Ewald Nowotny: The global economy – challenges and prospects

Opening remarks by Prof Dr Ewald Nowotny, Governor of the Central Bank of the Republic of Austria, at the Annual Meeting of Czech Ambassadors, Vienna, 29 August 2011.

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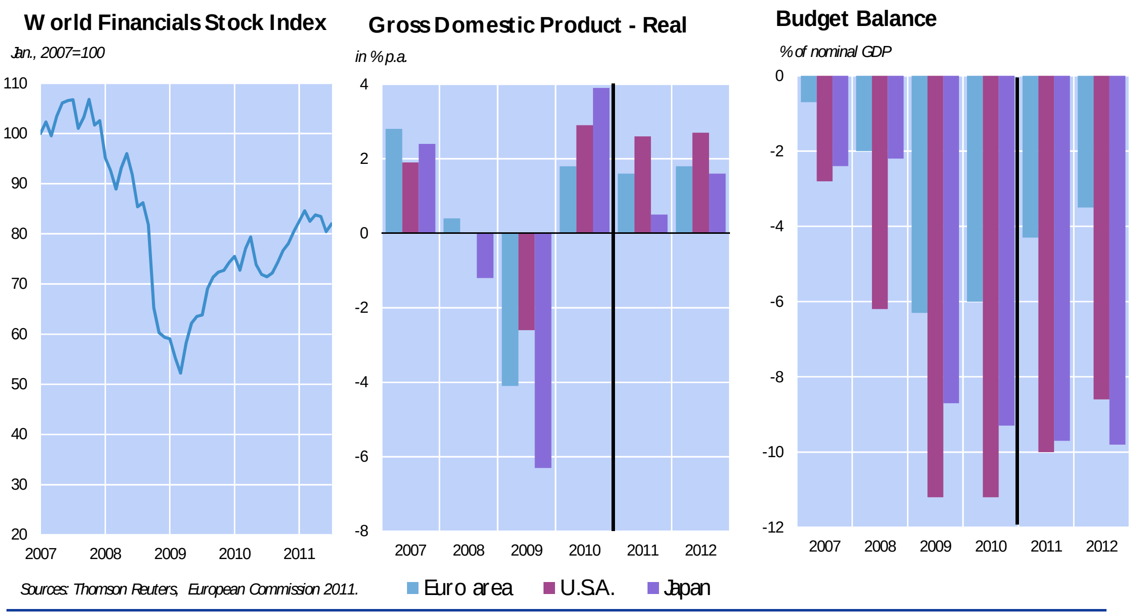
1. The global economy – unbalanced and fragile recovery

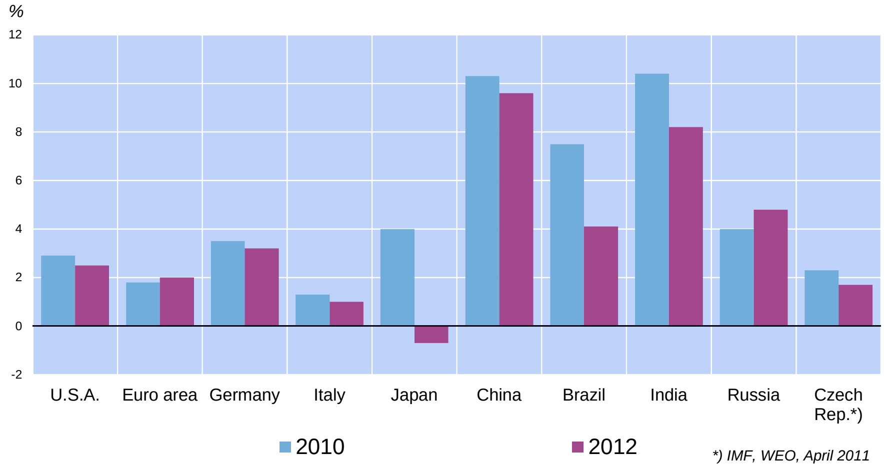
- Since the beginning of the global financial crisis, uncertainty about economic recovery and economic prospects in general has been elevated. What initially appeared to be an exceptionally rapid recovery after an exceptionally deep financial crisis turned out to be very fragile, unbalanced and globally uneven.
- Unlike in periods after earlier crisis episodes, this time growth rates in industrial countries remained at moderate levels, unemployment rates ceased to decline further and private consumption remained hesitant. The need to consolidate fiscal balances in all industrial countries after rapid deterioration further dampened consumer and business confidence. In some cases, the weakness of the recovery was amplified by adverse shocks such as the fatal earthquake in Japan.



- Many emerging markets, by contrast, struggled with an overheated economy and mounting inflation. Massive capital inflows put upward pressure on the exchange rate and harbor the risk of sudden reversals. Monetary and fiscal tightening as well as exchange rate interventions were initiated to cool demand, curb inflation and prevent the build-up of asset price bubbles, but the success of these measures has been only limited.
- In such an environment, adverse economic data and uncertainty about policy decisions can have severe effects on financial markets. With the protraction of negotiations about the lifting of the U.S. budget ceiling and the series of emergency meetings to solve the European debt crisis, market participants have become increasingly nervous. During the summer months, when markets are, in general, relatively dry and rely heavily on automatic stop-loss policies, adverse tendencies can easily become self-perpetuating. In such an environment, even good news

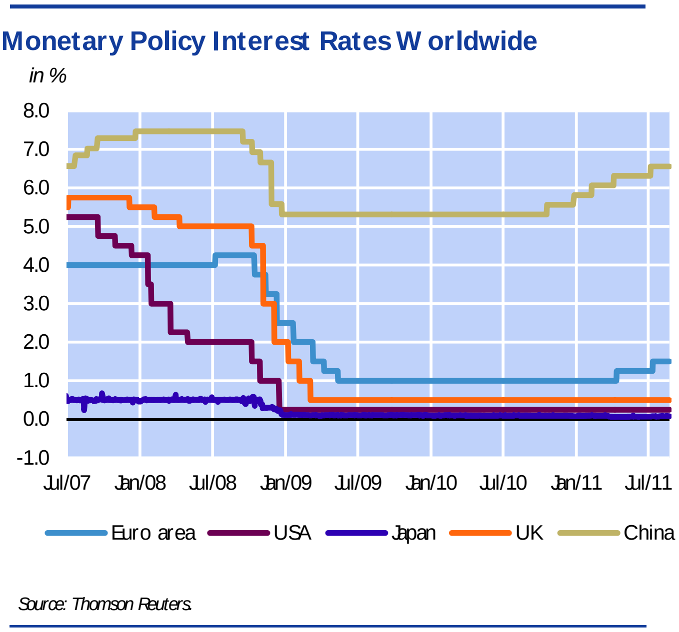
about the successful settlement of the U.S. debt ceiling conflict and far-reaching decisions at the European level can bring only minor relief.

Real GDP Growth in Selected Countries



Source: IMF, WEO, Update June 2011. 2012: forecast

- After the downgrading of U.S. debt and a series of adverse economic data releases, stock market prices plummeted around the world. At the same time, demand for U.S. bonds increased – a clear sign that investors seek safe haven investment alternatives in a highly uncertain environment. At the European level, we recently observed an increase in recourse to the Eurosystem's deposit facility, an alarming indication for mounting distrust among commercial banks.
- This re-emergence of financial market tensions led to swift monetary policy action worldwide. Central banks, which had already started to phase out some of their exceptional policy measures implemented during the crisis and had begun the monetary tightening cycle, envisaged the re-introduction of some of their expansionary policy measures. The Federal Reserve announced its commitment to keep key interest rates at the current low level at least until 2013. The Eurosystem responded to increasing liquidity needs by re-introducing longer-term (i.e. 6-month) liquidity operations. This will ensure that banks' temporary liquidity constraints do not turn into solvency problems.
- Overall uncertainty is currently exceptionally high, not only with regard to the further speed of recovery, but also with regard to the ability of policy action to re-establish market confidence. Jean-Claude Trichet, President of the ECB, recently referred to the current situation as the worst crisis since the Second World War.



- While I see important parallels to the situation of 2008, I also see important differences. Back then, private indebtedness was at the origin of the crisis. Since then, households, businesses and financial institutions have deleveraged successfully. Saving ratios have reached solid levels, the capital endowments of most banks are healthy, and asset bubbles and overly optimistic business ratings have bounced back. In the current crisis, by contrast, it is the excessive public indebtedness of individual countries that is at the origin of market tensions – a problem that will have to be solved at a completely different level.

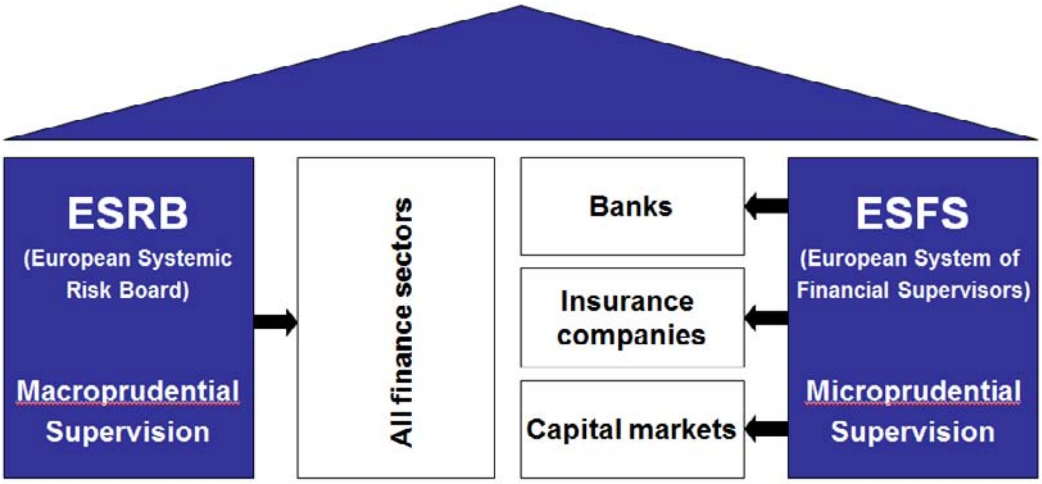
2. Five lessons to be learned from the global financial crisis

- The global financial crisis shares several characteristics with past crisis episodes. Among these are the rapid financial market liberalization in the years prior to the crisis in combination with an insufficient regulatory framework, a build-up of asset price bubbles and the widening of global imbalances. An exceptionally long period of high growth and low inflation made financial market participants less aware of risks. All these factors promoted an unsustainable explosion of asset prices and private indebtedness.
- At the same time, the global financial crisis was in several respects unique and required policy reactions in uncharted waters. Central bankers had to learn to expand their portfolio of policy instruments. In addition to cutting interest rate to historically low levels, central banks around the world provided ample liquidity at a higher frequency and with longer maturities to a larger group of financial institutions and against an extended list of collateral, agreed on foreign exchange swap lines and entered new territories by buying assets on secondary markets.
- A factor that was seriously underestimated was the global character of the crisis and the international linkages that go beyond trade links. This particular factor contributed to uncertainties about economic prospects and required an unseen level of international policy coordination.
  - ***A first lesson*** to be learned from the past crisis is the need to rewrite not only economic theory, but especially our forecasting and risk models. Traditionally, these models omit many potentially important contagion channels such as the

sudden reversal of capital flows or the correlation of business and consumer confidence across continents. At the same time, many historical patterns and regularities are still valid, but need to be reassessed in the light of the most recent experience. We should learn our lesson from history, being extremely careful with ex ante assessments that state – in the words of Carmen Reinhart and Kenneth Rogoff – that “this time is different.”

- A specific aspect that was underestimated was the impact of the global interlacement of the financial system. Today, calamities of single financial institutions may quickly provoke a chain reaction and ultimately lead to a systemic crisis. This calls for the global coordination of supervisory activities.
  - ***The second lesson*** to be learned is thus that the health of a single financial institution is no sufficient condition for its immunity against contagion. Microfinancial supervision, therefore, needs to be supplemented by macrofinancial supervision. Around the world, central banks and financial supervisors have taken this aspect seriously and have started to establish new supervisory authorities and strengthen the coordination of supervisory bodies, both at the national and the international level.

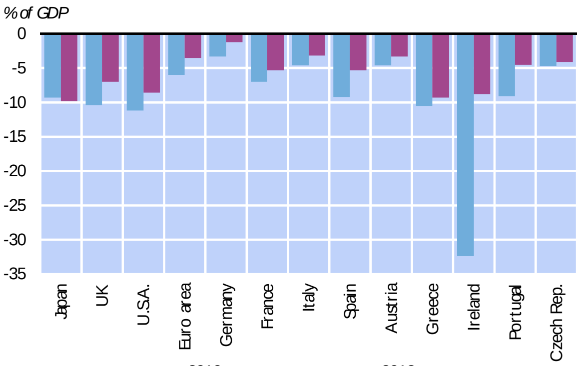
Financial Stability: A New European Supervisory Framework



- The new European financial supervision architecture aims at strengthening the crisis resilience of banks by boosting capitalization and improving capital quality. A macroprudential supervisory framework for the early identification of systemic risks as well as a new legal framework for crisis management have been established. Within the European System of Financial Supervision (ESFS), the European Systemic Risk Board (ESRB) was established as an institutionalized early warning system for financial market risk. Three new supervisory authorities deal with microprudential risks in banks, insurance companies and financial markets. Stress tests indicate, at an early stage, the possible recapitalization needs of individual financial institutions.
- Similar initiatives are under way at the international level. At the end of 2010, the Basel Committee on Banking Supervision agreed on a new international regulatory framework for banks, known as Basel III. In the U.S.A., the Dodd-Frank act aims at improving the transparency of the U.S. financial system and approaches the “too-big-to-fail” problem. This last aspect is of special relevance for Austria’s neighboring country Switzerland.

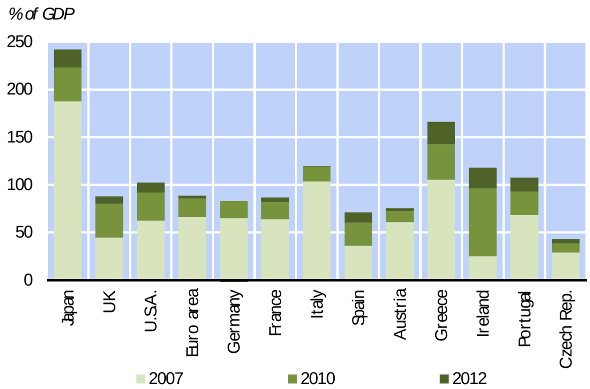
- Central banks have not only played an essential role as lenders of last resort during the crisis, they are also actively involved in shaping the new financial supervisory architecture. Since 2008, the Oesterreichische Nationalbank (OeNB) shares the responsibility for macroprudential supervision with the Austrian Financial Market Authority. The role of central banks in this area has changed dramatically over recent years.
  - This leads me to the ***third lesson***: We need to redefine the financial stability scope of central banks. Should central banks – in addition to warranting price stability – be given a clear mandate to prevent asset bubbles? I see serious risks for potential goal conflicts if central banks were to pursue price stability and asset price stability goals simultaneously. I am confident that the Eurosystem's two-pillar strategy, which supplements the short- to medium-term perspective of economic analysis by longer-term risk analyses derived from monetary and credit indicators, is an adequate tool to contribute to ensuring financial stability.
- Strengthening national and international coordination and forward-looking policies is not only a challenge with a view to financial stability but more generally with regard to the interaction of economic policies. The readiness of governments worldwide to fight an exceptionally deep economic contraction with large fiscal stimulus packages was certainly a major reason why the recession was overcome so quickly. This swift return to positive – although moderate – growth was, in many cases, instrumental in avoiding worse and self-reinforcing negative effects on structural unemployment, consumer confidence and risk aversion.

Budget Deficit in Selected Countries



Source: European Commission. 2012: forecast.

General Government Gross Debt in Selected Countries



Source: European Commission. 2012: forecast.

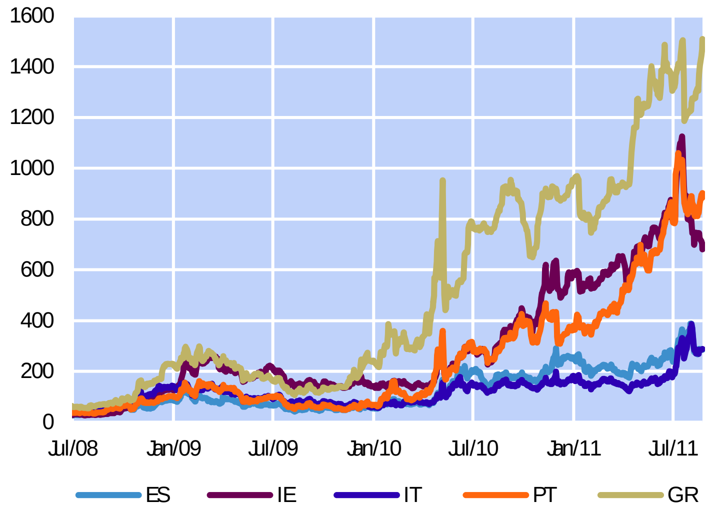
- However, this strong fiscal reaction also came at high costs. Budget deficits exploded and debt-to-GDP ratios reached record levels. In some highly indebted European countries, this translated into a veritable debt crisis. Markets that, for years, had failed to adequately price fiscal imbalances, rediscovered risks associated with high debt levels.
- When markets react late, they tend to overreact. Thus, bond spreads and the price for credit default insurances soared. Rising refinancing costs further aggravated fiscal consolidation. As recourse to market funds is currently not possible, the highly indebted countries need international financial assistance to tide them over until fiscal consolidation starts to be effective and markets regain confidence. But even if markets will have stabilized, debt stabilization will require many years of substantial primary surpluses.

– ***The fourth lesson*** to be learned from the crisis is therefore that we need to improve fiscal policy frameworks. We need a long-term commitment to fiscal stabilization at the national level and effective warning and supervisory mechanisms at the European level. We need to make sure that – once the worst is over – good economic times are used for fiscal consolidation so that fiscal margins are there when the next recession approaches.

- An exceptional crisis calls for exceptional measures. While it was commonly accepted prior to 2008 that rules-based fiscal approaches and the free operation of automatic fiscal stabilizers are best suited for ensuring long-term sustainability, the severity of the recession and the high level of uncertainty has led to a renaissance of fiscal discretion. Quick and determined action was certainly a key factor in keeping the recession short. However, long implementation lags of some of the anti-crisis measures and the inflexibility of budgeting processes are also at the origin of the strong deterioration of debt levels.

Spread of Ten-Year Government Bonds vis-à-vis Germany

basis points



Source: ECB.

- A focus on the measures with the shortest implementation lags as well as a regular reassessment of the adequacy of the size of the respective fiscal stimulus might have saved substantial funds in several countries and put them in a better position to weather the next crisis. We need to get back to the rules-based fiscal system that for decades proved to be best suited for providing long-term stability.

- An improved fiscal framework and well-functioning supervisory and warning procedures in Europe are even more important as recent years have taught us that we cannot rely on financial market mechanisms as the penalizing factor for bad fiscal behavior. One week before Lehman Brothers went bankrupt, rating agencies still rated it as "investment grade." Markets responded far too late and then overreacted. Currently, we are in a situation of self-fulfilling prophecies where major rating agencies can actually trigger a crisis just by announcing it.

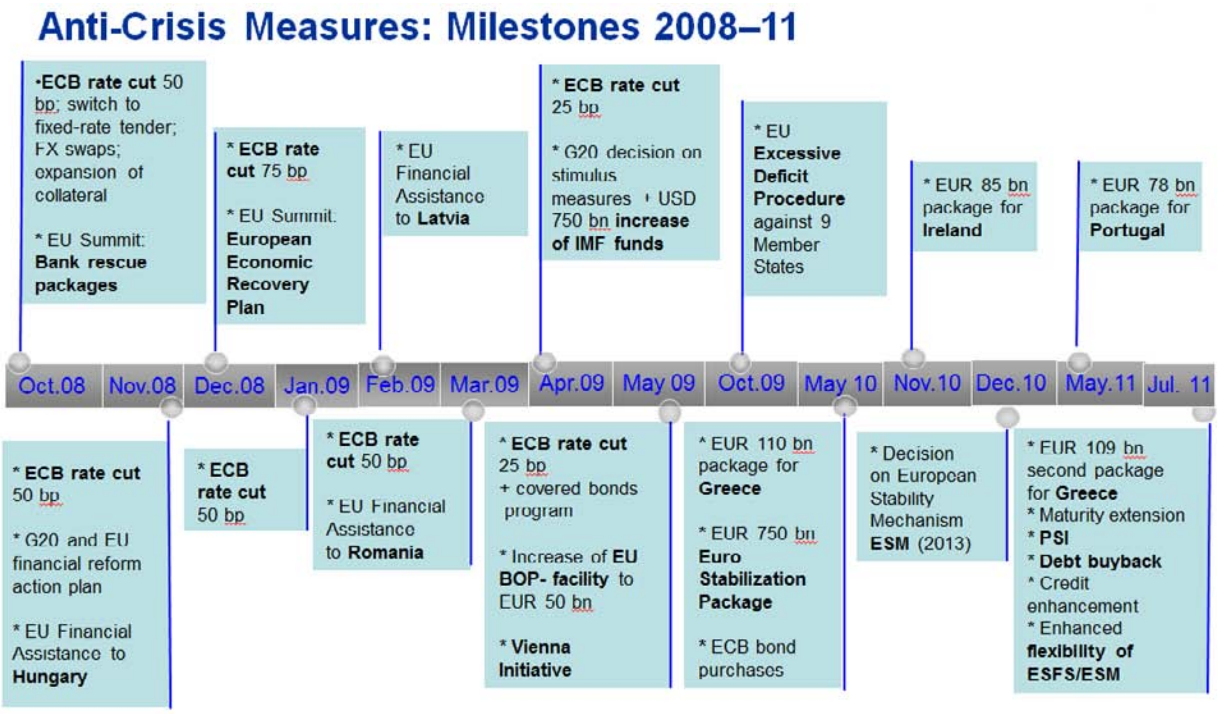
  – ***The final lesson*** I should like to draw from the experience of these past years is that we need to rethink the role of rating agencies. The liberalization of financial markets, which enhanced the influence of commercial ratings, is irreversible. Monetary policy, however, needs to reduce its dependence on assessments made by rating agencies. In that respect, the approach of the

U.S. Federal Reserve might be a good example for Europe. Furthermore, competition among rating agencies needs to be reinforced and supervised.

3. It is up to politics to let the euro unfold its full benefits

- We are currently back in a situation of high economic uncertainty and mounting pressures on the financial markets. In view of a sheer endless sequence of emergency meetings and new crisis measures, some people are beginning to lose confidence in the common currency and in international policy cooperation. I would therefore like to add a few thoughts on the global role of the common European currency and on the benefits the euro offers to euro area citizens.
- In the first years after the introduction of the euro, the citizens of the euro area profited from having a common currency in many respects. In spite of a series of adverse economic shocks, the monetary policy of the Eurosystem has been effective in keeping both inflation and deflation at bay, thus securing the value of the euro. Measured in terms of the Harmonised Index of Consumer Prices (HICP), the euro area inflation rate was on average slightly below 2% between 1999 and 2010, which was in line with the Eurosystem's definition of price stability. Thus, inflation in the euro area countries was 0.4 percentage points lower than in the seven years before the introduction of the euro.
- As exchange rate fluctuations no longer existed within the euro area, trading costs declined not only between euro area countries but also between the euro area and its major trading partners. This promoted the exchange of goods and services and contributed to economic growth.
- The euro and the single monetary policy of the euro area proved to be a shelter during the financial crisis. Rapid action and flexible provision of central bank liquidity secured the functioning of the banking sector and of payment systems in Europe even at the height of the financial market tensions. Moreover, years of strengthened economic policy coordination within the euro area facilitated joint action to safeguard the stability of the financial system and to reform the European system of supervision. After all, during financial storms it is better to be in a large ship than in a small vessel.
- The common currency does, however, not come without costs. Within a monetary union, where monetary and exchange rate policies are no longer the responsibility of national governments, a high level of coordination between fiscal and structural policies and a forward-looking approach are essential to ensure that national policies do not interfere with the common monetary policy.
- The interest rate decline in the countries at the periphery of the European Union was an important factor for their impressive catching-up process, but also the source of mounting internal and external imbalances. Unsustainable labor cost developments and widening external deficits are clear indicators of losses in competitiveness. Housing price booms and excessive credit growth signal asset price bubbles that harbor the risk of sudden trend reversals. At the European level we can support countries by giving advice and – if necessary – by executing peer pressure and providing incentives for adequate policies. We also continue to strengthen the supervisory powers of European institutions under the enhanced Stability and Growth Pact.
- Since the introduction of the euro, many economists have argued that any monetary union faces the risk that the economic developments of some of its members diverge, even if an adequate mix of national policy measures is applied. They have

called for some form of transfer or fiscal union as a complement to common monetary policy. Some have argued that a monetary union without a minimum of fiscal solidarity cannot persist. At the beginning of Stage Three of Economic and Monetary Union, however, the political will to move in that direction was small.



- The recent months have proved that the euro area countries are ready to show a substantial level of solidarity in view of the current debt crisis of some Member States, out of the profound conviction that only the health of each individual euro area country can ensure the health of the euro area as a whole – just like, at many stages during the last decades, obstacles had the potential to mobilize political forces that moved the European integration process forward.
- Currently, Greece, Ireland and Portugal receive financial assistance from European countries and the IMF. This aid takes the form of guarantees and loans extended under strict conditionality. To support these three countries until they will have regular access to market funds again, this aid was recently stepped up by stretching maturities, reducing interest rates and providing additional funds. In the case of Greece, the package of support measures also involves a voluntary contribution of the private sector – an important factor to increase risk awareness among institutional investors – as well as a debt buy-back program. To calm markets and ensure the smooth functioning of the transmission channel, the Eurosystem reactivated its bond purchase program in mid-August.
- The most important step was the constitution of a mechanism to deal with debt crises in EU Member States. The temporary institutions European Financial Stability Facility (EFSF) and European Financial Stabilisation Mechanism (EFSM) as well as the permanent institution of the European Stability Mechanism (ESM) were subsequently endowed with additional funds and competences. Soon the EFSF will be able to buy bonds on the secondary market and contribute to the recapitalization of financial institutions. It will have a clear mandate to act in a forward-looking manner to prevent crises.

- The solidarity, member countries have recently demonstrated, does, however, have clear limits. In the end, it will therefore be up to every single euro area country to draw their own lessons from the crisis and to understand that the benefits of the common currency can only be fully reaped if policies at the national level contribute to the European idea and goals.

4. Multiple global fault lines require determined and coordinated action

- Overall, we are currently facing a highly precarious situation. Within an environment in which economic recovery proceeds at diverging speeds, all important economic regions struggle with specific challenges.
- In ***Europe***, the debt crisis in some countries at the periphery of the EU threatens to spread to individual core economies. Even though these countries share certain vulnerabilities with the highly indebted countries, the extent of the financial market reaction is not justified by economic fundamentals and shows clear contagion signs. These contagion effects require solutions at the euro area level since they may endanger the stability of the common currency.
- Deficit and debt levels are also mounting in the ***U.S.A.*** To a certain extent, its special role as an international reserve currency shields the U.S. dollar. But hesitant recovery and the recent downgrading by a major rating agency point toward emerging market tensions.
- ***Japan*** has, to a large extent, overcome the damages of the catastrophic earthquake. Production lines are mostly operating smoothly and reconstruction is in progress. The high fraction of domestically held bonds and the low interest rates facilitate the roll-over of Japan's record-high debt levels of around 200% of GDP. But in the light of projected further debt increases and the country's recent debt downgrading, the sustainability of public finances should not be taken for granted. The strength of the Japanese yen dampens growth prospects.
- The large capital inflows into ***emerging markets*** entail risks of blowing up asset and housing price bubbles and increasing inflation. Given the international origin of these capital flows, national policies have very limited possibilities of counteraction.
- I am confident that decision-makers – governments, central banks and international institutions – will find appropriate solutions for every individual case at hand. However, the danger of these multiple fault lines is not only their number and severity but also their interconnectedness. As the current situation in Europe shows, increasing market concerns about debt sustainability may quickly spread from one country to another. Just like in 2008, liquidity shortages in industrial countries may force investors to withdraw funds from emerging markets that initially appeared to be decoupled from financial market tensions.
- These global linkages call for enhanced international cooperation. But – to remain realistic – this has its limits. I rather expect the dynamics of global peer pressure and the high current problem awareness among the population to have the potential of opening a window of opportunity for far-reaching reforms.
- I see several options of how small countries can increase the crisis resistance of their economies and improve their political safety net.
- A first option is to join a larger economic or monetary entity. The global financial crisis has shown that world currencies have been largely spared from sudden exchange rate fluctuations. The central banks of large economic areas are, in fact, unlimited in their ability to provide liquidity and act as a lender of last resort. They can furthermore count on the assistance of other major central banks.

- For small countries within the euro area, the sheltering function of the euro adds to the other benefits of the common currency. By contrast, in recent years countries with an autonomous monetary policy such as Iceland and Switzerland experienced the negative aspects of monetary autonomy.
- A second option – which is rather a supplement to than a substitute of the first approach – is to implement reforms and follow policies aimed at reducing the vulnerabilities of the economy. These vulnerabilities include fiscal and external imbalances, unsustainable health and pension systems and marked social inequalities. A high level of fiscal indebtedness always implies a large exposure to financial market assessments. An efficient supervision of the monetary and banking system – take the Irish achievements as a role model – has the potential of detecting mounting imbalances early and of providing enough leeway to implement the necessary.
- Overall, most countries around the world currently face similar challenges and have limited room for maneuver. But it pays to fight for the achievements of past decades and it makes sense to take the crisis as a chance for reform.