Josef Bonnici: Lessons from the crisis

Address by Professor Josef Bonnici, Governor of the Central Bank of Malta, at the annual dinner of the Institute of Financial Services, Saint Julian's, 25 November 2011.

* * *

Hon. Minister, Excellencies, Members of the Institute, Distinguished Guests

I would like to thank the Malta Institute of Financial Services for inviting me to address this distinguished audience. Mr President, I am aware of your Institute's leading role in banking and financial education in Malta and of its endeavours to establish forms of collaboration with other educational institutions with the aim of increasing the variety of courses offered to professional staff within the financial services industry. I understand that a notable development over the last year was the relationships you established with the University of Bangor and other strategic partners in order to launch a Chartered Banker MBA course locally. This is certainly an achievement and I augur you further success in expanding your reach to all members of the financial community through the activities that your Institute organises and the training facilities it provides.

This evening I shall dwell on the sovereign debt crisis in the euro area, a topic which has persistently made news headlines over the past 18 months, and unfortunately continues to do so today. There are lessons from this period of crisis that are relevant for both policymakers and the banking community.

The origins of the crisis

We are all aware that the sub-prime mortgage crisis in the US during 2007 and the subsequent collapse of Lehman Brothers in September 2008 sent shock waves to the financial markets that plunged the global economy into the most severe recession since the Great Depression of the 1930s. However, although these two events did trigger off the international financial crisis, the sovereign debt crisis in Europe was largely home-grown, characterised by cases of excessive risk-taking by banks, imprudent fiscal policies on the part of a number of governments as well as shortcomings in the institutional framework of Economic and Monetary Union.

With the adoption of the euro, most euro area countries benefitted from the greater credibility that the monetary policy, decided collectively by the Eurosystem, offered within a legal framework that ensured its independence and promoted price stability as its primary objective. In addition the advent of the single currency also meant a significant step forward towards the completion of the EU single market, which was viewed as an important element in bringing about faster economic growth in the European Union.

The establishment of the euro area led to a significant reduction in both nominal and real interest rates, especially for the fiscally weaker member states, as these converged to German benchmark levels.[1] This reduction in interest rates, coupled with stronger economic growth expectations in the euro area, gave rise to faster growth in, and cheaper interest rates on, credit to both households and non-financial corporations in many of these countries.

It is instructive to compare the underlying causes of the sovereign debt crisis in Ireland with that in Greece. In the case of Ireland, it was the financial system and bank lending policies that drove the country into crisis, which then engulfed the government's finances. Excessive

---

1 See L. Bini Smaghi, "Eurozone, European crisis and policy responses", *Goldman Sachs Global Macro Conference – Asia 2011*, 22 February 2011.

risk-taking by the banks led to strong credit growth and the consequent surge in house prices. The bursting of the housing bubble not only had a severe impact on the banking sector's balance sheet but also led to a rapid deterioration in government finances. Tax revenue flows, particularly from construction activity, dried up, while the banking system was hit by its heavy exposure to the property market. This brought about an extremely rapid deterioration in public finances as the government bailed out the banking system.

In the case of Greece, it was the government's fiscal irresponsibility that was the root cause of the crisis that then had dire consequences for the domestic financial system. Poor governance, the absence of a culture of accountability, and an inadequate internal auditing mechanism,[2] led to a mismanagement of public finances. The resulting accumulation of public debt led to serious financing problems for the Greek banks, which were considerably weakened by the loss in value of their asset holdings as Greek government bond yields surged. Difficulties were further amplified by the withdrawals of deposits as a result of a loss of confidence in the banking system.

To a considerable extent, the sovereign debt crisis was also the result of institutional design weaknesses within EMU. To reduce the risk of fiscal imprudence, the Stability and Growth Pact was intended to dissuade and prevent Member States from undertaking unsustainable fiscal policies resulting in excessive deficits and a build-up of public debt. Furthermore, Article 125 of the Lisbon Treaty states that the European Union, as a whole, as well as the individual Member States are not liable for commitments of governments or public authorities of other Member States. This was included in view of what is called the "moral hazard" that would arise within EMU in the absence of a closer coordination of fiscal policies. In the same vein, Article 123 prohibits the ECB and the national central banks from lending directly to governments.

However, experience shows that the effective implementation of the Stability and Growth Pact was rather weak. It failed to prevent the occurrence of excessive fiscal deficits in several euro area countries, although without it, fiscal imbalances would probably have been larger. Peer pressure from other Member States was clearly insufficient.[3]

The policy response

Faced with the unfolding of a sovereign debt crisis, the European Union's response involved a two-pronged approach. On the one hand, it needed to rapidly address the immediate financing needs of distressed countries, but at the same time it also recognised that the origins of the crisis had to be tackled through a comprehensive reform in economic governance in the Euro area.

When Greece signalled that it needed financial support from its Euro area partners, the first financial programme for this country took the form of a bilateral loan agreement with its euro area partners, supplemented by aid from the IMF.

It was clear at the outset that there was a need to establish a framework that could swiftly and efficiently respond to possible requests from other Member States. Thus, in May 2010 the European Financial Stability Facility (EFSF) was set up with a lending capacity backed by guarantees from the Member States of the euro area. As from July 2013, the EFSF will be replaced by a permanent framework, in the form of the European Stability Mechanism.

---

2 See I. Sarmas, "The Greek Financial Crisis from an Auditor's Point of View", World Class Performance Symposium 2011: Trust and accountability in public financial management, London, 17 March 2011.

3 See J. M. Gonzalez-Paramo, "The reform of the Stability and Growth Pact: an assessment", Conference on "New Perspectives on Fiscal Sustainability", Frankfurt, 13 October 2005.

However, it is important to underline that the financial mechanisms created by the EU to assist Member States in distress come with strict conditions that are designed to ensure that needed changes are implemented in economic policies and in national institutional capacity building.

The European System of Central Banks has also responded to the crisis. Apart from the conventional interest rate tool, which is currently almost at a historical low, the Eurosystem introduced a number of so called non-standard measures to ensure that the transmission channel of monetary policy is not impaired. These measures include the provision of the necessary liquidity to eligible counterparties, against adequate collateral, on the basis of a fixed rate and full allotment procedure.

When tensions emerged in the financial markets after Greece requested financial aid in April 2010, the Eurosystem also activated a Securities Market Programme which is intended to facilitate the monetary transmission mechanism. This involves secondary market purchase of government bonds of a number of euro area countries, and the programme was broadened in the summer of this year to cover purchases of securities of other countries facing funding difficulties.

Apart from instituting financial mechanisms, European authorities responded to the sovereign debt crisis by also focusing on reform in economic governance. Clearly, the macroeconomic imbalances that developed in a number of Member States, together with the ineffective implementation of the Stability and Growth Pact, signalled a need to strengthen the surveillance framework. In addition to the setting up of the European Systemic Risk Board, entrusted to monitor financial stability, the European Commission presented six legislative proposals, the so-called Six-Pack.[4] These were aimed at strengthening the preventive and corrective action needed to ensure fiscal sustainability, reducing macro-economic imbalances, and promoting competitiveness. They were approved by the European Parliament in September and will come into force in January 2012. In launching these measures the European Authorities recognised that in a single currency area there are limitations to the debt that can be issued by participating sovereign Member States. Essentially, we are going through a period of further development of the currency union and the implications this has on other aspects of governance.

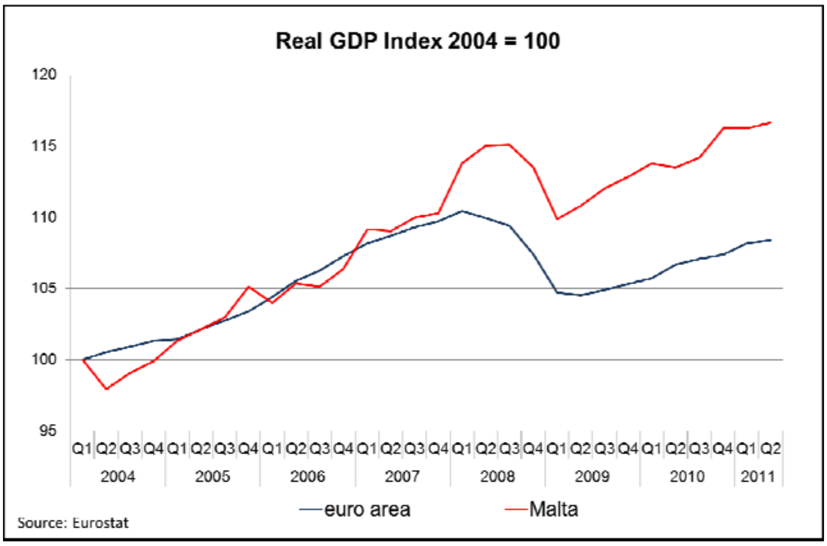
Lessons from the crisis

From a national perspective, at the policy making level, there are a number of lessons that can be learned from the sovereign debt crisis.

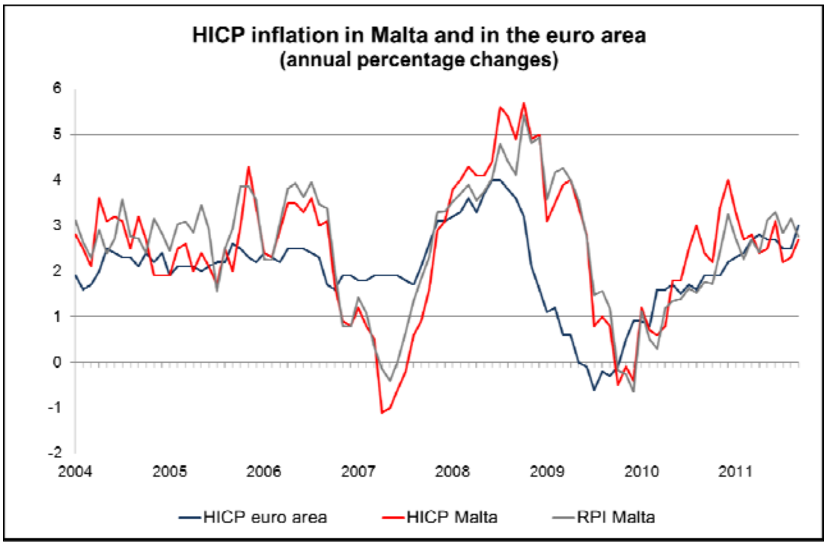
As I highlighted earlier, macroeconomic imbalances and unsustainable fiscal policies were the root cause of the sovereign debt crisis in Europe. The example of Ireland is a reminder that while strong GDP growth is a desirable goal, what ultimately matters is that such growth can be sustained. In turn, competitiveness is the key for a country's success in achieving sustainable growth and improvements in living standards.

---

4 See European Commission, EU Economic governance "Six Pack" – State of Play, Brussels, 28 September 2011.



In Malta GDP per capita grew by 11.6% over the last decade while the increase in the euro area amounted to 5%, and the recession in 2009 was shorter and relatively less deep than that experienced by Malta's trading partners**.** The Maltese economy, nevertheless, still faces a number of challenges.



One area of relevance is the inflation rate, which at an average rate of 2.5% since 2004, has tended to stay slightly above the 2.1% average rate in the euro area as a whole, although the latest data show an annual inflation rate below that for the euro area. In this context, greater attention should be given to the identification of any structural shortcomings that may be contributing to the slightly higher inflation, and the excessive volatility apparent in Malta's inflation rate as compared to the euro zone. Although imported inflation is inevitable, we have to be particularly mindful of locally generated price pressures or inflexibilities in structures which may not be responding sufficiently to competitive pressures.

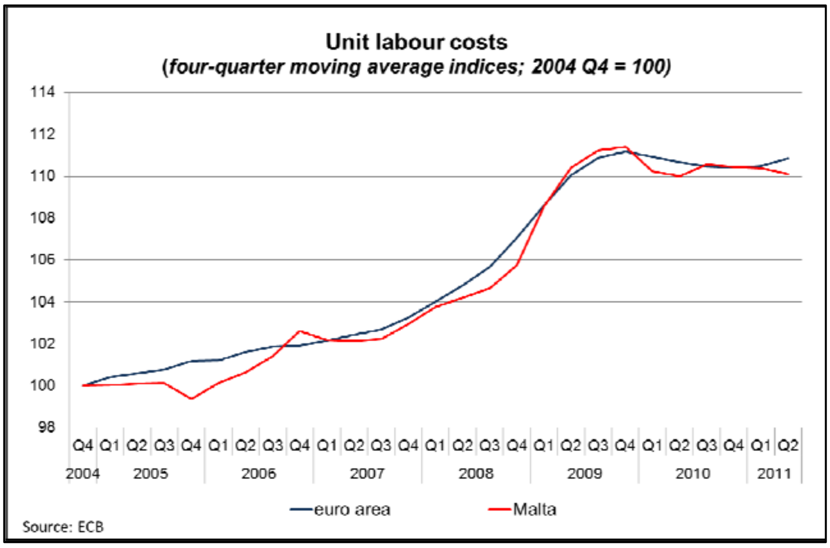
Productivity growth is essential not only for enhanced competitiveness but also to justify wages that permit a sustainable increase in living standards. Productivity growth in Malta since EU accession was broadly in line with that experienced by the euro area as a whole. Still, catching up with the rising living standards of the more affluent EU countries requires even faster growth in productivity. To overcome this challenge, policy makers need to continue in their efforts to provide the necessary incentives for investment and to remove the impediments, such as needless bureaucracy, that may hinder its implementation.

On a positive note, however, Malta's efforts to diversify its economy into new sectors, especially in business services and more capital intensive manufacturing industry have helped to prevent the boom-bust cycles that were being experienced in other economies.

Productivity is also influenced by growth in human capital. In this regard, substantial public funding has been allocated to investment in education, training and retraining programmes which enable workers, to acquire new skills required by newly set up industries in Malta. Labour market flexibility also contributes to productivity growth by enabling a smoother transition from old to new sectors.

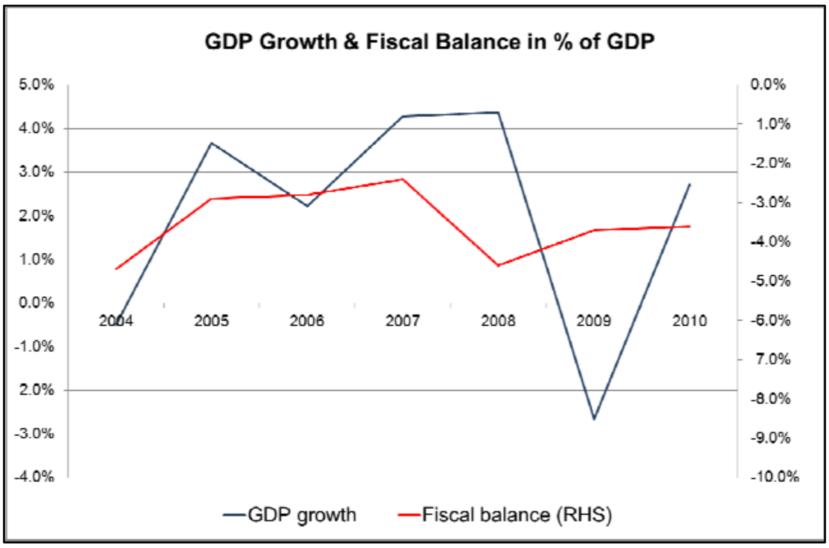
Over the past decade the proportion of the working-age population with a tertiary education level grew by two-and-a-half times to 12.4% of the labour force. Nevertheless, there is still further catching-up to be made as the euro area average is almost double that of Malta. Furthermore, not only must the number of graduates be increased, but the quality aspect is also of crucial importance for productivity improvements.

Apart from productivity aspects, competitiveness is also affected by cost developments. Labour costs are a crucial element particularly in open economies, where a significant share of output is exported.

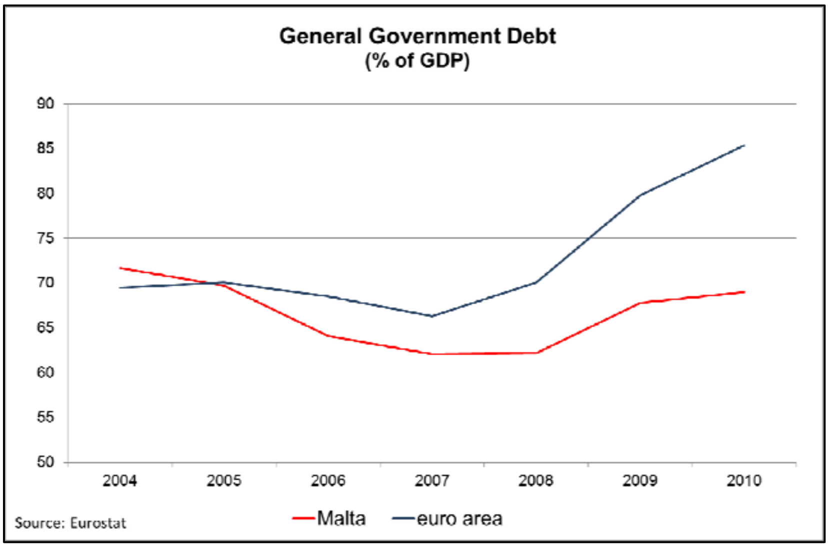


Since EU membership, growth in unit labour costs practically matched the euro area average. Thus, in terms of labour cost competitiveness, Malta has kept pace with the euro area average. However, to maintain competitiveness a further focus on the wage setting process may be appropriate. In particular the basic principle must be to emphasise that productivity improvements are at the basis of sustained wage increases, and that these are best negotiated at firm level, where improvements in productivity can be best gauged. Consequently, any cost of living adjustments should form part and parcel of the collective agreement and not be superimposed on collective agreements by legislation as happens today. Indeed, already a number of collective agreements incorporate the COLA increase, and I suggest that this should be the norm.

Another important message that has emerged from the sovereign debt crisis is the need for fiscal prudence, which provides the space for countercyclical fiscal policy during a downturn. In the euro area, fiscal policy is the major macroeconomic management tool at the national level. Thus, in periods when economic activity is relatively strong, policy needs to be sufficiently prudent to build the necessary fiscal buffers that would be utilized during periods of weaker growth.



In the aftermath of one-off expenditure during 2008, the deficit ratio in Malta declined in 2009 despite the recession of that year and narrowed slightly further in 2010. The debt ratio generally declined until 2008, but then picked up in 2009, partly in response to the contraction in the economy. Although the debt ratio has been considerably below that of the euro area as a whole, the government's determination to achieve its fiscal targets is welcome. Strong efforts need to be made in order to adhere to these targets, particularly during times of slow economic growth.



Recent experience has shown that with the adoption of targeted and limited spending measures, the economy has proved relatively resilient to external shocks. Still, at this juncture, the continuing slowdown in external demand is likely to impact the economic growth rate, adding further pressure on the fiscal balance at a time of heightened institutional and market scrutiny. This will introduce a delicate balance between two considerations. First, cutting the deficit is important in order to reduce macroeconomic imbalances that in the longer run hinder economic growth. Secondly the immediate effect is to reduce aggregate demand, whether via spending cuts or through higher taxation, which would slow the economy down.

Given the desirability of avoiding such dilemmas, this may be the time to follow the lead of other countries and consider the adoption of self-enforced regulations, such as expenditure rules.[5] Spending decisions involve the reconciliation of various spending needs. While it is the cabinet of ministers that collectively sign off on the budget, the compilation of the budget document involves the reconciliation of diverse demands. If, as is likely, the sum of the separate demands exceeds the previous year's spending total, the end result is the observed and inefficient upward creep in total spending. A widening of the deficit is more likely when growth in tax revenues is constrained by the slow rate of economic growth.

Spending rules can be viewed as a remedy for the problem of coordination between competing interests. In addition the formulation of the rules requires the setting of spending priorities. For example, it would be reasonable for an expenditure rule to give priority to capital expenditures, while another rule prioritizes the various types of social spending.

The choice of the rules will involve the difficult task of setting of priorities, but once the rules are determined, there will be considerably less discretion on the overall fiscal outcome of the yearly budgetary exercise. For example, to remain within the rule, spending cuts may be necessary in some areas to allow a larger outlay in a higher priority area. This kind of trade-off is an essential feature of budgetary management.

Expenditure rules are also helpful for the purpose of assuring long-term budget sustainability. In this regard, the reform of the pensions system requires particular consideration.

As things stand, the gap between pension contributions and benefits is of concern. The Financial Estimates for 2012 include an amount paid by government to top up the contributions of employers and employees in the private sector. While such an arrangement was understandable in the early phase of Malta's economic development, it is less justified today.

Over 145 million euros are earmarked in 2012 for this so-called direct contribution by Government by way of a grant to the private sector in terms of the Social Security Act of 1987. The total top up for both public and private sector employees comes to just over 191 million euros. This amount is in addition to the national insurance contribution by the government in its capacity as an employer.

To put these numbers into perspective, one must keep in mind that the deficit in the consolidated fund for the same year is projected at roughly 145 million euros.

The size of these outlays should be of concern for two reasons. The shortfall is certainly not arising from pension benefits that are too generous. Secondly the amount of the welfare gap as identified in the Estimates is going to rise rapidly as people live longer and the population ages.

One suggestion for alternative financing would involve a multi-year programme that would reduce the government's matching contribution gradually over an extended period of time, ideally through a tripartite consensus at the MCESD. This programme would be financed from productivity growth. During times of economic growth, when the growth rate exceeds a particular threshold, the revenue from a marginal increase in income tax or national insurance rates would be earmarked to reduce the subvention. The increase in rates would automatically be suspended during times of slower growth. Such a scheme would be justified as one which reallocates resources from current to future consumption, and the reallocation would occur only during a time of relative prosperity.

---

5 See F. Holme-Hadulla, S. Hauptmeier and P. Rother, "The impact of numerical expenditure rules on budgetary discipline over the cycle", ECB *Working Paper Series* No 1169, April 2010; see S. Hauptmeier, J. S. Fuentes and L. Schuknecht, "Towards expenditure rules and fiscal sanity in the euro area", ECB *Working Paper Series* No 1266, November 2010.

While this on its own would not ensure the sustainability of the pension system, it would be an important component in the process of pension reform, and, as I have already mentioned, I would suggest that it would be appropriate for deliberation at the MCESD.

The phenomenon of population ageing raises sustainability challenges also for the public provision of healthcare, which represents a significant share of government expenditure. It must be recognised that the extent of provision of free healthcare and other services by the State must ultimately be financed by the taxpayer. The earmarking of certain revenue measures or particular revenue streams for this purpose may also be an appropriate topic for consideration by the social partners.

The sustainability of funding the government's capital expenditure programme, particularly in relation to the infrastructure and the public utilities through fiscal resources may also have to be reviewed. One step in this direction is to harness the ample immovable property of the government which presently may not be rendering an adequate return. It appears that the setting up of special purpose vehicles may be addressing in part this issue. Perhaps, however, we should go a step further by considering the establishment of a development bank which would utilise various assets of government that are presently underutilised as well as other sources of funding, on similar lines that exist in many EU countries, particularly Germany, where development banks at the regional level undertake very successfully a role in promoting the economy and assisting the government in social and environmental projects.

Let me turn now to the domestic banking system. On taking on my responsibilities as Governor of the Central Bank of Malta, I actively involved myself in financial stability issues given my concern with financial markets overseas that were characterised by volatile trading conditions and the contagion effects of the sovereign debt crisis. There is no doubt that the impact of the sovereign debt crisis highlights the importance of ensuring a stable domestic financial system. In fact the case of Ireland shows us that imprudent bank policies can have devastating effects on the economy.

In contrast, the domestic banking system played a crucial role in preventing a more severe downturn in economic activity after 2008, and in averting a sharper deterioration in public finances, because of prudent behaviour on the part of the banks in both asset and liability management.

The reliance on retail deposits has been a major source of funding for the domestic banks. These remained stable during the period of financial turmoil. In other countries, banks that relied heavily on wholesale funding sources came under severe stress as interbank markets dried up and the cost of funding increased significantly.

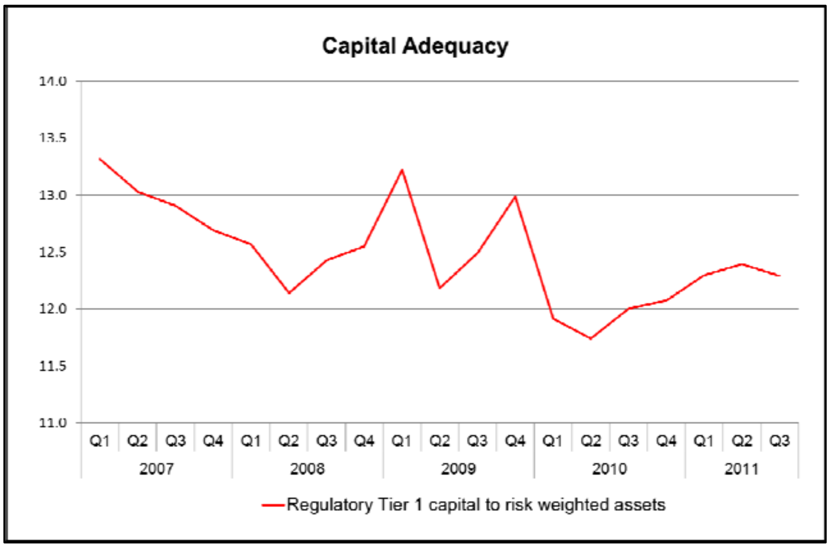
As I mentioned earlier the Eurosystem has stepped in with ample liquidity, and the Central Bank of Malta, as an active member of the system, stands ready to fulfil its intermediation role within the local banking system. Nevertheless, it is firmly my view that domestic banks should continue to operate along the lines of their traditional business model. This method of doing business has certainly protected them from the vagaries of the wholesale funding market.

In this context, I would like to emphasise once again that the Central Bank will not be supportive of banking institutions that operate in Malta and seek central bank liquidity as their primary source of funding their loan and investment activities.

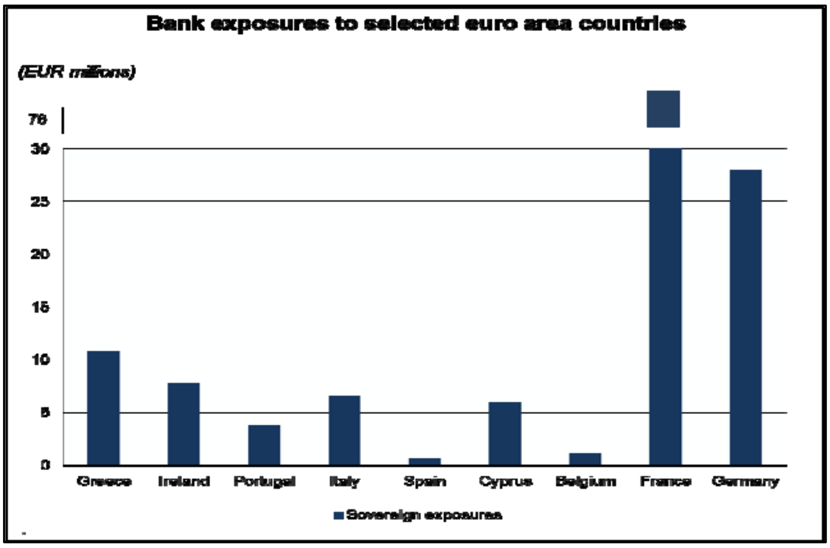
When a banking institution funds its purchase of high yielding assets from short term sources, it is not only exposing itself to losses on the asset side but also to adverse changes in its funding costs, particularly at a time when historically low interest rates are in effect. For this reason, the Central Bank expects such institutions to look primarily to the markets for their funding requirements.

I am pleased to note as well that the domestic banking system continues to be characterised by relatively high liquidity levels. Furthermore, a major strength of the domestic banking system is its prudent approach towards credit, where loans are fully covered by deposits, while loan-to-value ratios, which were already at relatively prudent levels at the time of the global financial crisis, declined further to around 70%.

Another major strength of the domestic banking sector is its strong capital base. Capital adequacy ratios improved further from already healthy levels, with the core capital adequacy ratio rising to 12.4%. This ratio is significantly higher than the present statutory requirement of 4%.



The debt crisis has highlighted the importance of risk diversification. Encouragingly, the investment portfolio of the domestic banks has limited exposure to securities issued by countries in financial distress.



It is equally important for the banks to diversify risk in their loan portfolio. Most of the troubles of banking systems overseas, particularly in Ireland and Spain, stemmed from their relatively large exposure to the construction sector, especially the housing market. While the latest update of the Central Bank of Malta's Financial Stability Report[6] provides a generally

[6] Central Bank of Malta, *Financial Stability Report Update – June 2011*, 17 October 2011.

favourable assessment of the situation in the domestic banking sector, it notes that credit and concentration risks remain elevated, mainly due to corporate borrowers in construction and real estate activities. However, on the positive side, the share of lending to these sectors has now eased slightly since before the crisis to around 10.5% of total assets as at September 2011, and domestic banks are encouraged to continue on this path to reduce concentration risk.

In the same vein, I would also like to stress that the sovereign debt crisis has also highlighted the importance of prudent credit standards and for banks to improve the institutional capacity to appraise risk, not only as it relates to the individual borrower but also from a sectoral and economy-wide perspective.

The Central Bank of Malta also continues to urge banks to expand loan loss provisioning levels, especially related to the construction sector, and also to strengthen further the capital buffers through the adoption of prudent dividend policies. Such measures are also needed for banks to eventually implement the stringent Basel III regulatory requirements.

I must stress that there is never room for complacency, especially at a time of uncertainty in the global financial system, and also because economic growth in our main trading partners is expected to slow down appreciably during 2012.

Conclusion

I have touched on a number of areas in this my first speech to you as Governor of the Central Bank of Malta. In concluding, I would like to say that the challenges faced by the Maltese economy today are not so dissimilar from those of the past. It is true that the setting has changed considerably but as a small open economy these relate mainly to competitiveness aspects and the capacity to deal with external shocks. It must be stressed that competiveness is not exclusively a concern for the export-oriented part of the private sector, but also for those who focus their business activity on the domestic market. Non-competitive practices and inefficiency in that part of the economy that is not directly exposed to foreign competition tends to spill over into the tradable sectors thus threating the overall competitiveness of the whole economy. We must avoid this as much as possible. I am cautiously optimistic about the future and feel sure that despite the persistence of the sovereign debt crisis and the prospect of a weaker global economy, Malta will overcome the challenges that lie ahead, if all stakeholders remain focused on meeting the country's economic objectives in a prudent and effective manner.

Thank you for your attention.