Yves Mersch: The crisis – point of view of a central banker

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, on the occasion of the conference "Bank crisis, then and now", organised by the Chamber of Commerce and the Swedish Embassy, Luxembourg, 8 July 2009.

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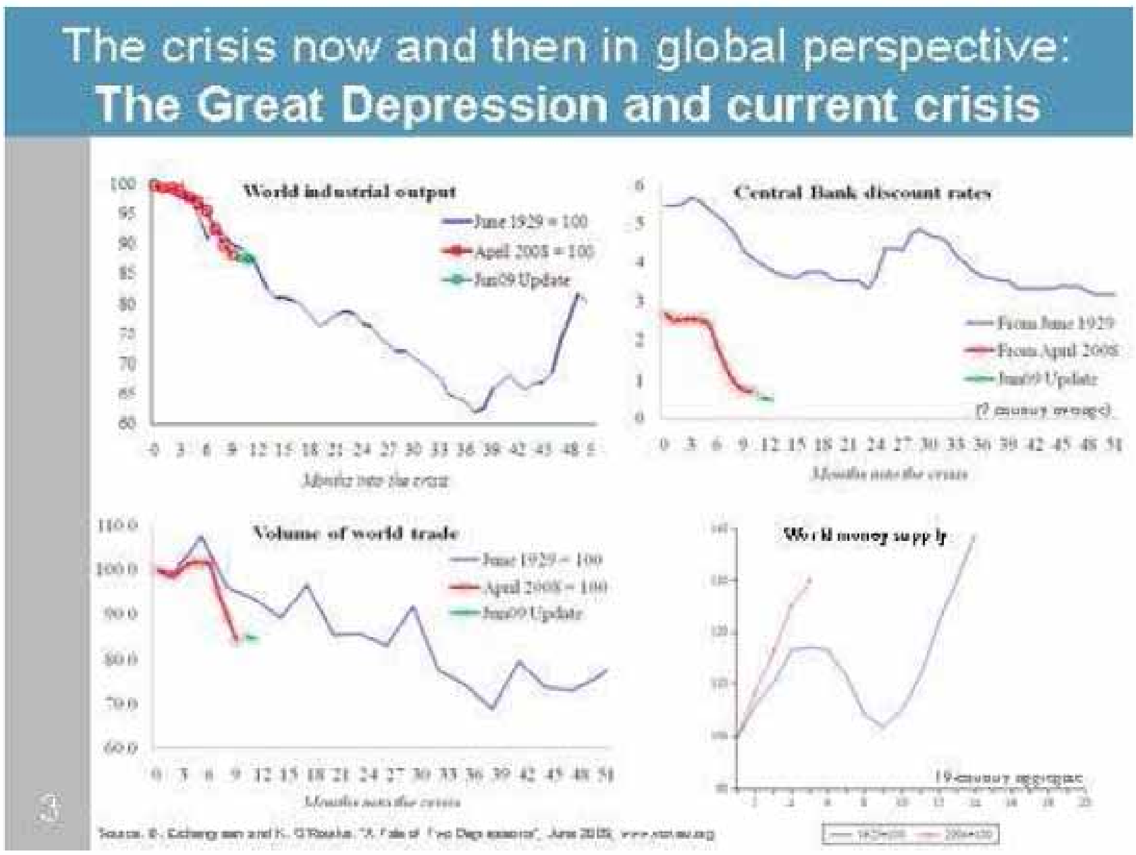
I will start by drawing parallels between the current recession and the Great Depression of the 1930s. It appears that the world is undergoing an economic and financial shock as big as the shock of 1929-1930. Fortunately, we have benefitted from past experience and lessons since the Great Depression. As a result, the policy response has been much more rapid and effective. In keeping with the principles of crisis management, the goal of aggressive policy decisions is to limit the propagation of the crisis and mitigate its impact on the real economy.

I will describe the reaction of the Eurosystem to the crisis. Consequently, I will examine the evolution of output in the euro area and consider the ECB's macroeconomic projections and recommendations for a successful and efficient resolution of the crisis. Lastly, I will discuss proposals to mitigate and minimize the occurrence of future crises and threats to economic and financial stability.



The crisis now and the Great Depression

Globally, the current crisis path is tracking the Great Depression's. Eichengreen and O'Rourke have drawn parallels between the current crisis and the Great Depression from a global perspective.[1] While the evidence suggests that both crises originated in the United States, they were transmitted internationally through mechanisms involving trade and capital flows, financial linkages and commodity prices. Although it was hoped that Europe and Asia could decouple from the spreading economic contagion, this view turned out to be too optimistic. The graphs on the current slide show that, so far, the world industrial production path continues to follow closely that of the 1930s decline, while exhibiting no clear evidence of widespread "green shoots". Despite early indications that world trade and stock markets appear to have stabilized, for the moment they, are still following paths far below the historical levels of the Great Depression's.

In contrast to the Great Depression, however, the policy response and its impact so far allows for some cautious optimism. Experience with crises since the Great Depression suggests that this crisis, and its subsequent resolution, require measures taken both at the national and international levels. Those measures include a prudent monetary policy and diverse economic policies that target a range of issues, from trend growth to the labour market. This time, interest rates have been cut more rapidly and to a lower level than during the Great Depression.[2] While monetary expansion was more rapid in the run-up to the 2008 crisis than during the 1925-29 period, the global money supply continues to increase rapidly, unlike in 1929 when it leveled off and underwent a subsequent catastrophic decline.[3] Finally, fiscal policy has also been far more aggressive and targeted this time. As a result, it is already possible to witness some signs of stabilization in economic conditions.

Response by the Eurosystem

The Eurosystem reacted to the crisis promptly and decisively by easing monetary policy and embarking on a range of "non-standard" policy measures. Several exceptional decisions were taken as early as August 9, 2007, long before the true extent of the crisis became apparent. While preserving the overall objective of price stability, the Eurosystem's operational framework has been modified and an exceptional set of non-standard policy tools has been adopted. To ease banks' balance sheet constraints and avoid a "credit crunch" and the emergence of a systemic crisis, the following measures, unprecedented in nature, scope and magnitude, were adopted:

- The standard monetary policy tool, the interest rate on the main refinancing operations of the ECB, was lowered 325 basis points since October 2008, which is the largest cut ever implemented over such a short period in Europe. The key interest rate now stands at 1%, the lowest level since the launch of the Euro.
- Shortly after the breakout of the crisis in 2007, the Eurosystem provided additional temporary liquidity to banks with immediate liquidity needs.[4] In effect, the ECB was the first central bank to embark on "non-standard" liquidity management.
- The Eurosystem also engaged in the provisioning of foreign currency swaps with the United States Federal Reserve System, the Bank of England, the Bank of Japan, the National Bank of Switzerland and the Bank of Canada. Thanks to these agreements, euro area banks were able to obtain foreign exchange liquidity against collateral

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[1] "A Tale of Two Depressions", June 2009, http://www.voxeu.org/index.php?q=node/3421.

[2] Top right graph: GDP-weighted average of central bank discount rates for 7 countries: US, UK, ECB, Japan, Sweden, Poland.

[3] Bottom right graph: Money supply for a GDP-weighted average of 19 countries accounting for more than half of world GDP in 2004.

[4] The market was provided with €95 billion within few hours through a fixed rate operation with full allotment. Overnight lending of the same kind continued over the following three days.

eligible in Eurosystem operations. The frequency, volume and maturity of these refinancing operations were continuously increased during 2008.

- Following the default of Lehman Brothers and a virtual halt of interbank trading, the Eurosystem switched to a new mode of liquidity provision adopting a "fixed-rate full allotment" tender procedure in open market operations. Thus, banks have been granted essentially unlimited liquidity at the key policy interest rate. This is in contrast to the practice in normal times, when a predetermined amount of central bank credit is auctioned in refinancing operations with short maturity. The interest rate would be determined through the competition among bidders.
- In May 2009 the Governing Council extended the maturity range of liquidity-providing operations, introducing a new one-year operation.[5]
- Before onset of the crisis, the list of assets that the Eurosystem accepted as collateral was relatively large compared to that of other central banks. The Eurosystem now accepts even wider range of securities as collateral.[6]
- Unlimited refinancing against a wide range of collateral at longer maturities was coupled with an extended list of counterparties in the Eurosystem's refinancing operations. More than 1700 counterparties were eligible before the crisis and this number rose even further after changes in the operational framework were agreed upon in October 2008. Most recently, the list was extended to include the EIB.
- The last unconventional element of monetary policy added in May 2009 was outright purchases of euro-denominated covered bonds issued in the euro area. Before the crisis, banks in the euro area used covered bonds as a major source of funding of a longer-term nature than the ECB's refinancing operations. However, the market was virtually abandoned after the intensification of the crisis last autumn.[7]

The positive impact of the measures adopted since the start of the crisis is becoming apparent. Money market rates have fallen to record lows in June, reflecting the first one-year refinancing operation executed by the Eurosystem. Similarly, loan interest rates charged by banks have declined. This suggests that crucial elements of the monetary policy transmission mechanism continue to work. The Eurosystem's balance sheet shrunk to 15% of GDP in May 2009 from its peak of 19% of GDP in December 2008. This appears to be the result of increasing money market activity, at least at short maturities, and a sign of improving confidence.

Recovery in the euro area

While surrounded by an unusual degree of uncertainty, ECB macroeconomic projections expect a moderate recovery in the euro area in 2010. The accompanying graph shows that during the first quarter of 2009, economic activity in the euro area weakened considerably.

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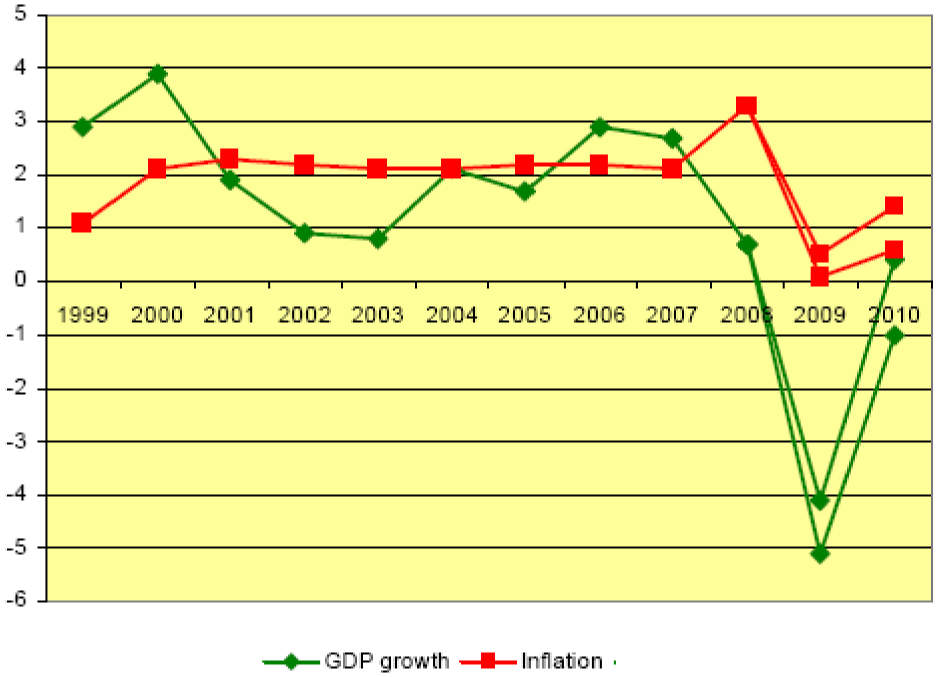
[5] The June auction saw a record demand for €442 billion which may suggest the persistence of some funding strains.

[6] The total value of these eligible securities is currently about €12 trillion, or 130% of euro area GDP.

[7] Already the announcement of the program before any purchases were carried out was positively accepted in the market and lead to a wave of new issuances and lower spreads.



However, confidence indicators hint to subtle signs of improvement at very low levels. This suggests that the decline in economic activity over the remainder of this year will decelerate, and after a stabilization phase, moderate positive quarterly growth rates are expected by mid-2010. The recovery will be driven by the macroeconomic stimulus and other measures designed to restore the normal functioning of the financial system. For the moment, the risks to the economic outlook appear balanced. On the positive side, the macroeconomic stimulus might have stronger effect than anticipated and confidence might improve more quickly than expected. On the other hand, a range of adverse factors might flatten the recovery path, e.g. feedback effects from the turmoil in financial markets on the real economy and vice versa; relatively more unfavorable developments in labour markets; the intensification of protectionist pressures or adverse developments in the world economy stemming from a disorderly correction of global imbalances.

Past experience shows that financial crises cause deep economic crises that can lower the level and growth rate of potential output for a significant period of time. In some cases, there has been a protracted loss in output in the aftermath of the slump. For example in the case of Finland and Sweden, the recovery of real GDP towards the pre-crisis trend level took more than 8 years. A downward shift in the level of potential output might occur, for instance, through scrapping or stronger discounting of previous investment (e.g. in the automobile and financial sector), or through depreciation of human capital in case of an increase in structural unemployment. In addition, there is no guarantee that the economy will return to its pre-crisis long-run trend potential output growth rate. The experience of Japan suggests that the crisis might have a lasting impact not only on the level of GDP, but also on its potential growth rate. A longer term moderation of the rate of growth of potential output may occur if a deep recession reduces the growth rate of labour in the long run. This can happen if some groups in the labour force are discouraged over time from participating, or if the trends in migration flows are reduced. In addition, more restrictive lending practices and higher risk premia might slow down investment. Finally, there is a risk that protectionist measures could distort the efficient international allocation of capital.

The crisis has highlighted the urgency of structural reforms in the labour and product markets to limit the crisis' negative impact on output and employment. The crisis may become a catalyst for the implementation of structural reforms to increase labour force participation, enhance the flexibility of the labour market, improve human capital, increase competition in goods and services markets and boost investment in R&D. Reforms can affect the level and/or trend growth of the potential output. Without such measures, it might take a politically inacceptable amount of time to return to pre-crisis output levels and trend growth rates.

Towards more robust financial framework

As stated earlier, from the early stages of the ongoing financial turbulence, public authorities have sought to identify the weaknesses in the financial system and draw lessons to inform policy changes. Policy actions have been geared toward maintaining the effective functioning of intermediation services, and to reinforcing the resilience of the financial system and safeguarding its integrity. In this context, I would like to highlight the crucial role that central banks and governments from around the globe have played since the deepening of the crisis in the autumn of 2008, a period during which the strains in the financial sector started to spillover into the real economy.

Unstable financial markets prompted central banks and governments to take a number of exceptional measures beyond guaranteeing continued access to liquidity. Short- and medium-term policy objectives were not only to guarantee continued access to liquidity. In fact, policy measures also swiftly sought to deal with impaired assets as well as recapitalizing viable institutions and swiftly resolving non-viable ones. It is remarkable that this happened despite the absence of a common EU framework for crisis management. Governments, for their part, organized a second line of defense against what was qualified by the ECB as "systemic solvency risk". The main measures have included recapitalizations, guarantees, and asset support schemes for an estimated total commitment of nearly 24 percent of euro area GDP.[8]

Beyond the short- and medium-term issues, the current crisis has highlighted substantial structural weaknesses in many areas of the financial system, both in the micro and the macro domains. Therefore, many issues are currently under consideration at the national and international levels with the objective of putting in place coordinated, focused, and consistent long-term policies to build the foundations of a more resilient global financial system. I would like to concentrate on two dimensions which are very relevant from a central bank's perspective, namely liquidity supervision and macro-prudential supervision.

The crisis has brought to the front the importance of macro-liquidity risk in the global financial system and the need of regulating and supervising it. Any threat to liquidity supply has the potential to create adverse effects that can disrupt both the economy and the smooth operation of the financial system by triggering discreet changes in asset prices, in the capital base of financial institutions, and thus by feedback, onto banks' funding capacity. As a result, interbank markets can now become a source of turbulences, or even exacerbate a crisis, if fundamental uncertainty makes it too costly for banks to assess counterparty risk. Until recently, public authorities did not pay sufficient attention to liquidity supervision. However, some governments, such as that of Luxembourg, have begun to close this deficiency gap. The law of 24th October 2008 attributes to the Banque centrale du Luxembourg (BCL) the responsibility of monitoring the general liquidity situation of markets as well as evaluating financial market operators' liquidity risk. In this context, liquidity supervision by the BCL will be complementary to the prudential supervision carried out by the Commission de Surveillance du Secteur Financier (CSSF) and will require a close cooperation with the supervision authority

The crisis has also shown the limits of the financial stability paradigm that restricts central banks' involvement in financial stability to safeguarding the financial system

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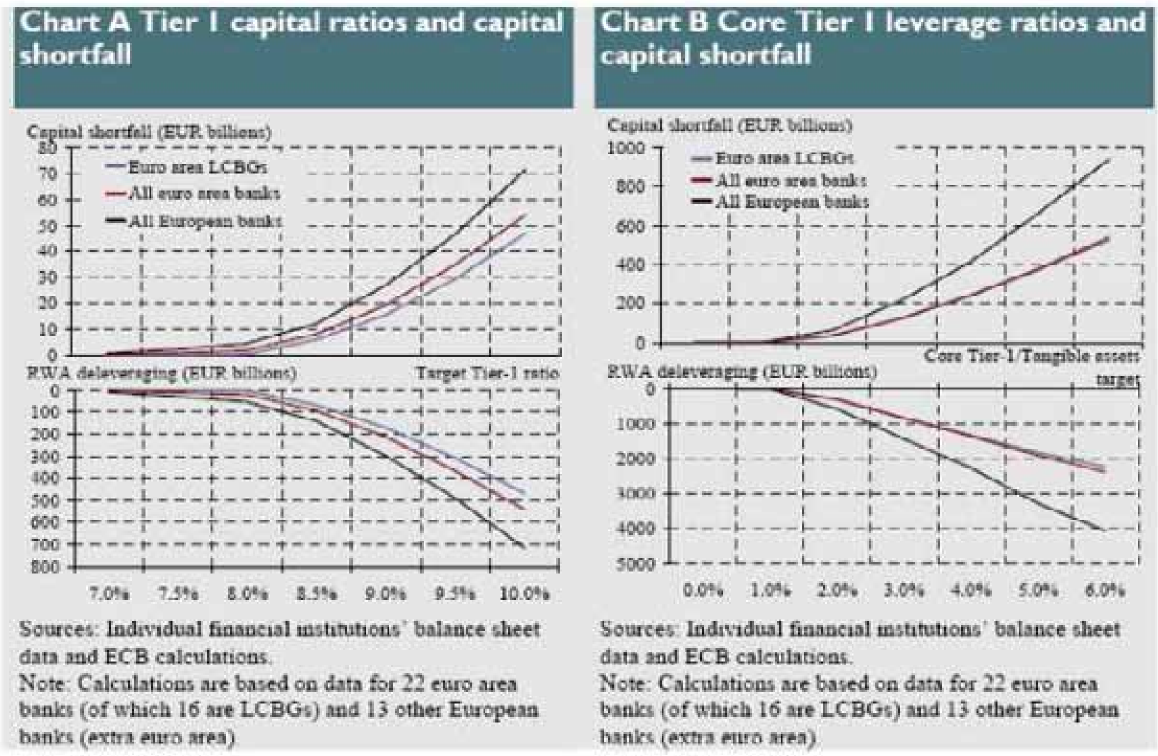
[8] ECB Financial Stability report, June 2009, p. 88.

and to acting as ultimate providers of emergency liquidity. There is now an international consensus that a central bank is well placed to contribute to macro-prudential analysis given its inherent function as monetary authority. While micro- and macro-prudential analyses are both tools used to promote financial stability, they differ markedly in approach and methodology. Macro-prudential analysis treats aggregate risk as endogenous and, unlike micro-prudential analysis, is therefore not focused on the analysis and surveillance of individual financial institutions. For this reason, it evaluates systemic risk and considers correlations and common exposures across institutions rather than within institutions. Contributing to financial stability using such an approach is a natural extension of a central bank's mandate under the EU Treaty. Macro-prudential supervision includes developing early warning systems for the analysis and detection of systemic risk as well as conducting macro stress-testing exercises on the financial sector. This suggests that central banks can readily undertake an active advisory role on financial regulation and supervision issues. Despite a central bank's natural involvement in macro-prudential supervision there still exists a need for close cooperation with micro-prudential supervisors since effective macro-supervision is effected through micro-supervisor's actions. In addition, and reminiscent of the argument in favor of a "twin-peaks" supervisory framework as suggested by the de Larosière Group report, central banks' assessments of macro-prudential risks should be reflected in the actions of micro-prudential supervisors.

Macro-prudential supervision will be enhanced by addressing the unintended consequences of pro-cyclicality in financial markets. Pro-cyclicality recognizes several institutional and non-institutional sources. Institutional sources of pro-cyclicality include leverage and the increase in market-sensitive valuation techniques such as value-at-risk, procyclical haircuts, triggers in over-the-counter derivative contracts, use of mark-to-market valuation techniques even in illiquid markets, as well as upfront recognition of profits in structured products even though some risks were retained. During the crisis, pro-cyclicality exacerbated asset price changes as financial institutions attempted to sell-off assets once they had exceeded their leverage ratios, which in turn resulted in lowered market prices. Capitalization requirements and accounting regulations subsequently initiated a negative feed-back loop which was intensified by adverse developments in the credit markets as institutions were required to mark their trading books to market. As a result, it became necessary for them to either sell more assets to maintain adequate capitalization levels or to reduce their loan values. What started as a liquidity problem quickly turned into a solvency problem. In this respect, policy measures require a revision of the pro-cyclical elements of the Basel II guidelines; the use of stress tests in lieu of value-at-risk for new risks or products with a short history; the use of "dynamic provisioning" as introduced by the Bank of Spain, an approach that involves building up anti-cyclical buffers during expansions and offers the possibility of drawing them down during recessions. In fine, the pro-cyclical effects arising from the interplay between leverage and valuation need to be assessed from a financial stability perspective.

Common, EU-wide stress testing of the overall banking sector is another area of regulation in which central banks can perform an important role. The objective of stress testing is to assess the resilience of the banking sector along with its ability to absorb shocks. Whereas supervisory authorities remain responsible for stress testing of banks on an individual basis, central banks would conduct analyses in order to determine aggregate need for capital and liquidity requirements. These testing procedures, based on common scenarios, would focus on macroeconomic shocks and the resulting response of the banking sector. The tests would focus on credit risk, equity price risk, foreign exchange risk, interest rate risk and liquidity risk. As an example of the stress testing, the recent ECB exercise shows that euro area 16 Large and Complex Banking Groups (LCBGs) are forecast to lose approximately 200 billion Euros due to credit risk exposures, a figure that illustrates the importance of stress testing national banking sectors (see text chart). Additional simulations performed by the ECB show that to meet a Tier 1 capital ratio of 10 percent, 47 billion Euros in additional capital would be required by the group of 16 LCBGs. If instead of raising capital, the same set of banks reduced risk-weighted assets, simulations show that risk-weighted assets should shrink 469 billion Euros. Shortfalls and deleveraging would be even larger on the basis of leverage ratios, such as the core Tier 1 to tangible assets. Finally, last April, the EFC requested the CEBS to coordinate EU-wide stress testing of the banking sector. These exercises, built on common scenarios derived from the ECB adverse scenario, are designed to assess the resilience of banks and the implications for financial stability of the EU banking system as a whole on a consistent and comparable manner.



Source: ECB Financial Stability Review, June 2009.

The regulatory paradigm that relies on self regulation has proven to be insufficient. Recent proposals for a new regulatory framework put forward by the de Larosière Group and the Obama administration are poised, along with the work by central banks and supervisory authorities, to enhance the stability of the international financial system. These proposals offer several important steps towards a more robust financial sector regulation. In June of this year, the European Council voiced its agreement in favor of the creation of a European Systemic Risk Board (ESRB) whose mission will be to monitor and assess risks to financial stability in the EU financial system. This decision followed the publication of the de Larosière Report on 25 February 2009, the Commission Communication of 27 May 2009 and the ECOFIN Council conclusions of 9 June, 2009. The ESRB will deliver quarterly assessments of risks to financial stability and policy recommendations. To carry out this task, the ESRB will require a wide range of information from both macro- and micro-prudential analysis. These data would be obtained from the national supervisory authorities and national central banks. Additionally, impact assessments would draw on information resulting from stress-testing exercises. This new framework poses a strategic challenge for the Eurosystem because of issues pertaining to administrative support, logistical support and support in the form of expertise for the ESRB.

Many European central banks and international organizations are about to implement permanent organizational changes as a result of the crisis; enhanced coordination and cooperation will be unavoidable components of the new nascent regulatory and supervisory framework. In combination with more effective and strengthened regulation, central banks need to enhance their mission of ensuring financial stability. Although this will require more resources and the development of expert knowledge, it is necessary to strengthen the financial system. For its success, it will also require support in terms of macroprudential supervision and coordination at both the EU and international levels. At the EU level, financial stability frameworks are largely national with an EU umbrella superstructure to facilitate cooperation, but which has been found wanting in terms of efficiency, of ex-ante compatibility between micro-prudential and financial stability objectives, of a mismatch between responsibilities and accountability in crisis management, of the lack of a crisis resolution framework for systemic banks, and of deposit guarantee schemes not fully consistent with the single financial market. Thus EU financial stability will be enhanced by developing a commonly shared philosophy concentrated not on what the system can deliver, but on what it should deliver within the single market. At the international level, the crisis made clear that there has been a deficit of multilateral surveillance, and thus, the IMF reform and setting up an operational framework for joint work with other international organizations and fora constitute inescapable tasks.

I wish to conclude on a positive note: The crisis may be a “welcome” opportunity to gather the political will to put in place long-needed structural reforms in good, service and labour markets with the objective of offsetting the possibly lasting negative impact of the crisis on trend growth. Similarly, the crisis can be a golden opportunity to put in place the foundations of a more robust regulatory and supervisory framework in line with the large number of reform proposals currently discussed.