Jürgen Stark: Taking stock – where do we stand in the crisis?

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the BMW (Bayerische Motoren Werke) Stiftung Herbert Quandt, Washington DC, 15 April 2010.

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Ladies and gentlemen,

Introduction: macroeconomic developments and outlook

In autumn 2008, the world economy entered the worst financial crisis and the deepest recession since the Great Depression. Both monetary and fiscal policies responded vigorously to this exceptional situation and contributed to the emergence of a recovery in the course of 2009.

Hence, after falling last year, global activity is expected to grow by around 4% this year, while global trade is expected to grow by almost 6% (IMF January WEO update). Strong growth in emerging market economies in Asia is a major driving force behind these figures, while growth in many advanced economies is forecast to be weak. Questions can be raised as to whether such an uneven pattern of the recovery will prove sustainable.

In the euro area, recent information indicates that the recovery has continued to expand in the first few months of this year. Looking forward, euro area growth is expected to remain moderate, owing to ongoing balance sheet adjustments in the private sector, weak prospects for the labour market and low capacity utilisation. Available growth forecasts for 2010 put it at, on average, around 1%. The crisis is also expected to have lasting effects on our economy, as both the level and the growth rate of potential output are most likely reduced for a longer time.

Turning to price developments in the euro area, according to Eurostat's flash estimate, annual inflation increased to 1.5% in March, from 0.9% in February. This was higher than expected. While this does not change our assessment, it is important to understand whether the surge in inflation in March is temporary or more lasting in nature. This is difficult to assess without a breakdown of developments in the overall HICP, which will only become available tomorrow (16 April). However, it seems reasonable to consider energy and food prices as the main drivers behind the higher than expected inflation outcome in March.

Looking ahead, we expect inflation in the euro area to remain moderate over the policy-relevant horizon. The outcome of our monetary analysis confirms the assessment of low inflationary pressures over the medium term, with money and credit growth remaining weak.

At the same time, we need to monitor price developments in the more dynamic regions of the world very closely, as well as the evolution of commodity prices and their potential impact on global inflation. Notably, a multi-speed recovery of the world economy, with some regions growing fast, while the recovery in others remains rather slow, has the potential to exert upward pressure on prices. In the same vein, we also need to monitor very closely the possible adverse impact from fiscal developments on the inflation outlook. All in all, risks to the inflation outlook seem to be tilted to the upside.

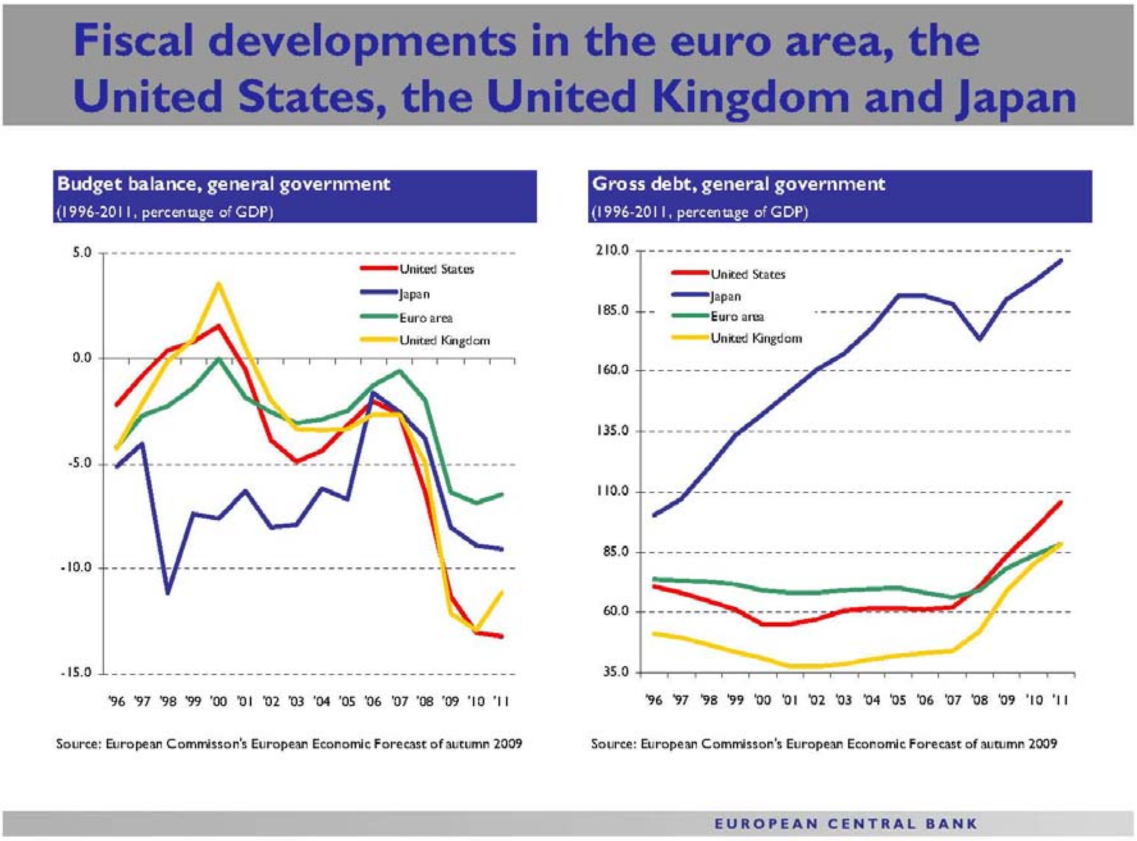
This notwithstanding, inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term.

Let me turn to the banking sector. Adjustments are continuing in light of a re-focusing on core business and markets, the necessary re-organisation arising from state aid and forthcoming changes to regulatory environment. Although there have been improvements, profitability remains subdued. Further credit-related write-downs are expected throughout this year, and the risk of a negative feedback loop emerging between the household and corporate sectors and the banks persists. Banks' may remain under pressure to continue the process of de-leveraging, with possible credit constraints impacting on economic growth in the event of credit demand picking up.

Thus, although the response of policy-makers to the crisis has certainly helped to avert an even more dramatic collapse in economic activity in the euro area and elsewhere, challenges abound. Indeed, most advanced economies will continue to face severe macroeconomic imbalances in the years to come. I am particularly concerned about the dramatic deterioration in public finances, which will require very ambitious fiscal consolidation efforts in the years to come. We may already have entered into the next phase of the crisis: a sovereign debt crisis following on the financial and economic crisis.

Fiscal policy challenges

Most governments in the advanced countries will exit from the recession with the highest deficit and debt-to-GDP ratios recorded in times of peace.



General government fiscal development

percentage of GDP	Budget balance		Gross debt	
	2008	2011	2008	2011
United States	-6.4	-13.2	70.7	105.8
Japan	-3.8	-9.1	173.1	206.0
Euro area	-2.0	-6.5	69.3	88.2
United Kingdom	-5.0	-11.1	52.0	88.2

Source: European Commisson's European Economic Forecast of autumn 2009

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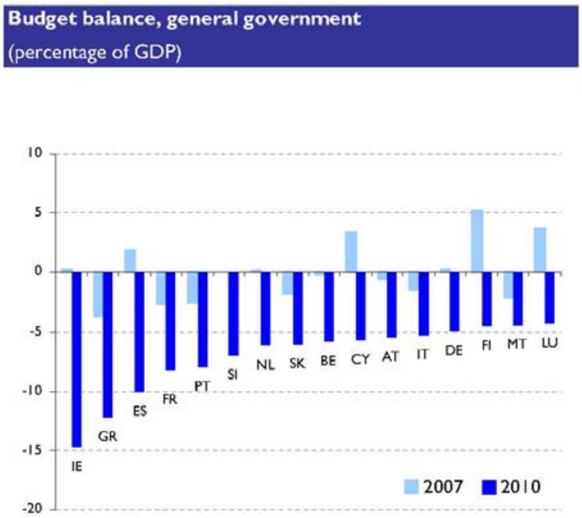
As can bee seen in the chart, the general government deficit in the euro area is expected, according to the latest projections by the European Commission, to exceed 6.0% of GDP in 2009, 2010 and 2011. In Japan, the government deficit-to-GDP ratio is foreseen to reach around 9.0% of GDP in these years, whereas the UK and US government deficits are expected to be in excess of 10.0% of GDP in the period 2009–11. These high government deficits are reflected in mounting government debt, which will reach 88% of GDP in 2011 in both the euro area and the United Kingdom, 100% of GDP in the United States and 200% of GDP in Japan.

These developments are the consequence of sizeable fiscal stimulus measures and of interventions in support of financial institutions in many advanced countries, but also of the sharp contraction in economic activity.

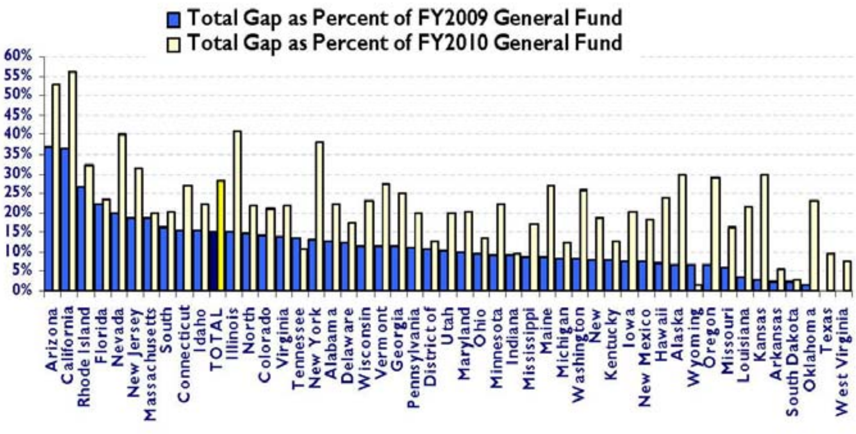
In the euro area, adverse fiscal developments are a cause of particular concern in several countries, generally those that did not exploit more buoyant economic times to firmly consolidate their public finances. In the United States, too, some States (e.g. Arizona and California) have adopted a less prudent approach to the management of their public finances than others.

Fiscal developments: euro area countries



Source: European Commisson's European Economic Forecast of autumn 2009

Fiscal developments: US budget gaps by State (as a percentage of the respective General Fund budget)



Source: Center of Budget and Policy Priorities. ***Note: Estimates as of December 2009. 2009 estimates are not available for Texas and West Virginia. Total Budget Gaps refer to the gap before the budget was adopted plus the additional Mid-Year Gap.***

There is no doubt that fiscal policies have been put on a path that is not sustainable. Indeed, as simulations for the euro area show, without a very ambitious fiscal adjustment effort, the debt ratio is projected to continue rising in the next decades. With an annual structural deficit reduction of only 0.5% of GDP, it will take the euro area 20 years or more to return to the pre-crisis debt-to-GDP level. Substantially stronger consolidation efforts are warranted to bring the debt ratio down to a more prudent level of below 60% of GDP and to prepare for the rising budgetary costs of the ageing population.

Euro area government debt scenarios: assumptions on adjustment paths

- Three scenarios:
  - Red: no policy change
    (annual change in primary balance $\Delta p_t = 0$)
  - Orange: limited consolidation effort
    (annual change in primary balance $\Delta p_t = 0.5$)
  - Green: more ambitious consolidation effort
    (annual change in primary balance $\Delta p_t = 1$)

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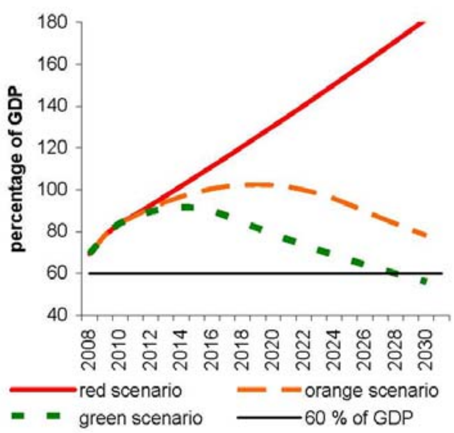
Euro area government debt scenarios



Source: ECB simulations.

Note: debt scenarios do not cover the expected increase in the costs of ageing.

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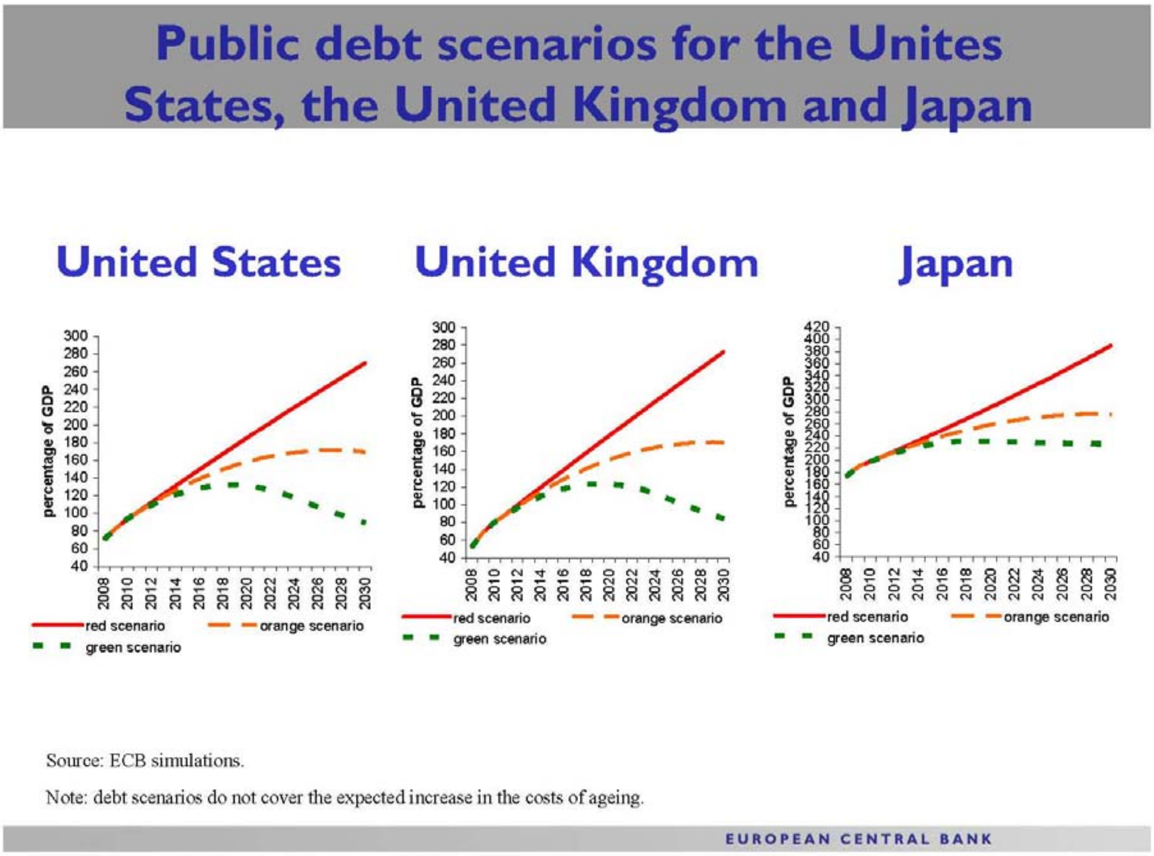
The challenges are particularly large for countries with relatively high government deficit and debt levels, as well as a rapidly ageing society, and even more so for those that face relatively high interest rates and low potential growth.

Outside the euro area, bringing the public debt ratio back to safer regions appears even harder for the United Kingdom, the United States and Japan. Given their high budget deficits and the high and rising debt levels, they must undertake very strong consolidation efforts to manage a reversal of the rising trend in public debt ratios.



Growing fiscal imbalances, if not promptly corrected, are a cause of concern for several reasons. Let me focus on the three most important ones.

First, high levels of government budget deficits and debt may push up inflation expectations and place an additional burden on the monetary policy of central banks and their task of maintaining price stability.

Second, large fiscal imbalances may drive up (real) medium and longer-term interest rates, with adverse consequences for private investment. Given the large debt financing needs of many advanced countries, this constitutes a serious risk for the recovery. Moreover, rising interest expenditure on government debt reduces the scope for public spending on other, growth-enhancing items. Taken together, this would reduce long-term growth, especially in countries with high debt ratios.

Third, deteriorated fiscal positions severely limit the ability of governments to counter adverse shocks, given the reduced budgetary room for the operation of automatic stabilizers. In addition, large budgetary imbalances reduce the scope for fiscal stimulus measures, and their effectiveness, as a fiscal expansion in the context of high and rising government debt may trigger an increase in precautionary savings and show negative fiscal multipliers.

Against this background, it is now of the utmost importance that national fiscal policy-makers rapidly implement a credible and ambitious consolidation agenda. While fiscal consolidation may entail some costs in terms of lower economic growth in the short run, their longer-term benefits are largely undisputed.

They consist, notably, of a reduction in governments' debt financing needs, leading both to lower long-term interest rates (due to lower demand and declining risk premia) and to the release of revenues to finance more productive expenditure or growth-enhancing tax cuts. More leeway is then also created for the operation of automatic fiscal stabilizers in response to a cyclical downturn. In sum, fiscal consolidation is essential to secure public trust in the long-term sustainability of public finances, and to strengthen the foundations for sustained and durable growth.

At the European level, fiscal consolidation should be in line with EU countries' commitments under the Stability and Growth Pact, which provides the appropriate framework for the coordination of their fiscal policies. Given past experience of a slow and hesitant correction of excessive deficits, I see strong arguments for strengthening the implementation of the Stability and Growth Pact and reinforcing its rules for fiscal discipline. This could be complemented with enhanced national budgetary rules and procedures that are consistent with the EU fiscal framework.

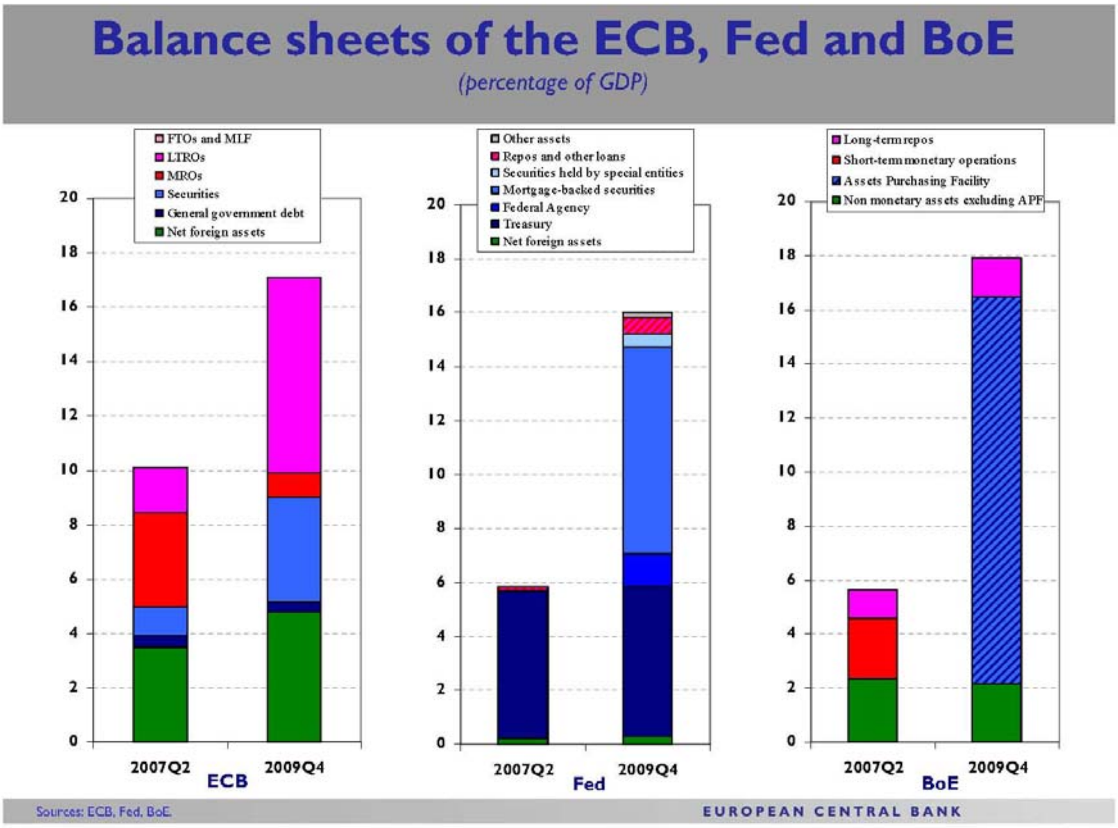
Monetary policy challenges

Let me now turn to monetary policy and focus, in particular, on the response of the ECB to the crisis, and its current exit strategies.

In response to the crisis and the ensuing subdued inflationary pressures, the Governing Council lowered its key interest rates to historically low levels. In particular, it reduced its main refinancing rate by 325 basis points to 1%, a level not seen in recent history in any of the euro area countries. Overall, the Governing Council still views these low policy rates as appropriate.

To foster financing conditions and facilitate the transmission of lower key ECB interest rates to money market and bank lending rates, the Governing Council also introduced a number of non-standard measures. Notably, the Eurosystem provided unlimited liquidity to banks at a fixed interest rate and at maturities of up to one year. It also provided liquidity in foreign currencies, extended the list of eligible collateral and purchased covered bonds outright. These measures have contributed not only to lowering perceived liquidity risks on the part of banks, but also to a better flow of credit to households and firms than would otherwise have been the case.

The ECB's approach differs from that of some other central banks in many respects. Notably, our outright purchases of securities have been limited to the covered bond market, a market segment that is very important in Europe and a primary source of financing for banks. Moreover, we have refrained from buying government bonds.



This has been different in other regions, especially in the United States and the United Kingdom, as you can see from this slide. Notably, in providing extra liquidity, we have relied primarily on repurchase agreements (red parts of bars), whereas the United States and the United Kingdom have focused on buying securities outright (blue parts of bars).

From the very beginning, we have been aware of the fact that keeping our non-standard measures in place for longer than necessary would entail the danger of creating harmful distortions. Therefore, we designed the measures with exit considerations in mind. In view of the improvements in financial market conditions seen since last spring, we have started to gradually phase out some of them.

More specifically, we have stopped providing liquidity in foreign currencies, and we have stopped operations involving maturities longer than three months. Also, we have decided to return to variable rate tenders in the regular three-month operations towards the end of this month.

However, the Eurosystem will continue to provide liquidity support to the euro area banking system at very favourable conditions in its shorter-term refinancing operations (that mature after one week and after approximately one month). We have decided to do this for as long as necessary and at least until mid-October this year.

The speed and path of the subsequent gradual phasing-out of the non-standard measures will depend on economic and financial market developments. The remaining measures are not many. They include, inter alia, the tender procedures to be applied in the main refinancing operations and the operations with a duration of one maintenance period, approximately one month (which could be returned to variable rate tenders). All our actions will remain fully in line with the objective of maintaining price stability over the medium term.

We do not know today what normality will look like after the crisis. Likewise, we cannot be specific today about the design of the "final" post-crisis operational framework. Before deciding on this, we will need to consider thoroughly the lessons to be learnt from the crisis. However, the operational framework that prevailed prior to the turmoil seems to provide a good benchmark. It served us well prior to the crisis, and could be adapted quickly as circumstances worsened.

Concluding remarks

Let me conclude.

There is no doubt that the crisis will leave us a heritage of severe macroeconomic imbalances. Dealing with them will represent one of the most daunting challenges for policy-makers in modern history.

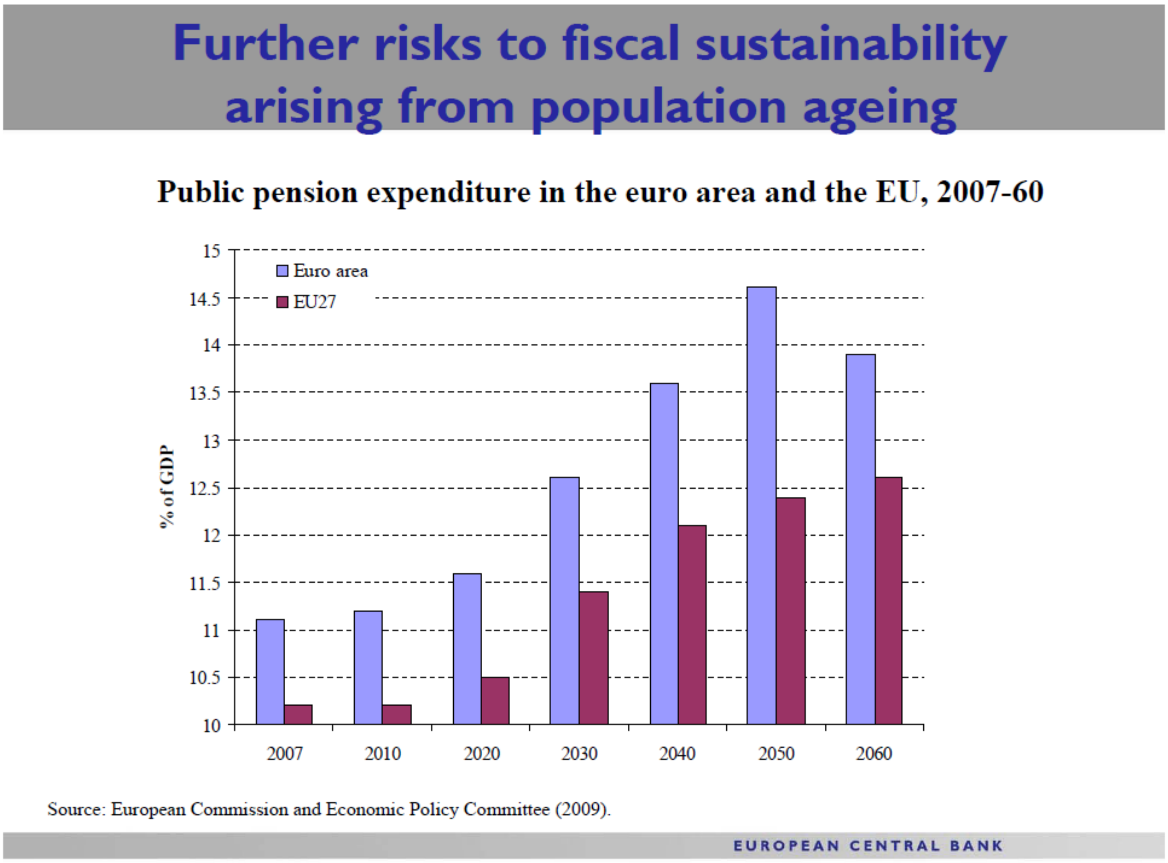
Against this backdrop, let me emphasise that the Governing Council will continue to deliver on its mandate, which is to maintain price stability over the medium term. All our decisions regarding an exit from supportive measures need to be seen within this context.

As regards fiscal policies, it is essential to prevent public finances from running out of control. Clearly, this will require a very ambitious fiscal consolidation effort. In particular, as regards the consolidation strategy, and given that the tax burden is already high in many countries, the fiscal adjustment will have to be primarily expenditure-based.

Finally, let me stress that any call to reduce the real value of public debt through higher inflation will be firmly opposed by the ECB. A low and stable level of inflation is a prerequisite for confidence, stability and sustainable growth.

Thank you.

Background slides



Assumptions behind public debt scenarios

	Euro area	Japan	United Kingdom	United States
Time horizon	Starting point 2010, simulations 2011onwards until 2030			
Initial debt ratio (percentage of GDP) 1)	84.0	197.6	80.3	94.4
Nominal GDP growth (percentage per annum) 2)	3.4	0.2	4.8	4.6
The interest rate (percentage) 3)	4.3	1.4	4.4	3.8
Initial primary balance (percentage of GDP) 4)	-3.7	-6.1	-10.3	-10.1

1) The initial debt ratio is equal to the value for 2010 published in European Commission's autumn 2009 forecast.
2) The nominal GDP growth is equal to the average of nominal potential growth over 1995-2014 estimated in the IMF World Economic Outlook.
3) The nominal implicit interest rate on government debt is assumed constant at the value recorded in 2008 (as the values for the period 2009-10 could be distorted by the financial crisis).
4) The initial primary balance is equal to the value for 2010 published in European Commission's autumn 2009 forecast.

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