Peter Praet: Economic adjustment in the euro area

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Institutional Money Congress 2013, Frankfurt am Main, 27 February 2013.

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I would like to thank Arthur Saint-Guilhem, Melanie Ward-Warmedinger and Niels Bünemann for their contribution to the preparation of this speech.

Ladies and Gentlemen,

Introduction

Thank you for inviting me to share some thoughts with you on what has been achieved and what remains to be done in the process of addressing the economic challenges we are faced with in the euro area. I will give you a central banker's view on the role of monetary policy in managing the current crisis, but I will also extend my discourse to cover the broader institutional landscape, including some thoughts on what policy-makers in other fields than monetary policy could contribute to improve the euro area's resilience. Today, I will focus on three points:

First, the European Central Bank – together with the national central banks of the Eurosystem – has acted forcefully within its mandate, in order to counteract any risks to price stability stemming from the crisis. The ECB's monetary policy during the crisis has invoked both standard instruments such as interest rate changes and non-standard instruments to ensure that the standard instruments would have the intended effects.

Second, the most distressed countries within the euro area have embarked on a correction of their policies. This correction is painful and requires perseverance of all responsible parties. The reward should be positive results that are now in fact tentatively observable.

Third, governance reforms at the level of the euro area and the European Union at large have contributed to an improvement of the foundation for a better performance in future, and this work is still in progress.

The multi-layered crisis

When looking at the crisis as it has developed since 2007, it can be helpful to use the metaphor of an iceberg. In each phase of the crisis we have discovered new layers, from the visible tip of the iceberg to the dangerous ice cliffs that linger under the surface – and which, in the economic context, have emerged in the subsequent phases, each time proving to be larger than previously thought. This has challenged policy-makers to acknowledge the real dimensions of the problems, and to adjust their response accordingly.

The tip of the iceberg – the liquidity crisis – was revealed in mid-2007 when the US mortgage market, which lay at the basis of a complex, tangled web of globally-held financial derivatives, took a sharp down-turn. This triggered the first case of what we have later come to describe as "frozen" interbank-markets around the world, quite a fitting extension of the iceberg metaphor. The underlying cause was a spike in counterparty risk, due to the obscure distribution of exposures to the risks in the market for subprime mortgages.

The second layer of the iceberg – dissipating bank solvency – became overwhelmingly apparent in September 2008 when Lehman Brothers collapsed. This seminal event unleashed a sudden re-pricing of risks, leading to a severe financial crisis. The consequence was a sharp downturn in private investments and consumer demand, and the result of that was a sizeable fall in economic activity.

The third layer of the iceberg – the sovereign debt crisis – emerged in the beginning of 2010, when the true scale of the dis-connection between some countries' official debt and their capacity to generate income to service the debt became clear to everyone. In all fairness, I remind you that central banks in general and the ECB in particular had pointed to this risk long before the sovereign debt crisis erupted. The re-pricing of risks escalated, it spread from banks to the sovereigns and back to the banks, reflecting an adverse feedback-loop between banks and their respective home country.

The feedback-loop was composed of three elements to varying degrees in the affected countries: (i) some banks' solvency was under pressure due to their high exposure to their home country's sovereign debt. Decreasing value of the debt necessitated write-offs and eroded bank capital; (ii) lower market value of government bonds also strained liquidity, given the widespread use of these bonds as collateral for funding in the private repo market, a prime source of non-retail financing for banks; (iii) faced with a fragile banking system, some governments had to spend public money on keeping otherwise insolvent banks afloat.

This was a full-blown twin banking and sovereign debt crisis. But it did not affect all euro area countries in the same way. Instead of the convergence and financial integration we want to see in a monetary union, we were witnessing increasing heterogeneity and financial fragmentation within the euro area. Moreover, many countries neglected the need for structural reforms. They faced severe competitiveness deficiencies and therefore built up substantial current account deficits. Tensions in financial markets made the financing of these deficits more difficult. And this set the stage for hopefully the last layer of the iceberg. In the summer of 2012 the hitherto loose talk of a possible break-up of the euro area translated into investors' fears, then panic, and manifested itself in what we call a perceived redenomination risk, or in other words: an exorbitant widening of the spreads in yields on government bonds issued by stressed countries as opposed to those issued by the hard core of the monetary union.

Monetary policy response to the crisis

Let me now describe in more detail how the ECB has responded to these crisis elements. First of all, I'd like to underscore that we are well aware of both the power and the limitations of monetary policy instruments. Monetary policy can help bring about a smooth economic adjustment, but this can only be done in order to fulfil the primary objective, to maintain price stability in the euro area. The ECB responds to the price stability symptoms of the crisis, not to its fiscal and structural root causes. Seen from the perspective of the authorities responsible for fiscal and structural policies, monetary policy can buy time for reforms that become effective with some time lag, monetary policy can alleviate the macroeconomic duress that past policy mistakes can inflict on citizens, but it cannot substitute for reforms.

The ECB's response was composed of two types of measures, standard and non-standard. Standard measures activate those instruments we have also used before the crisis to achieve price stability, primarily changes in short-term interest rates. After the intensification of the global financial crisis in September 2008 – the second layer of the iceberg – the ECB reduced its main interest rate from 4.25% in the summer of 2008 to just 1% in May 2009. This was a series of rate cuts that was unprecedented in speed and size over such a short time-span.

However, the third and fourth layers of the crisis also posed a threat to the effectiveness of such standard measures. In normal times, monetary policy impulses are transmitted to the real economy – where goods and services are produced, bought and sold – via the interest rate channel. Reductions in the rate at which banks can borrow from the central bank are supposed to feed through to the complete range of retail interest rates (loan and deposit rates for bank customers) as well as market determined interest rates (e.g. yields on corporate or sovereign bonds) and a wide spectrum of prices of non-fixed income assets.

But during the crisis, the interest rate channel of the monetary policy transmission mechanism was jammed, initially because the interbank market was dysfunctional, then because illiquidity and fear led financial players to be less willing to make use of price differentials between different maturities. In response, the ECB engaged in a sequence of non-standard measures to restore a proper transmission of the monetary policy signals. The first action was to conduct lending operations through a fixed rate tender procedure with full allotment. This means that banks' demand for liquidity would be fulfilled without any other limit than the constraint coming from the need to post eligible collateral for the loans. In response to the seizing up of term lending, it was also decided to provide more liquidity with longer maturity than the usual one-week and three-month operations. In order to allow banks to mobilise a larger share of assets for refinancing purposes, the Eurosystem expanded the set of assets that could serve as collateral for central bank credit.

Belonging to the same family of tools are the two 3-year Longer Term Refinancing Operations that were announced a little more than a year ago, also to address a funding crunch in solvent banks.

As a further step to address the banks' funding problems and the deep financial fragmentation within the euro area, the instrument of intervening in securities markets was launched. This tool has been available to the ECB since the inception of the third stage of Economic and Monetary Union in 1999, but it was not until 2009 that it was actually used. The first action of this type was the purchase programme for bank-issued covered bonds. In May 2010 the Securities Markets Programme (SMP) took effect, in conditions in which the collapse in the markets for securities issued by distressed governments threatened a renewed wave of chain defaults. The SMP programme was finally superseded by the so-called Outright Monetary Transactions (OMT), announced in September 2012 but so far not activated. I will talk more about the OMT later.

The standard measures have definitely served their purpose, to maintain price stability. And it is undisputable that the non-standard measures have helped repair the monetary policy transmission mechanism by alleviating funding pressures in banks and thus complementing standard measures.

At the same time, I want to emphasise that these monetary policy measures cannot address the root causes of the crisis. The longer we carry on with a highly accommodative monetary policy, characterised by extremely low interest rates and excess liquidity in the banking system, the more we will see a phenomenon manifesting itself with greater and greater evidence. I am referring to what used to be known as "instrument instability" in policymaking: the need to apply larger and larger doses of the same policy interventions only to see their macroeconomic influence becoming more and more tenuous. Monetary policy is a relatively blunt instrument that will not in itself change the fundamental course of economic developments, when imbalances are plural and lie outside its sphere of responsibilities.

The causes of the crisis are to be found in the policies that led to an accumulation of huge imbalances in several euro area member states. In some countries imbalances occurred because of imprudent fiscal policies, not least surging expenditures in a fast-growing public sector or spending on social transfers or excessive reliance of fiscal structures on revenue sources that evaporated quickly as the crisis destroyed the income-generating capacity of entire sectors. In other countries we saw a strong increase in the indebtedness of the private sector, reflecting lower financing costs and easier access to finance. This latter development was in some cases fuelled by imprudent bank lending practices.

On top of that, banking supervision and regulation did not always mitigate the destabilising tendencies. Being in the hands of national authorities, banking supervision sometimes had a bias towards allowing more risk taking and credit growth in the supervised institutions that were operating in competition with banks from other jurisdictions. Consequently, there were cases when banks did not develop sufficient capital and loss buffers in good times, and they were not sufficiently discouraged from investing heavily in government bonds issued by their own home country.

Again, I think you will agree with me that the root causes for the crisis – as I have described them – cannot be addressed by monetary policy instruments. At most, the central bank can foster a smooth adjustment. It must never lose sight of its primary mandate, maintaining price stability. And even if the central bank "buys time" for the governments, there is a risk that this will delay or postpone the actions that are needed in terms of fiscal consolidation and structural reforms.

Let me give two examples:

First, expectations that interest rates will remain low for a long time, and that abundant liquidity will be provided, might weaken the incentives for banks to downsize operations and repair their balance sheets. In the absence of a tough banking supervision they could delay the recognition of losses and keep non-performing loans on their books for longer than a realistic assessment of their profitability and viability would suggest. On the side of governments, the same expectations for low interest rates could weaken incentives to reduce public sector deficits.

Second, the perception that the central bank will always "pick up the pieces" might give incentives to excessive risk-taking and high leverage. Even in good times that perception could discourage sound fiscal policies and prudent financial behaviour.

In the design of non-standard measures and in its communication, the ECB has taken great care not to give such adverse incentives to either banks or governments. The following elements, among others, serve as proof:

- The non-standard measures are temporary in nature. Some of them will expire automatically, if not renewed. On top of that, we have all the necessary instruments to reverse the current situation of abundant liquidity provision.
- The mandate of the ECB as stipulated by the Treaty has an unambiguous focus on price stability. In combination with the ECB's monetary policy strategy it provides a clear guidepost and has proved effective in anchoring inflation expectations over time.
- The monetary policy strategy gives a prominent role to the monetary analysis which captures money and credit developments and ensures a symmetric reaction to financial forces.
- The design of the tool called Outright Monetary Transactions creates the right incentives for governments to improve their performance with respect to fiscal prudence and structural reforms.

I will expand a bit further on this fourth point. OMTs will only be activated in cases where the benefiting country has signed up to strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. They can also be considered for Member States currently under a macroeconomic adjustment programme, but only once they have regained bond market access.

This type of conditionality actually protects the independence of the ECB and empowers the ECB in its monetary policy function. It protects and empowers our policy action because it re-constitutes an institutional environment in which solvency is not a problem and the quality of our credit is guaranteed. You see: we conduct our monetary policy primarily through temporary lending to banks. While doing so, we rely on solvency legislation to ensure that our counterparties are sound and capable to repay our credit. However, while banks are subject to solvency regulations, governments – due to sovereign immunity – are not. We therefore need a super-national structure which guarantees that, should an OMT be activated, government solvency – fiscal sustainability and macroeconomic viability – is in place and sufficiently constraining – national policies. This is why we need programme conditionality and multilateral surveillance as a precondition to initiate OMT.

Moreover, the design of OMTs entails interventions only in the short end of the government bond market – up to three years' time to maturity – and they will be fully sterilised, meaning that we would absorb all amounts of liquidity injected by OMTs.

Early results of economic adjustment

Now I will turn to the "green shoots" of a nascent recovery that can already be observed. Almost six years down the road since the start of the financial turmoil that turned into a crisis, many euro area countries have experienced a significant, but to date still partial, correction of external and domestic imbalances.

Substantial progress can be seen most clearly in the development of current account balances. In the programme countries – Greece, Ireland and Portugal – current account balances have improved by more than 7 percentage points (relative to GDP) between 2008 and 2012. In Spain the current account has improved even more dramatically. Much of this was driven by an inevitable drop in domestic demand, but we have also seen strengthening exports in a global environment that is not really buoyant. This indicates that the countries' efforts to rebalance their economies are starting to bear fruits.

Part of this picture is also the partial reversal of previous losses of competitiveness, but here the pace of progress varies across countries. Ireland has performed very well, with accumulated unit labour costs falling by 18 percentage points relative to the euro area average. Greece, Portugal and Spain have seen a 10 percentage point relative improvement so far. In some other countries in need of strengthening competitiveness we are still waiting for the correction to become apparent. And in yet other countries, notably some of the countries that joined the euro area more recently, we have actually seen an incipient loss of competitiveness. It is important that these countries take a lesson from the mistakes of others.

Fiscal balances have shown strong improvements. For example, Greece's structural primary balance (that is, the fiscal balance adjusted for cyclical developments, interest payments and one-off factors) is estimated by the Commission to have improved by more than 13 percentage points. I acknowledge that the concept of cyclical adjustment is surrounded by large uncertainty in real time, but there is no doubt that quite a lot of progress has been made.

At the same time it is positive to see that the general upward trend in private sector indebtedness has been halted, both in the household and the corporate sector.

Last but not least, the structural reforms have gathered pace, possibly under the imperative of the crisis. The programme countries have taken many initiatives to make their economies more flexible and market-oriented, thus sowing the seeds for better performance in the future. These efforts include pension reforms, the fight against tax evasion, simpler and better tax revenue services, optimisation of tax structures and – not to be underestimated – politically difficult labour market reforms.

All of these developments give reasons to be cautiously optimistic about the prospect for crisis-ridden countries' return to a path of sustainable growth, productive investments and creation of new jobs with more social security than has been experienced in the past few years. The severe recessions and increases in unemployment in some euro area countries were caused by many years of misguided policies and lack of reforms that could have strengthened the growth potential.

Cautious optimism does not entail a naïve expectation that the "land of milk and honey" is just around the corner. Historical experience teaches us that the cocktail of an economic downturn and a financial crisis is usually associated with a prolonged recession and losses of jobs and welfare. Most structural reforms take time to generate positive effects, and some of the countries in distress are still saddled with rigidities in the markets for goods, services and labour. High nominal rigidities, for example, induce a pattern of adjustment to shocks that falls disproportionately on employment and production volumes. Countries must progress with a deep-seated structural reform agenda to address the existing rigidities, reduce costs to firms, and to increase competitiveness.

To prevent – and indeed reverse – job losses, the downward adjustment of both prices and wages need to be stronger in those areas where unemployment is still high, and where this adjustment has not taken place due to structural or institutional factors. If this goes hand in hand with a continued consolidation of public sector budgets, then the cautious optimists will be vindicated through a chain of reduced uncertainty, renewed investor and consumer confidence, better access to funding and a return to robust and sustainable growth.

Reforms at the European level

Domestic reforms are important, but we also have work to do at the level of the euro area and the European Union. Much has already been done by way of strengthening fiscal and macroeconomic governance of the euro area. In EU jargon we talk about the "six-pack" and the "two-pack", of which the former entered into force already in December 2011, and on the latter a final agreement was reached just last week ("trilogue agreement" on 20 February). These packages of legislation included the reform of both the preventive and corrective arms of the Stability and Growth Pact (SGP), the new minimum requirements for national budgetary frameworks, the new Macroeconomic Imbalance Procedure (MIP), and a stronger enforcement mechanism through new financial sanctions, under both the SGP and the MIP. The two additional regulations that are just about to be adopted will further strengthen surveillance of euro area countries.

Rather than talk about what has already been achieved I would like to sketch out the further improvements that are in the pipeline, in particular in the area of financial regulation and supervision.

One of the structural flaws that exacerbated the crisis was that supervisory policies often failed to prevent excessive risk-taking in the financial sector. Supervisory decisions at the national level did not always take their potential effect across national borders into account. More fundamentally, supervisory decisions were "microeconomic" in nature, concentrating on the financial health of individual institutions rather than on systemic impact at the "macroeconomic" level.

The recognition of these fault lines led to the creation of two institutional bodies that are or will be closely associated with the European Central Bank in Frankfurt: the European Systemic Risk Board (ESRB), and the Single Supervisory Mechanism (SSM). The ESRB addresses shortcomings in the macro-prudential policies, while the SSM will ensure a uniform and consistent supervision of all banks in the euro area.

Better supervision will benefit the conduct of monetary policy, because a stable financial system is a prerequisite for the proper transmission of monetary policy signals across the euro area. Effective bank supervision is conducive to a stable macroeconomic environment with a stable price level. And strong supervision will minimise moral hazard concerns when it comes to crisis intervention.

The SSM is an important first step towards a genuine banking union. But more must follow. Another indispensable element is a Single Resolution Mechanism (SRM) that will be able to ensure swift and orderly resolution – and, if need be, the closure – of non-viable banks with minimum recourse to taxpayers' money. In addition to the SRM it would be highly desirable to establish a deposit insurance framework built on common EU standards.

Conclusion

We have experienced challenging times but are laying a solid foundation to build on. Signs of stabilisation are becoming more and more frequent, and we continue to expect a gradual recovery in the course of 2013. The same expectation was expressed in the European Commission's Winter Forecast released on Friday last week.

These somewhat better prospects are primarily due to policy changes in the field of fiscal and structural policies at the national level as well as in the European Union. For sure, the ECB's monetary policy has contributed to the process by maintaining an accommodative monetary policy stance and by fostering improved financial market confidence. As host of both the ESRB and soon also the SSM, the ECB is committed to playing a positive role in the further development of the euro area as a well-structured and stability-oriented part of the global economy. We call on the euro area's governments to keep up the efforts to undertake still necessary reforms, while acknowledging what has already been achieved.

Adjustment of such a magnitude as was needed to address the crisis is a long haul, and I am confident that we are on the right track to get there.

Thank you very much for your attention.