Josef Bonnici: The changing nature of economic and financial governance following the euro area crisis

Introductory remarks by Professor Josef Bonnici, Governor of the Central Bank of Malta, at the Malta Financial Services Authority, Attard, 17 January 2013.

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The success of the European monetary union was always contingent on three considerations. The first requirement is the maintenance of fiscal discipline; the second is effective financial regulation and the third condition is the management and minimization of macroeconomic imbalances. In reality, these requirements were often not met. In fact, there was a general lack of awareness of their importance.

For the past several years, the headlines have been dominated by the ramifications of the European crisis, which was first manifested in the banking system and then in sovereign debt markets, and subsequently in the economic slowdown and related problems that followed the introduction of fiscal consolidation.

The European Central Bank has engaged in a wide range of policy measures that seek to expand liquidity and restore normal conditions in the banking sector and in the financial markets. These monetary policy measures include conventional or standard measures, which have reduced policy rates to very low levels.

In addition the ECB has adopted various non-standard measures, which have included long term refinancing operations that inject ample liquidity into the financial system. The ECB has gone a step further by announcing an Outright Monetary Transactions (OMT) programme. This is designed to repair the link between policy rate cuts and ample liquidity provision, on the one hand, and lower borrowing costs, on the other. It is also meant to counter the so-called redenomination or convertibility premium that compensates investors for the perceived risk of a breakup of the monetary union. OMT are actually equivalent to traditional open market operations that central banks have long resorted to in order to provide stability and a better functioning of the monetary transmission process that can get impaired in certain circumstances.

The unfolding of the crisis has revealed various intertwined dimensions of the existing fragilities and a broad range of imbalances. In various ways, the problems that are evident in the euro area are of a structural nature, resulting in a number of governance reforms that are currently underway. Inappropriate banking practices, weak regulatory frameworks, fiscal slippage and deterioration in competitiveness are now recognised as the main sources of the crisis.

A fundamental aspect of the banking crisis is the failure of regulation, which allowed financial institutions to engage in excessive risk that was not matched by adequate capital protection. Systemic risk was exacerbated via strong linkages between financial institutions.

Economic fragilities were worsened by the burden imposed on government budgets by bank bail-outs, the lack of market funding available to sovereigns, and the negative impact of sovereign debt downgrades on bank balance sheets. Lack of trust spread across the euro area, with this contagion creating a mutually reinforcing loop between weak sovereigns and bank credit conditions. Although policies have now been in crisis management mode for five years, the interbank market has yet to return to its normal state, reflecting the extent of the lingering damage within the financial sector.

To a considerable extent, the common currency masked vulnerabilities related to the build-up of various imbalances, since such imbalances could no longer be addressed by exchange rate corrections.

These factors have raised questions on the viability of the European single currency model as this has perhaps failed to achieve the targets it was primarily set-up for. The extent of these fragilities is reflected in Chart 1, which shows a convergence in sovereign yields in the run-up to the formation of the monetary union, followed by a decade-long stability.

In retrospect the low yields were clearly not consistent with the underlying fiscal positions or economic fundamentals at the national level. Indeed, low interest rates enabled governments to pile on additional debt at relatively cheap interest costs. This period coincided with deterioration in competitiveness and wider current account deficits as peripheral countries continued to finance such deficits via capital inflows. Eventually, when markets switched their focus to economic sustainability, the flow of capital reversed direction, sovereign debt was downgraded and yield spreads widened dramatically, as seen in Chart 1.

Chart 1

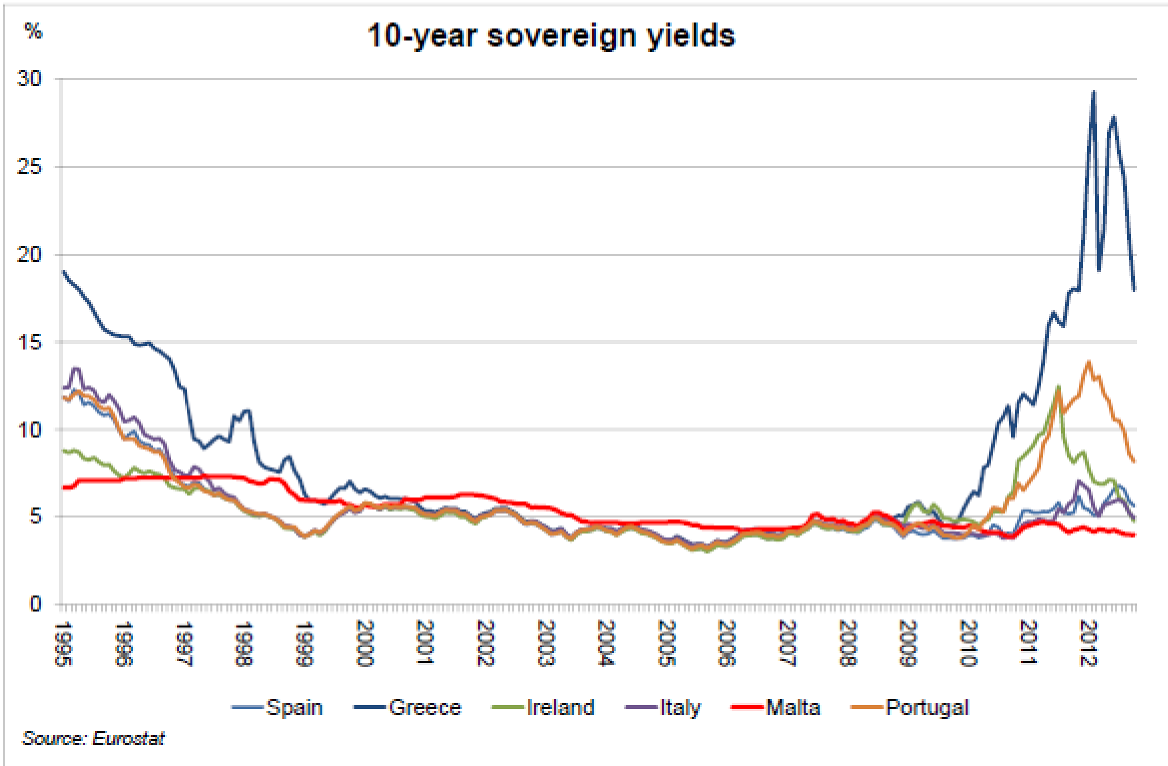
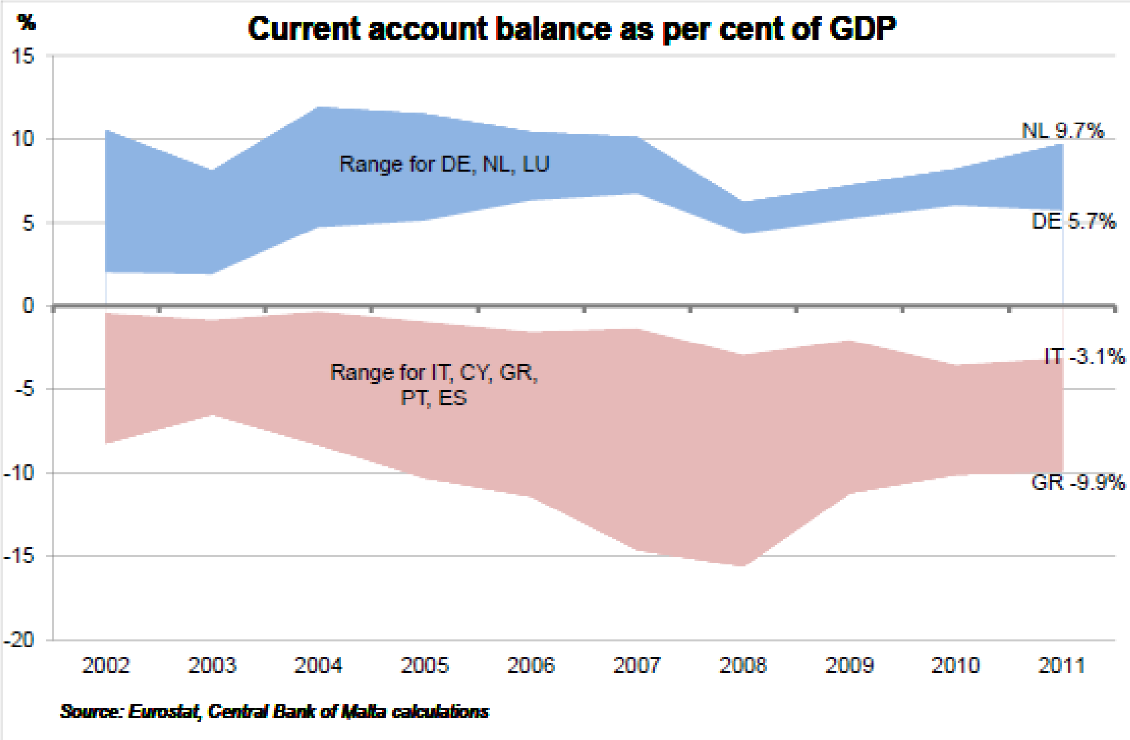


Chart 2 provides a contrast between two groups of countries. It focuses on the current accounts of euro area countries (as per cent of GDP) and shows the difference between various countries running generally current account surpluses, and selected countries in the periphery with a negative balance. These deficits are financed by a corresponding capital flow in the opposite direction.

For each year, the upper band depicts the range of current account surpluses for a group of countries that include Germany, Luxembourg and the Netherlands. Similarly, the lower range depicts the corresponding range of deficits for Cyprus, Greece, Italy, Portugal and Spain. The divide between the groups is notable and it is not surprising that those countries in the lower part of the chart featured prominently in the unfolding crisis. Eventually, when markets reoriented their focus towards economic unsustainability, the flow of capital reversed direction; market discipline now took the form of capital flight.

Chart 2



Governance problems are perhaps better understood by looking more closely at the origins of the Greek situation. On the fiscal side, Greece was not adhering with the Maastricht criteria while its competitiveness was being eroded. This situation was aggravated since government spending was underreported.

Writing in 2011, Ioannis Sarmas, my former colleague at the European Court of Auditors, presented three dimensions of the Greek governance problem: "[first] the lack of an internal control system allowing the government to pilot the country out of turbulence zone; [secondly] the absence of a culture of accountability requiring public fund managers to demonstrate the results achieved and finally … the inadequate powers for the auditing mechanisms preventing them from focusing on the waste of public money."[1]

Governance reforms

I will now move on to major reforms at the European level that are addressed to correct weaknesses in governance.

On the fiscal side, governance has been enhanced by the strengthening of the Stability and Growth Pact. There appears to be broad consensus that to avert the recurrence of the crisis, fiscal consolidation should be enshrined in the governance structure of every country.

Surveillance is enhanced and the monitoring of economic policies is becoming more comprehensive. To this end, the Fiscal Compact obliges all euro area countries to run a structurally balanced budget. In particular, the problem of sustainable budget planning is addressed by introducing a country-specific medium-term budgetary objective, which involves a cap on growth of public expenditure that is in line with the medium-term rate of

[1] Ioannis Sarmas "The Greek financial crisis from an auditor's point of view" *Cour des comptes européenne Journal* July–August 2011.

growth. The Fiscal Compact also accelerates the application of the excessive deficit procedure by introducing sanctions when the debt and deficit to GDP ratios are excessive.

Fiscal surveillance has been extended to a broader excessive imbalances procedure, which goes beyond fiscal imbalances and seeks to identify and correct a range of macro imbalances and shortcomings in competitiveness. In fact, various euro area member states ran into problems despite of their adherence to the SGP criteria, to the extent that they nonetheless manifested other types of imbalances, such as excessive private indebtedness. Preventive recommendations are provided to member countries at an early stage in the formation of imbalances.

The severity of the financial crisis has also exposed the inadequacy of the current financial-sector regulation and supervision. As already indicated, macro-prudential risks were overlooked and the link between sovereigns and banks was underestimated. In reaction to this, European institutions and member states have engaged in a major overhaul of bank regulation and supervision with the objective of creating safer, sounder and more transparent financial institutions.

One of the major initiatives to strengthen the governance framework was the establishment of the European Systemic Risk Board (ESRB). In its first year of operation, the ESRB tackled key issues relating to the interaction between three factors: the creditworthiness of European sovereigns, the increasing difficulty of banks in raising funds, and weakening economic growth. Furthermore, the ESRB adopted three public recommendations on:

i) the macro-prudential mandate of national authorities;

ii) lending in foreign currencies;

iii) US dollar-denominated funding of credit institutions.

It is important to note that the voting members of the General Board of the ESRB include the Governors of National Central Banks. Indeed, ESRB activities are based on strong cooperation between its members. A key part of the ESRB's work is to combine the analysis produced by the micro-supervisors and central banks. Clearly, the central bank's role of ensuring financial stability has extended to the international level, implying further responsibility in decision-making.

In Malta, the cooperation between micro- and macro-supervision is embodied in the setting up of the Joint Financial Stability Board. The Central Bank of Malta, in its capacity as the macro-prudential authority, has agreed with the MFSA to set up a Joint Financial Stability Board which will be formally constituted in a few weeks. The objective is to enhance the cooperation between the two bodies for the assurance of the stability of the financial system. The intention is to strengthen the resilience of the financial system and to mitigate the build-up of systemic risks. To these ends, the Board's mandate includes the development of mechanisms that would identify risks to financial stability, and the establishment of the necessary macro-prudential policy tools. The Joint Financial Stability Board will also be able to make recommendations to the CBM or MFSA boards on macro or micro prudential issues, as the case may be. The board is also responsible for the follow-up of recommendations made by the ESRB.

A further euro area governance reform relates to the Single Supervisory Mechanism (SSM) which involves the establishment of effective and early intervention mechanisms. The SSM endows the ECB with the ultimate responsibility for specific supervisory tasks related to the financial stability of Euro area banks. The rationale for a single supervisory mechanism comes from the increasing interconnectedness between financial institutions and markets across the euro area.

In addition, the proposed banking union does not only provide for the shifting of supervision of banks to the European level, as in SSM, but also brings up for consideration the introduction of an integrated system of bank crisis management and deposit protection.

Various recent reports, such as those authored by Liikanen, Volcker and Vickers, recommend a structural reform of the banking sector. The proposed reforms are designed to limit the likelihood of banking crisis, improve the resolvability of banks and safeguard taxpayer interests. Furthermore, the Liikanen Group concludes "that it is necessary to require legal separation of certain particularly risky financial activities from deposit-taking banks within a banking group."

Conclusion

Regardless of the particulars of the eventual governance changes, it is clear that the economic and financial crisis has been the spark for reforms that may reshape economic institutions and financial supervision at both the national and international levels. These high-level governance reform changes will also filter down to the corporate level, especially at the level of financial institutions, affecting also borrowers and lenders across the economy.