Lorenzo Bini Smaghi: The euro area macroeconomic situation – where do we stand, where are we going?

Keynote address by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the New Year's Reception 2010 organised by Industrie- und Handelskammer, Frankfurt am Main, 18 January 2010.

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Ich freue mich sehr, am Beginn des neuen Jahres bei Ihnen zu sein und die Gelegenheit zu haben, mit Ihnen über die ökonomische Situation im Euro-Raum und den Ausblick für 2010 zu diskutieren.

I would like to stop here with my very poor German and switch to English, which is, after all, the language of business. And Frankfurt is a city of business, so much so that even parking tickets are written in the two languages. This is the excuse I give for not having improved my German over the last four years: English is so widespread.

I guess that at the beginning of any New Year we are all quite interested in looking ahead, but especially after such a horrendous year as 2009. As business people, you know well how severely affected the euro area economy was, in terms of the speed and depth of the fall in economic activity. By the middle of 2009, euro area real GDP was more than 5% below its peak at the beginning of 2008, wiping out much of the growth witnessed between 2005 and 2007. Euro area industrial production excluding construction fell by more than 18%, while export volumes came down by more than 17%.

The euro area was not alone – indeed, this stark decline in economic activity took place amid a global slowdown unprecedented in recent times. But with its high degree of openness, the euro area economy was hit particularly hard by weak external demand.

The extreme financial tensions triggered a strong response from governments and central banks, without which the downturn would have been even more dramatic. On the monetary policy side, the ECB reacted swiftly to ensure that liquidity risk did not become solvency risk and lead to a major systemic financial crisis. Fiscal policies also significantly helped to contain the growth fallout in the euro area.

Against this background, where do we stand now? The latest available information suggests that euro area quarterly real GDP growth turned positive in the third quarter of last year. Information for the last quarter of 2009 is still incomplete, but survey indicators suggest that real GDP growth remained positive. The euro area benefited from a steady recovery in global demand throughout 2009, driven in part by the monetary and fiscal policy stimuli in most of the world's regions since the beginning of the recession, as well as by modest improvements in confidence. Activity has also been boosted by a reversal of the inventory cycle. But growth remains sluggish, reflecting the ongoing balance sheet adjustments in the euro area and elsewhere. This process has not only affected the financial sector, but also households, which have cut back consumption and increased their savings, and firms, which have restrained their investment spending.

The key question now concerns the economic recovery, its strength and fragilities.

Let me start with a comment of a general nature. I have the impression that many people, whether in the business sector, the financial markets, or in academic and political circles, think that the post-crisis world will be quite similar to the pre-crisis one in 2006–2007. In other words, they expect the economic recovery to bring us back to where we were before the crisis.

My feeling is that those who think like that are deluding themselves. The pre-crisis situation was not in equilibrium. It was not sustainable. The crisis occurred precisely because the situation was unsustainable, both within certain countries and globally.

If the world economy were to return to the pre-crisis situation, within a short time span a new crisis would be likely to occur because the same imbalances that led to the crisis would build up again. Considering some recent developments and behaviour, and considering the way certain policies are being discussed and the thinking of some key players, such a scenario does not seem that unlikely.

I think that it would be a big mistake to regard the recession we experienced in 2008 and 2009 as just a somewhat sharper cyclical downturn. There has been a major structural shift in our economies. Once the crisis is over, the world economy will look very different. This is true not only for the overall aggregates, but also for individual enterprises. The longer people take to recognise it, the more difficult it will be to recover.

Some would say that it is useless to make forecasts under the current circumstances, given the state of uncertainty. I don't think so. After all, economic agents – individuals, households, companies, financial institutions – have to have some idea about the future in order to take their day-to-day decisions on investment, expenditure, education, savings. This is especially the case in the aftermath of a crisis like the one we have just been through. Many of the decisions that economic agents will take over the next few months will turn out to be right or wrong depending on whether they have fully understood the implications and the opportunities of this crisis and have made a realistic assessment of how the post-crisis world could turn out. Not being forward-looking is a luxury that cannot be afforded under current circumstances. But being forward-looking is quite difficult amid the current uncertainties, even for a central bank. Indeed, all our economic models are estimated over a sample period in which imbalances were accumulated. These models may thus consider disequilibrium behaviour as "equilibrium". The resulting forecast might inevitably be biased. Judgement is thus required, but also some ability to think "outside the box".

Let me come back to the economic perspectives. The pick-up in activity since mid-2009 has been supported by a rebound in global trade and a reversal of the inventory cycle. It has also been underpinned by unprecedented monetary and fiscal stimuli. Overall, the recent economic recovery has largely relied on temporary factors. Yet, it is also clear that firms and households are also coping with the longer-term challenges of restructuring and adjusting balance sheets. These elements contribute to the moderate pace of growth projected for the euro area economy this year. The latest Eurosystem staff macroeconomic projections place euro area real GDP growth between 0.1% and 1.5% – well below the annual growth rate of above 3% witnessed in 2006. As for next year, euro area activity is expected to improve further, but with the expansion remaining moderate and probably uneven.

As the recovery unfolds, euro area activity should be supported not only by exports, but also by stronger domestic demand. Global economic growth is expected to remain below past trends. Advanced economies, in particular, are likely to experience a subdued recovery given the ongoing effects of the crisis. Indeed, it is likely that a number of factors will weigh negatively on the economic outlook, making it difficult to achieve pre-crisis growth rates. Let me briefly mention a few of these factors.

First, before the crisis erupted, economic growth was sustained by excessive credit, which in turn reflected unsustainable domestic and international developments. We are experiencing a substantial de-leveraging of the financial system, which will have an impact on the real economy. I will come back to this issue shortly.

Second, the dramatic drop in economic activity could have lingering effects on potential and actual output. There are several sectors of the economy where activity is unlikely to return to pre-crisis levels because of structural shifts in the composition of world demand or permanent changes in relative prices. The construction and automotive sectors are perhaps the most obvious examples.

Third, the increase in public debt and the cost of servicing it may crowd out private spending. This risk is not apparent yet because of the fall in private investment. However, as the recovery picks up, the pressure on financing both private investment and public spending will mount.

Fourth, the slower the recovery, the greater the impact on unemployment, which may in turn affect confidence and thus reduce spending and heighten uncertainty.

Finally, supply shocks stemming from rises in commodity prices cannot be ruled out.

On the domestic side, a continued need to repair balance sheets in various sectors will affect the outlook, as it did in 2009. In the near term, uncertain labour market prospects might also continue to constrain household spending. Indeed, while the recession may have ended in terms of GDP contraction, we should bear in mind that employment growth typically lags business cycle fluctuations. Moreover, there are reasons for believing that such lags may be more pronounced in the current context. Many euro area governments implemented special working time schemes – such as Germany's Kurzarbeit programme – as the economic crisis unfolded, in an attempt to prevent a sharp rise in unemployment and to smooth the process of adjustment. But if capacity utilisation remains at low levels, job losses may increase further as the impacts of these schemes fade. The pace of private consumption will be affected by employment prospects.

Concerning private investment, the pace of contraction is expected to slow over the year. But business investment is likely to be held back by low capacity utilisation, weak demand, high uncertainty and depressed profits.

As I said earlier, this – or any other scenario – is surrounded by high uncertainty. There are several risk factors. I will not mention all of them. I would like to consider one which may be relevant for you, related to the financing conditions of companies.

During the financial crisis, there was a sharp fall in bank loans to non-financial corporations, partly reflecting banks' balance sheet difficulties, and partly the plummeting loan demand.

It seems that some firms have replaced some of their bank financing with market-based financing, as was reflected in the strong recourse to financial markets by non-financial firms during 2009. Relatively favourable cost developments, but also the refinancing needs of corporations have contributed to this development. While generally large and high-rated firms are able to profit from favourable market conditions, the high-yield bond market segment is also benefiting.

Let me turn now specifically to the financing conditions of small and medium-sized enterprises (SMEs) in the euro area. These companies typically have a strong dependence on bank financing. SMEs play an important role in the euro area corporate sector. They account for the vast majority of all non-financial businesses, for roughly 60% of gross value added and for about 70% of employment. So it is important to monitor not only the non-financial corporate sector as a whole, but also large firms and SMEs separately.

Recent survey results[1] confirm the finding that SMEs were generally somewhat less successful than large firms when applying for bank loans in the first half of 2009. Typically, the larger and the older a firm, the more successful it was when applying for a bank loan. This is a familiar story: banks typically have greater difficulties in assessing the financial situation of SMEs, which are subject to greater information asymmetries between lenders and borrowers.

Let me now look ahead to this year with respect to financing conditions. I will focus in particular on the recovery in bank lending, which is subject to some risks.

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1 See European Central Bank, "Survey on the access to finance of small and medium-sized enterprises in the euro area", September 2009.

Experience shows that loans to non-financial corporations recover with some lag vis-à-vis the turning point in the economic cycle. As I mentioned, the latest available information indicates that the economic recession in the euro area ended in the third quarter of 2009. Therefore, it can be expected that corporate loan growth will continue to decelerate in the first few months of this year. However, the uncertainty surrounding the outlook for loan growth is exceptionally high, related to the depth of the current economic cycle.

One factor that contributes to the uncertainty of the loan recovery is the interplay between the supply and demand of loans. While subdued bank lending has so far mainly reflected the weak state of the real economy, credit supply restrictions may become more binding when loan demand by enterprises picks up as the economy recovers. At the same time, however, there are signs that banks are starting to ease their credit conditions and that efforts to support the financial system are bearing fruit.

The recovery in both loan demand and credit supply in 2010 depends to a considerable extent on further improvements in the corporate sector as well as in the banking sector.

The banking sector plays an essential part in any economic recovery. When the demand for credit based on enhanced investment perspectives rises again, the banking system will have to be able to accommodate it. The traditional role of banks is to grant credit to projects which promise a return on their money. This is vital if SMEs are to realise their investment plans and finance their working capital.

This raises at least a couple of questions, from a policy perspective. First, how can banks be made sound enough to extend credit as soon as the real economy picks up and investment demand increases? Second, how can the environment for private companies, in particular SMEs, be improved so that they can boost investment and start growing again?

Let me briefly answer the two questions.

Let me start with the banking system. Large and complex banking groups have recently benefited from higher trading income, associated largely with the low level of interest rates. At the same time, however, banks' profitability remains fragile. The expected losses on loan exposures to households and corporations are likely to increase, as a lagged effect of last year's recession. Furthermore, the short-term profits obtained through trading activities hide risks which may materialise over the medium term and weaken banks' profits over time. This second factor appears to be widely underestimated, as banks seem to be conducting carry trades – including those in the same currency which exploit maturity mismatches, i.e. borrowing short-term to buy long-term bonds – on the assumption that such activities are risk-free. Experience shows instead that the short-term gains of such trades may be eroded by capital losses at a later stage, resulting from changes in short-term financing conditions and in the underlying value of the asset. Each bank may think that it can unwind its trades before its competitors and avoid capital losses. But not all banks will be able to do that at the same time. There is thus a risk that, in addition to the losses resulting from non-performing loans, banks may suffer capital losses on their trading activities that further hinder their willingness and ability to provide loans, adding to the generally high uncertainty about the economic recovery.

Banks thus need to recapitalise and restructure so as to prepare themselves to meet the stronger demand for credit, when the latter materialises. Banks should use the substantial profits they obtained in 2009, in particular through trading activities, to strengthen their capital position rather than to remunerate their shareholders and their managers. This policy is not only preferable over the medium term; it is also more ethical. Indeed, it does not appear appropriate under the current circumstances that banks use the profits stemming from the direct or indirect support of public policies, be they fiscal or monetary, for remuneration purposes.

This applies not only to those banks that have received direct public support, but also to those that did not. In fact, without the support for some of the weaker banks, those that claimed to be stronger would have succumbed as well. Furthermore, these banks are benefiting from very easy liquidity conditions, which have allowed them to be profitable. To sum up, even for the banks that look healthier, their profits are the result of public interventions and should thus be used to bolster their capital position rather than for remuneration purposes.

There is still a lot of work to be done, in several countries, including in the euro area, to ensure that banks are sufficiently equipped to support the real economy as it recovers. This work is urgent and cannot be delayed in the expectation that other policies will bear the burden. The experience of the past, particularly the case of Japan in the 1990s, has shown the dangers of underestimating the problem.

This brings me to the second question. Monetary and fiscal policies have successfully averted a collapse in economic activity. This success may now create the illusion that monetary and fiscal policies will be able by themselves to restore economic activity to its pre-crisis level. Why is it an illusion?

As I said earlier, the pre-crisis situation was not in equilibrium, in particular because of the excessive level of private indebtedness. If monetary and fiscal policies aimed at re-establishing that situation, especially by replacing private debt with public debt, they would themselves become unsustainable. It is already widely expected that most advanced countries will come out of the crisis with higher public debt, and with higher payments to be made on that debt through higher public revenues. The sustainability of the debt depends on the ability of governments to withdraw their very expansionary fiscal policies in a timely way.

The only way to get the economy back on a path of sustainable growth is to improve the growth potential of the economy through profound structural reforms. There are still huge inefficiencies in our economies, largely due to restrictions, barriers to entry, monopolistic rents and other factors. This affects all sectors in all euro area countries.

The objective of structural reforms is to make markets function better, in particular the labour as well as the goods and services markets. Greater competition has to be achieved in many sectors. This would create job opportunities and reduce prices, thereby increasing the purchasing power of consumers.

Let me give you an example of the positive effects of better functioning markets, taken from the experience we have had in planning the new premises of the ECB, here in Frankfurt.

When we launched the tender procedure, we initially opted for a general contractor to build the new premises in the area of the Frankfurter Großmarkthalle. But there was little competition and few truly competitive bids as not many large firms were able to take on such a large-scale project on their own. We then split the original tender into 12 distinct sub-tenders, with smaller lots; this encouraged competition as it allowed many SMEs to participate in the tender and it led to considerably lower bids for the construction work, which is, overall, within the agreed budget. We will now proceed with the construction, which is expected to be finalised by mid-2014.

The lesson from this episode is not new but it is a reassuring one. Although the changes in the economic environment have certainly contributed to reducing the costs, competition has been beneficial, not only for the ECB but also for the contractors. A construction project which was not possible under the previous tender model can now be realised.

This is obviously only one example, but we should ask ourselves: how many times do we as individuals decide to postpone projects because they are too costly? I am sure we can spend a whole evening talking about how difficult it is to get certain services, and how expensive they are just because of market rigidities and a lack of competition.

This example reminds us that without major structural reforms, in all euro area countries, growth potential cannot be achieved and the recovery is likely to be subdued. As in the past, there is a risk that growth will only rely on exports, while domestic demand remains sluggish.

The euro area economy cannot grow in a sustainable way only on the basis of exports. Employment and productivity have to start rising again if purchasing power is to increase and thus support private consumption and investment.

The reforms needed vary from country to country, because both the problems and the rigidities differ. But all countries need to work hard to remove the numerous obstacles to growth, starting with the labour and product markets. Ultimately, this effort should be stepped up also at European level, with a view to implementing a true internal market. The most serious repercussion of this crisis would be that the integration of Europe's economies moves into reverse and that protectionism within the Union stages a comeback.

Let me conclude.

The prospects for economic recovery are fraught with considerable uncertainty. However, this should not be an excuse for inaction, either for policy-makers or for companies. After all, this is not the first time that we have been through very uncertain times. When we look back, can we really say that our countries – whether in Europe or even the US – have never experienced comparable levels of uncertainty? Consider 1947–48, with the post-war recession and the start of the cold war. Can we say that in those days the uncertainty was any less than it is today? Or even in 1974, immediately after the first oil shock, people here in Germany, for instance, were not allowed to drive their cars on four successive Sundays. Nobody knew exactly how long the world's oil reserves would last. Was the world less uncertain than it is today?

It's difficult to answer, but I guess there have been cases of high uncertainty also in the past. And people coped and ultimately the economy recovered.

Of course, the world is more complex today than it was forty or sixty years ago. Our societies are older, wealthier. As a result, the reaction might be slower. I think that what is most important is not to fool ourselves into thinking that problems can be overcome by repeatedly postponing them, by borrowing indefinitely from future generations. Our economies will face serious challenges in the coming years, not least because, as I mentioned, the post-crisis world will be different from the pre-crisis one. Facing up to those challenges calls for action not only from policy-makers but all economic agents – companies, unions, financial institutions, households. Immobility is the biggest danger ahead.

I hope that over the last couple of years the ECB has shown that it can act quickly and effectively. But it cannot solve all problems. All those who play a part in economic life have to take action, they have to reform our economies so as to restore prosperity.

Thank you for your attention.