Peter Praet: The crisis response in the euro area

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the afternoon session "The challenges ahead" at Pioneer Investments' Colloquia Series "Redrawing the map: new risk, new reward", organised by Unicredit S.p.A., Beijing, 17 April 2013.

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I would like to thank P. Hess, L. Stracca, R. Beck, A. Mehl and R. Straub for their contribution.

A pdf of clearly detailed accompanying slides to this speech can be found on the European Central Bank website.

Ladies and Gentlemen,

It is a great honour and pleasure for me to speak to this esteemed audience at this esteemed place.

Introduction

Today, I will provide you with a central banker's view on the role of monetary policy in overcoming the current crisis in the euro area, but I will also touch on other, equally essential elements of policy-making in the euro area. I will structure my observations around four points:

- First, the factors that have led to the crisis and in particular how the euro area became engulfed first in the global financial crisis and then in the sovereign debt crisis;
- Second, the crisis response in the euro area, including both monetary policy as well as other policies;
- Third, the key lessons we have learned from the global financial crisis in the euro area and in particular the institutional weaknesses that were uncovered during the crisis;
- Finally, I will touch on institutional reforms at the level of the euro area and the European Union at large, which have also contributed, in my view, to an improvement of the foundation of our monetary union which is, we hope at least, the harbinger for a better performance in future. Work in this area is still in progress, and for that reason I will then conclude by sketching the challenges that still lie ahead of us.

1. The factors leading to the crisis

As I have argued on previous occasions, it might be useful to think about the development of the global financial crisis and subsequently the euro debt crisis in the last five and a half years as the gradual discovery of an iceberg. As you probably already know, because the density of ice is lower than the density of sea water, normally only one-ninth of the volume of an iceberg is above water. Moreover, the shape of the underwater part can be difficult to judge by looking at the section which is visible above the surface. This is in my view a useful metaphor, because as the crisis gradually unfolded, a chain of unexpected problems came to the surface and vulnerabilities that were previously underestimated became apparent.

Let us consider first the tip of the iceberg, namely the liquidity crisis. Tensions in money markets erupted in August 2007 when the US mortgage market, which was at the epicentre of a complex network of financial derivative products held globally, started to un-ravel. Liquidity in interbank markets worldwide dried up as market participants became paralysed by uncertainty. The key problem was that counterparty risk – which had hitherto remained

limited – suddenly increased in great proportions because the distribution of risk exposures to US subprime mortgage markets was markedly opaque. This led some market segments to partially freeze and others to close completely.

This is where the second layer of the iceberg comes onto the stage. The collapse of Lehman Brothers in the autumn of 2008 triggered an exceptionally abrupt re-pricing of risks globally. It led to a very significant intensification of the financial crisis; to a temporary freeze in trade financing and a global trade decline; to a curtailment of credit and domestic demand; and, ultimately, to a severe decline in global demand and output.

The main channels through which the crisis was transmitted internationally are now relatively well understood, although the extent and strength of the interconnectedness was quite surprising in real time. Activity corrected most in countries where credit was booming prior to the crisis, with large current account deficits, high external debt and highly leveraged financial sectors, in particular.[1]

In the euro area, a channel of particular importance was the fact that some banks had tapped US wholesale funding markets in large amounts to finance their activities.[2] Some of these banks were in addition as heavily involved as US banks in the production of allegedly risk-free securities, such as asset-backed commercial paper, that aimed to meet the needs of US money markets funds.[3] They were severely hit when these markets froze. Moreover, although the euro area's current account was broadly balanced, it still had significant gross external assets and liabilities vis-à-vis the US, which acted as a powerful conduit of the crisis.

Challenges became more intricate still when the third layer of the iceberg – the sovereign debt crisis – surfaced towards the end of 2009. Risk re-pricing intensified, spreading from banks to sovereigns and back to banks in an adverse feedback loop, and interacted with existing – but previously hidden – vulnerabilities in several euro area countries. This feedback loop included three separate ingredients. First, the solvency of some banks was strained by significant exposures to domestic sovereign debt and write-offs or declines in the market value of government bonds that eroded their capital. Second, declines in the market value of government bonds led to liquidity strains, insofar as these bonds are widely used as collateral in interbank markets. And third, in some instances, governments had to step in to recapitalise vulnerable domestic banks, thereby increasing their own debt in turn.

This "tale of two debt overhangs", as some have called this twin crisis of banks and sovereigns, had uneven effects across euro area countries.[4] Some countries were markedly more affected than others, which contributed to increased financial fragmentation in the euro area. This also laid bare further fragilities that had been accumulated in the past, including the fact that some euro area countries had neglected structural reforms and as a result faced competitiveness losses and the built-up of external deficits. While these fragilities had not gone completely unnoticed, and had been pointed out early on by the ECB, they had not received the attention they deserved until the crisis struck. This bears similarities with the Asian financial crisis, which is well remembered in this part of the world. Some experts saw it coming and warned at an early stage against the causes that led to it, such as short-term

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[1] See e.g. Berkmen, P., G. Gelos, R. Rennhack and J. Walsh (2009), "The global financial crisis: Explaining cross-country differences in the output impact", *IMF Working Paper*, No. 280; Berglöf, E., Y. Korniyenko, A. Plekhanov and J. Zettelmeyer (2009), "Understanding the crisis in emerging Europe", *EBRD Working Paper*, No. 108; Lane, P.R. and G.M. Milesi-Ferretti (2010), "The cross-country incidence of the global crisis", *CEPR Discussion Paper*, No. 7954.

[2] See H. S. Shin (2012), "Global banking glut and loan risk premium", mimeo, Princeton.

[3] See V. Acharya and P. Schnabl (2012), "Do global banks spread global imbalances? The case of asset-backed commercial paper during the financial Crisis of 2007-09", NBER Working Paper, No. 16079.

[4] See V. Acharya, P. Schnabl and I. Drechsler, "A tale of two overhangs: The nexus of financial sector and sovereign credit risks", 15 April 2012.

financing in foreign currency of long-term investments (*maturity mismatch*) and insufficient prudential standards leading to excessive risk taking and rent seeking behaviour. Unfortunately the warnings were not taken seriously until the issues and risks materialised first with the depreciation of the Thai baht in July 1997. Perhaps we have not learnt enough from the past!

As growing financial market tensions made the financing of these deficits ever more difficult, the last and most unexpected layer of the iceberg – namely the so-called "redenomination risk", the possibility of a break-up of the euro area – came to the surface in the middle of last year. By that time, the sovereign spread of high-yield euro area countries relative to other euro area countries had widened to an exceptional extent, hardly justified by fundamentals and fundamentally incompatible with a well-functioning monetary union. This led to the announcement by the ECB of the modalities for Outright Monetary Transactions (OMT), which helped to remove redenomination risk.

2. The monetary policy response to the crisis

Let me now outline in more detail how the ECB has responded to this multi-layered crisis. Before I delve into this, however, let me also first emphasise upfront that monetary policy can buy time for reforms that become effective with some time lag, but ultimately cannot substitute for reforms and decisions in the political sphere. Monetary policy is therefore only a crisis mitigation tool, and it is important to keep this fact in mind and not to expect too much from the central bank in terms of crisis resolution. In addition, monetary policy is surrounded by two goalposts: the overarching objective of price stability and the independence of the central bank.

The ECB's response included two types of measures, standard and non-standard measures. The standard reaction of monetary policy was to adjust our key interest rates downwards owing to a less benign macroeconomic outlook and downward risks to price stability. Short term interest rates are now close to zero in the euro area, and overall financing conditions are very favourable in the euro area as a whole.

At the same time, the standard monetary policy action was judged as insufficient because, during the crisis and especially from 2010 the interest rate channel of the monetary policy transmission mechanism was impaired, initially because the interbank market was dysfunctional, then because the banking sector in some countries became itself dysfunctional and was unwilling or unable to perform its normal intermediation role. In response to this challenge, the ECB engaged in a sequence of non-standard measures to restore a proper transmission of the monetary policy impulses, including lending operations through a fixed rate tender procedure with full allotment, the provision of liquidity with longer maturity and an expansion of the set of assets that could serve as collateral for receiving central bank liquidity. As financial integration in the euro area was being severely eroded and banks largely retrenched within their national borders, the Eurosystem remained ready to provide liquidity at consistent and uniform conditions over the entire euro area, as it should be in any monetary union.

As a further step to address the banks' funding problems and financial fragmentation within the euro area, the Eurosystem started intervening directly in securities markets in order to correct severe mal-functioning of certain segments. The first action of this type was the Securities Markets Programme (SMP) launched in May 2010, followed by a purchase programme for bank-issued covered bonds started in October 2011, and finally the Outright Monetary Transactions (OMT) programme announced in September 2012 but so far not activated. Let me now spend a few words on the OMT programme in particular.

It is important to emphasise that the design of the Outright Monetary Transactions programme creates the right incentives for governments to improve their performance with respect to fiscal prudence and structural reforms. In fact, OMTs will only be activated in cases where the beneficiary country has signed up to strict and effective conditionality

attached to an appropriate EU/IMF lending programme. They can also be considered for Member States currently under a macroeconomic adjustment programme, but only once they have regained bond market access. Moreover, the design of OMTs entails interventions only in the relatively short end of the government bond market – up to three years' time to maturity – and they will be fully sterilised, meaning that the Eurosystem would absorb all amounts of liquidity injected by OMTs.

Since the announcement of the OMT programme, financial market conditions in the euro area have improved significantly, sovereign spreads have declined substantially and there are some signs that the process of financial fragmentation in the euro area is being reversed. It is important to recognise that the role of policies other than monetary policy being implemented in the meanwhile, at both national and euro area or EU level, have also materially contributed to restoring confidence in the euro area.

3. How the crisis revealed institutional weaknesses in the euro area

As I already noted, the monetary policy response to the crisis has been mainly aimed to buy time for reforms that become effective with some time lag, but it cannot substitute for reforms as time goes by. In this respect, the crisis has unveiled the incompleteness of the euro area's institutional design which currently policy makers are addressing both at the national level and at the euro area/EU level. Let me first outline these main weaknesses and then go through the progress that has been made so far and the road ahead.

The euro area was missing an effective framework for (i) crisis prevention (ii) and crisis management and resolution, which are, as I will argue, essential ingredients for effective policy-making in a monetary union. Let me elaborate.

The lack of effective crisis prevention framework before the crisis was indeed evident.

First, too complacent regulatory policies in the financial sector still allowed excessive risk to build up. The establishment of the monetary union made is easier for deficit countries to finance macroeconomic imbalances through cross-border capital inflows for too long, resulting in the accumulation of risk. When these flows turned into outflows as the economic environment deteriorated after 2008, these imbalances not only led to problems for the countries concerned but also produced contagion to other parts of the euro area. These externalities led to the emergence of a twin crisis, where private sector debt (often by financial intermediaries) was rapidly converted into public liabilities, resulting into the self-reinforcing negative feedback loop between sovereigns and banks I alluded to before.

A single mechanism for banking supervision and a common authority with strong tools for bank resolution could have mitigated the emergence of these negative externalities. The crisis clearly highlighted that financial stability is a common good and as such requires shared responsibility for its preservation. We have learned the hard way that high financial integration without a commensurate deeper integration of financial stability policies is intrinsically unstable.

Second, sustained divergences in competitiveness and macroeconomic imbalances were largely ignored. Persistent current account imbalances within the euro area, signalling vulnerabilities of some Member States, were long considered as irrelevant in a monetary union. Besides fiscal surveillance, the working assumption was that there is no need to closely monitor macroeconomic imbalances. Disequilibria originating from the private sector were supposed to be only short-lived and eliminated by market forces. The crisis has taught us that imbalances in individual countries may have powerful negative externalities on other countries within a monetary union. This recognition led to the belief that the governance of economic policies at the EU level has to be reformed: more effective macroeconomic policy coordination at euro area level is an essential building block of a monetary union.

Third, the euro area availed of a fiscal policy coordination and surveillance framework. The existence of fiscal rules at the EU level, codified in the Stability and Growth Pact and in the

Treaty Excessive Deficit Procedure, was motivated by the need to ensure fiscal discipline, preserve fiscal space and hence allow automatic stabilisers to play out in full during downturns. More fundamentally, the fiscal rules were supposed to prevent countries from pursuing irresponsible fiscal policies with negative externalities on the rest of the monetary union. However, the previously existing framework did not have sufficient “teeth” and its implementation by Member States within the Eurogroup remain insufficiently strict. As a result, EU fiscal rules did not constrain budgetary policies sufficiently.[5]

At the beginning of the crisis, it became painfully evident that the euro area was also lacking effective crisis management tools.

First, the design of the euro area assumed that stabilisation would take place at the national level and to a large extent automatically. The crisis has shown us, however, that shock absorbers at the national level are insufficient in case of a major financial and economic crisis. Indeed, the scale of the shock after the 2008 financial crisis was unprecedented in a number of countries and it far exceeded their national shock absorption capacity. The euro area had no mechanisms to provide financial support for countries in difficulty, ensure efficient risk sharing and prevent cross-border contagion; notably, there were no area-level institutions to prevent fiscal sustainability from being jeopardised by severe problems in their domestic banking systems. This underscored the pitfalls of a design that relied too much on the national level to fulfil the stabilisation function.

Second, the financial crisis demonstrated that financial contagion is the unintended consequence of financial market integration. The euro area, however, was lacking effective instruments to mitigate contagion. Policy instruments that can act as circuit breaker, limiting thereby negative feedback loops, are an essential crisis management tool in a monetary union.

To summarize, one of the key lessons that we have learned from the crisis is that the design of the euro area was incomplete. Indeed, the euro area lacked certain institutional elements which are associated with federations and which act as crisis prevention mechanisms ex ante as well as shock absorbers ex post. The logical corollary is that we need to compensate for these “missing institutions” by establishing a much stronger financial and economic union. I will now outline the main elements of that endeavour. I will first discuss reforms implemented at the national level – though sometimes also decided in the context of EU-IMF lending programs – and then move to the reforms at the EU or euro area level.

4. The road ahead towards deepening the union

4.1 Reforms at the national level

Almost six years down the road since the start of the financial turmoil that turned into a crisis, many euro area countries have experienced a significant, although to date still partial, correction of external and domestic imbalances. This is positive news, before reform action at the national level is ultimately the most important for getting the crisis behind us.

Substantial progress can be seen most clearly in the development of current account balances. Much of this was driven by an inevitable drop in domestic demand, but we have also seen strengthening exports in a global environment that is not really buoyant. This indicates that the countries’ efforts to rebalance their economies are starting to bear fruits. Part of this picture is also the partial reversal of previous losses of competitiveness, but here the pace of progress varies across countries.

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[5] See D. Ioannou and L. Stracca (2013): “Have euro area and EU economic governance worked? Just the facts”, European Journal of Political Economy, forthcoming.

Fiscal balances have also shown strong improvements. For example, Greece's structural primary balance has improved considerably, though the fiscal situation is still facing big challenges. At the same time it is positive to see that the general upward trend in private sector indebtedness has been halted in most countries, both in the household and the corporate sector, including the financial sector.

Last but not least, structural reforms have gathered pace. The countries under an adjustment programme have taken many initiatives to make their economies more flexible and market-oriented, thus sowing the seeds for better performance and increased competitiveness in the future.

All of these developments give reasons to be cautiously optimistic about the prospect for crisis-ridden countries' return to a path of sustainable growth, productive investments and creation of new jobs.

However, historical experience suggests that the combination of an economic downturn and a financial crisis is usually associated with a prolonged recession and losses of jobs and welfare. Most structural reforms take time to generate positive effects, and some of the countries in distress are still saddled with rigidities in the markets for goods, services and labour.

In order to prevent – and indeed reverse – job losses, the downward adjustment of both prices and wages need to be stronger in those areas where unemployment is still high, and where this adjustment has not taken place to a full extent due to structural or institutional factors. If this goes hand in hand with a continued consolidation of public sector budgets, then the cautious optimists will see their views confirmed through a chain of reduced uncertainty, renewed investor and consumer confidence, better access to funding and a return to robust and sustainable growth.

4.2 Reforms at the European level

Let me now turn to the last and arguably most important topic of my intervention today, namely the reforms which have been introduced in order to make the euro area and the EU stronger in the long haul. To an external observer, especially from Asia, the reform process may seem slow and haphazard, but one has to keep in mind that institutional evolution is almost never a formal optimization exercise starting from a "clean slate", but rather something that builds on the existing institutional setting and adds additional layers and structures, and the institutional evolution of EMU is no exception, as pointed out in recent ECB research.[6] The need to agree on reforms at both the domestic and the European level also introduces an additional element of complexity, which is perhaps difficult to understand from the outside. But it is important to point out that if one looks back it is impressive how much has been achieved in a matter of a couple of years. Let me just briefly describe what has changed in the institutional setting of EMU – and indeed also in the EU more generally – in just a few years. I will start with innovations in the crisis prevention toolkit, and will then move to crisis resolution tools.

Fiscal governance reforms. As I mentioned earlier, one of the major weaknesses of the original institutional setting of EMU was that EU fiscal rules were not sufficiently binding and in particular that sanctions were not credible. This has been addressed in a series of reforms, starting with what we call "six pack", a group of six Regulations which entered into force in December 2011. Without going into the details of the Regulations, let me only mention that their effect is to strengthen the Stability and Growth Pact and to make sanctions a more credible threat.

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[6] See M. Salines, G. Glöckler, Z. Truchlewski and P. Del Favero (2011): "Beyond the economics of the euro. Analysing the institutional evolution of EMU 1999–2010", ECB Occasional Paper No. 127.

Another important innovation has been the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, known as "fiscal compact", which entered into force in January 2013. This is an intergovernmental treaty which establishes, among other things, that Member States must enact laws (preferably at Constitutional level) requiring their national budgets to be in balance or in surplus within the treaty's definition. The laws must also contain a self-correcting mechanism to prevent any breach. The treaty defines a balanced budget as a general budget deficit less than 3.0% of the gross domestic product (GDP), and a structural deficit of less than 1.0% of GDP if the debt level is below 60% – otherwise it shall be below 0.5% of GDP.

Finally, the so-called "two-pack" Regulations entered only very recently into force, subject euro area countries to the obligation of ex ante notification of budgetary plans to the European Commission. Should countries be subject to an excessive deficit procedure (EDP) or be involved in a financial assistance program by the European Stabilisation Mechanism (on which I will touch on shortly), they will also be subject to an enhanced monitoring by the European Commission.

Overall, the cumulative effect of these reforms will be a significant enhancement of fiscal governance in the euro area and it is important that the reforms are now implemented fully.

Macroeconomic Imbalances Procedure. Another important innovation of the "six pack" Regulations is the introduction of the Macroeconomic Imbalances Procedure (MIP), which is designed to prevent and correct phenomena such as high current account deficits, unsustainable external indebtedness, abrupt or prolonged loss of competitiveness and housing and credit booms and busts. Unlike reforms in fiscal governance, which were mainly aimed at strengthening what was already in place, the Macroeconomic Imbalances Procedure is something which was completely absent in the initial design of the founding fathers of EMU. The procedure starts from a scoreboard of indicators, whereby the European Commission identifies the countries and issues which require in-depth reviews. Based on these in-depth reviews and depending on the severity of the imbalances the Commission proposes a policy recommendation under either the "preventive arm" or the "corrective arm" of the MIP. In particular, if the Commission identifies an excessive imbalance that may jeopardise the proper functioning of EMU, it will propose a follow-up under the corrective arm of the MIP, the Excessive Imbalance Procedure. The Member State concerned will have to prepare a corrective action plan with a roadmap and the deadlines for implementing adequate measures. Note that this process may end up in sanctions up to 0.1% of GDP, in case of non-compliance by the affected Member State.

The procedure for identifying and correcting macroeconomic imbalances is very important and addresses a concern that the ECB has voiced repeatedly in the European context. Also in this case it will be important to implement it fully, while being aware of the unavoidable difficulties, also of an analytical nature, of identifying relevant imbalances ex ante.

Macro-prudential policies. Turning to macro-prudential policies, in line with other jurisdictions the EU has equipped itself with a body whose task is to recommend actions to reduce systemic risk in the EU financial sector, the European Systemic Risk Board (ESRB), which is closely associated with the ECB. While the ESRB cannot take direct action, its advice and recommendations carry great weight. In addition, the Single Supervisory Mechanism (SSM) – which I am about to describe in a moment – will assign micro-prudential powers to the ECB for the banking sector of those countries which adhere to the SSM. The ESRB will remain responsible for macro-prudential issues in the EU as a whole and for the whole financial sector (i.e. beyond banks).

Financial market union. Let me now turn to plans to establish a financial market union in the euro area. The nexus between banks and sovereigns and financial fragmentation in the euro area are phenomena that contradict the very essence of a monetary union, where monetary and financial conditions should in principle be uniform in the whole union. Plans to establish a financial market union in the euro area are very important, I would say decisive, in breaking

the link between financial conditions and countries. An important and very well advanced element of the financial market union is the Single Supervisory Mechanism (SSM), whereby the ECB shall assume ultimate responsibility for specific supervisory tasks related to the financial stability of all euro area banks as foreseen in the EU Treaty. While I will not go into the details of the proposals currently on the table, which establish direct ECB supervision of the largest euro area banks and delegate the supervision of the other banks to the national authorities (with the possibility for the ECB to claim direct supervisory powers also for these banks if necessary), let me mention that the ECB considers them an appropriate basis for taking on supervisory responsibilities, while being aware of the many practical challenges associated to them.

It is important that the SSM does not remain the only staple of the financial market union. It is essential that the SSM is accompanied by a euro area (and even better EU) Single Resolution Mechanism.

Economic union. In concluding my remarks on reforms aimed at making future crises less likely, let me also mention proposals currently on the table for the establishment of a Convergence and Competitiveness Instrument, also known as "reform contracts", within the EU budget. The proposal is essentially to create a special EU budget account supporting timely implementation of needed (and possibly unpopular) structural reforms following contractual arrangements between Member States and the Commission. A review of the compatibility of product and labour market structures in euro area countries with the requirements of EMU is also underway, which might provide further impetus to structural reforms in the euro area and make countries less vulnerable to future shocks.

After describing reforms aimed at crisis prevention, let me now turn to crisis resolution mechanisms. Like fire safety restrictions and fire-fighters, the two elements are individually imperfect but should reinforce each other and work in symbiosis.

The European Stability Mechanism (ESM) was created in order to provide financial assistance to euro area countries in financial difficulty. The ESM will function as a permanent firewall for the euro area with a maximum lending capacity of €500 billion. Euro area Member States can apply for ESM financing if they are in financial difficulty or their financial sector is a stability threat in need of recapitalization. ESM interventions are conditional on Member States first signing a Memorandum of Understanding containing a programme for the needed reforms or fiscal consolidation to be implemented in order to restore the financial stability. Note that a precondition for receiving financing from the ESM is to have fully ratified the fiscal compact, which creates a link between crisis prevention and resolution schemes. The involvement of the IMF in the financing schemes is not strictly required but is still highly desirable, also in view of the Fund's analytical expertise in crisis resolution.

I would also like to emphasise that the range of tools available to the ESM compares favourably with those available to the International Monetary Fund (IMF). Hence with the ESM the euro area has equipped itself with a state of the art and permanent crisis resolution scheme, a key missing piece in the initial design of EMU.

Conclusions

As Asia knows very well from its own crisis in 1997/1998, a crisis can be an opportunity for reform and renewed growth. This is embodied by the character *ji*, which in Classical Chinese means at the same time "danger/crisis" (*weiji* in today's language), as well as "chance/opportunity" (*jihui* to use today's term). In this sense the Asian crisis experience is a useful lesson for the euro area, which – I am convinced – will emerge more integrated and stronger from the current challenge.

Perhaps the greatest challenge at this point in time is to keep up the reform momentum even if hopefully the most severe manifestations of the crisis abate and financial market conditions, including financial integration within the euro area, come back to more normal

conditions. While the ECB will continue to play its part and maintain price stability in the euro area, as noted the role of the central bank is limited. Keeping up reforms at the national level is particularly important, as is providing a better foundation for a stronger monetary union and hence fully implement the institutional changes that have been agreed or are currently on the table. Among the latter, I would single out an ambitious and full realisation of a financial market union comprising three legs (single supervisory mechanism, single resolution mechanism and possibly common deposit insurance as decisive for the long term viability of the euro area. Also in this case, the ECB will play its part in full.

Thank you very much for your attention!

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EUROSYSTEM

The crisis response in the euro area

Peter Praet
Pioneer Investment's Colloquia Series
Beijing, 17 April 2013

EUROPEAN CENTRAL BANK

Outline

A. How the crisis developed

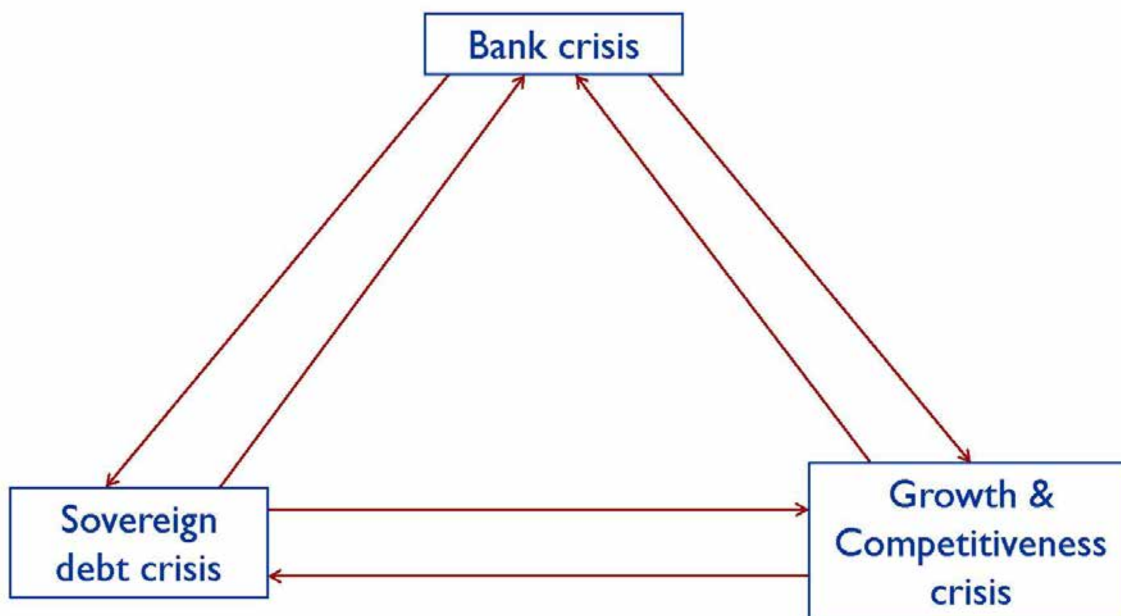
B. Monetary policy response

C. Structural adjustment underway

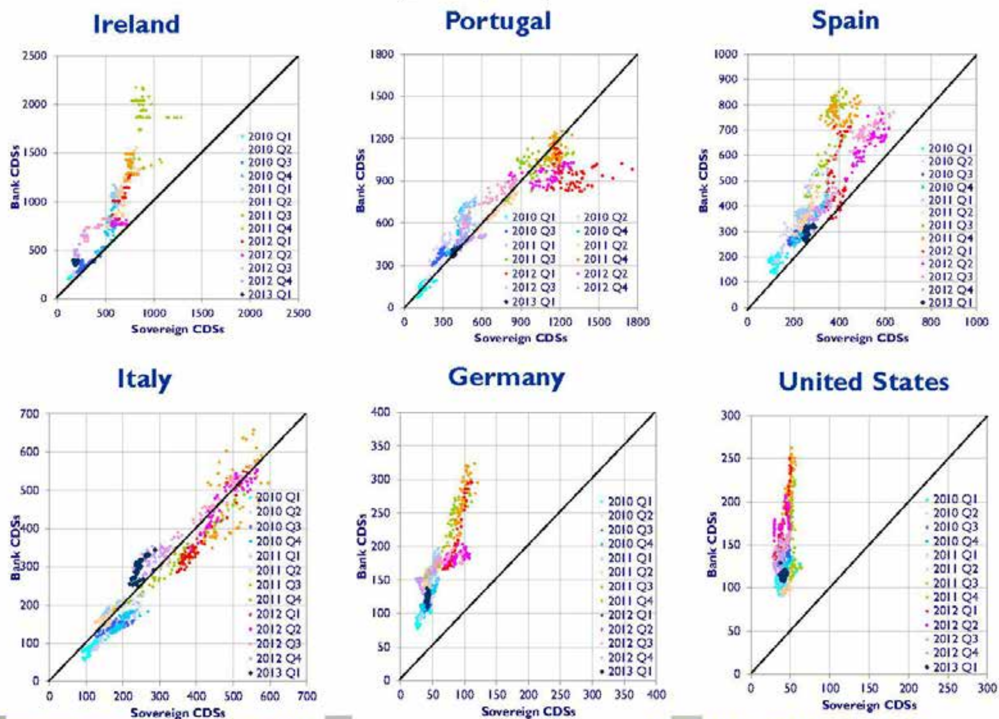
D. Eurozone governance

EUROPEAN CENTRAL BANK 2

A. How the crisis developed
2007 : USA - subprime crisis
2008: Lehman Brothers
2009: great recession
2010: public finance crisis
2011: vicious circle – financial sector ⇨ public finances ⇨ competitiveness crisis
2012: governance crisis in the euro area
EUROPEAN CENTRAL BANK
3


A. How the crisis developed: the feedback loops between banks, sovereigns, and economic growth
Bank crisis
Sovereign debt crisis
Growth & Competitiveness crisis
EUROPEAN CENTRAL BANK
4

A: How the crisis developed: link between bank and sovereign risks



Source: ECB calculations. Last observation: 4 March 2013.

A. How the crisis developed

B. Monetary policy response

C. Structural adjustment underway

D. Eurozone governance

B. Monetary policy response: the ECB's standard and non-standard policy measures

In exceptional circumstances, the ECB took exceptional monetary policy measures:

- Standard measures: historically low key ECB interest rates
- Non-standard measures:
  - Fixed rate full allotment
  - Extension of maturity of refinancing operations
  - Expansion of collateral pool
  - Securities Market Programme
  - Outright Monetary Transactions
- Overall stance of monetary policy is accommodative
- Non-standard measures facilitate the transmission of accommodative monetary policy stance to the euro area economy, in a context of impairment in the transmission mechanism

EUROPEAN CENTRAL BANK 7

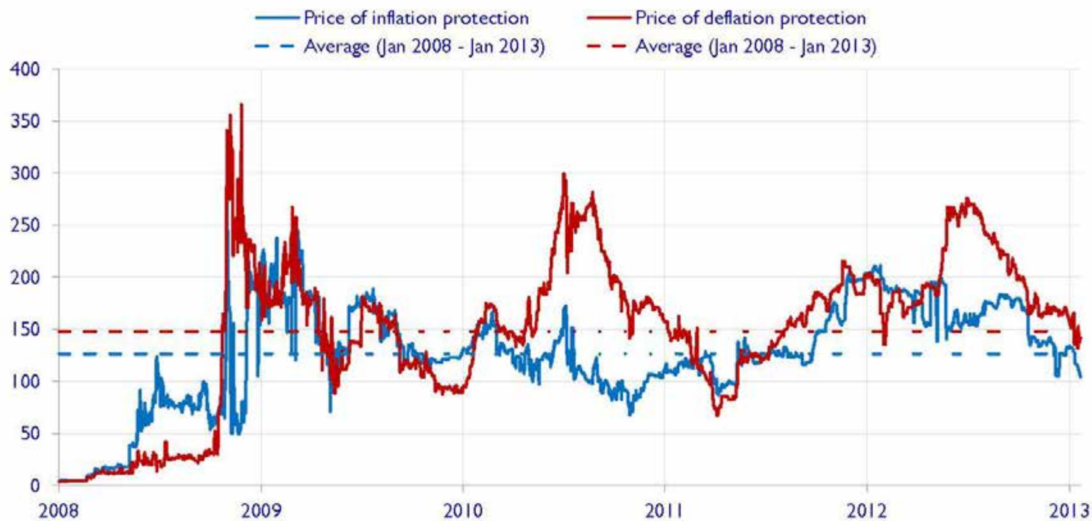
B. Monetary policy response: base money, M3 and the money multiplier

(annual percentage change for M3, index for base money, 2004 = 100)

Source: ECB.
Latest observation: November 2012

EUROPEAN CENTRAL BANK 8

B. Monetary policy response: price of deflation and inflation protection declined below 5-year average

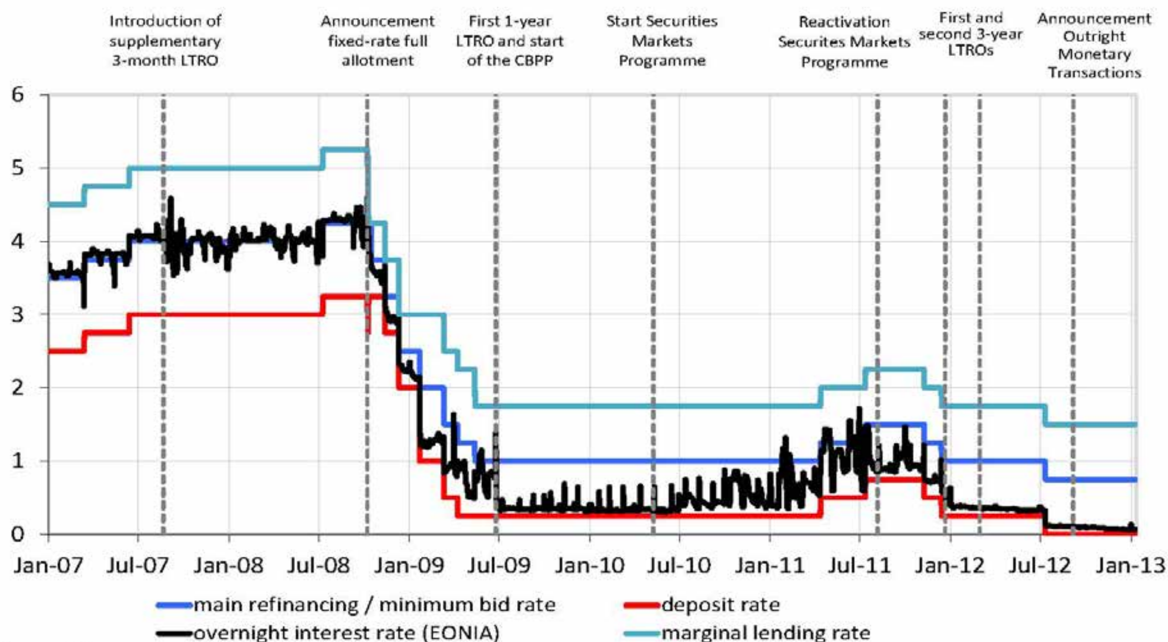


Sources: Bloomberg. ECB calculations.

Note: The market for inflation-linked options is relatively illiquid and often heavily influenced by specific demand and supply patterns. Developments should therefore be interpreted with caution. The underlying instruments are for the inflation protection: year-on-year cap of 4% with 5 year maturity; for deflation protection: year-on-year floor of 0% with 5 year maturity.

EUROPEAN CENTRAL BANK 9

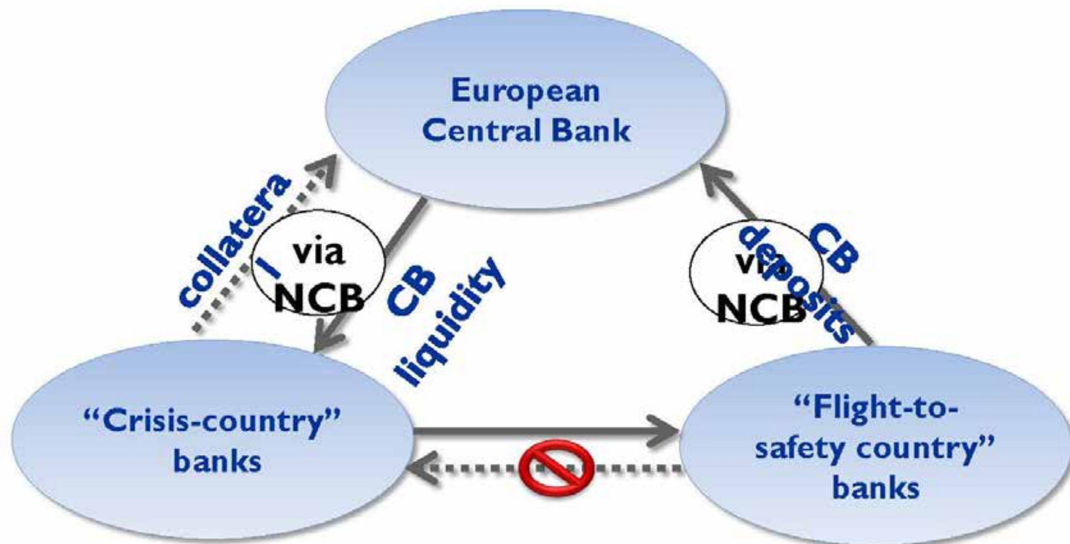
B. Monetary policy response: key ECB rates were cut forcefully and stand at a record low since July 2012



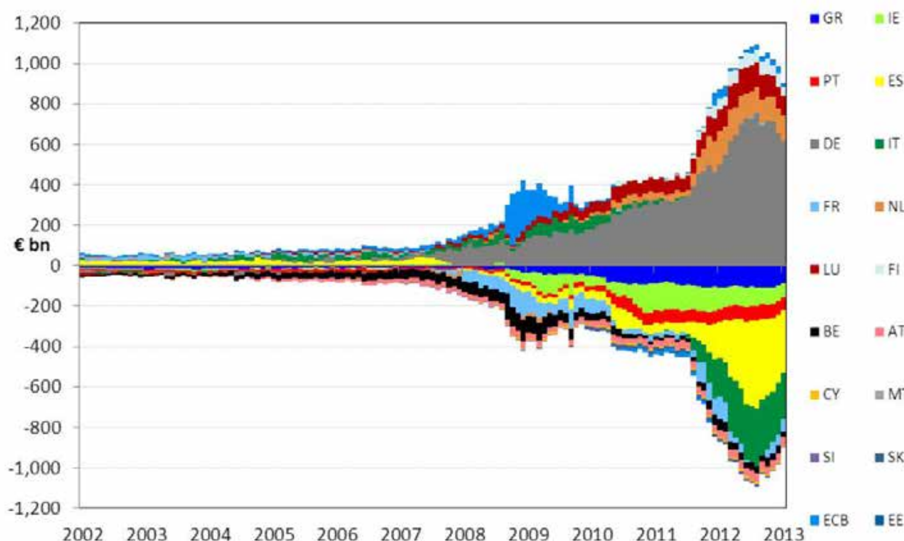
Source: ECB

EUROPEAN CENTRAL BANK 10

B. Monetary policy response: central bank intermediation

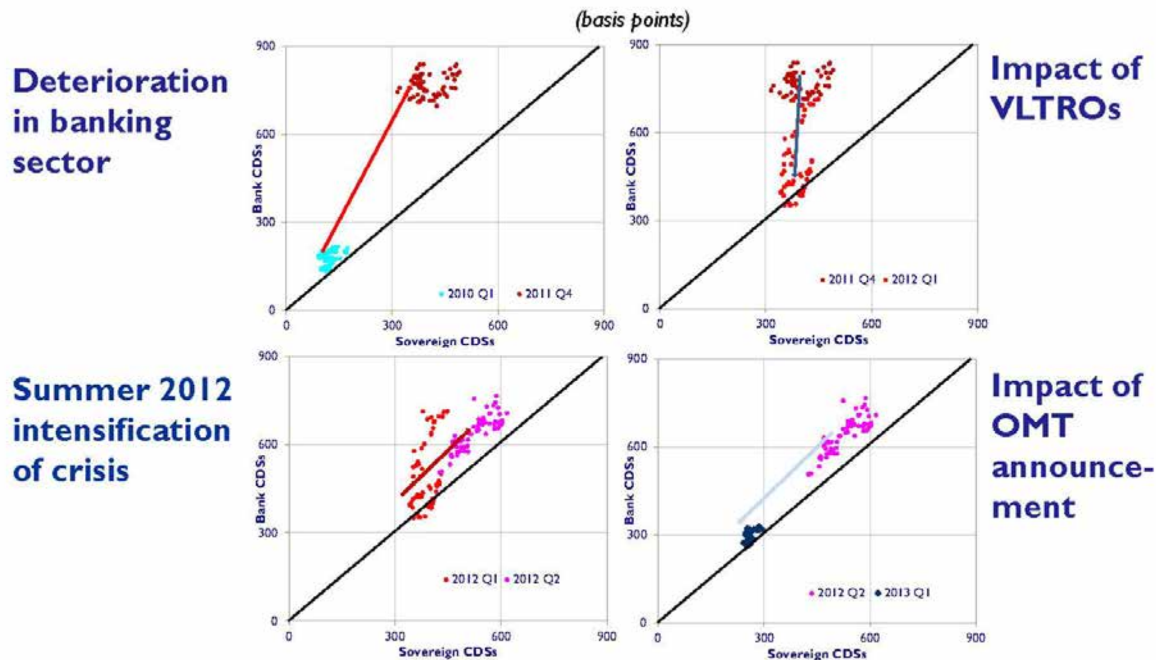


B. Monetary policy response: Target2 balances



Source: ECB, NCB and IMF data and author's calculations (P. Cour-Thimann, Target balances and the crisis in the euro area, mimeo).
Notes: Last observation is end-January 2013.
A positive (negative) sign reflects a net claim (liability) of the national central bank vis-à-vis the ECB in the TARGET2 payment system. Claims and liabilities (including that of the ECB) add up to zero.

B. Monetary policy response: impact of VLTROs and OMT on crisis in Spain



Source: ECB calculations. Last observation: 4 March 2013.

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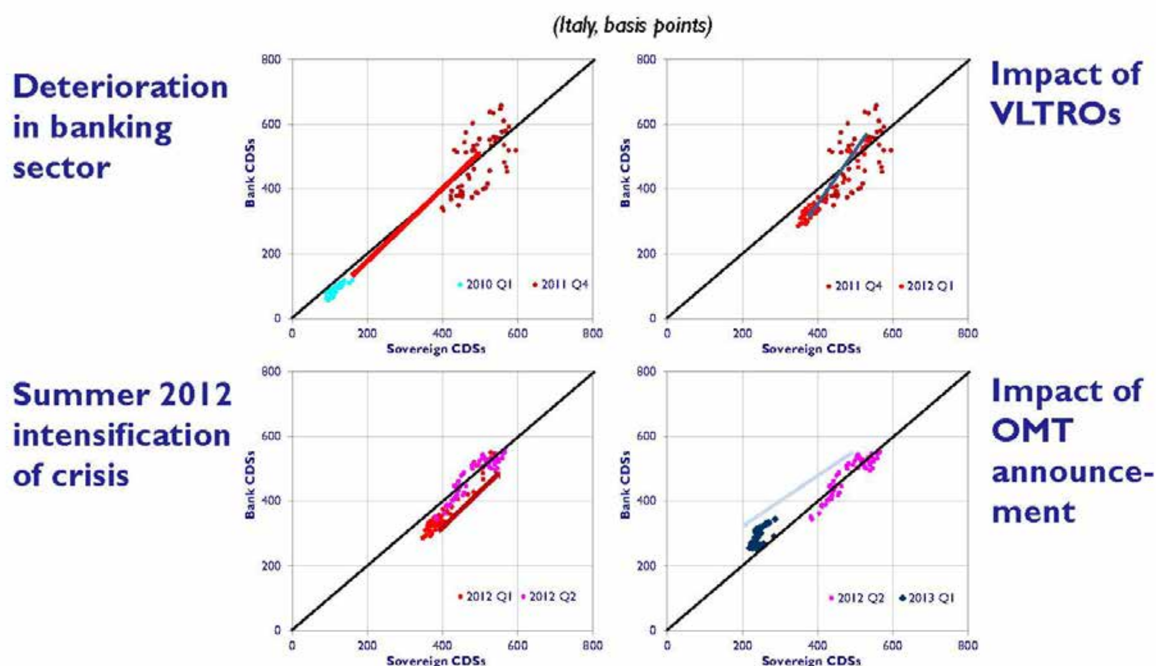
B. Monetary policy response: impact of VLTROs and OMT on crisis in Italy



Source: ECB calculations. Last observation: 4 March 2013.

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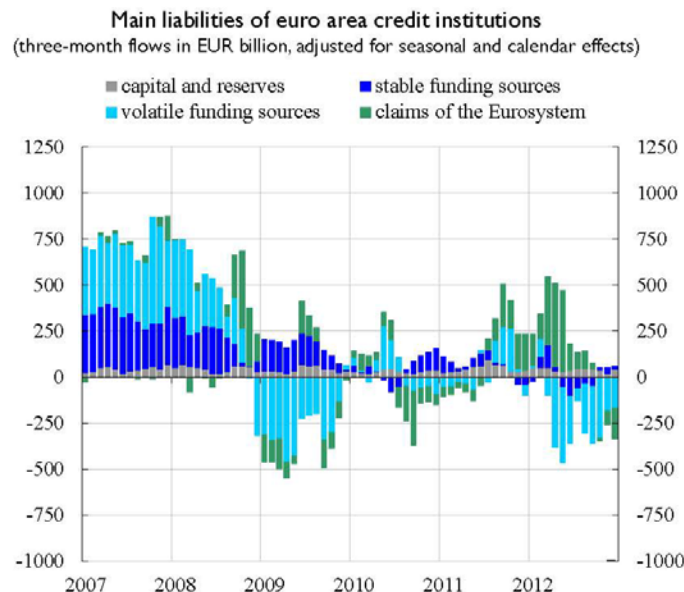
B. Monetary policy response: euro area bank funding developments



Source: ECB. Latest observation: December 2012. Note: Reporting sector is MFIs excluding the Eurosystem. Stable funding sources include deposits of the non-financial sector excluding central government, longer-term deposits of non-monetary financial intermediaries, deposits of non-resident non-banks and MFI debt securities with a maturity of more than one year. Volatile funding sources include deposits of MFIs excluding the Eurosystem, short-term deposits of non-monetary financial intermediaries, deposits of central governments, deposits of non-resident banks and MFI debt securities with a maturity of up to one year.

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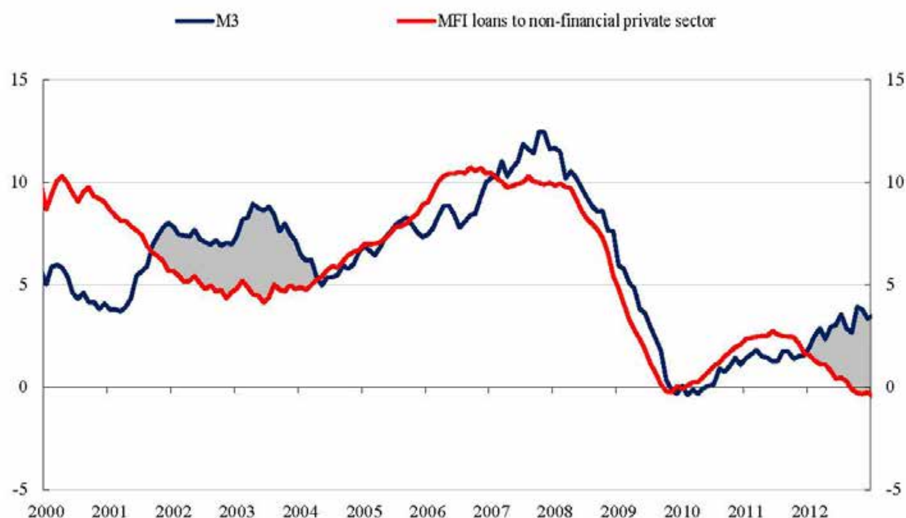
B: Monetary policy response: money / credit growth disconnect



Source: ECB.
Notes: Last observation: January 2013.

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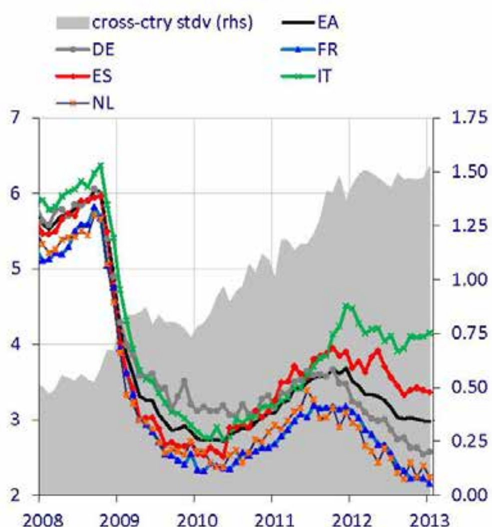
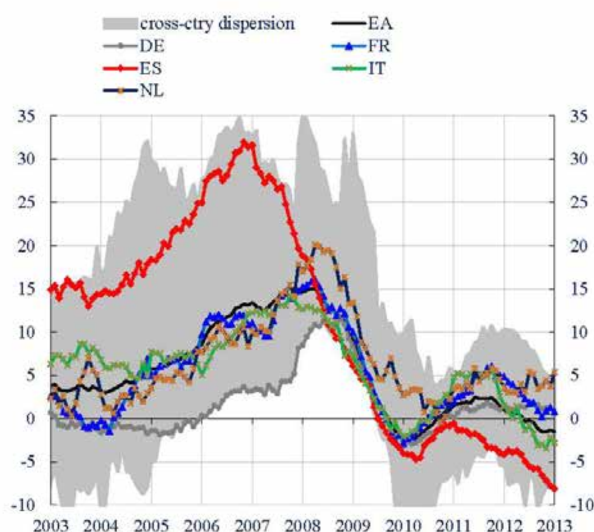
B. Monetary policy response: dispersion in credit conditions

Composite Nominal MFI Bank Lending Rates to NFCs *(% p.a.)*



Source: ECB, MIR Statistics, ECB calculations.
Notes: Last observation: January 2013. Aggregations based on new business volumes of loans.

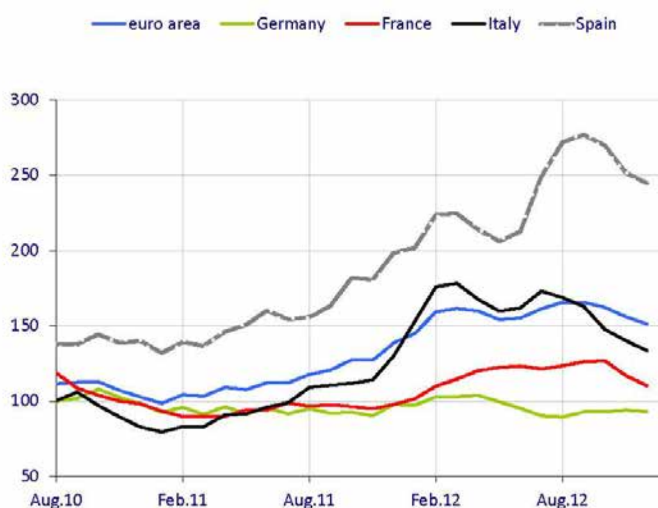
MFI Loans to NFCs *(annual growth rates in %)*



Sources: ECB calculations based on ECB BIS statistics.
Note: Last observation: January 2013.

B. Monetary policy response: declining spreads between small/large loans and further decline in volumes

Spread between lending rates on small and large loans
(bps; three-month moving averages)



Source: ECB., MIR data base.
Last observation: January 2013.
Notes: Small loans are defined as loans of up to 1EUR millions; large loans are above 1EUR million.

A. How the crisis developed

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C. Structural adjustment underway: euro area real GDP growth and HICP developments

(annual growth rates, percentages)		1999-2007	2008-2013
Real GDP	average growth	2.3	-0.2
	variance	1.0	4.2
HICP	average growth	2.1	2.0
	variance	0.1	0.9

Sources: Eurostat and Consensus Economics.
Notes: Calculations based on annual data. Average growth refers to the average of growth rates. Data for 2013 are calculated using the Consensus Economics forecast of February 2013.

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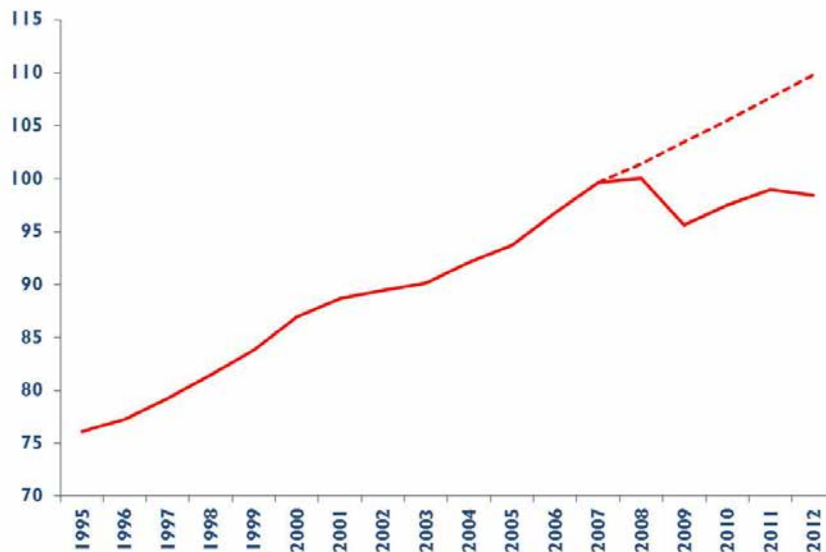
C. Structural adjustment underway: euro area real GDP growth: actual and predicted in early 2008



Sources: Sources: Eurostat, Consensus Economics and ECB calculations.
Latest data: 2012 for GDP outcome. The dotted line represents the evolution of GDP based on private sector expectations as measured by Consensus Economics in January 2008.

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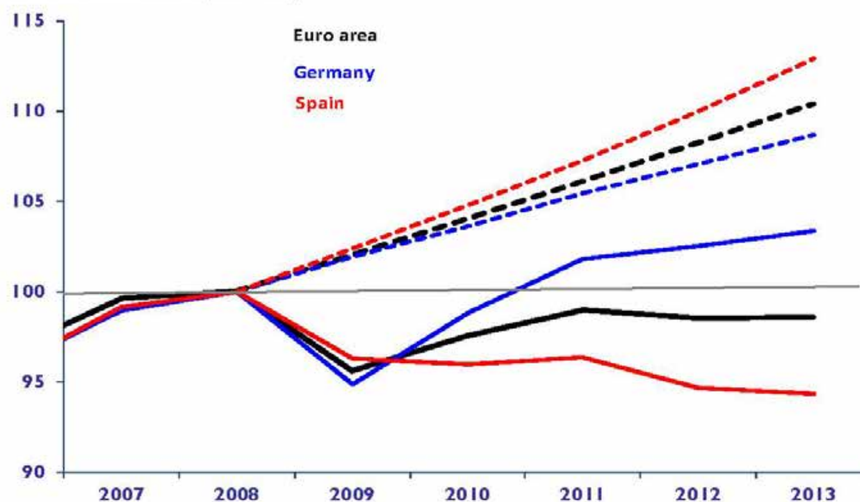
C. Structural adjustment underway: impact of the crisis on real GDP - Expected growth in late 2007 and realisation

Real GDP, euro area, Germany and Spain
All series in index form (2008=100);



Sources: Eurostat, Consensus Economics and ECB calculations.
Latest data: 2012 for GDP outcome, 2013 are EC projections.
The dotted line represents the evolution of GDP based on private sector expectations as measured by Consensus Economics in October 2007.

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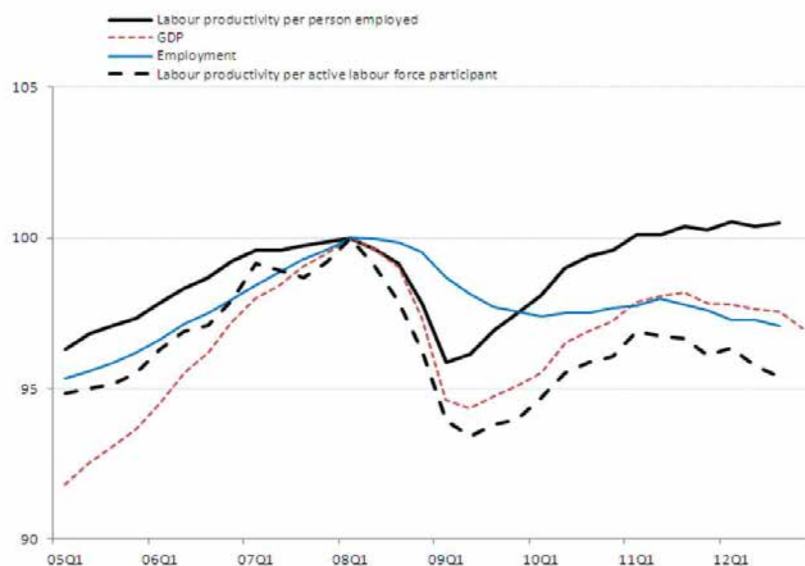
C. Structural adjustment underway: euro area productivity

Euro area productivity developments and components
All series in index form (2008 Q1=100).



Source: Eurostat and ECB calculations.
Latest observations: GDP to 2012 Q4; employment and labour productivity to 2012 Q3.

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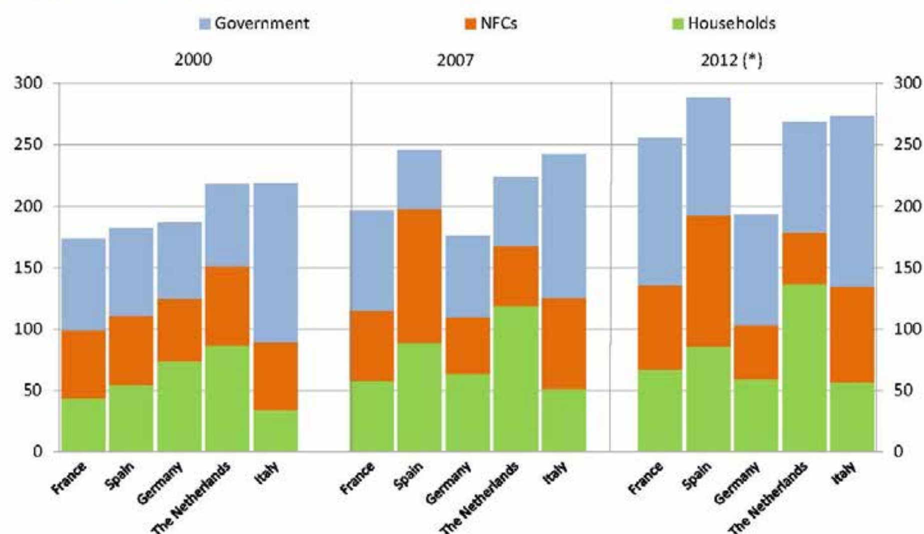
C. Structural adjustment underway: evolution of debt levels in selected euro area countries by sector

(as a percentage of national GDP)



Source: ECB.
Note: Data for 2012 refer to September 2012. For all sectors, debt is defined as total financial liabilities minus shares and other equity at the end of the period. All data is reported on an unconsolidated basis.

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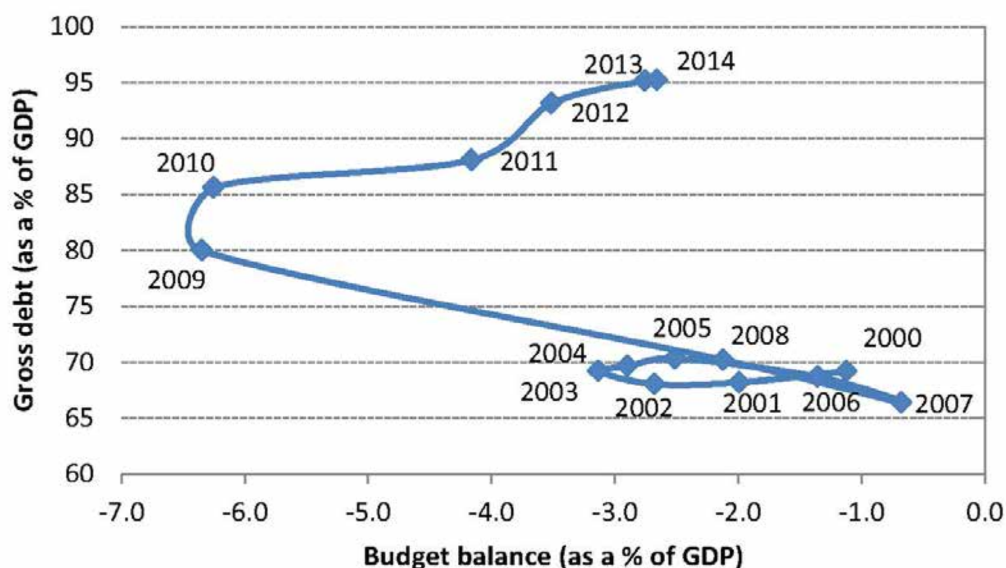
C. Structural adjustment underway: euro area sovereign debt keeps rising, owing to automatic stabilisers, fiscal stimulus and bank support

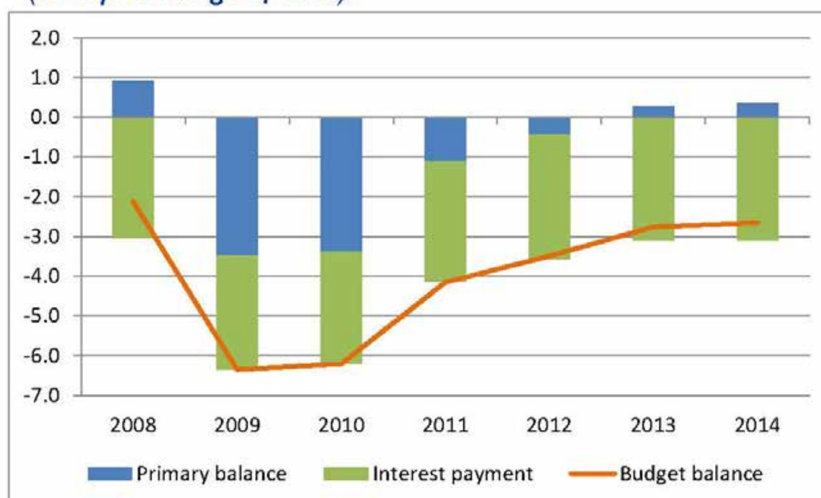


Source: European Commission's winter 2013 economic forecast.
Note: Budget balance excludes UMTS proceeds.

C. Structural adjustment underway: fiscal multipliers

Fiscal Instrument	Short-run multipliers				Long-run multipliers	
	Imperfect credibility	Full credibility	More liquidity constrained households	Higher propensity to work	More liquidity constrained households	Higher propensity to work
Gov. consumption	-	-	--	-	+	0
Gov. investment	--	-	--	--	--	--
General transfers	0	0	0	0	++	++
Targeted transfers	0	0	-	0	++	+++
Labour tax	0	-	0	0	+	0
Consumption tax	-	0	-	0	+	+
Expenditure package	-	0	--	.	0	0
Revenue package	0	0	0	0	+	+
Exp. + rev. package	-	0	-	-	+	0

C. Structural adjustment underway: euro area budget balance adjustment



Source: European Commission's winter 2013 economic forecast.

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C. Structural adjustment underway: budget balance path for euro area and selected countries

(as a percentage of GDP)

	2009		2012		2009-2012	
	Budget Balance	**Structural Primary Balance**	**Budget Balance**	**Structural Primary Balance**	**Budget Balance**	**Structural Primary Balance**
Ireland	-13.9	-7.9	-7.7	-3.5	6.3	4.3
Greece	-15.6	-9.6	-6.6	4.6	9.0	14.2
Spain	-11.2	-6.8	-10.2	-2.9	1.0	3.9
Portugal	-10.2	-5.8	-5.0	-0.1	5.1	5.7
Euro area	**-6.3**	**-1.6**	**-3.5**	**1.0**	**2.9**	**2.6**

Source: European Commission's winter 2013 economic forecast

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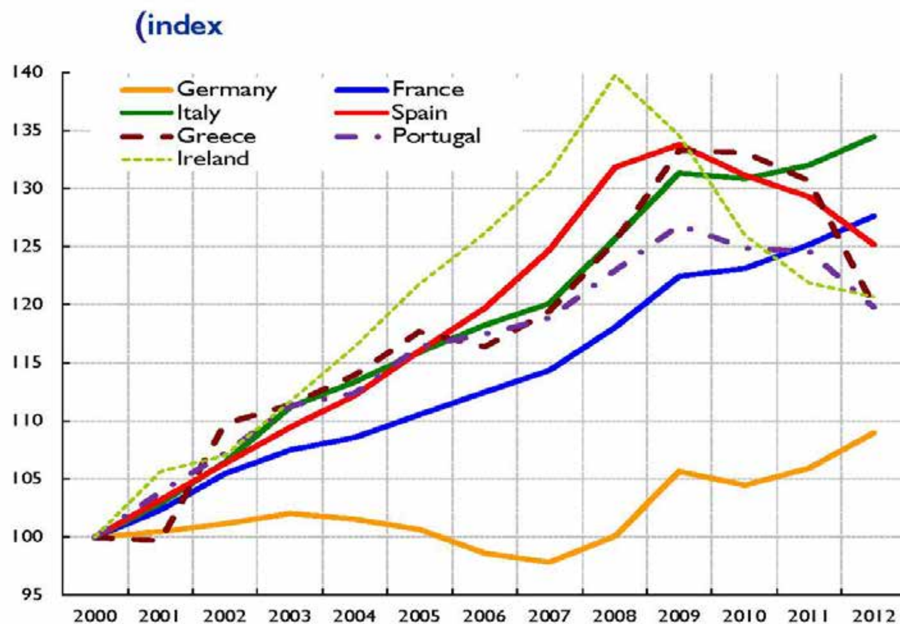
C. Structural adjustment underway: unit labour cost adjustment in the euro area

(index



Source: European Commission (Winter 2013 Forecast), ECB calculations.
Note: Data for 2012 are forecast. Unit labour costs data are calculated on the basis of full-time equivalent measures of total employment and employees for DE, ES, FR and IT.

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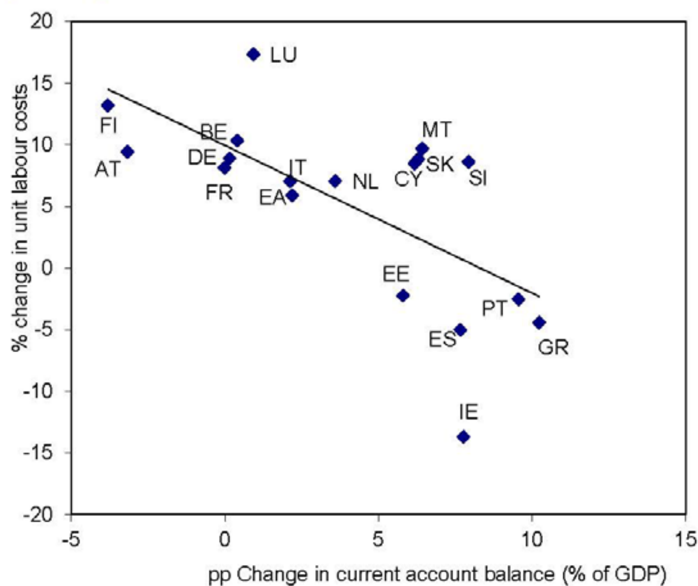
C. Structural adjustment underway: rebalancing within the euro area

(Changes in current account and unit labour costs since 2008)



Source: European Commission Winter 2013 Forecast, ECB Calculations.
Notes: Changes refer to the period between 2008 and 2012.

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A. How the crisis developed

B. Monetary policy response

C. Structural adjustment underway

D. Reinforcing Eurozone governance

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D. Reinforcing Eurozone governance

Four building blocks

1. **Banking Union: An integrated financial framework**
   - Single supervisory mechanism
   - Resolution authority
   - Common deposit insurance

2. **Fiscal Union: An integrated budgetary framework**
   - Establish mechanisms that prevent and correct unsustainable fiscal policies
     - Common agreements on upper limits to annual budget balances and government debt levels for individual Member States
   - Set up of a framework for budgetary discipline and competitiveness
     - Euro area fiscal body, such as a treasury office

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D. Reinforcing Eurozone governance

3. Economic Union: An integrated economic policy framework

- Promote economic integration
- Ensure that unsustainable policies do not jeopardise the stability of EMU
- Enforce the framework for policy coordination

4. Political Union: Strengthening democratic legitimacy and accountability

- Promote mechanisms to make joint decision-making legitimate and accountable

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Thank you for your attention! Questions are welcome!

谢谢注意！ 欢迎提问！

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