Peter Praet: Managing financial crises – the role of the European Central Bank

Address by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 40th Economics Conference of the Central Bank of the Republic of Austria "European Monetary Union – lessons from the debt crisis", Vienna, 10 May 2012.

*   *   *

I would like to thank Fédéric Holm-Hadulla for his contribution to the preparation of this speech.

Ladies and Gentlemen,

It is a real pleasure for me to share my thoughts on the role of the European Central Bank (ECB) in managing financial crises at the 40th Economics Conference of the Oesterreichische Nationalbank.

1. Introduction

We meet here to discuss this subject at a time when it has already preoccupied us for almost half a decade. And yet it could not be more topical today. What started as a liquidity crisis in the money market in 2007 quickly morphed into a full-blown financial crisis following Lehman's collapse in autumn 2008, and finally into a sovereign debt crisis starting in May 2010. We have been facing a situation in which all these elements rapidly and profoundly reinforce each other, thus combining to create a challenge far bigger than the sum of its individual parts.

Since the onset of the crisis, financial market turbulence and the associated deterioration in credit conditions and overall economic confidence have dragged down the real economy. The resulting downward impact on economic activity has led to an erosion of tax bases and taken a massive toll on public finances. The concomitant threats to debt sustainability, in turn, have required several governments to adopt ambitious fiscal consolidation measures during the downturn to regain control of their fiscal positions. Furthermore, the financial and economic crisis forced many governments to intervene in domestic banking sectors, again placing severe strains on fiscal positions in several cases. Vice versa, fiscal sustainability concerns have rapidly spilled over to the financial sector, thus giving rise to a vicious cycle that is difficult to break.

Disentangling this web of mutually reinforcing risk factors is the number one challenge that we, as economic policy-makers, are facing. As I will show, the ECB has played an important role in confronting this challenge. By cutting its main policy rates and introducing additional measures to directly address liquidity and funding constraints in the banking sector, it has bought time to facilitate the structural adjustment of the financial industry. It belongs to governments to continue their efforts to ensure fiscal discipline, restore competitiveness and to remove remaining shortcomings in economic governance at the European level.

Identifying and addressing these shortcomings is key for the future.

2. Lessons from the past – risks for the future

A central observation regarding the period before the crisis is that most countries did not do enough to ensure resilience in the face of adverse economic shocks. For example, while headline fiscal balances in many countries improved over the period between the introduction of the euro and the start of the crisis, this improvement was driven to a considerable extent by very favourable cyclical conditions. These in turn disguised the vulnerabilities originating from expansionary expenditure policies. Moreover, despite benign economic conditions, half of the euro area member countries were already recording deficits before the crisis. This failure to sufficiently consolidate public finances in good times left little or no room to absorb the fiscal burden arising from the recession and bank rescue measures. In addition, rather than using the cyclical upswing to implement far-reaching structural reforms, a number of countries witnesses a sharp deterioration of their competitiveness, as evidenced, *inter alia*, by sharp increases in unit labour costs. The reliance on demand-side expansion, often fuelled by public sector deficit spending, exacerbated the downturn in these countries when credit conditions took a turn for the worse.

While responsibility for addressing these developments was – and continues to be – for the most part on the side of national governments, the situation has wide-ranging implications for financial and economic conditions in the euro area as a whole. And it thus creates substantial challenges for monetary policy in EMU.

The ECB's monetary policy is firmly and unambiguously anchored in our primary objective of maintaining price stability in the euro area which is defined by keeping euro area HICP inflation below, but close to, 2% over the medium term. The credibility of this commitment is corroborated by medium-term inflation expectations for the euro area economy, which remain in line with our objective.

This mandate has also guided the ECB's policy response throughout the crisis. When confronted with acute downside risks to price stability, the ECB reduced its main policy rates and adopted a range of additional policy measures, often referred to as "non-standard" measures. These have served as a complement to the changes in interest rates when the channels by which, in normal times, the central bank transmits policy signals to the broader economy were seriously impaired. As I will discuss in more detail below, these policies were devised in such a way that the ECB's capacity to ensure price stability over the medium term was preserved, thereby contributing to the overall stability of the financial system in the euro area.

However, the central bank's contribution to fighting the impact of the crisis entails a delicate balancing act. On the one hand, the risks to price stability emanating from a possible financial meltdown call for decisive action from the central bank. On the other hand, the resulting mitigation of a crisis which, to a considerable extent, reflected shortcomings in other policy areas and excesses in the financial sector, can alter incentives for the different actors to correct the imbalances that undermined financial stability in the first place. If the central bank does not react forcefully, it risks losing its ability to deliver on its mandate of price stability. At the same time, monetary policy cannot address the root causes of the crisis; this can only be done by policy-makers at national level and actors in the different sectors of the economy that have built up excessive leverage. This in turn requires a broad range of measures usually comprising growth-enhancing structural reforms, fiscal consolidation, restructuring of the domestic banking sector and balance sheet repair. But such measures are likely to prove challenging and politically costly to implement.

If domestic policy-makers and other economic actors delay necessary reforms and adjustments on the expectation that the central bank may have to provide renewed support should market conditions deteriorate, monetary policy may end up being subject to a short-term bias. Such a strategy could give rise to a regime of "financial dominance", which Hervé Hannoun, the Deputy General Manager of the Bank for International Settlements, recently described as a situation in which "monetary policy becomes increasingly dominated by short-term concerns about adverse financial market developments".[1]

[1] See Hannoun, Hervé (2012), "Monetary policy in the crisis: testing the limits of monetary policy", speech at the 47th SEACEN Governors' Conference, 13–14 February.

To avoid such a situation, extraordinary monetary policy interventions have to be temporary in nature and tied to a commitment of swift reversal as soon as conditions improve. But would this commitment be sufficient to align the incentives of the different actors involved? This question relates to the concept of "time inconsistency", which describes conditions in which a policy-maker states its intention to follow a specific course of action in the future but cannot credibly commit itself to this course. As a consequence, other economic agents expect the policy-maker to deviate from its stated intention and adjust their actions accordingly.

The solution proposed in the economic literature to this type of problems is based largely on two elements: institutional frameworks setting out clearly defined objectives for key policy areas and the adoption of "rule-type behaviour" that consistently and predictably determines the response of policy-makers to specific circumstances. These elements increase the credibility of policy commitments, thereby allowing a policy-maker to steer expectations of other actors in line with its long-term intentions and overcoming the short-term bias resulting from the time inconsistency problem.

Both of these crucial elements are in place in the euro area as regards the single monetary policy. The Treaty on the Functioning of the European Union establishes a strong institutional framework for monetary policy in the euro area based on central bank independence and a primary objective of price stability, as enshrined in Articles 130 and 127, respectively. Together with the prohibition of monetary financing of public debt, laid down in Article 123, this framework provides an important safeguard against monetary policy being dominated by fiscal policy considerations. And the ECB's monetary policy strategy, which builds on a comprehensive analysis of risks to price stability via its two pillars and is communicated to the general public in a regular and transparent manner, entails "rule-type behaviour" on the part of the ECB. These elements provide a framework which is geared towards the medium term and which counteracts short-term bias towards fine-tuning macroeconomic and financial developments.

The current crisis has instead exposed severe shortcomings in the institutional architecture of EMU as regards the areas of fiscal, structural and financial stability. These shortcomings have made it possible for national authorities to often pursue economic policies that finally led to strong negative externalities on the euro area as a whole. Besides inducing a build-up of risks, this also indirectly affected the smooth functioning of EMU by exacerbating heterogeneity between countries. In particular, misaligned budgetary policies, unsustainable wage developments and structural rigidities in product and labour markets, as observed in several countries, constitute a source of persistent inflation differentials within the currency union. These in turn represent also a challenge for monetary policy.

As regards the origin of such institutional shortcomings, there are four factors that play a particularly prominent role: *first,* weakly enforced fiscal rules incapable of promoting prudent fiscal policies in times of favourable economic conditions; *second,* the absence of a mechanism to prevent and correct macroeconomic imbalances within the EU; *third,* insufficient coordination of macro and micro-prudential supervision of financial sectors at the EU level; and *finally,* the absence of a crisis management framework to avoid contagion between countries and sectors.

In response to these problems, policy-makers have set in motion ambitious reforms to strengthen economic governance at the EU level, and many national governments have committed to ambitious fiscal and structural reforms. All these measures should contribute to addressing the underlying causes of the crisis, thereby also supporting the smooth functioning of EMU in the future. But let me first explain, in more detail, the ECB's policy since the start of the current crisis.

3. The ECB's response to the financial and sovereign debt crisis – measures and guiding principles

Since the intensification of the financial crisis in September 2008, and against the background of rapidly receding inflationary pressures, the ECB has implemented monetary policy measures that are unprecedented in nature and scope. This has included a swift reduction in our key interest rates to historical lows, with the rate on the main refinancing operations now standing at 1% as compared with 4.25% in summer 2008. These steps are often referred to as "standard" policy measures, since changes in short-term interest rates are the main tool adopted by the ECB to achieve its price stability objective.

However, besides triggering a sharp fall in global economic activity, the crisis severely affected the monetary transmission channels. In particular, central banks around the world were confronted with repeated waves of market turbulence, in which liquidity in overnight and longer-term money markets was sharply falling, in view of heightened uncertainty about counterparty risk between banks. As consequence, the functioning of the interbank market was seriously hampered and the ability of banks to provide credit to the real economy was at risk. These developments severely jeopardised the ECB's ability to affect economic magnitudes and ultimately to contain downside risks to price stability.

In response, the ECB embarked on a series of "non-standard" measures with the aim of relieving liquidity and funding constraints in the banking sector and mitigating impairments to the monetary policy transmission channels. In particular, they have taken the form of: provision to euro area banks of unlimited liquidity at a fixed rate against adequate collateral; a substantial lengthening of the maximum maturity of refinancing operations; the extension of the list of assets accepted as collateral; and the provision of liquidity in foreign currencies. These measures have served to improve financing conditions and credit flows above and beyond what could be achieved through reductions in the key ECB interest rates.

While these measures clearly differ in their specific design and scope, they all follow the same guiding principle: a clear focus on the ultimate objective of price stability, supported by the intermediate target of ensuring depth and liquidity in dysfunctional market segments to restore the proper functioning of the monetary policy transmission mechanism. To that effect, they serve as complements to our standard monetary policy tools and can be unwound should upward pressures on price stability materialise.

Let me provide an example of this guiding principle, by looking at the most recent non-standard monetary policy measures taken by the ECB, i.e. the long-term refinancing operations (LTROs) decided in December 2011.

The second half of 2011 was characterised by a renewed intensification of turbulence in sovereign debt markets, which quickly spilled over to the banking system. As a consequence, the access of euro area banks to market-based funding came under strain, as reflected, for instance, in a substantial surge of euro area money market spreads since July 2011. In the ECB bank lending survey more than half of all participating euro area banks reported a deterioration in wholesale funding conditions.

Without effective remedies, these developments could have severely undermined bank lending to firms and households and triggered broad-based selling of assets. The LTROs were aimed at alleviating these adverse funding conditions. Banks were able to satisfy their additional liquidity needs, in the context of a net liquidity injection of around €520 billion – taking into account the shifting of liquidity out of other operations. Moreover, the LTROs provided banks with a more certain medium-term funding situation owing to the longer maturity of the new operations.

The full supportive impact of the three-year LTROs will need time to unfold. Any assessment of their impact on the economy can be only preliminary in nature at this stage.

However, the data available to date give some encouraging signals. Money and credit figures up to March confirm a broad stabilisation of financial conditions and thereby the avoidance of an abrupt and disorderly adjustment in the balance sheets of credit institutions. Funding conditions for banks have generally improved, and there has been increased issuance activity and a re-opening of some segments of funding markets. At the same time, the demand for credit remains weak in the light of still subdued economic activity and the ongoing process of balance sheet adjustment in non-financial sectors.

Beyond these short-term effects on market conditions, a key aspect in the design of the three-year LTRO is its consistency with the ECB's capacity to ensure price stability in the medium term. Most importantly, the interest rate on the three-year operations is indexed to the ECB's main policy rate, i.e. the rate on the main refinancing operations. Thus, if ECB were to increase this rate, the costs for the remaining period of the three-year LTROs would also rise. Hence, the three-year liquidity allocation does not stand in the way of an increase in short-term interest rates; rather, it would allow such an increase to be immediately translated into the outstanding liquidity operations.

As in the past, the Governing Council will be vigilant in order to contain upside risks to price stability. In this context, let me point out that what is relevant for measuring monetary liquidity is not the balance sheet of the Eurosystem, but the balance sheet of the euro area banking sector. Only the latter shows the interaction with the real economy. This interaction is captured by monetary and credit data which, despite the recent stabilisation I mentioned earlier, are still very subdued.

If these conditions were to change in a way that entailed upside risks to price stability, the Governing Council would use all the instruments at its disposal to continue delivering on its primary mandate.

The ECB's monetary analysis pillar serves to assess signals coming from developments in money and credit conditions. I would also like to mention that our monetary analysis is not narrowly confined to the analysis of headline money and credit dynamics, but also tries to understand their determinants.

Let me summarise. The ECB has taken an active role in mitigating the financial and economic crisis in the euro area, which has been fully consistent with its mandate. Reductions in the main policy rates have served to counteract acute downside risks to price stability. Non-standard measures have addressed impairments to monetary transmission channels, thereby complementing changes in policy rates when highly dysfunctional and perturbed market conditions impeded their effectiveness. To preserve our primary objective to ensure price stability, these non-standard measures are temporary and will be withdrawn if upward pressures to price stability materialise.

4. The way forward and conclusions

However, the ECB's exceptional measures should not distract from the fundamental causes of the crisis and the adjustments needed in the fiscal, structural and financial domains. The institutional architecture in the EU has to ensure that Member States live up to their responsibility for restoring fiscal sustainability and competitiveness and for implementing effective financial supervision. It is crucial to clearly separate the central bank's responsibilities from other policy domains, such as fiscal sustainability and financial stability.

Therefore, efforts to reinforce the economic governance framework at the European level are indispensable. In this regard, European policy-makers have made important progress recently. As a result of the strengthening of the fiscal rules of the Stability and Growth Pact and the introduction of the fiscal compact, member states now face stronger incentives to adopt sound budgetary policies, which are crucial for a smooth functioning of EMU. These derive, *inter alia*, from the requirement for national authorities to legally adopt a fiscal rule, preferably at constitutional level, stipulating that the general government deficit remain below 0.5% of GDP in structural terms. The new Macroeconomic Imbalances Procedure constitutes a useful mechanism requiring governments to adopt competitiveness-enhancing policies and tackle potential sources of financial instability in their domestic economies. The establishment of the European Supervisory Authorities and the European Systemic Risk Board has led to closer cooperation in micro and macroeconomic supervision within the EU that is commensurate to its deep economic and financial integration. Finally, the creation of firewalls in the form of the European Financial Stability Facility and European Stability Mechanism will contribute to isolating the euro area as a whole from financial turmoil affecting individual or a small group of countries. By providing financial assistance linked to strong and comprehensive conditionality, these mechanisms should also grant recipient countries additional time to overcome structural deficiencies in specific sectors of their economies.

While the EU governance framework thus contains some key elements necessary to overcome the current crisis and mitigate future crises, it is now paramount that all these elements are implemented in a swift and steadfast manner.

Moreover, to meet the challenges with which our economies will be confronted over the coming decades, most notably in the form of population ageing and increasing competition from emerging market economies, structural reform efforts aimed at boosting long-term economic growth should be high on the European agenda. Only if productivity and competitiveness keep pace with these challenges will Europe be able to preserve a standard of living similar to that we enjoy now. To mark this commitment to fostering long-term economic growth, key principles for sound and sustainable growth could be enshrined in the common economic governance framework.

All these reform efforts will put the framework for fiscal and macroeconomic policies (the "E" in Economic and Monetary Union) on a stronger footing and will facilitate the conduct of monetary policy – which has been supported by the strong institutional framework provided by the Maastricht Treaty since the very beginning of EMU. A strong institutional framework as regards both Economic and Monetary Union, coupled with an extension of "rule-type behaviour" to other key policy areas, can also make it possible to address the moral hazard problem inherent in any supportive policy measure that needs to be taken during the crisis.