

Economic, financial and monetary stability in Europe: reinforcing our policy instruments

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1. Fiscal sustainability and its implications for monetary and financial stability in the euro area

The recent crisis has led to a severe deterioration of public finances in most industrialised countries. Governments in the advanced countries came out of the recession with the highest deficit and debt-to-GDP ratios since World War II. In the euro area, deficit and debt numbers surged. According to the European Commission, the euro area general government deficit increased from 2.0% of GDP in 2008 to 6.0% of GDP in 2010. The euro area general government debt, after declining to around 66% of GDP in 2007, is projected to increase to almost 88% of GDP in the current year. For some individual euro area and EU countries – but also for the US and Japan – the fiscal deterioration has been even worse. Fiscal consolidation in many euro area countries started in 2010 and according to the EC Spring 2011 Forecast it is expected to bring the euro area general government deficit down to 3.5% by 2012.

In many cases fiscal problems in euro area countries have their origin in unsound fiscal policies that were already in place before the crisis. Fiscal positions also deteriorated because many euro area states missed several opportunities during favourable macroeconomic times before the crisis to cut public deficits and debt faster, and create margins to let automatic stabilisers operate freely. In 2007, one year before the start of the crisis, the euro area deficit was 0.7% of GDP and debt remained well above the 60% of GDP threshold.

We should, however, not forget that in the recent crisis fiscal policy faced a double challenge. On the one hand, it had to address the sharp contraction in economic activity. Many governments adopted fiscal stimulus packages to soften the real economic impact of the crisis. On the other hand, governments had to rescue financial institutions and counter the risk of a financial system collapse. Deteriorating fiscal positions stemming from government support measures to the banking sector – as particularly in the case of Ireland – have highlighted the linkage between financial sector stability and public debt and deficit levels. The fragility of a large multinational banking system can have a severe impact on public finances that were previously perceived to be sound.

The impact of a banking crisis – even of a large, cross-border nature – ultimately has to be absorbed by national budgets. The euro area has so far lacked integrated regulatory, supervisory and resolution institutions for the financial sector at European level. Such Europe-wide institutions could mitigate the risks of the link between multinational banking systems and public finances by closer and better regulation and supervision of systemically important financial institutions. More fundamentally, there is an urgent need for a European resolution framework.

Fragile public finances can also have serious implications for the stability of the financial sector. Public debt is commonly held as a low-risk asset by financial institutions and it is also used as collateral in refinancing operations, for example. When the financial markets doubt the sustainability of public debt, the liquidity and even the solvency of financial institutions can deteriorate, in turn potentially destabilising the financial sector.

Operating under such forms of “fiscal stress” can also put a central bank in a difficult position. If in a situation of sustained financial instabilities stemming from distressed financial

institutions or sovereigns, the delegation of fiscal tasks to monetary policy endangers the central bank's primary mandate of ensuring price stability. A central bank may find itself overburdened with the task of providing sufficient liquidity to the financial sector on the one hand, and maintaining sufficient independence and operational capability to ensure price stability on the other hand. In the long run, the credibility of the central bank's commitment to price stability may be called into question. Thus, to avoid the build-up of excessive risks on the central bank's balance sheet and to avoid the creation of adverse incentives in the financial markets, all non-standard measures by a central bank must remain exceptional and temporary. Moreover, the support of insolvent financial institutions or sovereigns is clearly a task for fiscal authorities, not the central bank.

In the euro area, the ECB accordingly lends to its counterparties against "adequate collateral" in accordance with Article 18.1 of its Statute in order to ensure protection of the Eurosystem from losses in the conduct of credit operations. If the adequacy of the sovereign collateral is called into question, however, this would make it difficult for the central bank to perform its role of providing sufficient liquidity to the financial sector.

All of this points to the conclusion that we require clear policy tools to pursue economic, financial and price stability.

First, the independent central bank has to be mandated to ensure price stability. At the same time, it should take due account of the implications of asset price developments for medium- to longer-term risks to price stability. Second, fiscal policy – in general, but particularly in the euro area – has to be conducted in a way that ensures sound public finances at all times. This will allow national governments to effectively let automatic stabilisers counteract business cycles. To this end, public debt has to be put on a sustainable path and balanced positions have to be reached such that fiscal policy has sufficient margins to operate even in severe economic crises. Margins also prevent pressures on the central bank to use monetary policy for economic stimulus purposes rather than price stability in the case that fiscal leeway is exhausted. The original Stability and Growth Pact, with the objective of balanced budgets in normal times and its deficit and debt limits, would have provided such margins for all but the most extreme scenarios. And third, macroprudential policy, if well designed, would not only mitigate the downside tail risks in financial markets – reducing the hazard for fiscal and monetary policy – but also moderate the amplitude of financial cycles.

2. Reinforcing fiscal and macroprudential policy instruments in the euro area

This brings me to the reform of the euro area's economic governance framework. I think we can agree that the economic governance framework was insufficient to ensure economic policies in the euro area countries that were commensurate with the requirements of a monetary union. The Stability and Growth Pact was not implemented to a degree that would have ensured sound fiscal policies in member states. We also lacked tools for preventing the emergence of large and persistent divergences in competitiveness among the euro area countries, and this led to large and unsustainable imbalances within the currency union.

Against this background, the ECB has welcomed the European legislation on its way to implementation as a step in the right direction of broadening and strengthening the existing framework for fiscal and macroeconomic surveillance in the EU. However, the ECB's Governing Council is untiring in its efforts to remind policymakers that more is needed if the economic governance reforms currently being discussed in European legislatures are to ensure the euro area's fiscal and, more broadly, macroeconomic sustainability. It cannot be said often enough: we need more speed and automaticity in the sanctioning mechanism, particularly in the Stability and Growth Pact, but also in the broader macroeconomic policy surveillance framework. The experience of the past months has vividly demonstrated the

importance of a timely correction of internal and external imbalances. The enforcement tools within the governance framework need to be more effective, leaving as little room for discretion as possible. Requirements for fiscal and other macroeconomic indicators should be more ambitious. Finally, the implementation of sound policies is best ensured if these are solidly anchored at the national level, which calls for strong national budgetary frameworks in the euro area member states.

We have also made progress in the area of macroprudential supervision in Europe and in the international policy forums. As you know, stricter banking regulations and more ambitious capital requirements to absorb losses have been devised. These should increase coverage, reduce incentives for excessive borrowing and make capital buffers more countercyclical. At the same time, the organisational structure of financial oversight has been overhauled. The ESRB – the European Systemic Risk Board – has been set up to warn and make recommendations as regards systemic risk. And the ESAs – the European Supervisory Authorities, comprising the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) – will closely monitor Europe's financial markets.

However, more also needs to be done in macroprudential supervision. First, we need to ensure that the envisioned reforms are fully implemented at European and international level. And second, as the ECB has repeatedly pointed out, more progress has to be achieved in other areas, including the treatment of systemically important financial institutions, the oversight of the shadow banking system, and the further regulation and oversight of financial markets and their functioning.

Given the link between the stability of the financial sector and the solvency of sovereign member states, I personally believe we should consider going a step further in the euro area. We should seriously consider a European banking resolution mechanism that could address banks in distress and break up this dangerous link.

In summary, the reformed economic governance system of the euro area should provide effective and well defined tools to ensure economic and financial stability. To this end, we need to strengthen the fiscal and macroeconomic governance framework in the euro area. We need to implement and further strengthen the macroprudential supervision framework at European and at global level while at the same time continue to ensure price stability in the euro area.