absence of far more rigid fiscal rules and sanction mechanisms at European level – risk creating significant moral hazard effects in the beneficiary countries, and would thus further undermine the long-term economic stability in the euro area.

Also, the ECB has long warned against the third option – the restructuring of sovereign debt in the euro area. The exchanging of debt, as in the case of Greece, should remain a unique event. In this respect, it must be noted that the contagion effects of such measures are difficult to control, as has been demonstrated by the high volatility of financial markets over the past year. In addition, debt restructuring does not in itself address the underlying economic fiscal and structural imbalances.

There is only one way of solving the sovereign debt crisis in the euro area countries: governments should pursue policies of strict fiscal consolidation and far-reaching structural reforms so as to address macroeconomic imbalances and return their countries to sustainable paths of growth. The ECB should support the adjustment process in the Member States in the best manner possible, namely by providing price stability in the euro area as a whole.

The ECB's response to the crisis

Let me now address the measures taken by the ECB in response to the crisis, before turning to the response by the euro area governments.

During the crisis, the ECB has been confronted with unprecedented threats to monetary stability in the euro area. Broadly speaking, these have come from two sources: first, the deflationary forces stemming from the economic downturn and, second, the impairment of the transmission of its monetary policy, which reflected to the growing tensions in financial markets.

The ECB had to react decisively to these challenges.

First, we used our standard monetary policy measures to address the downward pressures on price stability that resulted from the sharp slowdown in economic activity in the crisis. In full consistency with our mandate, we reduced our key policy interest rate rapidly between October 2008 and May 2009, from 4.25% to 1%. In other words, we reduced our policy rate faster than any euro area country has ever done in recent history.

Given that the ECB has ensured that inflation expectations in the euro area as a whole remain very solidly anchored, we have been able to maintain an accommodative monetary policy stance over the past four years.

Second, we took additional non-standard measures to ensure that our interest rate decisions were transmitted effectively to the broader economy, despite the volatilities in the financial sector. If banks cannot easily access the money market or other sources of finance, they may not extend credit to households and companies, to the detriment of economic growth and employment.

At the outset of the crisis in 2007, the ECB reacted immediately to the rapidly worsening liquidity conditions and heightened credit risk, particularly in the interbank markets.

When stress in the financial markets re-emerged in the autumn of last year, the Governing Council of the ECB again took a series of measures to enhance the provision of liquidity to the banking system and to actively support lending, notably introducing two very long-term refinancing operations with a maturity of three years, which were conducted in December last year and in February this year. The exceptionally long maturity of these operations gave banks a longer horizon for their liquidity planning. It is also helping them to deleverage in a balanced and orderly manner over the medium term, thereby avoiding "fire sales" of assets and a downscaling of longer-term lending.

At the same time, it is crucial that all the crisis measures taken by the ECB to ensure monetary stability in the euro area – the standard and the non-standard – do not create adverse incentives for market participants or unanchor inflationary expectations. For this reason, the ECB has been very clear that the measures it has taken are designed to be temporary in nature.

Let me also emphasise that our non-standard measures do not in any way impinge upon our capacity to tighten our monetary policy stance in response to inflationary pressures.

In all our actions, we have been careful to keep inflation expectations well-anchored and have remained faithful to our mandate to preserve price stability in the euro area over the medium term. Our mandate is what has guided, and will continue to guide, all our monetary policy decisions.

But the success of the ECB's crisis measures in maintaining monetary stability in the euro area should not let anyone believe that monetary policy is the medicine that can solve the underlying, more structural problems in the euro area. The lasting resolution of the crisis is the responsibility of the euro area governments.

The euro area governments' responses to the crisis

Euro area governments face three main challenges. First, they need to address the internal and external macroeconomic imbalances. Second, they have to restore confidence in, and stability to, the European financial system. Third, they must deal with the remaining shortcomings in the institutional design of EMU. Let me elaborate on these factors in turn.

First, the rebalancing of the euro area economies requires, first and foremost, that public sector expenditure is brought back to a sustainable path and that the debt overhang is reduced. This is, of course, particularly true for those euro area countries that are currently under an EU/IMF programme or are experiencing disruptions in their sovereign debt markets. Much remains to be done, but we should not forget the steps that have already been taken – although there is no room for complacency.

Based on a direct estimation of revenue and spending (rather than on the cyclically adjusted primary balance), the cumulative fiscal consolidation achieved thus far is in excess of 10% of GDP in each of the three countries under EU/IMF programmes. While some countries have, most regrettably, fallen behind the targets in their programme, the consolidation efforts are significant in absolute terms.

One of the reasons why countries did not reach their headline deficit targets is to be found in the economic headwinds they are experiencing. Negative economic growth, higher interest payments and higher social security spending have led to quasi-automatic increases in expenditure and obscure the fiscal consolidation efforts. This stresses the importance of the implementation of well-designed and ambitious fiscal adjustment programmes being accompanied by growth-enhancing structural reforms.

There is no doubt that the long-term effects of fiscal consolidation on growth and employment are positive and significant. Whereas fiscal consolidation may have a dampening effect on economic activity in the short run, the extent to which it does so depends on several factors, such as the composition of the fiscal adjustment. National authorities need to set ambitious and credible targets, and to stick to them. Even small deviations from the targets can quickly jeopardise the progress made and undermine confidence.

To address imbalances, countries also need to take structural measures and deal with market rigidities. Suitable structural reforms can have a positive impact on growth and employment already in the relatively short term, and can thus also help to mitigate the negative effects of consolidation. Structural adjustment nevertheless remains difficult, but not impossible. This is proved by the experience in the Federal Republic of Germany over the past years. Losses in competitiveness after the reunification boom in the early 1990s were effectively addressed by means of moderate wage growth over extended periods of time.

At the same time, the German experience shows how well-targeted structural reforms strengthen potential growth and boost employment. The labour and welfare reforms contributed significantly to positive economic developments in Germany over past years.

In the remaining time, let me also briefly address the other two challenges faced by euro area governments, namely the instability of the financial markets and the remaining deficiencies in the European economic governance framework.

Banks should continue to strengthen their balance sheets. The financial system has to return to fulfilling its primary task of providing credit to the real economy. But, as I have said before, euro area governments also have to do their part. Sound fiscal positions across the euro area will contribute significantly to strengthening confidence in a banking sector that relies heavily on government bonds as safe assets and for use as collateral.

At the same time, euro area governments need to further strengthen the macro-prudential framework at the national and the European level. As you know, the European Systemic Risk Board is developing tools to identify and address potential future sources of systemic risk in the EU. And the three new European supervisory authorities – for banking, for insurance and occupational pensions, and for securities and markets – are strengthening our focus on spillovers within the EU's financial system. However, one important element in the framework for macro-prudential supervision in the euro area is still missing. We still have no clear mechanism in place to deal with the systemic risk emanating from large cross-border financial institutions. We should intensify ongoing work on the establishment of a mechanism for the resolution of bank failures at the European level.

This brings me to the third challenge that euro area governments face: the elimination of remaining institutional deficits in the euro area governance framework.

European governments have made considerable progress on this front. In particular, they have reinforced the Stability and Growth Pact, with more "automaticity" and less room for discretion in the application of the preventive and corrective arms. In addition, the European fiscal compact will ensure strong national budgetary frameworks in order to facilitate compliance with the government's obligations under the Stability and Growth Pact. And EU Member States have introduced a surveillance mechanism that aims to prevent and correct macroeconomic imbalances within the EU.

It is now essential that the new governance framework is implemented to the letter. Our governance framework has lost much credibility that must now be carefully reacquired.

Here, particular responsibility rests with the national authorities. In particular, the European governance framework will function best if national finance ministries conscientiously perform their role with respect to multilateral surveillance.

The sovereign debt crisis has taught us unequivocally that – in spite of the no-bail-out clause in Article 125 of the Treaty – the euro area countries are not insulated from one another. In an integrated single European market with a single European currency, spillover effects from one Member State to the other should make us all take a strong interest in the pursuit of sound fiscal and structural policies by our European partners.

Because of the close integration of the European economies, governments have also set up a European crisis resolution mechanism, the European Stability Mechanism. Its purpose is not, as some have argued, to bail out euro area countries that have failed to pursue sound economic policies. Its stated purpose is to safeguard financial stability if one or more countries endanger the euro area as a whole.

Conclusion

To conclude, the ECB's policies have been guided by price stability considerations, with policies targeted at those elements of the crisis that threatened to prevent it from fulfilling its mandate.

Responsibility for the resolution of the sovereign debt crisis rests with the governments of the euro area Member States. Major progress has been made in terms of fiscal consolidation and the enhancement of the euro area governance framework.

But we are not there yet. Governments need to urgently implement their fiscal consolidation programmes and to accompany these with well-designed structural reforms in the labour and product markets. The new fiscal and macroeconomic rules of the European governance framework need to be implemented to the letter. And the crisis management mechanisms at the euro area level need to be designed so as to ensure financial stability in the euro area.