Pentti Hakkarainen: The growth outlook and the challenge of financial stability

Presentation by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the Financial Times Group's Investment Series 2012, Helsinki, 26 April 2012.

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Dear friends and colleagues, ladies and gentlemen.

I want to thank the organizers for giving me this opportunity to speak to you on what I think is one of the most important issues in the European and the global economy today, the question of debt and deleveraging, and its relationship to growth.

The question is how the economies of Europe and the other advanced countries can revive and start growing again, when they are still suffering from high debt levels, extreme hoarding of liquidity, and an extraordinary degree of risk aversion.

How do we get out of the problems we are in? The economic situation of today reminds me of a tourist who on his trip to Ireland stopped a local old man to ask for the way. How do I get to Galway, he asked. The Irishman replied: Well, sir, if I was going to Galway I would not start from here!

But we have to start from where we are, and the obstacles on the way must be analyzed and overcome. I will argue that the present mood in the markets is partly an overreaction, a sort of mirror image of the irrational exuberance of the first years of the 21st century.

The tasks of financial consolidation and reregulation are real and unavoidable. However, we need growth too, and growth will require something else as well: a revival of confidence in real productive investment and a reversal of the negative psychology which has been perpetuating the state of gloom.

Recent experience

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The global economic outlook continues to be dominated by shadows of the 2008–2009 economic crisis. Recovery from the "Great Recession" has been much slower than was expected and there have been repeated disappointments. This has to do with debt. Economic history shows that economic recoveries are especially slow after slumps which have involved financial crises. This is precisely because financial crises leave the economy burdened with high levels of debt, and it has often taken a long time to digest that debt.

One recent disappointment on the way to normal was experienced towards the end of last year, when economic activity suddenly turned down, especially in Europe and Japan. There were several reasons, but the difficult debt situation of the Southern European countries was a key trigger. Not only the so-called peripheral economies were hit, but the disturbances were felt globally as well. The interbank markets also reacted, so that money market spreads increased dramatically, in Europe to highest levels since 2009.

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In the euro area as a whole, there was a clear risk of an actual credit crunch. The increasing pressures on banks' funding and their capital could have led to a dangerous scaling-back of bank lending to the private sector. The result could have been a vicious circle involving low economic activity, even more funding stress for banks, and a further reduction in lending. If that development had taken hold, a danger of deflation would have been imminent.

In early December, the ECB announced a set of powerful monetary policy measures to deal with this threat. The most significant were two long-term refinancing operations (LTROs) with an exceptional maturity of 3 years. The ECB also allowed the national central banks to accept a wider range of collateral than previously. The reaction of financial markets was very positive.

The confidence of the markets improved during the first quarter of this year, and the ECB policy measures announced in December contributed a lot to that.

Of course, monetary policy is no substitute for fiscal measures which are needed to ensure that budget deficits of all euro area countries are under control. The improvement in the market situation was also helped by the progress made by euro area governments towards instituting more binding common fiscal rules and strengthening the financial firewalls EFSF and ESM and by the progress in fiscal consolidation and economic reform in many countries.

The improvement of the first months of this year showed up particularly in the rebound of equity prices, and a decline in risk spreads in the bond markets. The expectation strengthened that Europe would follow in the tailwater of the US, where promising signs of economic recovery have already been observed.

The uncertainties

However, as you are aware, the last couple of weeks have again demonstrated the fragility of the situation. At the turn of the second quarter of 2012, doubts arose once more about the viability of the southern European fiscal programmes. The markets reacted again, risk aversion took hold once more and also the growth outlook weakened – judging from the nervous reaction of stock indexes and bond prices.

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In spite of those jitters, there are continued signs of stabilization in the global economy, and also in the euro area, although at a low level. We are still expecting growth to pick up in Europe during the latter half of this year. This cautiously positive outlook is highly conditional, however, and there are a number of risks and uncertainties.

We face a complex web of many uncertainties. In the US, the big issues of housing, unemployment and the federal deficit are still unsolved. There is a threat of overheating in China, with all sorts of adverse consequences. Japan has experienced about two decades of low growth, if any, and this seems to continue. What poses a downside risk to all economies, however, is the European situation. It is still very fragile and even minor adverse surprises can trigger a vicious downward spiral.

Let me propose two uncertain factors in particular which have to be taken seriously into account.

One is how the financially weakest European countries succeed in following their fiscal consolidation programmes. The watchword here is consistency. The situation is still very fragile, and so it is very important that governments avoid creating any uncertainty about their fiscal plans. There is a lot at stake: disruptions in the government bond markets might spill over to the real economy and harm activity again, also in other countries.

The second important challenge is how to avoid a prolonged economic stagnation in Europe. There is a risk we end up following the Japanese scenario where growth is hampered, banks are not lending and the government debt continues to accumulate.

The uniqueness of the present

To begin with, there is the debt situation itself. The debt ratios in the advanced economies are at the post-World War II level, and even higher in some countries. But in addition to that, the financial landscape has some other remarkable features too.

There is an unprecedented amount of liquidity in the system. This is seen in the record high central bank deposits of banks, and also the cash holdings of corporations are at very high levels. In a sense this liquidity is a consequence of the central banks' monetary operations, but it is important to underline that the central banks have merely made this liquidity available against collateral; they have not in any way "pumped" money into the system in excess of what is demanded by banks.

What we see is an exceptionally high ***demand*** for assets of high liquidity, as opposed to demand for earning assets. This is a symptom of deep distrust prevailing in the financial markets, and a malfunctioning interbank market, which, if left unattended, could have led to a dangerous and unwanted credit squeeze.

However, I must emphasize that the ECB's ability to control liquidity and to maintain price stability remains intact: we will have the possibility to adjust the interest rates and, if necessary, we have at our disposal a range of tools to actively absorb the excess liquidity when needed.

Another unusual feature of the present situation is the prevailing extreme risk aversion *(see slide 5)*. Spreads between "sure" and uncertain returns have exploded to very high levels and the valuation of productive assets reflects the reluctance to invest in anything perceived as risky. For example, the stock market has shown surprisingly little confidence despite of relatively low P/E ratios in many sectors.

Overreaction?

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All in all, the present situation marks a spectacular reversal of the behavior which was seen before the crisis. Then, liquidity preference was low as it was believed that most assets – bonds or stocks – could be easily converted to cash at any time in deep and continuously open markets. Risk premiums were also very low, because investors believed in the continuation of a favorable macroeconomic environment – dubbed great moderation – and because they trusted in the optimistic assessments dished out by the credit rating agencies.

Then it turned out that the great moderation was actually based on an unsustainable borrowing by American households and European governments and many others, on a too highly leveraged financial system, and that the optimistic credit ratings of many borrowers and structured debt instruments were actually based on faulty assumptions.

The markets have a tendency to be carried away by the prevailing sentiment. In the years of prosperity which preceded the current crisis, the markets were exuberant, as Alan Greenspan famously said, and now they seem to be stricken with almost incurable pessimism and doubt.

It is also in the nature of the market economy that the market sentiment is to a large extent self-fulfilling – in the short term at least. So, negative expectations can lead to lack of investment and a rush to quality which in turn harms the real economy and that again feeds back to the markets.

It may well be – I think it is likely – that the present skepticism is an overreaction just as the exuberance of the years leading to 2008 was an overreaction. There seems to be a lot of momentum which is independent of the deepest fundamentals in these swings of mood. The negative psychology shows now in the exceptional level of risk aversion.

Policy is not innocent of this. The various policy measures which have been taken in order to contain the crisis, have often been pushing financial problems to the future without solving them permanently, so that now there is a backlog of cumulated problems which understandably keeps investors worried as long as the markets are dependent on public support.

Paradoxically, the government interventions to restore the functioning of the market may have become a sign of alarm to the markets and can even increase risk aversion.

But if liquidity is ample, and if risk aversion is at a historical peak as it seems, there is a also lot of financial potential available for new investment and economic recovery once the necessary business confidence is restored. In the last instance, it is the perceived opportunities in the real sector, profitability of real investment, and economic transformation which can return the world economy and also the European economy to a more healthy state.

Deleveraging as a problem?

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However, in the medium term, forces of growth will be weighed down by the burden of debt – the excessive leverage – which still troubles the European economy in particular. The recession has further aggravated the problem, because of the downward revision of income prospects and the expected capacity for debt service. However, it is unavoidable that there has to be a lot of effort put to debt reduction.

At the same time, this may have adverse consequences for growth in the short run. The excess leverage is difficult to get rid of, and the impression of being overindebted even more so. Debt has become like an undesirable bucket that every firm, every government and every sector tries to pass on to the next.

This competition between sectors for financial health will slow down the growth prospects in the near term. Just last week, the IMF drew attention to the dangers that a contraction of bank lending would pose to the European economy, in particular.

In the European context, the ECB has consistently stressed the priority of reducing the budget deficits, while at the same time seeking to prevent the reduction in bank lending. In today’s situation, the necessary improvement of bank balance sheets should preferably happen through increasing banks’ equity capital rather than reduction of lending. The financial supervision authorities have urged banks to follow this course.

Some deleveraging, and the difficulties going with it, is however unavoidable. In particular, ensuring the sustainability of government finances is absolutely necessary for the normal operation of financial markets, and therefore also necessary for the indebted economies to return to a phase of durable growth.

Just as important is to encourage the banking sector to adjust and shed any excess capacity that exists in the financial services industry. Otherwise, the European governments in particular may end up supporting a number of ineffective and unviable banks.

A simultaneous improvement in the financial condition of banks, households, and governments will be a difficult and slow process as long as high risk aversion prevails in the capital markets and until there is growth and a recovery of investment activity. The improvement is especially challenging in countries which have lost their competitiveness and have run current account deficits, financed by borrowing.

Financial regulation

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One part of the new landscape is the new and coming regulatory environment of finance and banking. This will have a profound impact on how the financial sector will operate in the future. The aims of the regulators are logical as consequences of the lessons learned during the last years.

There are several regulatory reforms that are currently in progress.

Most importantly, banks are required to strengthen their capital ratios. This is motivated by two reasons. Larger capital buffers will make banks more resilient towards losses. At the same time, the owners of bank equity will have a larger stake in a bank's business and risk-taking. That is expected to encourage better monitoring of the business on the part of the owners. The complaint that in banking, "profits are private but losses socialized", that has motivated political decision-makers to require the new regime to be implemented quickly.

New so-called macro-prudential tools are also being developed. The word macro-prudential refers to the aim of these new regulations, which is to steer the market as a whole instead of focusing on the riskiness of individual banks. The macro-prudential regulation should, in particular, reduce the danger of excess indebtedness in the economy and the financing of asset market bubbles in the future.

There are also more far-reaching proposals on the table: In the US and the UK, proposals are under consideration to separate investment banking from the narrowly defined "normal" part of the banking business. In Europe, the need of such structural restrictions is now being considered in a European Commission working group under the chairmanship of Governor Liikanen of the Bank of Finland.

At the same time, more efficient procedures of crisis management are being developed. The goal is that the supervisors could intervene in a loss-making bank well before the equity is exhausted. This should reduce the risk borne by taxpayers in rescue operations. The possibility of early intervention by the supervisors can also improve the incentives of the managers and equity holders to avoid excessive risk taking.

Regulation vs. growth

The new regulatory measures have financial stability as their main aim. At the same time they would limit risk-taking by banks.

This raises an interesting and very important question: Is there a conflict between these safety-oriented reforms on the other hand, and growth and investment on the other? Is there a danger that the new regulations perpetuate the present tendencies of excessive risk aversion and liquidity hoarding? If that is the case, the consequences would be negative for an economic recovery in the short run and for growth in the long run.

These questions cannot be passed over lightly. How can the long-run goal of a more resilient financial system be reconciled with the need to have more investment and a more growth-friendly business environment? Will the quest for a safer banking system lead to scarcity of credit and finance for real investment?

It is only realistic to admit that this problem may be relevant in the short run. But we should not overstate the conflict. In the long run, the conflict between stability and the availability of finance should disappear, because in the long term, the focus is by definition on sustainable profits and returns. So, more a stable financial system should provide a better environment for investment as well.

The European Banking Authority is presently assessing banks' recapitalization plans which they have submitted as responses to the EBA's Recommendation on recapitalization. The first results suggest, fortunately, that European banks expect to be able to meet most, by far, of their recapitalization needs by far by raising new capital, retaining earnings or conversion of hybrid liabilities.

One observation related to that is that when the banking system is re-engineered and becomes safer and better capitalized, the cost of equity capital for banks should also fall. Investors in bank stock will be satisfied with a lower rate of return when the capital structure of banks is improved. Because of this effect, the cost of new regulations to the banks and their negative impact on growth is likely to be less than in has been claimed by some critics.

The way ahead

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In the future recovery, finance will probably take the back seat. Just as the financial expansion of 2001–2007 did not create sustainable growth in the developed world, financial consolidation – although necessary – will not alone be a sufficient condition for growth. A key ingredient to sustainable growth is the revival of real investment. It is not a substitute for financial consolidation, but a complement to it. And it requires a change in the time horizon and risk appetite of investors who for several years now have been hoarding liquidity and "quality".

The way forward is in profitability of REAL business investment, and improved international competitiveness of those economies and sectors which are in need to deleverage. The facts that there is an unprecedented amount of funds held in liquid assets and that the current levels of risk aversion seem exceptional in a longer perspective suggest that finance for economic recovery will be quickly and abundantly available when conditions are right.

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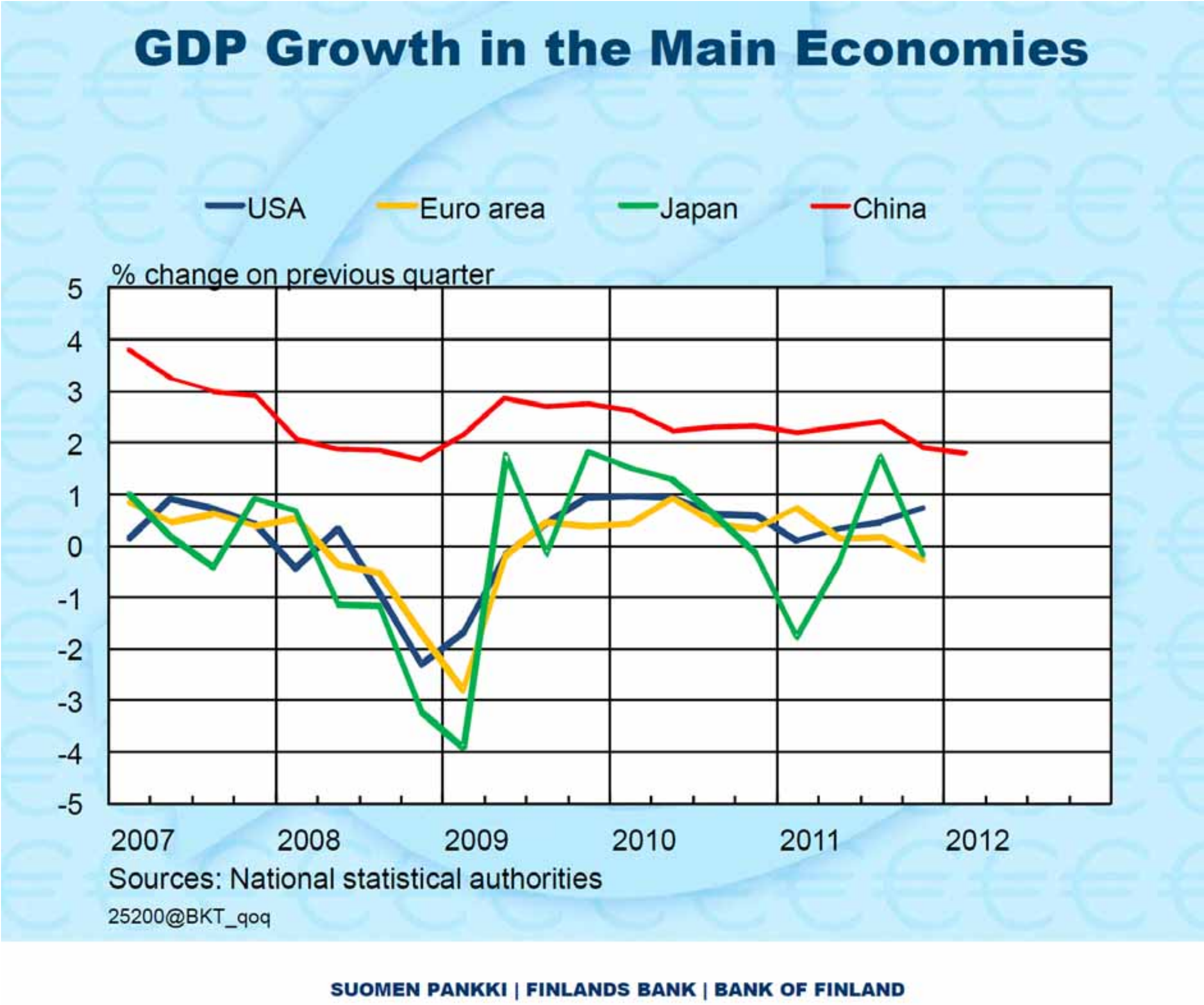
Ladies and gentlemen, let me come back to the story of the tourist asking the way to Galway. So, should you ask me for the way ahead to sustainable economic growth, I would propose you to consider whether and when it would make sense to start by shifting investments from liquidity to productive assets.

Slide 2



GDP Growth in the Main Economies
USA
Euro area
Japan
China
% change on previous quarter
5
4
3
2
1
0
-1
-2
-3
-4
-5
2007
2008
2009
2010
2011
2012
Sources: National statistical authorities
25200@BKT_qoq
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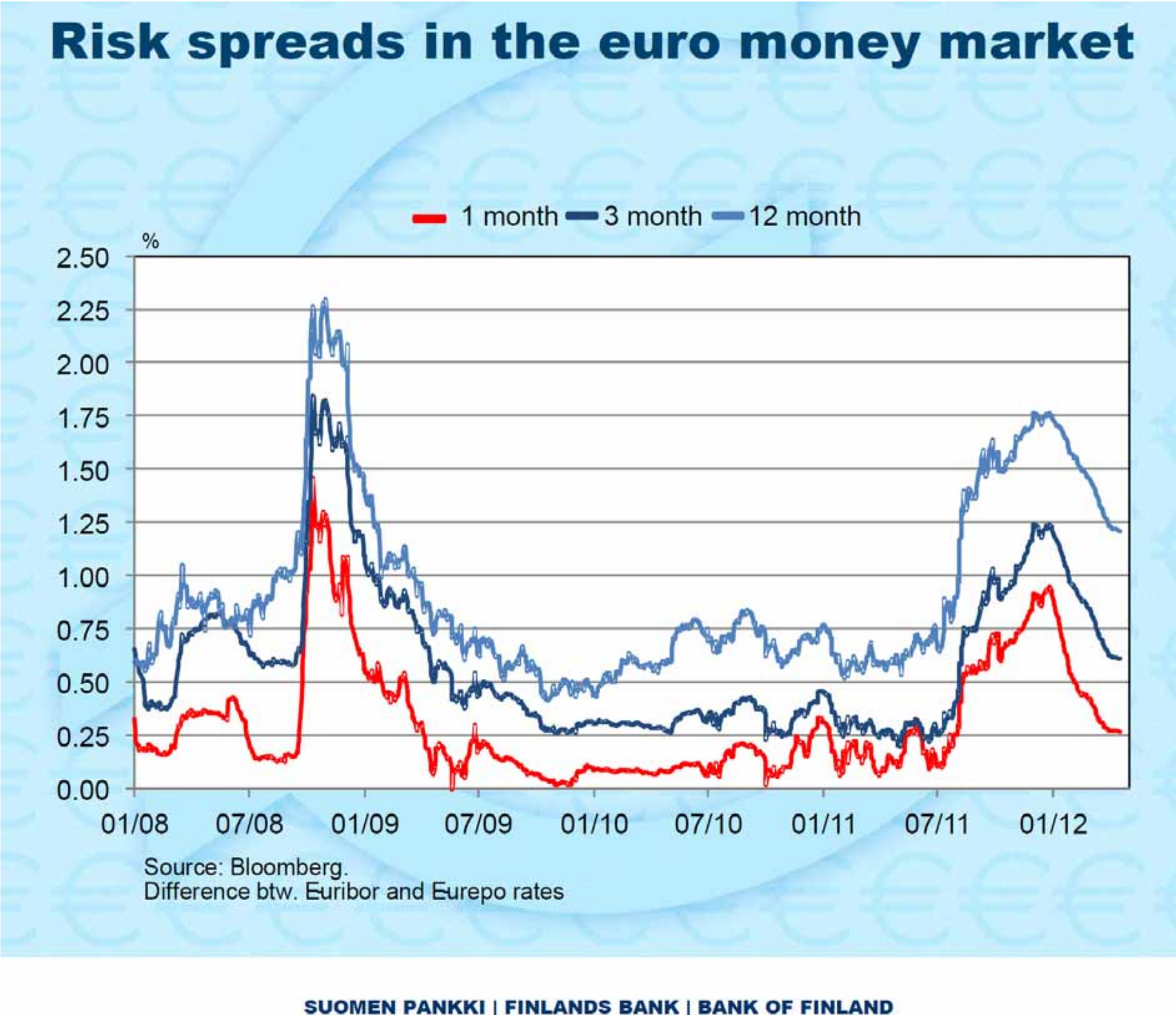
Risk spreads in the euro money market
1 month
3 month
12 month
%
2.50
2.25
2.00
1.75
1.50
1.25
1.00
0.75
0.50
0.25
0.00
01/08
07/08
01/09
07/09
01/10
07/10
01/11
07/11
01/12
Source: Bloomberg.
Difference btw. Euribor and Eurepo rates
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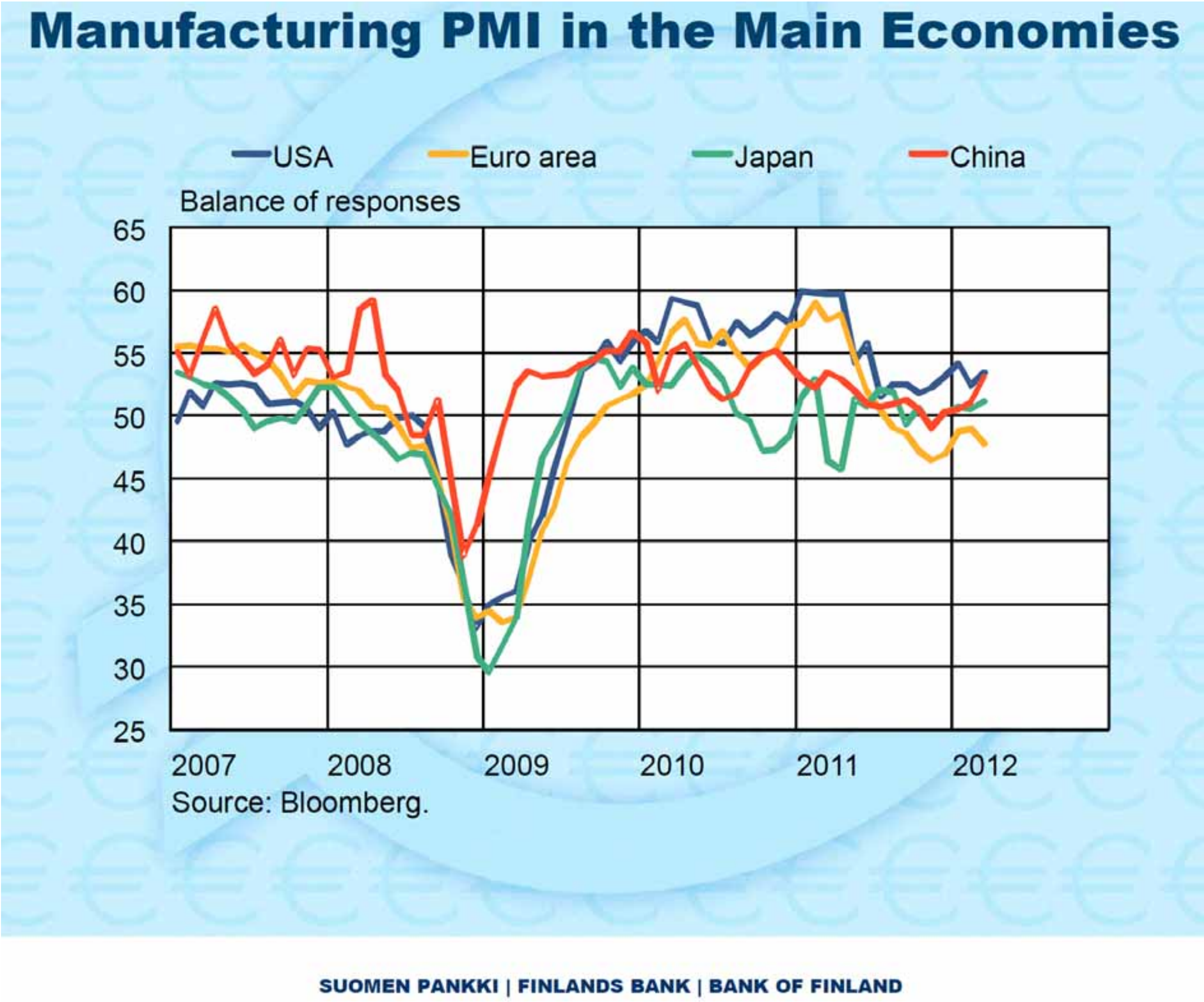
Manufacturing PMI in the Main Economies
USA
Euro area
Japan
China
Balance of responses
65
60
55
50
45
40
35
30
25
2007
2008
2009
2010
2011
2012
Source: Bloomberg.
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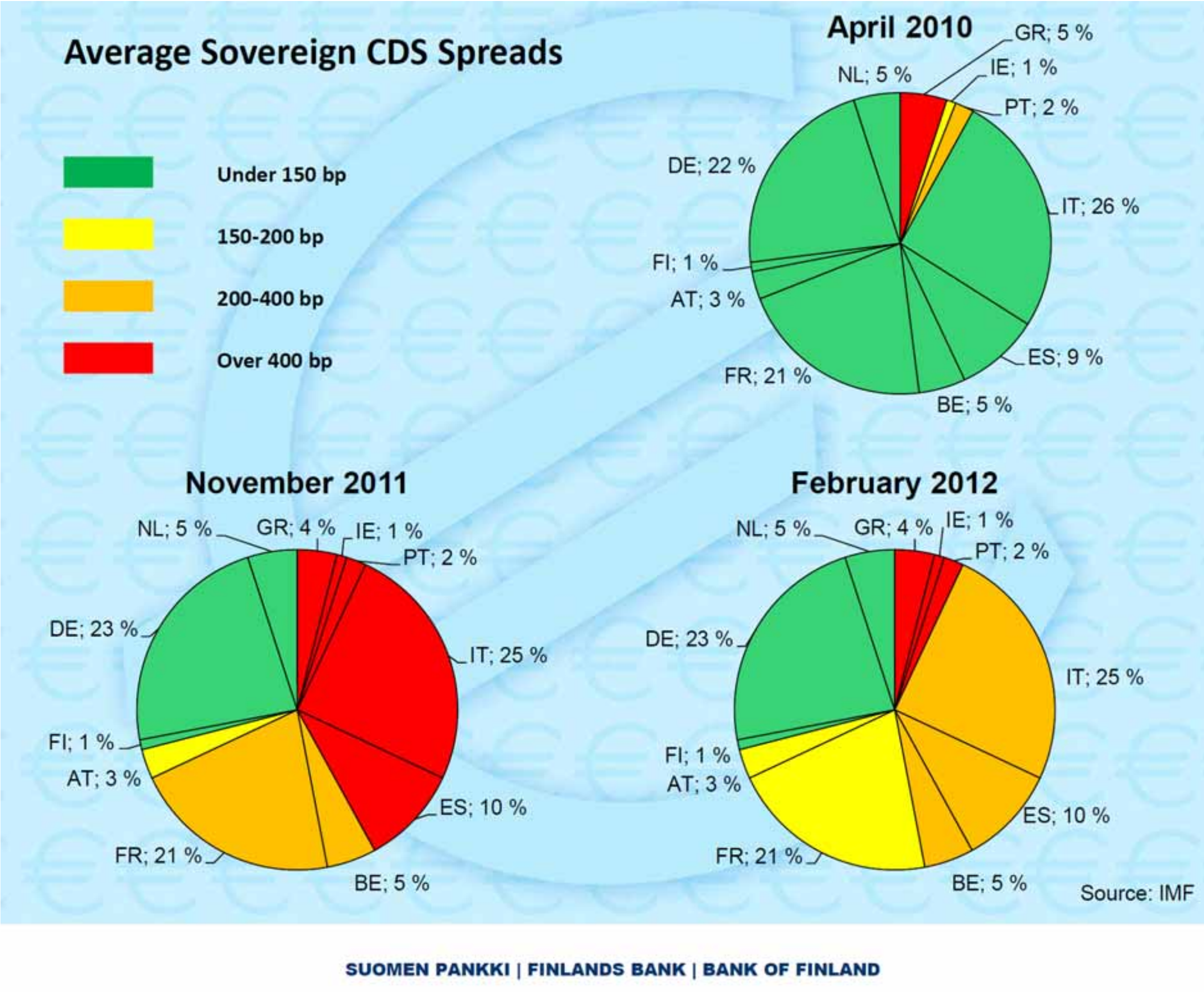
Average Sovereign CDS Spreads
Under 150 bp
150-200 bp
200-400 bp
Over 400 bp
April 2010
GR; 5 %
IE; 1 %
PT; 2 %
IT; 26 %
ES; 9 %
BE; 5 %
FR; 21 %
AT; 3 %
FI; 1 %
DE; 22 %
NL; 5 %
November 2011
NL; 5 %
GR; 4 %
IE; 1 %
PT; 2 %
IT; 25 %
ES; 10 %
BE; 5 %
FR; 21 %
AT; 3 %
FI; 1 %
DE; 23 %
February 2012
NL; 5 %
GR; 4 %
IE; 1 %
PT; 2 %
IT; 25 %
ES; 10 %
BE; 5 %
FR; 21 %
AT; 3 %
FI; 1 %
DE; 23 %
Source: IMF
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Recovery and Debt

- Overreaction?
  - A spectacular reversal of the pre-2007 exuberance
  - The present gloom may also be an overreaction

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  - Debt will be a burden on growth for several years
  - Consolidation and recapitalization necessary

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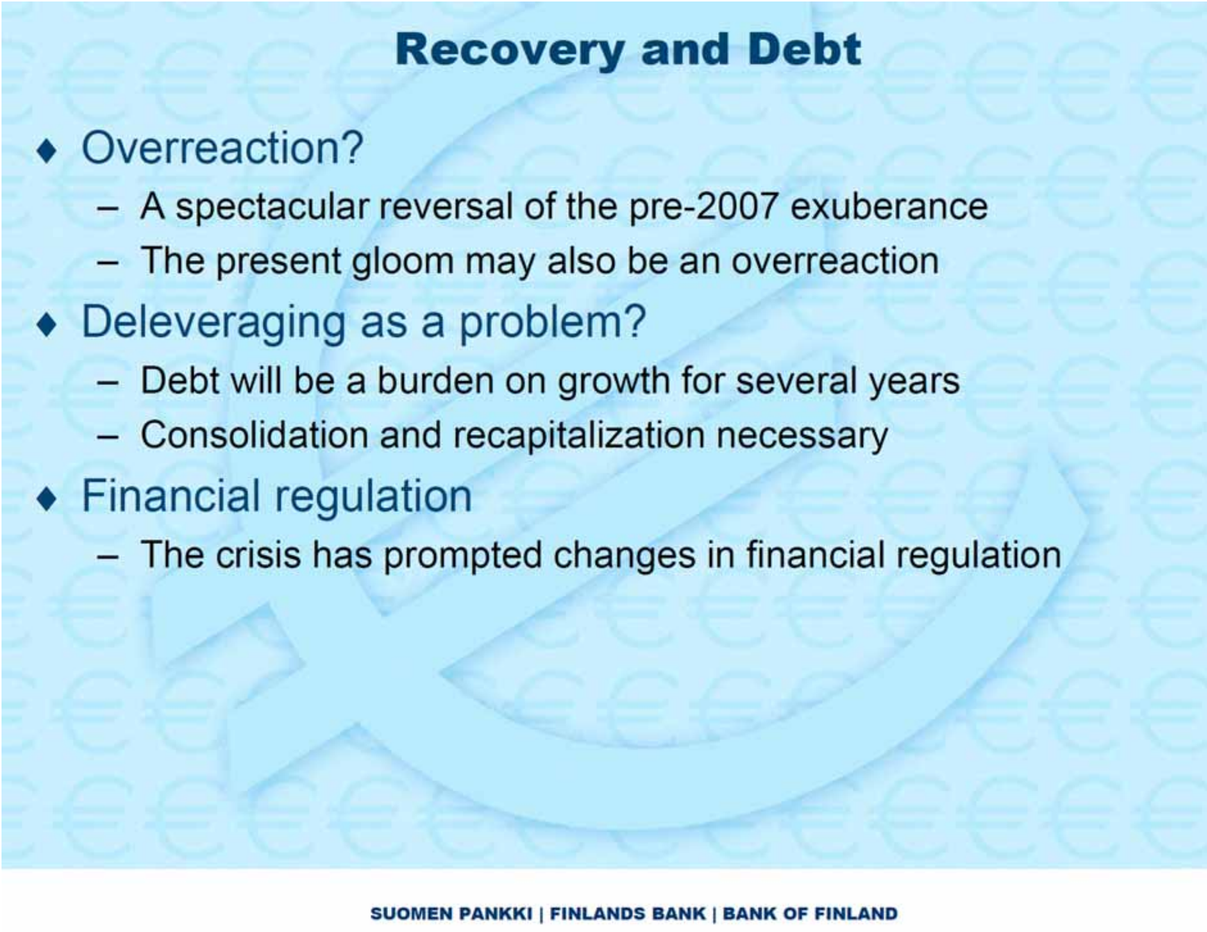
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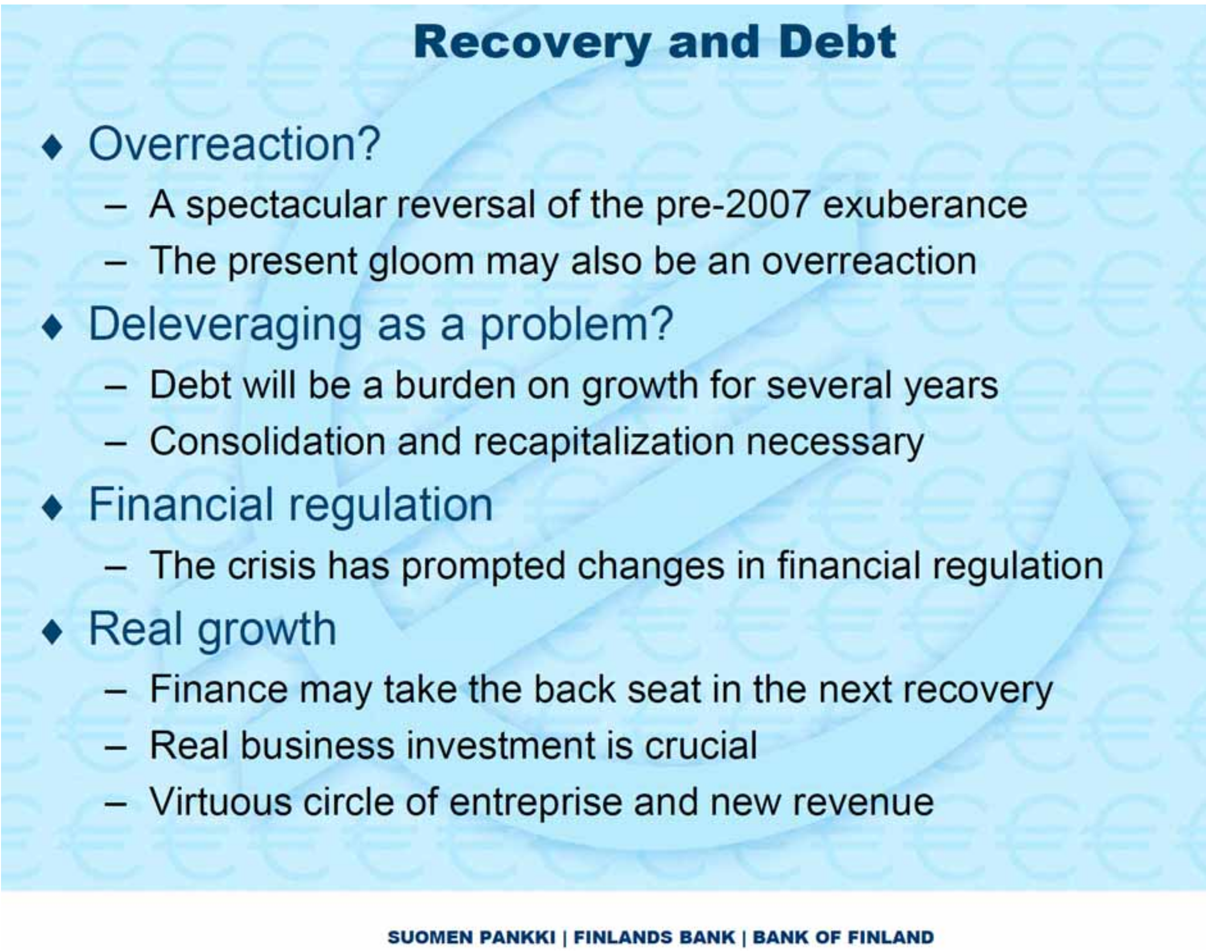
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♦ Financial regulation
– The crisis has prompted changes in financial regulation
♦ Real growth
– Finance may take the back seat in the next recovery
– Real business investment is crucial
– Virtuous circle of entreprise and new revenue
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The way ahead:

Investment in productive assets

Thank you!

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