Lorenzo Bini Smaghi: Developments and prospects for the European economy in 2009

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Conference "Altagamma: Scenari 2009", Milan, 30 March 2009.

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I would like first of all to thank the President of Altagamma, Leonardo Ferragamo, for the invitation to participate to this conference.

The issue I was asked to address – "Developments and Prospects for the European Economy in 2009" – is certainly not an easy one. Never has it been so hard to make a forecast, not only about the future but also about the present and even the recent past (although it might sound paradoxical). The forecasts of major international organisations are being systematically revised downwards, not only with respect to the next few months, but mainly due to what happened over the past months, which turns out to be much worse than expected. The last ECB forecast, from early March, was worse than the one published a few weeks earlier by the European Commission mainly because it was able to include preliminary data for the last quarter of 2008, showing a GDP fall of 1.5%.

In the last few days other forecasts have come out, based on more recent data, which are even more pessimistic. The difficulty in making forecasts in these circumstances derives from the fact that available economic models are not calibrated to take into account shocks of a size similar to the one we are experiencing, nor are they capable of understanding the nature and mechanisms of the transmission process.

Rather than elaborating a new scenario, which risks becoming obsolete quite rapidly, I would like to share with you some reflections on the current crisis and on possible developments. In this respect, I would like to remind that, given that the Governing Council will meet on this coming Thursday, we are in the so-called Purdah period in which we abstain from making comments on monetary policy. What I will say should thus in no way be associated to possible monetary policy decisions, and I would appreciate if the media reporting on this event could acknowledge it.

The starting point of this reflection is that before the start of the crisis the world economy was not in a balanced position. On the contrary, it was characterized by several imbalances, within individual economies and across countries.

At the global level, the world economy experienced wide and growing current account imbalances. On the one side, the US ran continuous deficits since the 1980s, with the exception of a couple of years, and growing over time, reaching 6% of GDP in 2006. On the other hand several Asian countries, notably China, recorded growing current account surpluses (which in the case of China reached over 10% of GDP in 2007). The financing of the US deficit took place largely through the purchase of dollar denominated Government bonds by the rest of the world, resulting in the accumulation of huge liquid reserves, in particular in China, Japan and oil exporting countries.

Another international imbalance derived from the growing pressure that world demand exercised on the scarce resources of the planet, in particular primary commodities, such as oil, generating a sharp price rise until mid 2008. Primary commodity price developments have put into question the convenience of several durable products with high energy intensity, thus reducing their demand.

Imbalances have emerged also within countries, generating excessive growth in some sectors, such as finance and housing, and large financial flows, especially household debt. In the US all these imbalances have developed at the same time. Just to give an example, in the five years before the crisis the share of profits made in the financial sector profits rose to

40% of overall corporate profits, the double with respect to the average of the previous thirty years.

From 2002 to 2007 the world economy grew at a yearly average of 4.3%, pulled by international trade growing by 7.3% per year. This has been the most intense period of post-war growth. It has also been the most fragile, as a result of domestic and global imbalances.

This suggests that won't be possible to exit from this crisis and return on a sustainable growth unless the imbalances which have accumulated until a couple of years ago are reabsorbed. It implies in particular that some sectors of economic activity which grew in an unbalanced way in the past might be substantially downsized, not only in the short term but also over the medium term, when the world economy will start growing again.

One of the sectors that is likely to be downsized, at least for some time, is finance, given that risk aversion is likely to remain elevated for some years, reducing the scope for innovation. Financial regulation will tend to reduce the scope for non regulated sectors. The whole financial system will have less leverage, lower margins and thus less employment than in the so-called "golden years". Another example is housing, where prices are unlikely to return soon to the pre-crisis levels, especially in some countries. Also in this sector profit margins are likely to be lower and so will investments and employment. Excess supply and debt might require years before being absorbed again, as shown in the early 2000s after the burst of the high-tech bubble. Other sectors which could be downsized in a permanent way are those in which technology turned out to be out of pace with medium term trends in energy prices.

Another grave side of the current crisis – which was also largely unpredicted – is the collapse of international trade, which has brought the process of economic integration backwards, some sort of de-globalization. This has hit exports and imports of all countries, in a rather brutal way, with multiplier effects on investment, consumption and employment. The sectors which have been more seriously hit are those that were more exposed to international competition, which had grown strongly over the recent years thanks to the global integration of production processes. Those countries which relied most on exports and manufacturing production have been hit hardly by a crisis which had originated in the financial sector.

According to some estimates, around 90% of world trade was partially or totally supported by financial instruments, which in the past years had also experienced a rapid process of innovation. The crisis of confidence which burst after the failure of Lehman brothers, stopped financial flows, especially those between agents located in different countries which are less acquainted with each other and base their transactions on market-based liquid and sophisticated credit instruments, which are however also riskier. The reflow of capital towards the major financial centres and the de-leveraging process, which started in the second half of September 2008, has induced banks to reduce their non-core activities.

Export credit, which consists in financing not only the export company but also the foreign importer which buys from the exporter, entails higher risks than domestic activities. Credit lines with foreign counterparties, which require a greater use of capital, tend to be reduced, especially for small and medium size enterprises and towards emerging markets. We are observing recently that trade finance is going back to simpler instruments, such as documentary credit and confirmed letters of credit, which substantially reduce risk.

The link between financial integration and trade integration has been the transmission mechanism through which the loss of confidence in the financial system has spread to the real economy, and from the country where the crisis started to the rest of the world. This implies that restarting the trade integration process will depend confidence coming back in all the components of the global financial system. The overall solidity of the global system depends on its weakest part. During the last few months enormous resources have been put in place, on both sides of the Atlantic, to support the commitment made by the policy authorities not to let any systemically important financial institution fail. The effects of these measures are starting to be appreciated.

Once the financial system is stabilised, time will be needed to rebuild a financial infrastructure for international trade comparable to the one prevailing before the crisis. This means that the pace of exports and imports growth during the recovery could be slower than before the crisis.

Another risk factor for the rebound of world trade, over the medium term, relates to the fragmented network of production, distributed across borders, which contributed to maximize efficiency. This network has been hardly hit. For instance, trade in euro area intermediate products fell in January 2009 by 20%, compared to the previous year. The protectionist pressures and the slowdown in foreign direct investments might lead to a restructuring of production, which might take time and turn out to be less flexible and efficient.

For those countries more open to international trade, which will be hit by the contraction of exports and imports, re-directing idle resources towards domestic demand might be slower and more difficult than expected.

To sum up, a thorough analysis of the causes of this crisis suggest that it is due not only to cyclical factors but also structural ones, associated to the downsizing of sectors which had grown too quickly and excessively in the past. This is not a novelty. During al recessions some sectors suffer more than others. Think about the burst of the high tech bubble in 2000. However, never before was the over-indebtedness so spread out and intertwined with the real economy. This explains why it is so difficult to understand how intense and lasting the downward adjustment of economic activity will be and how much dynamism there can be after the through.

This reflection suggests that the cyclical pick-up will hardly bring back economic activity to a level comparable with the one prevailing before the crisis, but rather to a lower level. This means that at the steady state, after the economy has stabilised and gone back to a growth path, production potential is likely to be significantly lower than before the crisis. This means that the so-called output gap, which measures the distance between the level of production and its potential, and which is generally used to estimate the path of economic recovery, could be substantially lower than the one estimated with traditional statistical methodology. In other words, this crisis might have affected the structure of the "world production function", as a result of the downsizing of some productive sectors, such as finance, and the permanent change in relative prices.

This is particularly relevant not only for economic analysis put also for the conduct of macroeconomic policies. These policies, in particular fiscal and monetary policies, contribute to cyclical stabilization by bringing forward resources in the low phase of the cycle and delaying payment to the favourable phase. For instance, an increase in public expenditures financed through debt delays payment to the cyclical upturn. Monetary policy also acts through incentives aimed at shifting consumption and savings over time. The sustainability of these policies crucially depends on the pace of economic growth and income level achieved over the medium term, after the crisis is over.

Given the uncertainty on the structural and cyclical components of the current crisis, there is the risk of a divergent assessment of the sustainability of economic policies, between financial markets on the one side and policy authorities on the other. The latter might have the tendency, or the temptation, to calibrate the policy response on an income target as high as the pre-crisis one, as if the crisis was entirely of a cyclical nature rather than structural, while financial markets might consider lower levels of potential income over the next few years, as a consequence of the structural effects of the crisis. Such a divergence might impair the effectiveness of macroeconomic policies.

It might be useful in this respect to recall the experienced of the 1970s, after the first oil crisis, when economic policies did not take into account that the higher oil price had reduced potential growth in advanced economies and calibrated their policy response to an unrealistic target.

What can be drawn from the above considerations is that the exit from the current crisis does not depend on macroeconomic policies only, but also on structural factors, such as the functioning of goods and labour markets. As I already mentioned, the contraction of sectors that had grown excessively before the crisis is likely to have a structural component, lasting over the medium term. This means that not all the employment lost in these sectors during the slowdown might be reabsorbed during the recovery. Some labour will have to be reallocated to other sectors, to avoid weighing on growth and on public finances, and on social conditions. This raises the need for accompanying short term macroeconomic policies with measures aimed at reallocating idle resources, for instance by enhancing training, human capital, market flexibility and income stabilizers.

Measures aimed at improving competitiveness are also required, especially in those sectors exposed to international competition and in those countries which experienced poor performance even prior to the crisis, due to low productivity growth. Furthermore, the global dimension of the current crisis shows the need to support trade finance, in particular through traditional instruments of risk insurance.

Experience shows that measures aimed at postponing the problems, such as early retirement, should be avoided, as they aggravate public finances and slow down production potential. Differently from previous crisis, the current one takes place in a phase of demographic stagnation, in which life expectancy increases while birth rates are falling. In a situation similar to that of Italy, an increase in the overall number of retired would dramatically worsen the working environment for the younger generation, which would have to pay for the higher contributions to finance the pension system. Under such circumstances all should be done to maintain a high participation rate in the labour market.

The highest risk, in this uncertain environment, is to limit policy action to the short term horizon, relying on stimulating the cycle without addressing the necessary structural reforms which would foster a better allocation of resources during the recovery. We would loose precious time and would find ourselves down the road with problems even greater than we can imagine. It would be a grave mistake. Thank you for your attention.