Peter Praet: Japan and the EU in the global economy – challenges and opportunities

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the conference "Japan and the EU in the global economy – challenges and opportunities", organised by Bruegel, the Graduate School of Economics, Kobe University, and Fondation France-Japon de l'EHESS, Brussels, 7 October 2013.

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Ladies and gentlemen,

It is a pleasure to be able to share some thoughts on the challenges and opportunities Japan and Europe are facing in the global economy. Since the beginning of the financial crisis, there has been no shortage of challenges along the road back to what I would call the "normal functioning" of our economies.

One of the biggest challenges I see is still to be addressed: that of how to grow in an era of deleveraging. Deleveraging can occur in an orderly fashion or it can be chaotic. It may drag our economies down or it can place them on a stronger footing. Which of these will be the case depends to a large extent on how we manage the process.

Today, I will focus my comments on the policy challenges faced by our two economies, especially as regards how to manage the deleveraging process in the euro area, keeping in mind the Japanese experience during the 1990s.

As witnessed in Japan, protracted and large-scale balance sheet adjustments can weaken economic activity over a protracted period of time. Repairing the financial sector was an important element in improving the Japanese economy. The lesson for the euro area appears to be clear: the overhaul of the financial architecture – including the establishment of a procedure for resolving failing banks – needs to be accomplished in its entirety; selective mending will not be enough.

In my view, we should make use of the momentum offered by the crisis to turn these challenges into opportunities – opportunities to put our economies on a sounder footing.

To underscore why I think that we need to address today's challenges in a comprehensive manner and why institutions are crucial in achieving this, I will first briefly review the build-up and adjustment of financial imbalances both in Japan and in Europe. Then I will elaborate on how to manage the deleveraging process and the institutional changes to be implemented, before touching upon the role monetary policy has to play.

Imbalances in Japan and the euro area

The Japanese experience provides important lessons as it demonstrates the difficulties of emerging from a "balance sheet recession".[1] With the euro area still battling the impact of the financial crisis, an important question is: how does the current euro area economy compare with the dynamics in Japan during the 1990s?[2]

1 Termed by Richard Koo in Koo, R., *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, Wiley, 2009.

2 See also "Comparing the recent financial crisis in the United States and the euro area with the experience of Japan in the 1990s", *Monthly Bulletin*, ECB, May 2012.

Both episodes clearly share elements of a "balance sheet recession", where strong credit expansion ends with a sharp correction in asset prices, thereby triggering the need for significant balance sheet adjustment.

Yet, the scope of the required adjustment in the euro area when viewed at the aggregate level differs markedly from that in Japan, even if some euro area countries struggle with excessive leverage.

In Japan, the sharp fall in equity prices from the peak of 1989 led to losses of almost 80% in the two decades that followed. Real estate prices also precipitated, with urban land prices declining by about 40%. By comparison, at the euro area aggregate level, equity prices fell by about 50% and have already rebounded from their post-Lehman trough, while residential property prices have fallen by a mere 3% since their peak in 2008.

Moreover, the levels of indebtedness across sectors clearly differ. As for fiscal imbalances, the fiscal response in Japan meant an increase in public debt from 67% of GDP at the start of the 1990s to about 240% in 2012. For the euro area as a whole, the increase was much smaller, with aggregate debt increasing from below 70% in 2008 to 92% in 2012. Obviously, the euro area aggregate figures mask the large heterogeneity among Member States, where gross debt ranges from 10% of GDP in Estonia to 157% in Greece. This notwithstanding, it goes without saying that general debt levels in European countries need to decline, also in view of long-term demographic challenges.

Turning to private sector debt, Japan faced severe adjustment needs in the corporate sector, with debt of non-financial corporations declining from 130% to 80% of GDP in the 15 years that followed the peak in economic activity. In the euro area, the debt level of the aggregate non-financial sector never reached the peaks seen in Japan and aggregate household indebtedness is also comparatively lower in the euro area. However, in those euro area countries which experienced housing bubbles, the household sectors have been facing much stronger adjustment problems. Here, again, euro area averages mask significant heterogeneity across Member States.

In fact, some euro area countries have seen strong capital inflows and unsustainable debt-financed economic expansion. This has not only brought the risk of reversal, as seen after 2008 when private capital inflows dried up and domestic demand collapsed, it has also led to economic divergence within the euro area. Some countries have lost heavily in terms of competitiveness relative to their peer euro area countries. Regaining this competitiveness will indeed be a more gradual and tedious process.[3]

The credit-financed housing boom in countries like Ireland and Spain led to residential property prices more than doubling in the seven years leading up to their peak. Since the peak, adjustments in house prices appear to have been completed in Ireland, while those in Spain are correcting more gradually. In both cases, the house price boom has left household debt-to-income ratios in these countries far above their pre-crisis levels with only a slow decline.

To summarise, while euro area aggregate dynamics appear different from those observed in Japan at the beginning of the 1990s, some euro area countries do share some features that are very similar to the Japanese experience in that a prolonged balance sheet adjustment is underway.

3 Of course, in a financially integrated area comprising several countries, financial deficits (or surpluses) of a given sector in any country can, in principle, be financed (or invested) equally well in any other country within the area. Following this line of reasoning, cross-country patterns in sectoral financial balances could reflect increased financial integration within the euro area. At the same time, the build-up of external deficits and surpluses across euro area countries reflects not only growth differentials, but also rising imbalances in competitiveness, particularly when measured by unit labour costs.

Notwithstanding this cross-country heterogeneity, a common response was required from monetary policy in the euro area to counter the initial fallout. The cuts in ECB policy rates together with our non-standard measures were crucial to contain the risks to price stability and to support the transmission of monetary policy across the currency area. While common monetary policy has been successful, the crisis has shown that we need more solid common institutions in other policy areas. In particular, a common monetary policy requires a common regulatory framework for the financial sector to be able to adequately repair the financial system, thereby securing a durable recovery in the euro area. The adverse impact of “zombie banks” and the evergreening of loans in Japan serve as a stark warning signal.

Given the challenges ahead, we should not relax our efforts to put the euro area economies on track to strong and sustainable growth. That way, we can turn the current challenges into opportunities – as the title of today’s event suggests. Further managing the deleveraging process will be key, especially balancing the speed of adjustment and reforming euro area governance. Let me elaborate on these two aspects in turn.

Managing the deleveraging process

To overcome debt overhangs, we have basically two options. We can consolidate or restructure debt to address the nominal debt stock; or we can implement growth-enhancing structural reforms that make our economies fitter to grow out of the debt burden. Or we could opt for a combination of both. A third theoretically possible option allowing for higher inflation to reduce the real value of the debt would go against the core mandate of central banks.

In recent years, we have seen some consolidation in Europe. As regards public finances, euro area fiscal deficits exceeded 6% at the peak of the crisis in 2009 and 2010, but are expected to fall below 3% this year, while primary budgets are even expected to post a surplus of 0.2%.[4] This adjustment strategy has brought with it painful cuts in our social models and has not been without controversy.

In fact, some commentators and academics suggest that governments should continue increasing deficits to support aggregate demand while the private sector is deleveraging. They argue that parts of the private sector are debt-constraint and need to reduce their leverage, while parts that are unconstrained are not increasing their leverage sufficiently.[5] In such an environment the role for government spending is to expand demand for funds, and especially so when the nominal interest rate is constrained by the zero lower bound.[6] I would agree to this approach if the fiscal budget allowed for room for manoeuvre. But the recent sovereign debt crisis has shown that fiscal space is very limited for many European countries.

In Japan, the strategy of fiscal expansion has led to a situation in which gross government debt levels now exceed 200% of GDP. The continued favourable financing conditions appear to also be owed to the fact that more than 90% of Japanese government bonds are held domestically. This situation can be seen as a special privilege for the government. But the high exposure of banks to their domestic sovereign – in fact, Japanese banks hold about 20% of their assets in domestic sovereign bonds – is not without risks,

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4 Fiscal deficits in the euro area reached 6.4% of GDP in 2009 and 6.2% in 2010 (according to Eurostat). The European Commission forecasts –2.9% in its Spring 2013 European Economic Forecast.

5 See Eggertsson, G. and Krugman, P., “Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach”, *Quarterly Journal of Economics,* 127 (3), 2012, pp. 1469–1513, and Guerrieri, V. and Lorenzoni, G., “Credit Crises, Precautionary Savings, and the Liquidity Trap”, *NBER Working Papers*, No 17583, 2011.

6 See also the series on deleveraging by Martin Wolf in the Financial Times, initiated with the comment “We still have that sinking feeling”, Financial Times, 10 July 2012, and the comment “Ways to accelerate private-sector deleveraging”, 30 July 2012.

especially in the event of sudden reversals in market confidence. Maintaining financial and economic stability therefore requires a clear and long-term fiscal strategy to avoid disruptions. This is true for Japan and Europe alike.

Debt consolidation is not limited to the public sector, however; it also applies to areas of the private sector with excess leverage. Let me focus on the euro area financial sector. While the ratio of financial sector liabilities to GDP has broadly stabilised, euro area large and complex banking groups have steadily increased the median core Tier 1 ratio from 8.3% in 2009 to above 11% in 2013.[7]

To strengthen their capital position banks have issued equity, converted hybrids, received capital injections and raised the levels of retained earnings. The stronger capital positions also mean that the relative share of debt in financing is reduced and substituted by more equity, which should provide a better buffer against economic shocks. After all, debt is a relatively inflexible form of financing as it requires repayments on time and in full.

But the stronger capital positions have also meant that banks have been shedding assets, a process which depresses credit growth and puts a drag on the economy. In addition, as households and non-financial corporations also reduce their indebtedness, they are demanding less financing from banks. Taken together, we can expect that bloated balance sheets will contract further.

It is important that this deleveraging process occurs in an orderly manner by balancing the adjustment of assets and liabilities. Most of all, unnecessary fire sales generating detrimental falls in asset prices and credit rationing for productive investments need to be avoided. Throughout the crisis, the ECB has demonstrated its ability to actively mitigate these effects by ensuring abundant funding to the banking sector through its liquidity operations. But more is needed, especially regarding a more solid institutional framework to repair balance sheets in a way that limits systemic risk and avoids damage to the real economy.

The Japanese experience has shown the risks created when banks' balance sheet problems are not recognised and addressed. Weakly capitalised banks initially extended loans to insolvent firms to limit the recognition of losses in the short run. Indications of evergreening became prominent as the share of loans to the construction sector continued rising for years after the bubble had burst, despite the fact that this sector was adjusting and needed to downsize. Write-offs on non-performing loans and necessary recapitalisations were delayed and the financial sector remained highly vulnerable to shocks. But delayed recognition was also facilitated by valuation standards that did not mark non-performing loans to market, unlike much of the losses from securitised products in the recent crises. In addition, the refusal of banks to foreclose on borrowers might have reflected a different resolution culture and code of civility in Japan; namely, one that eschews the large turnover of jobs and the frequent discharging of workers and avoids inducing a humiliating "loss of face" for delinquent borrowers.[8]

For the real economy, the evergreening of loans implied a weakening of growth prospects.[9] Potentially more efficient enterprises were denied financing, thereby hampering the natural entry and exit of firms to the market place. Indeed, with the recession in Japan at the

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7 See ECB, *Financial Stability Review*, May 2013.

8 On this point, see Greenspan, A., *The Age of Turbulence: Adventures in a New World,* Penguin, 2007, pp. 289–290.

9 See, for instance, Caballero, R., Hoshi, T. and Kashyap, A., "Zombie lending and depressed restructuring in Japan", *American Economic Review*, Vol. 95, 2008, pp. 1943–1977, Peek, J. and Rosengren, E., "Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan", *American Economic Review*, 95, 2005, pp. 1144–1166, and Nishimura, K.G. and Kawamoto, Y., "Why does the problem persist? 'Rational Rigidity' and the plight of Japanese banks", *The World Economy*, Vol. 26, 2003, pp. 301–324.

beginning of the 1990s, entry rates of firms declined from their pre-crisis peak of above 7% to a range of 4–5%, whereas firm exit rates remained subdued at their pre-crisis levels throughout the 1990s.[10]

The lesson from this experience is to recognise non-performing loans in a timely manner and have strong institutions in place to deal with the restructuring. This reduces uncertainty and avoids adjustment delays. For the euro area, it is a call to move forward in completing the banking union.

Supervision and resolution

Up until now, supervisory and resolution authorities have operated at the national level. During the crisis this set-up has revealed pitfalls on three fronts. First, differences in supervision maintain humps and hollows in the euro area playing field, thereby distorting competition; second, differences in implicit state guarantees affect banks' funding conditions; and third, differences in resolution frameworks – or a lack thereof – distort investor conditions across jurisdictions.

The envisaged European banking union is meant to address these three pitfalls.

First, the single supervisory mechanism (SSM) will level the playing field in supervision. Only a month ago, on 12 September, the European Parliament paved the way for this truly European supervisory body. I hope that the Council will soon give its final consent. The ECB will then take over supervision of euro area banks in the second half of 2014.

We will ensure that euro area banks are supervised in a consistent and stringent manner. This implies impartial supervisory decisions across all Member States. We are already in the midst of preparations to make sure we reach this goal. The ECB is currently working on the methodological design for a comprehensive assessment. We will communicate details on the exercise in the second half of October, but I can already say today that the exercise will include a risk assessment and a balance sheet assessment. The results of this exercise will form the basis for a stress test to be carried out by the European Banking Authority in close collaboration with the ECB. In order to achieve its goal, this review needs to be rigorous and stringent. For it to be credible, we need commitment on sound backstops as a fall-back option for fulfilling capital needs.

In Japan, such a close inspection of bank balance sheets was carried out in 2002. It proved to be an important step to recognising losses and cleaning balance sheets to eventually set off a gradual recovery with credit expansion in Japan.

Second, one of the objectives of a European banking union is to delink banks from their sovereigns. That also implies that bank funding costs will depend on the quality of banks' assets, and not on the location of their headquarters. Achieving this would mark a milestone in that it would establish a single capital market throughout Europe that companies can tap into. A single capital market, in turn, provides better financing for companies and eases productive investment, which will revitalise the European economies. Ultimately, it will be decisive in ensuring that Europe avoids a repeat of Japan's "lost decade", during which zombie banks poorly allocated financing across firms.

Third, orderly deleveraging in the euro area also requires that the restructuring and resolution of individual banks will not endanger financial stability or put public finances at risk. For this, the institutional framework needs to be solid. This is the rationale

[10] Entries of business establishments declined from their peak of 7.4% in 1988 and have not exceeded 5.0% since then, whereas exit rates remained at subdued levels of 2.5–4.0% between 1988 and 2000 and have increased to above 4.0% since then.

behind the creation of a single system with a single resolution authority and single resolution fund, in line with the proposal by the European Commission for a single resolution mechanism. The resolution fund is to be entirely financed ex ante by the financial industry itself so as to protect the European taxpayer. Still, until the fund is fully built up or for exceptional circumstances, it should be able to obtain external funds via a backstop. Here, the feasibility of a credit line from the European Stability Mechanism could be explored. Any such backstop should be temporary in nature and compensated by ex post levies on the banking sector ensuring that the fund is fiscally neutral over the medium term.

A banking union with these elements in place has the potential to delink banks and sovereigns, not least by following an important principle: bail-in precedes bail-out. This will ensure that shareholders and unsecured creditors according to the hierarchy of their claims are the first to bear losses, not the taxpayers.

Monetary policy

Speaking in my capacity as a central banker, let me finally come to the role of monetary policy in the deleveraging process.

To counter the risks from disorderly deleveraging, the swift cuts in ECB policy rates and our non-standard measures were key. Fixed-rate full allotment and longer-term refinancing operations stabilised financial markets early on and counteracted the risks from fire sales by providing liquidity where it was most needed.

Equally, the ECB did not shy away from bold measures to curtail tail risks and to restore the monetary policy transmission. Over the last year euro area financial fragmentation has fallen significantly, capital flows have reverted to stressed countries and financing costs for corporates have converged somewhat across countries.

These measures had the overarching purpose of ensuring price stability over the medium term. For the euro area, this is not merely lip service to the primary objective stated in the EU Treaty. It is, instead, the yardstick against which to measure the success of the ECB policies and to build credibility. In fact, inflation expectations remained firmly anchored throughout the crisis. By contrast, policy interest rates in Japan in the early 1990s remained at higher levels for longer, which, together with a lack of reforms in other areas, contributed to protracted economic weakness and falling prices. Eventually, inflation expectations became unanchored and made stabilisation more difficult for monetary policy once it was at the zero lower bound.

Some commentators would go further and argue that central banks should loosen the belt in the deleveraging process to actively stoke high inflation.[11] I disagree with this line of reasoning. Although surprise inflation would reduce the real debt burden in the short run, it would sow doubts about the central banks' ability and willingness to control inflation in the longer run. Ultimately, it would undermine efforts to implement structural changes and prudent policies.

However, as the Japanese experience has shown, monetary policy alone cannot place the economy on a sustainable growth track. Bold monetary policy measures may be effective in the short run, but they also bear the risk of reducing incentives for banks to restructure balance sheets. We are aware of these risks.

Furthermore, even if central banks operate within their own specific circumstances and mandates, the policy measures may lead to unintended spillovers to other countries. To ensure that monetary policy is transmitted adequately to the economy and domestic

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[11] See, for example, Blanchard, O., Dell'Ariccia, G. and Mauro, P., "Rethinking Macroeconomic Policy", *Journal of Money, Credit and Banking*, 42(s1), 2010, pp. 199–215.

financing conditions are insulated from those prevailing in the global economy, sound macroeconomic policies and strong domestic institutions are vital.

In addition, to place the economy back on track to sustainable growth, a medium-term fiscal consolidation strategy as well as structural reforms with productive investment are essential; these two elements combined with monetary policy form the three arrows identified by Prime Minister Abe. Monetary policy can buy time to implement structural changes and ease the deleveraging process, but it cannot cure the root causes of imbalances or be a substitute for structural reforms.

Conclusion

Allow me to conclude.

Both our economies face large challenges to counter the risks from deleveraging. Preventing disorderly deleveraging will remain key to limiting possible adverse effects on the economic performance in the most indebted euro area countries. At the same time, repairing banks' balance sheets and ensuring their soundness is a pre-condition for re-establishing adequate financing of the economy. This is why the SSM, including the comprehensive assessment, and the single resolution mechanism are crucial steps towards improving euro area governance. The European institutional context may sometimes appear cumbersome, but the progress made shows that Europe recognises problems and responds to them.

Nevertheless, even with these changes, solving a stock problem means addressing a prolonged adjustment in flows in the future. We are all well aware that debt consolidation alone weighs on economic activity just like a diet leaves one with the feeling of fatigue. The deleveraging process will require time; we should not lose patience in the process.

Compared with past episodes, deleveraging has, in fact, become even more challenging. The global dimension of deleveraging makes burden-shifting across countries impossible and today's demographic trends are putting strain on our growth prospects. It is therefore crucial to balance the consolidation across generations[12].

Nonetheless, I reemphasise the need to complement the consolidation process with structural changes in order to make our economies fitter. This involves reducing red tape to ease business creation, streamlining governance of state-owned enterprises and reallocating workers more flexibly from stagnating and declining industries to productive and expanding ones. Structural reforms are not only required in the countries in the euro area, but have also been recognised by Prime Minister Abe in his third arrow as essential to securing the Japanese recovery over the long term.

Thank you for your attention.

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[12] See, for example, Tokuoka, K., "Intergenerational Implications of Fiscal Consolidation in Japan", *IMF Working Papers*, 12/197, 2012.