Gertrude Tumpel-Gugerell: The way forward with monetary, fiscal and macroprudential policies

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the Conference "Europe after the crisis: resuming the long-term perspective", organised by the Confederation of Swedish Enterprise and the Centre for Global Studies, Stockholm, 11 December 2009.

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Introduction

Thank you for your invitation to speak here today.

In my short intervention, I will focus on the question how post-crisis monetary, fiscal and macroprudential policies in Europe should look like. Rapid and determined policy action have avoided that things turned worse at the peak of the crisis, but now that the worst seems to be behind us, it is time to look further ahead. Notably, we need to reverse what should only be temporary, and implement what needs to be changed structurally, so as to reduce chances of such a crisis from occurring again.

Monetary policy

Let me start with monetary policy. After the crisis had intensified significantly, a bit more than one year ago, the ECB responded swiftly and vigorously. In particular, it lowered its main interest rates substantially by 325 basis points between October 2008 and May 2009. The current rate of 1% is the lowest since monetary union started in 1999.

In addition, we have taken a number of non-standard liquidity and credit support measures to mitigate the adverse impact of dysfunctional money markets on the liquidity situation of solvent banks in the euro area and thereby avoid the emergence of a systemic liquidity crisis. To this end, for instance, we provided banks with unlimited liquidity against an expanded list of collateral, while prolonging the maturity of our refinancing operations up to 1 year.

From the very beginning, we have made clear that our enhanced credit support measures would be temporary in nature and remain in place only as long as needed. Now, taking into account the ongoing improvements in financial market conditions, we arrived at a situation where in fact not all our liquidity measures are needed to the same extent as in the past. Therefore, we announced last week some initial steps to gradually phasing out some of these measures.

At the same time, we continue to provide liquidity support to the euro area banks for an extended period of time at favourable conditions, as – despite the start of the phasing out – the impact of previously taken measures reach well into the next year.

While we are still in a period of high uncertainty, and we should not exclude setbacks on the road back to sustainable growth rates and stable financial market conditions, we also need to prepare ourselves for "normal" times. In this respect, in particular with a view to the recent experience, we need to ask ourselves whether the way monetary policy is conducted needs to be changed.

On that, let me first say that the primary objective of the ECB is and remains to maintain price stability over the medium term, and we have continued succeeding in that when looking at measures of inflation expectations which are well anchored in line with price stability. Secondly, in our comprehensive assessment of economic and monetary developments we already take into account a wide set of indicators, including for example also asset prices and credit developments. Thus, there is no need for changing our monetary policy framework in a fundamental way. Nonetheless, the crisis has shown that a more detailed and refined analysis of financial market indicators is important for both, financial stability and monetary policy objectives. Here we need to further invest and become more wary of how financial market risks can effect the macroeconomic environment.

Fiscal policies

As regards fiscal policies, I am concerned about the projected strong increase of government deficit and debt levels in euro area countries. According to the European Commission, the deficit ratio in the euro area would reach around 7% of GDP in 2010 compared to 2% in 2008; government debt as a ratio to GDP is expected to increase to 84% compared to 69% in 2008. 13 out of 16 euro area Member states are now facing an excessive deficit procedure due to budget deficits above the 3% of GDP deficit criterion of the Maastricht Treaty.

Certainly, the fiscal measures to stabilise the financial sector and the wider economy have helped to limit the adverse effects of the economic and financial crisis. However, it is now time to prepare ambitious and well-defined fiscal exit strategies. Otherwise, government debt in the euro area is set to quickly rise to levels above 100% of GDP, which might severely undermine the public's trust in the sustainability of public finances. Moreover, unsustainable debt developments would, in the medium to long-term, put upward pressure on interest rates.

At the European level, the fiscal consolidation process should be guided by the rules of the Stability and Growth Pact. First, this implies to set realistic but also sufficiently ambitious deadlines to correct excessive deficits in euro area countries. The ECOFIN Council has adopted recommendations for country-specific deadlines and fiscal adjustment requirements this month. Second, national governments need to specify their fiscal consolidation strategy and underpin it by well-specified measures. Given the projected strong increase in public spending ratios in euro area countries, governments should focus on expenditure-based fiscal consolidation. In the past, this has also proven to me more effective than tax increases to achieve successful fiscal consolidation.

Macroprudential policies

A formidable challenge for the central banking community in the period ahead is to respond in the best possible way to calls to enhance macro-prudential oversight. In the EU, a decision has been taken to establish a European Systemic Risk Board. This body will be responsible for carrying systemic risk surveillance and assessment at an EU-wide level and, where considered necessary, to translate these assessments into risk warnings and possibly policy recommendations.

The financial crisis has illustrated that a very large gap exists between, on the one hand, the risk surveillance and assessment tasks and, on the other, the advice on risk mitigation and possible policy follow-ups. The establishment of the ESRB along with its sister body, the European System of Financial Supervision, which will work in close co-operation, should represent a significant step in this direction.

In the new setting, macro-prudential policy instruments should aim at influencing variables such as maturity mismatches, excessive credit growth, leverage, or the risk appetite of market participants.

The types of policy tools that might be activated to address systemic risks may include counter cyclical capital buffers, enhanced liquidity requirements, forward-looking loan-loss provisioning, leverage ratios, haircut and collateral requirements in secured lending, or setting maximum loan-to-value ratios on mortgages. In this sense, the use of these policy tools should take account of both macro-financial and contagion aspects, and most likely will require a continuous interaction between the ESRB and the relevant supervisory and regulatory authorities.

Progress has been made in laying out a framework for systemic risk surveillance and assessment. The ESRB – or, for that matter, any other body responsible macro-prudential oversight – will aim at reducing systemic risk. The establishment of the ESRB but also the new EU supervisory architecture mean that vulnerabilities and potential sources of risk for the financial system will be detected in a timelier manner. This will foster better awareness of these risks and their potential implications.

Regulation will make the system more resilient. In fact, to the extent that we can narrow the policy gap between systemic risk assessments and their translation into risk mitigating policy actions, this will ultimately enhance the financial system's resilience to adverse disturbances. In this sense the political support for these reforms is absolutely essential.

Conclusion

Let me conclude. Monetary and fiscal policies, through vigorous and swift action at the peak of the financial crisis, have avoided a free fall in economic activity and a further drying up of financial markets. As we gradually seem to be leaving the extraordinary circumstances behind us, monetary and fiscal policies must return to their normal mode of operation.

Will that normal mode look different from the one before the crisis?

As for monetary policy, you can be assured that the ECB will monitor all developments carefully and continue to gradually phase-out at the appropriate time its enhanced credit support measures, without hampering the functioning of financial markets. Let me also assure you that maintaining price stability remains our primary objective. At the same time, let me also emphasize that central banks must become more wary of financial market risks and their macroeconomic implications to the overall benefit of achieving the monetary policy objective.

As regards fiscal policies, consolidation efforts need to be implemented timely and credibly, and as in the past with a particular focus on the expenditure side.

As to macroprudential policies, the recent crisis has strikingly illustrated the interconnectedness that characterizes the financial system. This has reaffirmed the need to strengthen macroprudential policies, i.e. the focus on the systemic nature of risks and their mitigation to reduce the chances on such a crisis from happening again need.

Finally, let us not forget the importance of self set standards and rules by the financial markets themselves. Importantly, the financial industry must be aware of their own responsibility and need to draw the right lessons from the crisis for future practises.

Thank you for your attention.

ECB monetary policy

- Extensive support via low interest rates and non-standard measures
- Time for gradual phasing-out has come
- Monetary policy assessment will benefit from enhancing the analysis of asset prices and credit aggregates

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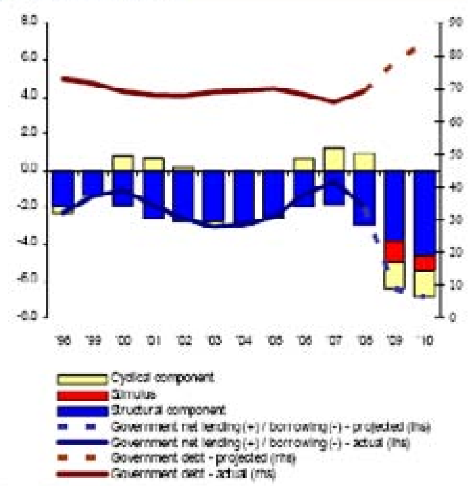
Fiscal costs of the crisis

Government net lending / borrowing
Euro area, percent of GDP



Source: European Commission

- European Commission Autumn 2009 forecast: euro area deficit ratio increases to 6.9% of GDP in 2010; debt ratio to 84%
- Less than one third of the total fiscal impulse in 2009 and 2010 due to the economic cycle; less than one fifth due to discretionary stimulus packages
- Structural deficit increasing due to i) structural spending growth in excess of GDP growth and ii) revenue shortfalls

➢ Need for credible and well-specified fiscal exit strategy

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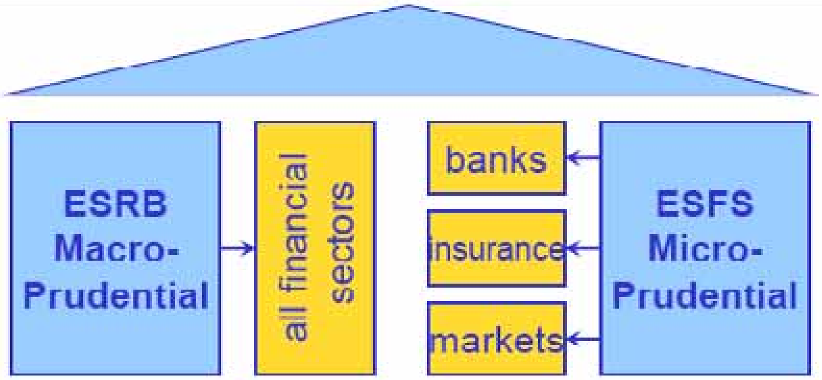
Regulatory reform:
The new EU supervisory architecture



Macro-prudential oversight at EU-wide level, across financial sectors:

- Enhanced systemic risk surveillance and assessment

Macro-prudential policy:

- Issuance of risk warnings and recommendations on measures in reaction to the identified risks

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