George A Provopoulos: From financial crisis to financial stability – a European odyssey

Speech by Mr George A Provopoulos, Governor of the Bank of Greece, at the Bank of Poland Biannual EU Presidency Lecture "From Financial Crisis to Financial Stability: A European Odyssey", Warsaw, 12 February 2014.

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I would like to thank President Belka for inviting me to be here. The occasion of these lectures provides an opportunity to take stock of the progress made toward European monetary and economic integration and the work that lies ahead.

My discussion of these issues will be structured as follows. I will begin by describing some important shortcomings in the original euro area institutional set-up. This will lead me to a discussion of the origins of the euro area crisis. Next, I will describe the ECB's reaction to the crisis, as well as the measures that have been, or are being taken, to address the euro-area's shortcomings, focusing on economic governance and banking union. I will then take stock of where we stand today – both in the euro area as a whole and in peripheral countries. Finally, I will comment on what remains to be done to make Europe more dynamic and globally competitive.

The euro area at its formation and the origins of the crisis

When deciding on what architecture to give to the monetary union, policymakers settled on a "bare-bones" approach. The approach rested on an independent, price-stability-oriented central bank – the ECB – and fiscal discipline by the individual countries, fostered by the rules of the Stability and Growth Pact and enforced by the markets. The Maastricht Treaty called on countries to pursue sound economic policies that would support the ECB in maintaining its price-stability goal.

The dominant view at the founding of the EMU was that current-account imbalances among countries in the monetary union would become as irrelevant as they are among regions of individual countries. Persistent current-account deficits were interpreted as capital flows from countries offering relatively-low returns on investments to countries offering relatively-high returns. In other words, they were welcomed as part of an equilibrating process under which the fast-growing periphery caught up to the core. This architecture proved inadequate for several reasons, setting the stage for the euro-area crisis.

First, the fiscal rules were poorly designed and under-enforced. As a consequence, in the years leading up to the crisis, the ratio of sovereign debt to GDP in many countries remained at high levels. In some countries, the debt ratios increased.

Second, instead of increasing the pressure for structural reforms and policy adjustments needed to strengthen competitiveness in the periphery, market forces acted in the opposite direction:

- The markets focused on the elimination of exchange-rate risk, while at the same time they mis-priced credit risk, underpinning large capital flows into the periphery and reducing interest rate spreads.
- The reduction in spreads and the abundance of capital led to a relaxation of the budget constraints that the peripheral countries faced and made it difficult to distinguish between those countries that were performing well in terms of policy adjustment and those that were performing poorly.

- To make matters worse, the current-account deficits in the periphery were financed through sources of volatile capital, such as debt securities and interbank loans, rendering the periphery vulnerable to sudden reversals of capital flows.

Third, the founders of EMU underestimated the importance of financial stability in a monetary union. Thus, whereas they focused on the prevention of fiscal imbalances and inflation, they made no provision to deal with private credit booms and busts or with the feedback loops between banking crises and fiscal crises.

Under the original architecture, national authorities were solely responsible for banking supervision, resolution, deposit insurance, and financial stability. The combination of a lack of adequate fiscal rules, the absence of market-enforced discipline, the lack of attention to the interconnections between the banks and the sovereign, and increases in public and private indebtedness financed by volatile capital inflows was toxic.

A tale of two crises

Broadly speaking, the euro area crisis has consisted of two separate crises – a sovereign-induced crisis and a banking-induced crisis. The sovereign-induced crisis is mainly what happened in Greece.

The initial tremors of the euro area crisis occurred in Greece in the fall of 2009 following news that the country's fiscal deficit would be much higher than had been expected by the markets. The country suddenly found itself at the centre of a sovereign debt storm, and interest-rate spreads began a relentless upward climb. The outbreak of the Greek sovereign debt crisis took the markets by surprise. It should not have done so.

Greece joined the euro area in 2001. From that year until 2009, large and growing fiscal and external imbalances should have sounded loud warning alarms in the financial markets. During those years:

- Fiscal deficits consistently topped 5 per cent of GDP, peaking at 15.6 per cent at the end of the period.
- The government debt to GDP ratio rose from about 100 per cent at the beginning of the period to 130 per cent at the end of the period.
- Greece's competitiveness, measured in terms of unit labour costs against those of its major trading partners, deteriorated by 30 per cent.
- The erosion of competitiveness, coupled with high growth rates generated by consumption and an unsustainable fiscal expansion, led to a widening of the current-account deficit.

Upon becoming Governor of the Bank of Greece in 2008, I began to publically warn the government – in not very subtle terms – that it needed to urgently take measures to address the fiscal and external imbalances. My warnings were overlooked.

Once the crisis started in late 2009, it rapidly became self-reinforcing. The sovereign debt crisis spilled over to the banking system, even though the banking sector had sound fundamentals – including high CARs, low loan-to-deposit ratios, and low ratios of total bank assets to GDP – prior to the outbreak of the sovereign crisis. As a result of the crisis, over the period from the end of 2008 until the end of 2013 real GDP contracted cumulatively by 25 per cent, intensifying the debt dynamics and contributing to the self-reinforcing nature of the crisis.

In the remainder of the periphery – especially Ireland, Spain and Cyprus – it was the banking sector that generated a sovereign crisis, not the other way around as in Greece. Capital inflows were mainly channeled through national banking systems to help finance construction. Private indebtedness financed by the capital inflows surged, leaving the

countries prone to the unwinding of the capital inflows. As with the case of Greece, the inflows fueled large competitiveness losses as rises in the prices of non-tradables spilled over to the tradables sector, setting the stage for a boom-bust cycle.

In these countries, the bust came through the banking systems. What happened was that the large size of the banks relative to national GDPs undermined confidence in the sovereigns, creating doom-loops between banking systems and the sovereigns. To explain why this happened, consider the following difference between banks in the United States and those in the euro area. The largest banks in the euro area and the US are of roughly the same size in terms of euro area GDP and US GDP, respectively. However, the largest euro area banks represent a much larger share of their individual national economies compared with the situation of US banks. Consequently, banking crises in individual euro area countries placed large fiscal burdens on governments, calling into question their solvency and making the use of counter-cyclical fiscal policy infeasible.

In light of the exposure of the banks to the debt of their sovereigns, the deteriorating fiscal positions, in turn, affected the banks. The lesson from this experience was clear; an effective economic and monetary union needs to include a banking union. Finally, it is important to underline that a common feature of each of the crisis countries prior to the outbreak of the Greek crisis was their large current-account deficits. The counterparts of these deficits were deficits in the saving-investment behavior of either the public sector or the private sector.

The contribution of the ECB to resolving the crisis

Exceptional times call for exceptional measures. The ECB responded to the crisis in a bold, broad and, frequently, unconventional manner. In considering the ECB's response, it is important to recognize that the euro area is largely a bank-based economy. The ECB's response reflected this circumstance. Prior to the crisis, monetary policy mainly comprised adjustments to the policy rate. The crisis disrupted the transmission mechanism. Banks became reluctant to borrow from, and lend to, other banks; the interbank market broke down. Uncertainty and perceptions of high counterparty risk led to the fragmentation of financial markets. The ECB's response to the crisis included the following:

First, interest rates were reduced sharply. With the onset of the crisis, the policy rate, which stood at 4.25 per cent in July 2008 was lowered in successive stages; it presently stands at a historic low of 0.25 per cent.

Second, to enhance the flow of credit both within and across borders, the ECB's Governing Council took a number of unconventional measures. In particular:

- To accommodate the liquidity needs of banks in the face of disruption in the interbank markets, the ECB introduced a policy of fixed-rate, full allotment. Under this procedure, banks were given access to as much funding as they desired, given adequate collateral, at a fixed rate. This measure has the advantage that it can react flexibly to liquidity shocks; it is set to continue until at least July 2015.
- Longer-term refinancing operations were introduced (initially for a maturity of 6 months, then for one year, and, ultimately, for three years).
- The list of assets acceptable as collateral was widened.
- When, in the summer of 2012, the risk of contagion rose sharply and investors were pricing in the tail risk of a break-up of the euro area, President Draghi announced the OMT initiative – Outright Monetary Transactions. Under the OMT the European Central Bank pledged to make purchases in secondary, sovereign bond markets of securities issued by Eurozone member-states, under certain conditions. It is important to note that OMTs are not designed to finance government budget deficits but to remove the tail risk of a euro area break-up. Bonds would only be bought on secondary markets, would be of short maturity, and would not necessarily be held to

maturity. More importantly, OMTs involve conditionality. Countries whose bonds are purchased need to be on an adjustment programme. To date, there has been no need to activate OMTs. The announcement of the availability of the OMT has sufficed.

- Finally, in the summer of 2013, the ECB changed its monetary policy communication strategy to include forward guidance on the policy rate.

Addressing the fundamental weaknesses in the EU's architecture

The ECB, of course, has not been alone in reacting to the crisis. The crisis brought to the surface the fundamental weaknesses in the EU's institutional structure. As a result, important initiatives have either been taken or are in the process of being taken at the EU level. It is important to note that, although some of these changes are binding only for euro area countries, they have been largely endorsed also by non-euro area countries. It is true that the initiatives do stem from an analysis of the problems of the euro area in particular. However, they are equally valid for all countries in a union with such a high degree of monetary and economic integration. And this is especially true when one considers that, with the exception of the UK and Denmark, all countries joining the EU are committed to joining the euro area.

Changes in the architecture include both improvements in macroeconomic surveillance and actions to establish a banking union. Economic governance has been improved through three main pillars: the so-called "six-pack", the fiscal compact, and the "two-pack". These pillars involve stronger macroeconomic surveillance designed to identify imbalances – both fiscal and external – on an early basis, and to monitor them effectively, thus ensuring their timely correction.

The so-called "six-pack" reinforces the preventative arm of the Stability and Growth Pact and introduces a debt trigger for the excessive deficit procedure whereas in the past the trigger was confined to a fiscal deficit above 3 per cent of GDP. Additionally, it includes the Macroeconomic Imbalances Procedure under which a variety of indicators of such imbalances can be monitored.

Under the Fiscal Compact, member states that have signed the Compact are required to limit structural deficits – that is, general government deficits over the cycle – to 0.5 per cent of GDP.

Finally, the so-called "two-pack" gives strong powers to the Commission to intervene directly in budgetary plans before they are approved by the national parliaments.

These new supranational tools will go a long way enguarding against the build-up of large imbalances of the kind that were present before the crisis. Other areas of intervention comprised the macroprudential oversight and the establishment of financial backstops:

- The European Systemic Risk Board was established in 2011 to exercise macro-prudential oversight of the EU-wide financial system.
- The EFSF was established as a temporary financial backstop in 2011, while its successor, the ESM provides a permanent facility for responding to new requests for financial assistance by euro-area member states.

However, the most ground-breaking reform of the EU's architecture as a result of the crisis has undoubtedly been the banking union. As I mentioned, the crisis has exposed the weakness of a monetary union not accompanied by a banking union.

In the early years of monetary union, considerable progress was made in integrating the various domestic – nationally-oriented – markets. In recent years, that progress has been reversed; there has been a marked retreat into nationally-based banking and financial systems. This retreat has led to a fragmentation of financial markets, contributing to the breakdown of the monetary transmission mechanism. To deal with that fragmentation, efforts

are well underway to build a banking union. As the crisis was characterized by negative feedback loops between banks and the state, the banking union will help maintain financial stability.

In Greece, where the crisis was sovereign-induced, the subsequent rise in sovereign spreads severely challenged banks' capital adequacy. Greek banks' capital was effectively wiped out after the haircut on Greek bonds. Recapitalization of banks was only possible through the introduction of the backstop of the Hellenic Financial Stability Fund, the resources of which were provided through official-sector loans to the Greek state.

In other countries, where the crisis was bank-induced, the size of the banks often overwhelmed the fiscal capacity of the countries in which they were based. The case of Ireland is an example. Measures to ensure continued financial stability resulted in a sovereign deficit which reached 31 per cent of GDP in 2009. Sovereign debt in Ireland now stands at almost 120 per cent of GDP, up from around 25 per cent of GDP in the mid-2000s.

For these reasons, the creation of a banking union is of paramount importance to promote financial integration and to ensure financial stability. Its further development is an important aim of the Greek Presidency. In this connection, I will now address three important issues.

The banking union will include the following key components: a Single Supervisory Mechanism, a Single Resolution Framework and the accompanying Single Resolution Mechanism, a Single Resolution Fund, and the harmonization of Deposit Guarantee Schemes.

The Single Supervisory Mechanism will become fully operational in November 2014. It will imply the transfer of supervision of around 130 banking groups (comprising some 2,000 individual banks) to the ECB. Almost 85% of total banking assets in the euro area will be covered. The Asset Quality Review, which will precede the full operation of the Single Supervisory Mechanism, provides a unique opportunity for the ECB to restore full confidence in the European banking sector. It will also give the ECB a vital snapshot of conditions in the banks for which it will be responsible.

A necessary complement to a Single Supervisory Mechanism is a Single Resolution Framework to deal with non-viable banks and preserve financial stability. The Single Resolution Mechanism, and its associated funding through the Single Resolution Fund, outlines a framework establishing the procedure for dealing with banks that are considered non-viable. Our experience with the successful resolution of 12 banks in Greece in the last few years has taught us that resolution mechanisms need efficient decision-making procedures which allow resolutions to take place quickly, typically over a weekend. To this end, the decision about the viability of an institution should lie with the supervisor only. The Single Resolution Mechanism should not have the competence to decide on viability since this would imply multi-layered decision making, which for resolution would be, to say the least, inefficient.

Resolution also needs to have a credible back-stop. Herein lies a significant challenge for the Greek Presidency. The European Council agreed a General Approach which will lead to an Intergovernmental Agreement, currently under negotiation. Under the General Approach, the Single Resolution Fund will be built up by contributions from banks over a maximum 10-year period. Should adequate funds not be available, the General Approach states that national authorities should be responsible. However, the continuation of national funding of resolution has a significant drawback. It implies that the negative-feedback loops which have been experienced between banks and sovereigns will remain.

Thus, the issue of whether common backstop arrangements will be in place, both for the transition period and in the steady state, is in question. In addition, I believe that the 10-year period should be shorter in order to minimise the period during which, effectively, a credible backstop will not exist. Even at the end of the 10 years, the resources of the fund could be depleted. In such a situation, it would be useful if the Single Resolution Fund were able to

borrow from the markets or have access to funds from the European Stability Mechanism. However, the challenges do not end there. The European Parliament is taking a somewhat different approach. It envisages that it will play a greater role in decision-making procedures. It also has reservations about the clear nature of the backstop. In short, there is still some way to go to forging an agreement on all aspects of bank resolution in the banking union.

Finally, the harmonisation of Deposit Guarantee Schemes will help prevent the emigration of funds in search of better coverage. The scheme will begin operation in January 2016. Over time, however, it might be wise to revisit the issue of going beyond harmonisation to creating an EU-wide Fund, in order to further break links in the negative feedback loops that can develop between banks and the state.

Where do we stand?

Since the onset of the crisis, policymakers in the crisis countries have made significant progress in addressing fiscal and external imbalances. The euro area has achieved an improvement in its fiscal deficit from 6.4 per cent of GDP in 2009 to 3.2 per cent in 2013.

Fiscal adjustment in programme countries has been extremely impressive. In Greece, the fiscal consolidation is one of the largest ever achieved by any country under an IMF programme: Between 2009 and 2013, the fiscal deficit was reduced by some 13 percentage points of GDP. The structural fiscal deficit – that is, the deficit that corrects for the business cycle – has shrunk by 19 percentage points of GDP. The primary fiscal deficit – that is, the deficit that excludes interest payments – was 10½ per cent of GDP in 2009. Last year it swung into a small surplus. What makes these achievements especially impressive is that they have taken place despite a contracting economy, which creates moving targets for fiscal consolidation.

As I mentioned, the crisis countries have made significant progress in reducing their external imbalances. Between 2008 and 2013, the current account balances of Ireland, Portugal and Greece as a percentage of GDP improved by between 10 and 16 percentage points. Much of this improvement reflects price and cost adjustments. Unit labour costs have fallen significantly. As a result, labour cost competitiveness has improved by over 20 per cent in Greece, Ireland and Spain during the crisis.

Structural reforms have also helped reduce external imbalances. That recipe worked for the U.S. and the U.K. in the 1980s, Sweden and Finland in the early-1990s, Asia in the late-1990s, Germany in the early-2000s, and in many other countries. However, the effects of such reforms took time to impact on growth. The gains do not come overnight. The euro area is now emerging from recession, although the initial recovery is modest, fragile and uneven. The baseline scenario is for slow growth.

Several factors are contributing to the initial weakness of the recovery. First, private and public sector balance sheets are still adjusting in many euro area countries. However, in light of the large fiscal adjustment that has already taken place, the fiscal drag is declining. Second, investment has been declining over the past year due to anaemic demand, weak confidence and bank deleveraging and, where loans are available, high lending rates, especially to SMEs in the stressed countries. Nevertheless, in light of (1) the very-large fiscal and competitive adjustments that have been taking place, especially in the stressed countries, (2) on-going improvements in the architecture, and (3) the ECB's accommodative monetary stance, enhanced by forward guidance that will ensure low policy rates for an extended period of time, I expect that euro-area growth will gradually pick-up.

The main risks to this scenario are as follows:

The first risk relates to social and political factors. As a result of the crisis, euro-area unemployment, at 12 per cent, is very high. It is particularly high among young people. This situation is a fertile ground for the breeding of social tensions, undermining confidence in the European project and European institutions. The upcoming European elections could well

produce results that reflect these tensions, as citizens look for extreme solutions. Political risks could make the implementation of necessary reforms more difficult.

The second risk is that of the threat of deflation in the euro area. Since October of last year, inflation has been below 1 per cent. The January outcome was 0.7 per cent. It is important to recognize that deflation, defined as a general, self-propagating fall in prices, is not something that characterizes the euro area at present. To a certain extent, the deflation in some countries, including my own, is a result of the necessary rebalancing of economies that have lost competitiveness. Nevertheless, deflation makes it more difficult to achieve fiscal targets. Although I do not believe that we are headed for euro-wide deflation, a protracted period of low inflation has the potential to make deflation a reality.

As ECB President Draghi has recently made clear, we are aware of the risks and are prepared to respond should the need arise. The ECB's monetary policy stance remains accommodative. We have shown that we can draw on a wide and powerful toolkit to steer the economy in difficult times. The nonstandard measures that we have adopted have had powerful effects in ensuring, not only that we have stuck to our mandate with respect to inflation, but also that we have preserved financial stability.

Concluding remarks: the future of Europe

Let me conclude with the following remarks:

Considerable adjustment in the euro area has already taken place in eliminating imbalances and restoring the conditions for sustainable growth.

Financial market fragmentation is receding and the euro-area banking sector is undergoing unprecedented adjustment, as evidenced in the case of the Greek banking sector. Banks have taken measures to consolidate and to increase efficiency. They are strengthening their capital basis. Market tensions have been receding, as evidenced by the narrowing of spreads in sovereign markets and improved access to bank credit. Recourse to Eurosystem lending operations has fallen sharply – down some 45 per cent from its peak.

More credible progress is, however, needed with respect to both balance sheet repair and the orderly de-leveraging of the non-financial sector. Such a process involves not only continued support to viable firms, but also the swift exit of non-viable ones. This process can deliver substantial benefits by helping to restore banks' balance sheets to health, thus helping to restore credit flows.

The Hellenic Presidency of the European Union is promoting policies that will help move the European project forward so that the conditions for a dynamic and globally competitive Europe are put into place.

I have already mentioned the importance of furthering steps to a full banking union, a necessary condition for moving Europe forward. We have already seen the costs that a dysfunctional financial sector can impose on the real economy.

In addition, the Hellenic Presidency will be giving emphasis to a number of other areas. These include: the financing of the real economy, focusing particularly on SMEs, since they account for about 99 per cent of firms and for around 60 per cent of jobs in the EU. To this end, progress needs to be made in relation to the Long-term Investment Funds Regulation, which focuses explicitly on the financing of large infrastructure projects and SMEs. Another policy area that will receive emphasis is that of tax policies and systems. Fighting tax fraud and tax evasion are crucial to exploiting the full benefits of the internal market. In this respect, the Presidency will promote the Directive of Administrative Cooperation for the extension of automatic exchange of information in early 2014 and the adoption of the revised savings taxation Directive by March 2014. Finally, work on the Directive on a Common Consolidated Corporate Tax Base will be taken forward.

The crisis in Europe has come at a large cost to the people of Europe, particularly those in the crisis countries. Nevertheless, by serving as a wake-up call, the euro-area crisis has led to a strengthening of the monetary union, in particular, and the EU, in general. We are now emerging from that crisis. The lessons of the crisis will prove invaluable in the task of undertaking policies that will enhance growth, employment creation and financial stability.

The crisis has taught that financial stability cannot be taken for granted. It has to be ensured through the steadfast implementation of financial institution supervision – both at the micro level and the macro-prudential level – and the appropriate conduct of monetary policy.

I am confident that we are taking measures needed to ensure that we will not undergo a comparable crisis in the future. It is for that reason that I am optimistic about the future of Europe, and the ultimate goal of improving the living standards of all EU citizens.