Gertrude Tumpel-Gugerell: The ECB's actions during the recent crisis and the policy elements needed for a sound recovery

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the conference on "How can the EU and China contribute to a sound and sustainable global economic recovery?" at the Shanghai Expo, Shanghai, 3 July 2010.

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Ladies and Gentlemen,

I am greatly honoured to speak here today at the World Expo 2010 in Shanghai, the first one in China. Two days ago I had the chance to visit the Expo myself and I am truly fascinated by the window to the world and its perfect organisation. I am told that the emblem of the Expo is inspired by the Chinese character for "world", and that there is a popular saying in China, which goes: "The world is wonderful, if you don't see it, you don't know" (*shijie zhen qimiao, bu kan bu zhidao*). I think this saying describes not only the atmosphere at the Shanghai Expo quite well, but also China's general attitude towards today's globalised world. And one could turn it around and say: *"If you have not seen China, you can not imagine how wonderful it is"* – and I have no doubt that it will one day become a major global financial centre as well.

The financial crisis has hit the global economy and has led to losses of income and costs to the system around the globe. Today, we are focusing on how the EU and China can contribute to a sound and sustainable global economic recovery, which is in the interest of all of us. We are here to discuss the policies needed to address the financial instabilities that we were faced with and we need to discuss the policies that will steer our economies back to a sustainable long term growth path.

Let me give you my key message in this regard right up front: I believe that the recovery in Europe is well on track and that we have the right policies in place to ensure the return to the levels of growth we have seen prior to the crisis.

In my speech today, I will take the opportunity to discuss how the European Central Bank (ECB) has responded to the adverse effects of the financial crisis since 2007 and how this has not only prevented worse outcomes but has also contributed in the current environment to setting the stage for a sound recovery in Europe. Indeed, also on the basis of low interest rates all along the money market yield curve, providing attractive financing conditions, the economy is expanding and we see a positive growth outlook.

I will also outline which policies – in my view – are needed for the recovery to be sustainable with the prospect of long term growth. First, structural reform policies to strengthen overall growth prospects. Second, a financial market sector reform (which is well on track), Third, fiscal consolidation (which is also well on track) and fourth, the continuous concentration of monetary policy to be directed at medium term price stability as this is the necessary and crucial contribution of monetary policy to fostering sustainable economic growth, job creation and financial stability.

Price stability and financial stability are indispensable elements shaping the outlook for global growth. A third element is sound public finances. But before addressing these issues, let me give you some ideas on what the ECB has done during the crisis.

The ECB's actions during the crisis

Recent years have been most challenging across the globe. What started as tensions in the money market in August 2007 quickly spread around the globe, leading to severe repercussions across economies and markets.

After the failure of Lehman Brothers in September 2008, we saw a sharp fall in global activity. In the fourth quarter of 2008 and the first quarter of 2009, global trade volumes fell by 18 percent. This development was also felt here in China, where year-on-year GDP growth decelerated to 6.2% in the first quarter of 2009 from 9.1% in the third quarter of 2008 and trade values decreased by 33% from September 2008 to March 2009. In the euro area, real GDP fell by altogether almost 4.5 percent and unemployment rose by 1.4 percentage points in just six months. At the same time, extra-euro area export volumes of goods decreased by 18.0% and import volumes by 12.8%.

The ECB acted quickly and decisively in response to the crisis. We reduced our key interest rates to unprecedented low levels. The interest rate at the main refinancing operations was lowered by 325 basis points to 1.0% between October 2008 and May 2009, i.e. within a period of only seven months. And, we have left it unchanged since then. In addition, we introduced a series of non-standard measures to support credit provision by banks to the euro area economy.

Our non-standard measures were designed to sustain financing conditions and credit flows above and beyond what could be achieved through reductions in key ECB interest rates alone. These measures, which we refer to as “enhanced credit support”, included essentially five elements: We lengthened the maximum maturity of refinancing operations, we extended the eligible collateral list, we provided liquidity in foreign currencies, we initiated a covered bond purchase programme, and, above all, we provided unlimited liquidity in all refinancing operations at a fixed rate.

The enhanced credit support led to a considerable improvement in market liquidity and helped to alleviate funding risks. As a result of our actions, money market interest rates, money market spreads and interest rates on bank loans declined significantly.

In early May of this year, we were confronted with renewed market tensions. These tensions arose in some segments of the euro area debt securities markets. Again, after carefully considering the situation, we decided to act, since the tensions were hampering the monetary policy transmission mechanism. We launched the Securities Markets Programme to ensure depth and liquidity in those market segments which are dysfunctional. The objective of this programme is to address the malfunctioning of securities markets and to ensure the proper transmission of monetary policy impulses to the wider economy and, ultimately, to the general price level.

Overall, all the non-standard measures we have taken have been consistent with our mandate to deliver price stability for the euro area as a whole. From the very beginning, we have made clear that those measures are, by construction, temporary in nature. In fact, the Governing Council remains firmly committed to its price stability objective. This is credible for financial market participants and the public, as reflected in inflation expectations that are firmly anchored at levels in line with the aim of the ECB’s Governing Council to keep inflation rates below, but close to 2% over the medium term.

Elements needed for a sound economic recovery

The ECB measures were indispensable to support the functioning of the euro area banking sector and to prevent worse outcomes during the crisis. But with our contribution to attractive financing conditions and the smooth functioning of money and credit markets, the ECB has also contributed to bringing the euro area economy on the recovery track.

Indeed, the economic recovery in the euro area is well on track. After a period of sharp decline, euro area economic activity has been expanding since mid-2009. Business and consumer confidence indicators have been trending upwards over the last quarters and the June 2010 Eurosystem staff macroeconomic projections – but also those of other organizations – see a further rebound in GDP growth to take place in 2010 and 2011.

This notwithstanding and taking a longer term perspective, I believe that more is needed for this recovery to be solid, sustainable and long lasting. So let me outline which policies – in my view – are needed to achieve good prospects of long term growth with at the same time ensuring both, price stability and financial stability. In the following, I will mention four policy elements. First, the strengthening of growth prospects through structural reforms. Second, fiscal consolidation aiming at sustainable fiscal positions. Third, monetary policy geared towards price stability and finally a comprehensive reform of the financial sector.

First, strengthening growth prospects. Structural reforms leading to higher growth and employment are crucial to support a sustainable recovery.

We know very well that structural reforms pay off. For instance, measures which increase competition in the consumer markets can curtail monopoly rents and lead to higher employment and output. The introduction of the Single Market, for instance, has – according to estimates of decreased monopoly rents by a quarter.[1] Studies have also found that this may have increased potential output in the range of 5–10 percent.[2] Also labour market reforms, such as for instance an adjustment of the unemployment benefit replacement ratio by 5 percentage points has been estimated to give rise to 1.5% more output and 1.7% more employment over a period of 5 years.[3]

Therefore, policies to enhance competition and innovation are needed to speed up restructuring and investment and to create new business opportunities. Increased labour market flexibility, but also investments in education and research are required to create employment opportunities and enhance competitiveness. Restructuring of the banking sector, aiming at solid business models, better risk management and increased transparency will be key.

In this respect, the European Commission has recently put forward its Europe 2020 strategy. The aim of this strategy is to deliver higher levels of employment, productivity and social cohesion. Europe can come out stronger from the crisis, if it seizes this opportunity to implement the reforms that are necessary.

Second, fiscal sustainability. Sound public finances are the basis for an economy to prosper and to develop in a sustainable way. This is particularly important in a monetary union, such as the euro area, where sixteen individual countries have a common monetary policy.

A number of euro area governments have adopted fiscal consolidation measures and set out ambitious fiscal targets. On 7 June, the euro area finance ministers agreed on the spring 2010 orientations for fiscal policies in euro area countries. We welcome the commitment to take additional measures, where needed, in order to ensure the achievement of the budgetary targets for 2010 and beyond.

Will these consolidation efforts have a negative impact on growth? In the short run, the effect will very much depend on the economic outlook and to what extent public demand will be replaced by private demand. Our current estimates foresee some dampening impact on growth, but not a very significant one, depending on the fiscal instrument that is used. In the long run, however, the benefits of fiscal consolidation prevail. An illustrative analysis of multi-year fiscal consolidation programmes conducted by our experts which we have published in the July edition of our Monthly Bulletin suggests that the long-term economic

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[1] H. Badinger, 2007, Has the EU's Single Market Programme Fostered Competition? Testing for a Decrease in Mark-up Ratios in EU Industries, Oxford Bulletin of Economics and Statistics 69(4), pp. 497–519.

[2] W. Roeger, J. Varga, J. in't Veld, 2008: Structural Reforms in the EU: A Simulation-based Analysis using the QUEST Model with Endogenous Growth, European Commission Economic Papers No. 351; T. Bayoumi, D. Laxton, P. Pesenti, 2004: Benefits and Spillovers of Greater Competition in Europe: A Macroeconomic Assessment, European Central Bank Working Paper No. 341.

[3] See sources from Footnote 2.

gains of restoring sound fiscal positions in the euro area outweigh by far the short-run costs. According to model simulations, long-run benefits of a permanent reduction in the euro area debt-to-GDP ratio over the years from 90% to 60% are generally in the range of 0.4–2.2% of initial steady-state real GDP.[4]

Therefore, cohesive action at a European level is essential. Each country needs to live up to its responsibilities, and European governments need to work together. This goes hand in hand with the conclusions of the G20 meeting in Toronto last weekend, where the G20 economies committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016. This should support a sound, longer-term economic recovery on a global level.

Third, price stability, which is our primary objective. As I have mentioned, we have used both standard and non-standard, temporary monetary policy measures during the crisis period to ensure price stability.

We remain firmly committed to price stability over the medium to longer term. We have done so in the past – with average annual inflation in the euro area over the past 11 years since the inception of the euro of only 1.98% – and we will do so in future.

This is also seen by financial market participants. In particular, inflation expectations in the euro area have remained well-anchored in line with the Governing Council's definition of price stability, also throughout the financial crisis. This can be seen in different indicators, for example in the Survey of Professional Forecasters, where inflation five years ahead is continuously expected to stand either at 1.9% or 2.0% since the beginning of 2002.

Thus, the ECB is credible in the delivery of price stability. This credibility is not only key in the implementation of monetary policy, but it is the necessary and central contribution that monetary policy makes to fostering sustainable economic growth, job creation and financial stability.

Fourth, financial stability. It is important to step up efforts to ensure financial stability. In many respects, the recent crisis can be seen as the direct result of vulnerabilities and imbalances in the financial system. We have all felt the negative effects that the financial crisis had on economies around the globe.

To build a safer financial system, the responsible authorities need to enhance their financial sector surveillance, both at a micro-prudential and macro-prudential level. Financial institutions also play a decisive role, as they have to improve their risk management practices. A key challenge for policy-makers will be to design appropriate responses to enhance the stability of the financial system without imposing restrictions that would unnecessarily hamper financial innovation and reduce the efficiency of the system.

At the micro-prudential level, several initiatives are now underway to create more effective supervisory regulation, taking into account the lessons learnt from the crisis. The proposals of the Basel Committee – known as "Basel III" – aim at enhancing capital and liquidity regulation to improve loss absorption, mitigate procyclicality and increase the resilience against shocks. These measures – when phased in gradually with the economy recovering – contribute to long term economic growth, not least by preventing such high costs of a crisis we are currently experiencing.

If there is one uncontested lesson from the crisis it is that systemic risks were largely underestimated and, therefore, make the development of a comprehensive macroprudential supervision absolutely essential.

4 ECB Monthly Bulletin, July 2010.

An effective macro-prudential framework aims at delivering a thorough analysis of systemic risks, as well as the formulation of appropriate policies to address such risks identifying, in a timely fashion, the emergence and build up of critical vulnerabilities, and deciding on effective (pre-emptive) intervention.

Central banks have a very important role in this regard. At the European level, a new body will be set up: the European Systemic Risk Board (ESRB), which will be an independent body responsible for conducting macro-prudential oversight of the EU's financial system as a whole and which will be supported analytically and logistically by the ECB.

The ESRB should be seen as a component of a global framework of macro-prudential oversight, also allowing it to contribute to the assessment and containment of global risks. In this sense, systemic risk surveillance and preventing those risks from materializing will be a key contribution to sustainable long term growth prospects.

Conclusion

Let me conclude.

The global crisis of the last years has shown that policymakers around the globe have acted successfully. Confidence has come back. With our policy actions, we at the ECB have supported credit flows to the economy and thus dampened the negative effects of the crisis to the extent possible. Looking ahead, we now need to draw lessons from the crisis and focus on the elements that ensure that the global recovery is sound and sustainable.

For this, I believe four elements are essential. These are strengthening growth prospects, fiscal sustainability, price stability and financial stability.

For price stability and financial stability, central banks play a key role. They will shape the global recovery by maintaining price stability and safeguarding financial stability. Price stability is the central contribution that monetary policy makes to economic growth, to job creation and to financial stability.

Financial stability, in turn, will be a major focus of policy-makers in the aftermath of the crisis. Central banks have specific tasks and responsibilities in this domain. For example, the ECB will contribute to the ESRB to conduct macro-prudential oversight at a European level.

Of course, central banks cannot act alone. Actions are required to address all conditions and challenges to spur long term economic growth. We all have to work together. National governments, regulators and supervisors, and the private sector and financial industry have to proceed with the difficult, but vital, measures required to ensure a sound basis for economic growth.

With China being one of the most important trading partners for the euro area and vice versa, recovery in the euro area and China is in our mutual interest. I am confident that we are on a good track.

Thank you for your attention.