Mario Draghi: The global recession

Address by Mr Mario Draghi, Governor of the Bank of Italy, at the 15th Congress of the AIAF – ASSIOM – ATIC FOREX, Milan, 21 February 2009.

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The risks to the world economy, which until last summer were only feared, have now materialized. Economic activity is falling sharply in all the main countries. The crisis of confidence is the worst since the Second World War.

The forecasts for 2009 have been revised repeatedly downwards. The International Monetary Fund now predicts a contraction of 1.6 per cent in output in the United States, 2 per cent in the euro area and 2.6 per cent in Japan. Recently released GDP data for the last quarter of 2008 and the latest economic indicators presage further downward revisions. The crisis has spread to the emerging economies, which have been affected by the fall-off in global demand and the drying up of net capital inflows.

In Europe and in Italy the contraction began in the second quarter. For 2008 as a whole output rose by 0.7 per cent in the euro area; in Italy it fell by almost 1 per cent. The deterioration in exports and investment, and to a lesser extent weak household spending, were contributory factors.

For Italy the data on orders, stocks, capacity utilization and the labour market all point to the protraction of the economic downswing in the coming quarters. The repercussions on employment have yet to emerge fully. The indicators available for recent months prefigure a marked deterioration. The fall in output has been accompanied by a sharp increase in recourse to the Wage Supplementation Fund. Businesses expect job losses in the months to come.

The contraction in demand can hit society's poorest and most vulnerable – precarious workers, the young, and low-income households – particularly badly. For more than ten years Italian employment increased at a sustained pace. Between 1995 and 2008 three and a half million jobs were created, thanks above all to wage moderation and greater labour flexibility. Temporary positions have more than doubled. In the third quarter of 2008 fixed-term, temporary and project workers numbered almost three million. Almost four-fifths of these workers' contracts expire within one year; they are subject to especially severe risk.

Economic policy initiatives

To break the grip of recession is the task of economic policies. There is general awareness of the need for sweeping interventions at global level, the more closely coordinated the better. Action must focus simultaneously on the three pillars of fiscal, monetary and financial stability policies. The sooner confidence is restored in the prospects for employment and income, a return to balanced growth and the soundness of the financial system, the faster the exit from recession will be.

Fiscal policies

Fiscal policy has become strongly expansionary in the main countries, with measures to support demand coming on top of those taken to safeguard the banking and financial system. The United States has approved interventions of almost $800 billion, with an aggregate impact on the deficit in 2009-11 of 5 per cent of one year's GDP. In Japan the measures for 2009-10 amount to 2 per cent of GDP; in Canada, 3 per cent. In Europe,

Germany approved a stimulus package amounting to over 3 points of GDP for 2009 and 2010; Spain, a little less than 2 points for one year; the United Kingdom almost 1.5 points; France around 0.75 points.

The increases in expenditure and reductions in revenue approved in Italy for countercyclical objectives amount to around 0.5 per cent of GDP, funded by measures of opposite sign. Additional measures are aimed at reassigning already appropriated resources to uses that will effectively stimulate aggregate demand. The structure of the measures reflects the prudence needed in view of the size of the public debt

The choice of the forms that public measures in support of demand can take is no less important than their size. While these vary depending on the specific effects of the recession and the state of the public finances, they must support consumption among the weakest sectors and enhance the economy's capacity for investment growth.

The Government has rightly extended temporary eligibility for social benefits to most of the workers who have atypical employment contracts. The funding of these programmes has recently been increased thanks to an agreement between regions and the state. The need remains for a comprehensive reform to cover all workers against the risk of unemployment and facilitate their return to productive activity.

Firms' trade receivables with general government in relation to extensions and delays in payment of goods and services are very large: about 2.5 per cent of GDP, more than 30 per cent of annual general government spending on consumption and investment. Faster payments would help support firms without any structural drag on the public finances.

In countries like Italy, where the level of private savings and public debt is high, fast-acting short-term interventions should be offset by structural measures that immediately confer certainty on the rebalancing of the budget in the medium term. It is essential to look further ahead: the long-term sustainability of the public finances is fundamental to ensure the effectiveness of policies in the short term as well.

Monetary policies

The central banks have made a prompt and coordinated response to the crisis. Official interest rates have been lowered rapidly; in many countries they are near zero. Worrying about getting too close to the lower limit for nominal interest rates cannot be a reason for inaction. The experience of the United States in the 1930s and of Japan in the 1990s suggests that in the initial stages of the crisis it is necessary to counter the tendency of real interest rates to increase. Rapid disinflation must not be allowed to turn into deflation.

The ECB has reduced its reference rate by 225 basis points since last October. In the euro area the real short-term rate is now below 1 per cent; if official rates had not been cut, it would have risen considerably because of the fall in inflation. The Governing Council is keeping a close watch on the real cost of money.

The main central banks have injected liquidity in unprecedented quantities. They have extended the range of their own instruments for action. In some cases, they have intervened directly by buying corporate debt, reactivating the circulation of credit where it had been blocked, helping to finance the private sector. They can act to influence long-term interest rates. To date, the judgement on the effectiveness of these measures is favourable.[1]

When macroeconomic conditions return to normal, the liquidity pumped into the economy should be rapidly drained. The adoption of a strategy to return to normality is premature until

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[1] See Ben S. Bernanke's testimony to the Committee on Financial Services, US House of Representatives, Washington, D.C., 10 February 2009.

output and employment have stopped falling: but, as with fiscal policy, it is important to provide for it from today to ensure the effectiveness of the monetary expansion, firmly anchoring long-term inflation expectations and countering any speculative bubbles in the prices of financial and real assets.

Policies for financial system stability and the revival of credit

Reactivating financial intermediation remains essential to get over the recession and return to lasting growth. The surrogate role played by central banks can only be temporary.

Interventions in the United States and Europe last autumn (guarantees on deposits and bank securities) affected the liability side of bank balance sheets. They prevented the collapse of the system, reviving some markets. Their usefulness is steadily declining, however; it is now urgent to proceed to new recapitalizations aimed at growth and interventions to support banks' assets.

The International Monetary Fund is now estimating that the losses of the world's banks and other financial institutions total $2.2 trillion; just five months ago, the estimate was $1.4 trillion. Worldwide, the losses recorded so far by banks come to more than $800 billion; intervention to reconstitute their capital has been approximately equivalent, almost half of it deriving from state funding.

It is clear that intermediaries' capital requirements cannot be satisfied by state intervention alone: the private capital market must be reactivated. The condition for this is the absolute transparency of banks' assets. Investors and markets remain sceptical about the balance sheets of many financial institutions, and as a consequence the flow of capital into the banking industry has dwindled to a trickle, the level of capital that the market requires of banks has risen, and banks are under pressure to reduce their assets. Internationally coordinated action by supervisors in the principal financial centres is needed to produce uniform valuations of banks' assets in order to enhance the credibility and reliability of financial statements. The measures announced by various countries in recent weeks, such as ring-fencing the most problematic securities in banks' balance sheets or transferring them to separate entities (bad banks), are welcome in that they encourage the emergence of the riskiest securities.

However, especially in the banking systems that are only marginally burdened by the legacy of the past, the conditions for future growth need to be recreated. Along the lines of what has been done in some countries for existing "toxic" securities, consideration could be given to public guarantees for senior tranches of new credit pools. Retaining part of the risk themselves, the banks could place these securities more readily, reviving a substantial channel of finance that is inactive today.

Keeping the markets open

Between the third and fourth quarters of 2008 world trade declined, on an annual basis, by around 20 per cent; the IMF forecasts a drop of around 3 per cent this year, the first since 1982. The contraction of trade, which represents one third of the value of global output, has serious repercussions on growth.

The siren song of protectionism is powerfully alluring in times of crisis. In the very short term it may bring some benefits and mitigate situations of real social hardship. In the medium term, though, it will certainly prove illusory and destructive, as indeed it did in the 1930s.

In November, the G20 countries vowed to keep their markets open, a commitment that was reaffirmed at the meeting of G7 ministers and central bank governors in Rome a few days ago. However, some worrying signs have appeared in recent months. In December, attempts to reach an agreement to conclude the Doha Round of multilateral trade liberalization negotiations failed. Some emerging countries have raised customs duties or initiated anti-

dumping actions. So far, such interventions have been limited and for the most part within the range permitted by multilateral regulations. A proliferation of such measures could prove deleterious, setting in motion a cycle of trade reprisals.

It is important for the new US Administration to take a firm stand against demands for trade restrictions, and crucial that appeals for free trade should not be contradicted by action within the European Union itself. The European Commission and the ECB are working with the Ecofin Council to draw up agreed policies in the field of financial intermediation and in other sectors receiving government aid.

Revising the regulatory framework

I have spoken at other gatherings about the progress we have made in revising the global regulatory framework, progress that would have been unthinkable just months ago. Today, I want to mention the work under way in international fora to build a system of macro-prudential supervision to flank the traditional oversight of individual institutions.

This new perspective carries significant consequences for the extension and application of the regulations. Among these: every financial institution capable of creating systemic risk will be subject to supervision; the authorities will insist on knowing both the correlations between the exposures of the various financial institutions and the way in which risk is transferred over time and space; consideration will be given to the possibility of creating new capital and liquidity buffers that expand in times of growth and contract in the downward phases of the cycle and to the establishment of a leverage ratio that limits the growth in financial leverage; and measures will be taken to reduce the risks attached to OTC products by creating central counterparties.

The announcement of banks' participation in the construction of a central platform for trading in credit default swaps is a step in this direction. The new platform will bring clarity in a market which, because of its size and opacity, is currently regarded as potentially capable of amplifying the crisis.

It is envisaged that, at international level, the governance of financial institutions, executive compensation, and the special duties of intermediaries to protect retail investors will be subject to explicit supervision. Further, the formation of supervisory colleges for major international intermediaries will be generalized.

Italian banks

Eighteen months after the world financial crisis erupted Italy's banks are in better shape than the largest international banks. They have been protected by a low level of financial leverage, a business model firmly based on traditional lending and rooted in the relationship with household and business customers, and a prudent regulatory framework and system of supervision.

In 2008 the major international financial centres were the scene of the sudden collapse of leading institutions and repeated, large-scale government bail-outs. The financial turmoil has affected the financial conditions of our banks, but to a fairly limited extent: from the onset of the phase of financial instability to the third quarter of 2008, the last period for which the consolidated quarterly reports have been released, the leading Italian groups made writedowns of some €4.5 billion as a result of the crisis, a substantial amount but less than for major foreign banks. Profits declined, but were still positive in the first nine months of the year.

Overall, capital has remained above minimum requirements. The capital ratios of Italian banking groups are calculated on the basis of stricter prudential criteria than are applied in other systems.

Above all, after the collapse of Lehman Brothers the greatest short-term risk for the stability of the international financial system has been the liquidity shortage. Italy has not escaped this. In the unsecured interbank market, turnover fell for all maturities and virtually disappeared for those beyond one week. Risk premiums jumped.

At present, liquidity conditions have eased. The spread between unsecured and secured three-month interbank rates, which had widened to 185 basis points on 10 October, has progressively narrowed, reaching 90 basis points in the last few days. Trading in slightly longer maturities has resumed. Some channels of finance that had been clogged appear to be opening up again, even beyond the short term; in January, the corporate bond market showed signs of revival, an important development in a phase when bonds issued by banks in recent years are maturing. But the recovery is fragile and highly uncertain.

To provide the banking system with liquidity, so as to prevent any interruption of the flow of credit and payments, has been the principal concern of the authorities for many weeks. Central banks have acted rapidly and in coordinated fashion; the Eurosystem has been one of the key actors. The guarantees introduced by the Italian government and the Bank of Italy have sustained confidence in the banking system and assisted the recovery of the interbank market; we have reported on this on several occasions.

On the second of February, in collaboration with the Italian Banking Association and e-MID S.p.A., we launched the Collateralized Interbank Market, which allows banks to trade interbank funds anonymously and with a guarantee against the risks of counterparty illiquidity and insolvency. The interest rates in this market have been lower than those on the uncollateralized market and in the Euribor fixing, reflecting the containment of risk premiums. The Collateralized Interbank Market is open not only to Italian banks but also to other European banks that meet the same requirements, subject to agreement with their home central banks.

Complacency about the danger we have avoided so far is of no help, we must look ahead. The recession in Europe will inevitably end up by weighing on the accounts of our banks. Credit risks are emerging both in the traditional sectors of activity and in the emerging economies; our banking system, like those of others, is exposed to deterioration in the latter's performance. The increase in provisions for loan losses will hurt the banks' results for this year. The market has discounted this in its valuations.

It is necessary to take action to strengthen the prudential defences against the worsening of the cyclical situation and at the same time to create conditions that will guarantee an adequate flow of credit, so as to avoid a downward spiral of tight credit and economic contraction. Beyond the short term, recovery of the real economy is a necessary condition for banks' solidity.

Credit

Lending by the Italian banking system, which was still growing fast in the first part of 2008, slowed down over the year; the deceleration became sharp in the last few months. In the fourth quarter the growth in credit to the private sector fell to 4.2 per cent on an annual basis, half as great as in the three previous months. In 2008 the stock grew by 7.4 per cent, a slowdown of more than 3 percentage points compared with 2007. According to the provisional data referring to the sample of banks that provide 10-day reports, the stock of total credit stagnated in January. If this is confirmed, this would imply a fall in just one month of about half a percentage point in the twelve-month rate of growth.

The slowdown is common to the other major European countries and has affected all parts of the country and all categories of borrowers.

The growth rate was modest particularly for small enterprises and manufacturing industry; construction recorded an especially large slowdown. The fall in production and the uncertain

cyclical outlook have depressed the demand for funds for fixed investment and working capital.

Households' demand for loans reflected the fall in housing market activity and purchases of durable goods. In 2008 lending to the sector grew by 6 per cent, compared with increases of more than 10 per cent in the previous years. Personal loans continue to expand at a lively pace.

The outcome for credit was also influenced by the more cautious lending policies adopted by banks in response to the increase in the cost of fund-raising, the partial closure of international sources, the deterioration in customers' creditworthiness and the need to improve capital ratios to cope with the pressure exerted by the markets at a time of pronounced uncertainty.

In 2008 resources obtained from foreign banks and money market funds fell by about 10 per cent. They had risen by 20 per cent in 2007 and 34 per cent in 2006, when they had contributed nearly half the growth in fund-raising. Banks have responded to the smaller inflow from abroad by increasing the funds they raise from Italian households, above all with bonds. In 2008 the average cost of total fund-raising rose by 40 basis points compared with the previous year; since October it has started to fall following the reductions in official interest rates and the partial normalization of the interbank market.

Loan quality is being affected by the recession. Since the third quarter of last year the flow of new bad debts has been increasing rapidly, and in the last quarter of 2008 the ratio to total outstanding loans was the highest since 1999 (not counting the peak in the fourth quarter of 2003 due to the failure of Parmalat). The deterioration continued in January, when the total debt of newly insolvent customers was 70 per cent greater than in January 2008.

The system has a major strength – private-sector debt is considerably lower in Italy than in other countries. Corporate financial debt amounts to 75 per cent of GDP, around 12 points lower than the European average. The leverage of Italian firms is now seven points lower than at the turn of the 1990s, on the eve of the last recession, and the percentage of financial costs covered by internally generated funds is higher. For households, though financial debt is greater than in the past, it is still no more than 49 per cent of disposable income, as against over 90 per cent in the euro area as a whole and 150 per cent in the United Kingdom and the United States.

The most recent data indicate that in the third quarter of 2008, allocations to provisions and value adjustments absorbed 30 per cent of the operating profit of Italy's largest banking groups. This ratio, though still far below the level recorded in the United States, is rising rapidly; it is worth recalling that at the end of the much less severe recession in the 1990s it exceeded 70 per cent.

Just as banks have been asked to shed full light on the troubled assets that have been on their books since the onset of the crisis, it is equally important that they conduct a realistic, unflinching estimate of the loan losses that they are bound to incur in the months to come; and that this estimate serve as the basis for conducting balance-sheet management and determining capital injections, dividend policy and executive compensation.

Strengthening the banks in order to sustain the economy

Guaranteeing a sufficient supply of credit while at the same time maintaining sound and prudent lending standards – this is the challenge that faces the banking system in 2009. A credit squeeze would aggravate the recession; a reduction in prudence could jeopardize the banks' stability, with serious consequences for their medium-term lending capacity and for the economy. The objective of making funds available to the economy must not be pursued by relaxing standards of creditworthiness but by strengthening the capital base, in order to overcome undue constraints on asset growth.

I have had occasion, elsewhere, to remark that the approach to capital strengthening must be pragmatic. Banks must take all necessary measures and seize all opportunities. Some groups have already begun to move by disposing of non-essential assets, retaining earnings and going to the market.

With the finalization of the implementing measures, the public funds provided by Law 2/2009 will soon be available. Thanks in part to a fruitful dialogue with the banking system, the instruments offered by the state have been refined, within the limits of EU regulations, to provide a range of flexible possibilities that can be adapted to the needs of the various banks and banking groups.

If the funds made available by the state are adequate and the accompanying conditions are reasonable and practical, designed to attain the objective without administrative interference in business decisions, they should be used.

It is also desirable to revise the tax treatment of loan losses. In Italy, banks and other financial intermediaries may only deduct loan writedowns up to 0.3 per cent of total lending. Writedowns above that amount are deductible over 18 years. France, Germany and the United Kingdom, by contrast, allow the full and immediate deduction of all value adjustments entered in the accounts. The Italian rules have a procyclical effect: if bad debts increase, the costs to the financial system are aggravated, because the volume of non-deductible losses increases. They are particularly onerous in the present phase of the cycle.

Banks' reputation, an underpinning of stability

Always, but especially at times of crisis, a bank's good name is its most valuable asset, the basis of a solid relationship with customers. Safeguarding and enhancing the banking system's reputation equally requires irreproachable conduct and rigorous rules.

The correctness of banks' conduct is important for the Bank of Italy because it is a precondition for stability. This is especially true at times like the present, when recourse to customers' savings has proved essential to enable the banking system to compensate, swiftly and substantially, for the contraction in other sources of funding.

Overseeing the transparency and correct conduct of those who offer financial products and investment services is the responsibility of Consob. For typical banking transactions, the law entrusts such supervision to the Bank of Italy. Within a few weeks we will hold a public consultation on new rules, which are being drafted in cooperation with the associations of banks, other intermediaries and consumers. We will make the documents for customers clearer, more concise and comparable. We will use especially incisive instruments for the most widely used products, mortgage loans and current accounts. We will ask that attention to customers' needs be at the centre of every phase of the production process.

Transparency of corporate governance and openness of ownership structures are also preconditions for the good name and efficiency of banks. Formerly, the banking system, constricted by extensive public ownership and a web of rules that conditioned all its activity, had a concentrated and closed ownership structure and its conduct was scarcely competitive. Enormous progress has been made in recent decades. The system of public banks has been dismantled. Consolidation has revolutionized the industry's ownership structures. Banking foundations, having given up control almost everywhere, have transformed themselves into investors attentive to long-run prospects.

The Antitrust Authority recently drew attention to some structural issues concerning the system: concentration of ownership, cross-shareholdings and interlocking directorships. These aspects deserve attention. However, it should be noted that concentration of ownership, a common characteristic of listed Italian companies, is less pronounced for banks than for companies in other sectors. The incidence of cross-shareholdings between the leading banks appears to be lower than in other countries of continental Europe. As regards interlocking directorships, a matter within the competence of the Antitrust Authority insofar as

it concerns competition, it is first of all up to the Government and Parliament, to which the Authority addresses its reports, to evaluate whether action is needed and what measures to adopt.

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When the channels of capital allocation are clogged, the normal operation of the economy becomes jammed and growth is impeded. It is necessary to restore confidence in the financial system, in the solidity of banks and markets. Society expects banks, monetary authorities and governments to offer decisive support in order to come through the storm while not losing sight of the shore.

Readiness to act immediately must be accompanied by a strong long-run strategy.

Banks are asked to demonstrate clarity and prudence, but also the foresight needed not to withhold credit from deserving customers. The monetary authorities are responsible for ensuring that sufficient liquidity is created and spread through the most suitable channels to the financial systems in which they operate, but they are also charged with firmly anchoring medium-term inflation expectations.

Governments are called upon to take prompt, vigorous action to support the economy. It is an opportunity for structural reforms that will enable our country to enjoy faster and better growth in the future. The margins for a countercyclical fiscal policy must be created by intervening resolutely on the basic mechanisms of expenditure, by credibly ensuring the sustainability of the public finances in the long and very long term.

At global level, the resources and capabilities of the international financial institutions, especially the IMF and the World Bank, will have to be mobilized. In the European Union, there are the instruments and institutions needed to give concrete support to some neighbouring countries that look to the EU as an anchor of stability.

There is no reason to give in to discouragement. Rather, it is an opportunity for the country, all of us, to demonstrate our ability to protect the weakest, to open up new paths for the future.