Vítor Constâncio: The global financial crisis – 5 years on

Intervention by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the China-Europe Economists Symposium, Beijing, 12 January 2013.

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Ladies and gentleman,

First of all, let me extend my thanks to David Marsh and OMFIF for inviting me to this symposium today. There are many themes on the relationship between China and Europe that we could fruitfully discuss but I would like to focus my remarks today on the euro area and the evolution of the sovereign debt crisis. In particular, I would like to review the key lessons from the experience of the last 5 years – and how these lessons have been incorporated into Europe's response to the crisis.

1. Lessons of the crisis

Let me begin with that first question: what have we learned about the euro area in the past 5 years? In my view, there are three main lessons.

First, the financial crisis demonstrated – quite compellingly – that financial contagion is the flip side of European financial market integration. We have learned that deep financial integration, without a commensurate deeper integration of financial stability policies is unstable.

This potential vulnerability has been characterized by Dirk Schoenmaker as a "financial trilemma": the three objectives of european financial integration, european financial stability and national supervision of banks cannot be achieved at the same time.

The existence of this trilemma was confirmed in the euro area experience. Indeed, as it happened, enormous capital inflows channelled by banks of core countries to banks in the periphery allowed for large financial imbalances in the public and private sectors of recipient countries. When these flows turned into outflows as the economic environment deteriorated after 2008, these imbalances not only led to problems for the countries concerned but also produced contagion to other parts of the euro area.

Financial stability – we have seen – is a common good and as such requires shared responsibility for its preservation. A single mechanism for financial supervision and a common authority with strong tools for bank resolution – could have more easily dealt with the situation.

Second, we have learned that shock absorbers at the national level are insufficient in the face of a major financial and economic crisis. Hence the European level has an important role to play.

The design of the euro area assumed that stabilisation would take place at the national level and to a large extent automatically. Stabilisation would be provided by national fiscal policies that would respond to idiosyncratic national conditions. Accordingly, a fiscal brake at the EU level, codified in the Stability and Growth Pact, was designed to prevent fiscal profligacy, preserve fiscal space and hence allow automatic stabilisers to play out in full during downturns. Moreover, country-specific shocks were expected to become ever less important as the euro would spur market integration and the flexible single market to allow an easy and fast rebalancing after such shocks.

However, the scale of the shock after the 2008 financial crisis was unprecedented in a number of countries and it far exceeded their national shock absorption capacity. The euro area had no mechanisms to provide financial support for countries in difficulty and stave off cross-border contagion; there were no area-level institutions to prevent governments from being pulled down by their domestic banking systems. This underscored the pitfalls of a design that relies exclusively on the national level to fulfil the stabilization function.

Third, we have learned that governance of economic policies at the EU level has to be broader and deeper than anticipated prior to the crisis.

Besides fiscal surveillance, which essentially focused on public deficits,[1] there was believed to be no need to closely monitor macroeconomic imbalances and disequilibria on the labour, product or financial markets. Disequilibria originating from the private sector were supposed to be only short-lived and eliminated by market forces.

The data clearly show that this was insufficient. Between 1999 and 2007, the ratio of public debt to GDP in EMU declined on average by 5.6 percentage points. The improvement was by large the result of favourable economic conditions rather than concrete fiscal consolidation measures which should have aimed at approaching the reference value of a 60% GDP to debt ratio at a satisfactory pace, as the Treaty prescribes it. In some countries – as we all know – the sovereign debt dynamics were much less favourable than the euro area average. Nevertheless, the accumulated private sector imbalances seem to have far exceeded those in the public sector.

In the same period – between 1999 and 2007 – the ratio of private sector debt to GDP increased by 26.8 percentage points. Also for the same period, in the stressed countries, the cumulative increase in the private debt ratio to GDP versus the public debt ratio, amounted respectively, to 49 and 24 per cent for Portugal, 75 and minus 35 per cent for Spain, 101 and minus 10 per cent for Ireland, 217 and 4 per cent for Greece. In 2007, at the beginning of the crisis, the public debt ratio was just 62.7% in Portugal, 46.4% in Spain and 26.6% in Ireland, in all cases well below the euro area average.

Nevertheless, the increase in total debt, both public and private, was associated with various destabilizing developments, ranging from rising asset prices to losses of wage and price competitiveness. Clearly, the euro area needed a framework to monitor macroeconomic imbalances and suffered from its absence.

2. Responses to the crisis

So how has Europe incorporated these lessons into its policy responses to the crisis?

It is useful to conceive of the European response in two phases. First, Europe has had to respond to what might be called the *acute* challenges, by which I mean the shifts in investor sentiment and market psychology that have led to market panic and cross-border contagion. These had to be addressed to manage the on-going crisis.

Second, it has had to respond to the *systemic* aspects of the crisis, by which I mean the underlying economic and institutional weaknesses that have led these acute effects to appear. These have to be addressed to find a sustainable solution to the crisis and prevent a re-emergence.

a. Acute challenges

The acute challenges have been addressed, first and foremost, by establishing crisis management tools at the European level. This included the temporary European Financial Stability Facility and Mechanism in May 2010 and more recently the permanent European Stability Mechanism. Their significance cannot be overstated. Financial support can now be given swiftly and efficiently, conditional on strong macroeconomic adjustment. This arrangement maintains the core principle that Member States are responsible for their economic policies, while at the same time removing the tail risk of a self-fulfilling

[1] Within the Excessive Deficit Procedure of the Stability and Growth Pact.

liquidity/solvency crisis. This partly remedies the lack of a 'federal' shock absorber, while not altering the fundamental balance of competencies within the euro area, which would require fundamental Treaty changes. The capacity of these arrangements also ensures sufficient scope for support. The ESM is a permanent institution that can raise up to 500 billion euros in financial markets – actually, one of the world's largest and most flexible international financial institutions.

b. Systemic challenges

As regards the systemic aspects of the crisis – the underlying economic and institutional challenges that lie at the heart of Europe's current difficulties – reforms have taken place on two main levels.

First, Member States have undertaken major internal and external adjustments to reduce fiscal and macroeconomic imbalances. Encouragingly, it is those Member States with the deepest vulnerabilities that have undertaken the most far-reaching adjustments.

For instance, on the fiscal side, Greece has closed its structural primary budget deficit by around 13 percentage points of GDP since 2009, Portugal by almost 7.5 pp, Ireland by around 6.5 pp, and Spain by more than 4.5 pp. This compares with an average reduction in the structural primary deficit of 2.6 pp for the euro area.

The competitiveness losses these countries accumulated over the first decade of EMU are also being tackled. From October 2008 to Jun 2012, unit labour costs decreased in Ireland relative to the euro area average by around 19%, around 12% in Greece, 10% in Spain, and by around 6% in Portugal. The internal rebalancing within the euro area is underway.

Current account positions have also improved. The three countries under full EU-IMF programmes have current account deficits that are on average around 8 percentage points of GDP lower than they were in 2008 and are approaching full balance or even in surplus as in the case of Ireland. This rebalancing is not just the results of declining imports associate with a recessionary period but are the consequence of a great increase in exports that in the case of Portugal and Spain exceeded the European average since 2009. The second level on which fundamental reforms have taken place to address underlying weaknesses is the strengthening of the institutional architecture of the euro area.

Fiscal governance has been strengthened on several occasions. Very recently, 25 EU countries signed up to the Treaty on Stability, Coordination and Governance, known as the European Fiscal Compact, and which entered into force in the beginning of this year. Member States commit to run structurally balanced budgets and introduce a respective fiscal rule into their national primary legislation. Additional regulations have strengthened the European fiscal governance framework, of which the final pieces – the so-called "two-pack" – will significantly add to the fiscal rule book for euro area countries. It will be important to have the new rules fully implemented and complied with. This should give credibility to fiscal policies, hence reducing investor concerns about fiscal sustainability.

The absence of any oversight framework for macroeconomic policies has been redressed through the creation of a dedicated procedure for the monitoring of macroeconomic imbalances such as excessive credit growth or exuberant house price increases. In addition, a new idea of "reform contracts" will be explored further next year, by which Member States would commit to specific measures to boost competitiveness and receive targeted financial support from the euro area in return.

c. Towards a banking union

However, the most significant governance development has been the commitment to create a real banking union in the euro area – to resolve the "financial trilemma" I referred to at the beginning of my remarks. Its first component is the elevation of supervisory responsibilities to the European level.

In mid-December last year, the Finance Ministers of the EU Member States unanimously reached an agreement on the legislative framework for a Single Supervisory Mechanism (SSM) through the attribution of banking supervision tasks to the ECB. This legislative framework is expected to be enacted in the course of the first quarter of this year.

The agreement on the SSM is a milestone in European integration, with no precedent in monetary union historical experiences. Member States have agreed to assign to the European level a full and complete set of banking supervision powers over all banks of the euro area Member States and also over the banks of the EU countries wishing to join the SSM. The supervisory powers range from authorisation, Pillar 1 and Pillar 2 tasks to early intervention and sanctioning powers. Furthermore, the SSM will also have responsibilities regarding macro-prudential supervision of the euro area financial system as a whole also of individual countries, which is a necessary complement for both central banking and banking supervisory policy, as the crisis has taught us.

The establishment of the SSM is essential for the functioning of Monetary Union. The independent supranational supervision by the SSM will help to restore confidence in the banking sector. This should reverse the trend towards financial fragmentation, prevent flows of deposits due to the lack of confidence, and help restart a well-functioning interbank market.

It is also a major step for the single financial market. The SSM will simplify supervision and support the development of a single rulebook by the European Banking Authority, while helping to better address systemic risks in Europe.

The Single Supervisory Mechanism, although very important, is only the first step towards a banking union. The next step is the establishment of a Single Resolution Mechanism – a necessary complement to the SSM. Building on a strong legislative framework on bank recovery and resolution (which is under preparation) such a Single Resolution Mechanism, with a Single Resolution Authority at its centre, is essential to enable timely and impartial resolution decisions focused on the European dimension and to minimise resolution costs. It will contribute to breaking the vicious bank-sovereign nexus and minimize the risk of supervisory forbearance in the absence of workable resolution options. The European Commission will present a proposal in the course of the year.

As you can see Europe has responded decisively to the challenges. Member states have progressed individually in rebalancing their economies and in common in strengthening the union's institutions.

Notwithstanding the achievements made, no time should be wasted in complacency. Continued policy actions are necessary to sustain confidence and revive the growth potential of euro area countries. The imperative is to further reduce fiscal and structural imbalances as well as to advance with financial sector restructuring and with European institution building. Additional progress on those reform fronts will send a strong signal to markets.

d. The monetary policy response

Let me also briefly touch upon the response of monetary policy. As you know, our primary objective is to maintain price stability in the euro area. Neither our mandate nor our resolve to deliver on it has changed in the face of the crisis.

However, the range of instruments we use to achieve price stability had to be widened. The crisis severely damaged the transmission mechanism of monetary policy and thus changes in the ECB's key interest rates could not be transmitted uniformly across the euro area. Moreover, the sources of disruption in the transmission varied over time. Hence, we used different types of non-standard measures as the crisis evolved: we provided liquidity in fixed-rate, full allotment mode, considerably extended the maturity of central bank credit, widened the eligible collateral set, bought government and covered bonds outright and reduced reserve requirements.

This is also the case for the last measure we announced: the Outright Monetary Transactions – OMTs. The OMTs are designed to tackle unfounded fears of the reversibility of the euro that distorted the sovereign bond markets in the euro area. The perceived redenomination risk had led to a fragmentation of financial markets along national borders and jeopardised the singleness of our monetary policy. Thus, the OMTs were designed as a credible backstop to self-reinforcing negative market expectations and has been successful in alleviating some of the acute crisis challenges I have alluded to before.

Yet, they were also designed to preserve incentives for prudent economic policies. The ECB will only intervene in government bond markets for countries that are subject to effective conditionality of certain ESM programmes – thereby re-enforcing also the resolution of the systemic challenges I mentioned before. The credibility in the eyes of the market of the OMT as a backstop certainly underpins the significant improvement of sovereign bonds' yields and spreads since the beginning of August, when the ECB's Governing Council took the decision to create the programme.

3. Conclusion

The global financial crisis – more than 5 years on now – exposed several structural deficiencies in the institutional set-up of the euro area. However, the lessons learned now translate into policy action. The Euro area has been making progress in all domains of the necessary response to the crisis: countries have been successfully applying adjustment programs; financial backstops have been created; monetary policy has delivered in its role of liquidity provision to the banking sector and Member States have started an ambitious programme of institutional reforms that is deepening European integration and improving the framework for monetary union.

Once again we can see the wisdom of one of the founding fathers of the European project, Jean Monnet, when he wrote: "Men only act in a state of necessity and usually only recognise necessity in a situation of crisis".

Once again, European countries have shown their resolve in making the euro a success and reaffirmed the deep political commitment to work together towards a stronger union.