Carlos da Silva Costa: The origins of the crisis and future prospects

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Centro Português de Estudos, London, 16 June 2011.

* * *

Introduction

Good Evening Ladies and Gentlemen. It is a real pleasure to be here.

Four years after the beginning of the largest financial crisis since the Great Depression global financial stability has yet to be secured and many policy challenges remain to be addressed.

Indeed:

- Global recovery is not proceeding at a balanced pace;
- Large global imbalances persist;
- Widespread public debt sustainability concerns have emerged;
- And links between weak balance sheets of both governments and the banking sector have led to renewed tensions in financial markets, particularly affecting the euro area.

Against this background, my intention today is to review the origins of the crisis and discuss future prospects.

1. What has happened?

The great moderation and regulatory failure

The causes of the global financial crisis are now well understood.

The mid-1990s marked the start of a decade of sustained macroeconomic growth and low inflation – a period which has become known as “the Great Moderation”. Globalisation has favored benign macroeconomic conditions, creating the illusion of a new paradigm in the economy. Low consumer inflation eased the pressure on central banks – most notably the US Fed – to tighten monetary policy and rein in credit growth.

Rather than translating into consumer price inflation, credit expansion, deriving from the ample liquidity and low interest rates, has led to fast rising asset prices. In particular, very low US interest rates have promoted the rapid expansion of consumer and mortgage credit, fuelling a widespread housing bubble.

Regulatory and supervisory failures have amplified these developments. Indeed, relevant factors to explain the magnitude of the financial bubble and the subsequent disruptions include:

- Wide-ranging financial de-regulation;
- Pro-cyclical elements in regulatory frameworks;
- Insufficient attention devoted to financial interconnectedness and macro-systemic and liquidity risks;
- And, last but not least, lack of market transparency.

The transition to the self-regulation paradigm and the move from the "originate-to-hold" to the "originate-to-distribute" business model have created perverse incentives: emphasis was put on expanding lending, rather than on the borrower's ability to pay.

Accumulation of imbalances in the US economy has mirrored the build-up of large global imbalances. Indeed, current account surpluses in emerging countries, most notably China, were invested in US securities and other low-risk assets further amplifying liquidity and depressing yields. This has encouraged investors elsewhere to search for higher yields in riskier assets, resulting in severe underpricing of risk.

The EMU accession impact

In Europe, specific developments were also at play, the most significant one being the plans to set up an Economic and Monetary Union. As from the mid-1990s, the prospect of EMU fostered the rapid convergence of interest rates to the levels prevailing in Germany (the anchor country in the then Exchange Rate Mechanism).

Prospective EMU members – especially those with worse track-records in terms of macroeconomic stability – initially benefited from a virtuous cycle between nominal convergence and the prospect of EMU participation.

In these so-called "converging" countries, policy efforts towards fiscal consolidation and lower inflation have increased the likelihood of EMU participation (as these countries became closer to fulfilling the Maastricht criteria); in turn, a higher probability of joining EMU has facilitated exchange rate stability, the convergence of interest rates to the lowest levels in the EU (declining risk premia) and the improvement of the budget balance (lower interest payments on public debt).

The magnitudes involved were impressive: long-term interest rates in Portugal declined from over 12 per cent in April 1995 to around 4 per cent in December 1998, just before the country adopted the euro. During the same period, the 10-year interest rate differential against the D-mark narrowed from over 5 p.p. to about 0.3 p.p. Interest expenditure more than halved, dropping from 5.6% of GDP in 1995 to 2.4% in 2005. Similar developments occurred in other converging countries like Italy, Ireland, Spain and, with some lag, also Greece.

As could be expected, this very substantial easing of liquidity constraints – arising both from the interest rate decline and access to a huge wholesale market for funding – led to booming private sector credit and lower savings. Households' consumption of durables and housing investment soared and corporate leverage increased significantly. Large current account deficits emerged in the converging countries as a counterpart to the boom in private spending.

The public sector has also benefited from lower interest rates and easier access to credit. In addition, booming private expenditure has pushed up tax revenue. All else equal, this should have meant substantially improved overall and primary balances, as well as declining debt levels.

Prudent fiscal management should have recommended that the boom in private spending be partly offset, even if only by letting automatic stabilisers play their role. However, while private sector dynamics were very similar within the group of converging countries, the behavior of the public sector was markedly different.

As this "new world" of low interest rates and abundant financing seemed to offer a free lunch to the converging countries, several imbalances started to build-up. Such imbalances took different shapes:

- In countries such as Portugal or Greece, fiscal imbalances became a major problem – even if the size of the problem was, and actually is, substantially different. In both countries, savings arising from lower interest rates and boom-related windfall revenues were used to finance expansionary expenditure policies. When interest rate convergence was completed and the initial impact of EMU on growth disappeared, the underlying unsustainable fiscal policies soon became apparent.

Also, structural bottlenecks arising from lack of competition and an excessive weight of the public sector in the economy, contributed to an overexpansion of the non-tradables sector, hampering competitiveness and aggravating external imbalances.

- In countries such as Spain or Ireland, fiscal policies were more prudent. Still, imbalances built-up, mainly taking the form of a real estate bubble.
- In Ireland, an oversized financial sector developed in tandem with the real estate bubble (a similar phenomenon also occurred in non-euro area countries, the most prominent case being Iceland).

As the financial crisis emerged in mid-2007, and then developed into global recession, the response of policy authorities around the world was the massive provision of liquidity by central banks coupled with huge fiscal expansion and the assumption or guarantee of banks' debts by governments. The aim was to mitigate the impact of the crisis on output and employment and to prevent a fully-fledged crisis that could resemble that of 1929. The consequence was of course a strong deterioration in the balance sheet of the public sector in general.

The resulting sustainability concerns, especially for those countries where the room for maneuver was more limited, have brought us to the third stage of the crisis, where we now are – the sovereign debt crisis, which has so far mainly affected the euro area peripheral economies.

2. How to explain what has happened?

With the benefit of hindsight, how can we explain the developments of the past 15 years?

How was it possible that such high current account deficits persisted in a number of euro area countries without financial markets questioning these countries' ability to repay their increasing debts?

Well, first and foremost, it cannot be ignored that, as a regime change, EMU had a major impact on the formation of expectations, the transmission channels as well as the equilibrium values of key economic variables. This made it extremely difficult to assess developments in real time, causing very reasonable and competent people to disagree about the best explanation, and therefore to advocate different policy responses.

For a number of years, the dominant view in academic and policy circles, as well as in financial markets, was what we might call the "***benign view***".

Many respectable economists and policy-makers claimed that current account imbalances were the expected result of deeper integration among countries with different levels of economic development. In a monetary union, a current account deficit reflecting the financial balance of the private sector would be no cause for concern. Credit risk monitoring would ensure adequate risk-pricing, and there would be no aggregate (and thus policy-relevant) macroeconomic imbalance.

This view found support in the predictions of standard macroeconomic frameworks. In a neo-classical growth model, an interest rate fall caused by a drop in the home country's idiosyncratic risk premium leads to higher consumption (through the wealth and inter-temporal substitution effects) and stimulates investment (reflecting a permanently lower user cost of capital). The initial disturbance also causes an increase in the relative price of non-traded goods (an appreciation of the real exchange rate) and an increase in real wages. Excess demand is then progressively eliminated on account of both improved supply conditions (reflecting the initial higher investment) and lower expenditure on consumer durables and housing investment (as the latter has adjusted to new equilibrium levels). The implied adjustment process is slow and efficient.

As it turned out, higher potential growth did not materialise as the investment boom was largely concentrated in non-productive investment (construction) and/or was soon reversed. Indeed, an alternative explanation of the converging countries' adjustment to EMU can be obtained from a standard intertemporal macroeconomic model without a production sector. Such a model illustrates the crucial importance of the intertemporal substitution effects in consumption that dominated EMU's early years. In this model too, the implied adjustment process, which will eventually be triggered by the accumulation of foreign debt, is slow and benign.

The assumptions underlying the benign approach turned out to be highly unrealistic and misleading from a policy perspective. Indeed, the conceptual frameworks described above abstract from the key realities of life such as complex expectations formation mechanisms, the possibility of default, the absence of frictions in product and labour markets or imprudent fiscal behaviour.

With the benefit of hindsight, it is clear that a more "***prudent view***" was warranted. Overoptimistic expectations about future growth prospects and short-sightedness, weak domestic institutions and real and financial frictions should have made a strong case for policy intervention aimed at mitigating the boom-bust pattern of monetary integration.

The buffers that would have resulted from lower public debt and stronger capital in the banking sector would have put the converging economies on a much sounder position to face the financial storm. Also, a more ambitious and consistent approach to structural reform would have left these economies better equipped to face the challenges of globalisation and ageing. Shall we infer from this view that only domestic policy and institutional failures are to be blamed for the current state of affairs in Europe?

The answer is clearly negative. While it is true that inadequate – and in many instances irresponsible – domestic policies go a long way in explaining where we are, one must also acknowledge that ***an incomplete EMU architecture*** is also key to explaining the current situation.

The EMU model of economic governance rests on ***four key principles***:

- Euro area members' ***fiscal sovereignty*** – in contrast with monetary unification, Member States maintain responsibility for fiscal policy, subject to common rules and procedures at EU level;
- ***No default*** – the possibility of orderly sovereign debt restructuring has not been considered;
- ***No bail-out*** – no crisis management mechanism has been established;
- ***No-exit*** – the possibility of one member abandoning the euro is not envisaged.

The Maastricht Treaty drafters were perfectly aware that we could not rely on market forces alone to ensure discipline and the correction of imbalances. Numerous historical episodes have shown that financial markets tend to be too slow and weak in penalising profligacy in normal times, and can suddenly turn disruptive and cause overshooting during crisis.

In order to contain moral hazard and prevent disruptions, the Stability and Growth Pact was agreed as a complement to the Maastricht architecture. The Pact sets budgetary rules and procedures to reinforce fiscal discipline at the national level. It was intended to avoid gross fiscal policy errors, through peer monitoring and peer pressure, as well as through the threat of sanctions.

However, implementation of the Pact was rather weak in EMU's early years. Tensions emerged already in the early 2000s, and in November 2003, when action should have been taken against both France and Germany, the ECOFIN Council decided not to act, overruling the European Commission. This unwillingness to apply the rules was a "mortal sin": a clear message was sent to the other euro area members that the Pact was not there to "bite". More generally, I would say that weak economic governance in the euro area had three major consequences:

- First, inadequate domestic fiscal policies were tolerated, leading to unsustainable fiscal positions in some countries and tensions in the conduct of the single monetary policy;
- Second, insufficient attention was devoted to losses of competitiveness and the accumulation of current account imbalances within the euro area;
- Third, and probably most important, the correlation between the ability of the financial sector and of the sovereign states to obtain financing was largely ignored. On the one hand, the market for funding was highly integrated within the euro area (i.e., the money market and the sovereign debt market); on the other hand, banking ownership and lending continued to be essentially domestic-based. The fact that the banking system and the sovereign states shared the same frontier meant that their ability to borrow depended on the same set of fundamentals. This inter-dependence turned out to be a major source of macro-systemic risk in the euro area.

The sovereign debt crisis has brought to the forefront the failures in EMU economic governance, and has exposed the particular vulnerability of euro area Member States to changes in markets' sovereign risk perception.

Indeed, when a country has its own free-floating currency, a loss in market confidence translates into a bond sell-off, which in turn leads to higher yields and exchange rate depreciation, leaving (all else equal) money supply, and the supply of credit to the private sector broadly unaffected. Also, the national central bank acts as a lender of last resort. Therefore, investors cannot precipitate a liquidity crisis that could force the country to enter into default.

In contrast, for a country belonging to monetary union, a loss of confidence and the resulting bond sell-off imply not only higher yields, but a shortage of liquidity, which can easily turn into solvency problems.

Crisis management by the EU has not been particularly effective in restoring market confidence. While swift and resolute action has been taken towards strengthening the EU's financial architecture, the EU has clearly been running "behind the curve" in dealing with the sovereign debt crisis. As a result, the ECB has been confronted with the inevitability of playing a compensating role, testing the limits of its mandate.

3. What do we need to do?

As mentioned, the root causes of the current crisis, both the global financial crisis and its ramifications in the euro area, are now well understood.

The issue to consider now is what to do. Measures have to be taken both at the national and at the EU level. To be successful, national and EU measures need to be consistent, both as regards their design and their timing.

At the national level, it is clear that utmost priority must be placed in restoring public debt sustainability, increasing domestic savings and enhancing potential growth in the crisis-hit countries. These are necessary conditions to stabilise external debt and put it on a downward path. These objectives are at the core of the recently approved financial assistance programme to Portugal.

At the EU level, a new economic governance model is needed to deliver fiscal discipline, prevent sustained losses in competitiveness and promote financial stability.

For this purpose, in October 2010, the European Council endorsed the proposals put forward by a special Task-Force on economic governance led by President van Rompuy. ***The new economic governance model*** will comprise:

- A reformed Stability and Growth Pact, aimed at enhancing the surveillance of fiscal policies and applying enforcement measures more consistently and at an earlier stage;
- New provisions aimed at strengthening national fiscal frameworks; and
- A new surveillance mechanism of macroeconomic imbalances.

The legislative package that will establish the new economic governance model is being negotiated between the Council and the European Parliament, and agreement is expected before end-June.

The so-called ***Euro Pact +***, agreed in March by the euro area Member States, and joined by 6 other EU countries, aims at strengthening policy coordination even further. The Pact focuses on those areas falling under national competence which are key to increasing competitiveness and avoiding potentially disruptive imbalances.

It remains to be seen whether the new surveillance framework that will soon be adopted will prove sufficient to ensure a smooth functioning of the euro area. The ECB has highlighted the importance of ensuring greater automaticity in the surveillance and sanctions procedures and of increasing the political and reputational costs for non-compliance.

The strengthened economic and budgetary surveillance procedures will be complemented by an enhanced regulatory and supervisory framework at EU level. Following the recommendations of the de Larosière Group, the European System of Financial Supervisors was established, comprising (i) new European Supervisory Authorities (the so-called ESAs) for banking, insurance and securities markets and (ii) the European Systemic Risk Board (ESRB) to address macro-prudential matters.

In addition, an EU framework for cross-border crisis management in the banking sector is being considered and, a ***European Stability Mechanism*** (ESM) – a permanent facility to provide financial assistance to euro area Member States subject to strict conditionality – is expected to become operational at the beginning of 2013. The EMS will have an effective lending capacity of €500 billion, to be reviewed on a regular basis.

The ESM concrete design is now being negotiated, even if its broad features have already been agreed and announced by the European Council. A number of question marks remain, in particular as regards the extent of private sector involvement, whether the ESM is to act more as a preventive or a rescue tool, and also how, and to which extent, intervention in primary debt markets may take place. Key challenge is how to prevent temporary liquidity problems from becoming solvency problems while at the same time minimising moral hazard which is always implicit in any ex-ante rescue mechanism.

Other institutional innovations have been proposed, among which the ***possible creation of euro-bonds***. So far, this proposal has not been enthusiastically received by many Member States. However, the European Parliament, the European Commission and a few Member States have shown some interest and I believe that the debate on this issue is far from over.

Conclusion

To conclude, these are undoubtedly challenging times for us all. The crisis has shown the need for enhanced international cooperation, better governance, strengthened market supervision and increased transparency. This is relevant not only for governments, but also for central banks and supervisory authorities.

As rightly pointed out in the de Larosière report,

"… The world's monetary authorities and its regulatory and supervisory financial authorities can and must do much better in the future to reduce the chances of events like these happening again."

Thank You.

London, 16 June 2011

References

Barbosa, António Pinto et al., (1998), O Impacto do Euro na Economia Portuguesa, Lisboa, Publicações D. Quixote.

Blanchard, Olivier and Francesco Giavazzi (2002), "Current Account Deficits in the Euro Area: the End of the Feldstein-Horiokka Puzzle", Brookings Papers on Economic Activity, 2:147:209.

De Larosière et al (2009), Report by the High-Level Group on Financial Supervision in the EU, http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

European Central Bank, "Opinion of the European Central Bank of 16 February 2011 on economic governance reform in the European Union" (CON/2011/13), Official Journal of the European Union, 25/5/2011,
http://www.ecb.europa.eu/ecb/legal/pdf/c_15020110520en00010041.pdf

European Council Conclusions – 24/25 March 2011,
http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf

Fagan, Gabriel and Vítor Gaspar (2008), "Adjusting to the euro", Chapter 4 of Bulding the financial foundations of the euro – Experiences and challenges, Jonung, Lars, Walkner, Christoph and Max Watson (eds), Routledge, 2008 (also available as ECB Working Paper N.716, January 2007).

Von Rompuy et al (2010), Strengthening Economic Governance in the EU – Report of the Task-Force to the European Council, 21 October 2010,
http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf