Global Financial-Economic Crisis: Challenges and Prospects

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Ladies and Gentlemen,

It is a pleasure to address such a distinguished audience, on a topic that unfortunately is not yet history. Governments and Central Banks certainly managed to safeguard financial stability in turbulent times. However, certain repercussions of the crisis have not yet been fully dealt with and some vulnerabilities may reappear. In this sense, looking back with a critical view may help us understand the factors that put at risk the global economic recovery.

The global financial and economic crisis that was triggered by a distortion in the U.S. sub-prime mortgage market, highlighted serious weaknesses in the financial regulatory frameworks of the globalized and broadly interrelated national markets. As a result, the validity of the theory of self-correcting market mechanisms has been strongly contested.

Global Financial Crisis

- The roots of the global financial crisis can be traced back to both macroeconomic and microeconomic factors. On the macro level, global imbalances for over a decade before the crisis resulted in ample liquidity in

world financial markets and in low interest rates, facilitating high levels of leverage, excessive dependence on unsustainable short-term financing and weak risk management.

- At the same time, on the micro level, financial innovation and the investors' "search for yield" led to the creation of complex financial instruments with an obscure credit risk distribution. The originate-to-distribute model, according to which loans are traded between investors, became widespread practice. This led, in effect, to a loosening of lending criteria and facilitated the creation of the aforementioned complex credit instruments.

- Over time, excessive credit risk and liquidity accumulated in the so-called "investment vehicles." The placement of credit institutions in such vehicles was not recorded on their balance sheets, and as a result, the associated risks slipped through the cracks of internal control mechanisms. Moreover, the opacity and the uncertain dispersion of risks of these instruments were further exacerbated by the rapid growth of the derivatives market, in particular of derivatives traded outside regulated markets ("over the counter").

- As revealed in retrospect, in many cases, banks and investors had failed to realistically assess the nature and extent of risks. The high degree of correlation between credit risk, market risk and refinancing risk had also failed to be properly assessed. As a result, the risks associated with certain credit instruments were not properly reflected in their price. When this was made evident in the US market for sub-prime mortgages in 2007,

it led to a market-wide reassessment of financial risks and the collapse in the market values of credit instruments. This, in turn, affected negatively the net worth and profitability of banks which held such assets in their portfolios. The once believed "too big to fail" institutions rapidly became illiquid and insolvent.

- In order to rebalance their portfolios, affected banks performed widespread liquidations of their assets and attempted to raise capital in an attempt to strengthen their capital base. Through the subsequent fall in asset prices and via banks' balance sheet cross-exposures, the crisis quickly spread to the financial system globally. The euro-area was similarly affected.

- Uncertainty about banks' exposure to "toxic assets", especially in Europe, led to mutual distrust between banks. As a result, the interbank market has been severely impaired causing liquidity problems, which required the necessary intervention by monetary policy authorities.

- The crisis in the financial markets, aggravated by the pro-cyclicality of banks, where in times of economic downturn they tighten risk criteria and decrease lending, thus amplifying the contraction of the economy, quickly spread in the real economy, and economic conditions deteriorated globally.

Euro-area crisis

- The international financial crisis brought about the crisis in the euro area. However, here also, the roots of the crisis can be traced to the creation of serious imbalances.

- According to the theory of monetary integration, as it had developed by the time of the inception of the euro in 1999, it was thought that nominal convergence along with a single monetary policy would gradually promote real convergence. Banks had no special role in transmitting financial market shocks to the real economy or in producing spillover effects across union members.

- However, monetary union has to go hand-in-hand with financial integration. Indeed, financial integration did proceed apace with increasing capital flows among the member-states of the euro area, leading to increased interdependence between financial institutions and markets.

- Such interdependence is necessary for the smooth operation of the single monetary policy, because it facilitates the transmission of monetary policy throughout the euro area.

- The prevailing view was that persistent capital flows from the north to the south, which financed the current account deficits of the south during the early years of EMU, were an equilibrating force – capital moved from countries where the rate of return on investment was low to those where it was high.

- The elimination of exchange rate risk was interpreted by markets and institutions as an elimination of all risks. Credit risk was essentially ignored.

- With the outbreak of the global financial crisis in 2008 and the re-pricing of risk, the ample capital inflows to the EU periphery were suddenly reversed.

- This sudden reversal led to a negative feedback loop between banks and public finances, exacerbating the effects of financial instability on the real economy.

- In some countries, such as Spain, the sudden reversal led to a collapse in demand, a collapse in asset prices and bank distress. The bank distress then fed back into a fiscal and, ultimately, sovereign crisis. A similar narrative can be told for Ireland. In other member-states, such as Greece, the sudden reversal initially affected the refinancing of debt and subsequently inflicted damage on the banking system following the haircut of Greek government debt.

- As a result, the crisis revealed important weaknesses in the EU architecture and inadequacies in the implementation of the structures that had been put in place.

- First, the existing framework of economic governance was not sufficient to prevent the creation of imbalances. The Stability and Growth Pact was not properly enforced and there was no mechanism in place for monitoring external imbalances.

- Second, the increased interdependence between financial institutions and markets, which was the result of the monetary union and the ensuing financial integration, was not accompanied by a more unified regulatory framework.

- Third the link between financial stability and the financial cycle had been largely ignored. The architects of monetary union chose to keep financial

sector supervision and regulation largely at the level of the nation state, with insufficient coordination of macro and micro-prudential supervision.

Policy responses to the crisis

- In this unprecedented global crisis, Governments, Central Banks and international organizations reacted with coordinated actions. These actions included first, direct monetary and fiscal interventions, aiming at enhancing liquidity to maintain system stability and support the economy; second, a broader mobilization to reshape the global financial architecture and mitigate the magnitude and duration of future financial crises.

- Following the eruption of the crisis, it was understood that any kind of supervision should be exercised taking into account not only the behaviour of individual credit institutions but also the interconnections and interdependencies between financial institutions, markets and economies. The increasing degree of integration of economies and financial markets required more coordinated action between supervisory and regulatory authorities worldwide, as well as continuous, timely and accurate exchange of information between supervisory authorities. It was made clear that the new architecture of financial supervision required the strengthening of micro-prudential and macro-prudential supervision. Regulatory and supervisory efforts focused on financial stability and on trying to limit the build-up of systemic risk.

Monetary policy response

- More specifically, as a first response to the global financial crisis, central banks were quick to put in place measures that ensured adequate liquidity in the financial system by facilitating access to central bank financing.

- Moreover, central banks largely adjusted their respective monetary policy stance to reflect the diminished risks for price stability. The size of interest rate reductions implemented by central banks pushed policy rates at historically low levels.

- The ECB initially reduced its interest rates by 50 basis points in a coordinated move with five other major central banks [Bank of Canada, Bank of England, the Federal Reserve, Sveriges Riksbank and the Swiss National Bank] in October 2008. This was followed by successive reductions in the interest rates, resulting in a cut in the main refinancing rate by 325 basis points within seven months, between October 2008 and May 2009.

- In addition, the ECB adopted temporary non-standard measures in order to reduce obstacles in monetary policy transmission and to address liquidity shortfalls in the interbank market.

- First, the ECB switched to fixed-rate tender procedures with full allotment for all refinancing operations, ensuring unlimited access to central bank liquidity at the main refinancing rate.

- Second, the ECB introduced longer-term refinancing operations (LTROs), initially at 6-month maturities, then at one year and finally, at three year maturities, aiming at reducing uncertainty and encouraging banks to continue to provide credit to the economy.

- Third, during the global turmoil the ECB temporarily provided liquidity in US dollars through currency arrangements with the Federal Reserve in order to provide banks with adequate funding in US dollars.

- Fourth, the ECB extended the eligibility of collateral that could be used for central bank financing, facilitating banks' refinancing liquidity shortages caused by halts in interbank lending.

- Fifth, the ECB introduced in May 2010 the Securities Markets Programme. By intervening in the secondary markets of public and private debt securities, the ECB could ensure depth and liquidity in dysfunctional market segments and restore the proper functioning of the monetary policy transmission mechanism.

- Finally, in September 2012, the ECB announced the Outright Monetary Transactions (OMT) initiative, essentially the intention to purchase, if necessary, securities of euro area member-states in economic adjustment programmes from the secondary market. Although not activated, the announcement of the initiative has contributed significantly to the improvement in financial market conditions, the decline in sovereign bond spreads and the gradual reversal of financial fragmentation.

Changes in the EU architecture

- With the outbreak of the euro area crisis, it was made clear that both imbalances in the real economy and in the financial sector are sources of financial instability.

- A more comprehensive policy framework was therefore necessary.

- In this context, improvements in the policy framework aimed at completing the EMU architecture with more coordination of economic policies, sufficient backstops to address liquidity shortfalls and, last but not least, common supervision of the financial sector.

- The Stability and Growth Pact was strengthened through a series of EU regulations in 2011 and 2013. The new legislation clearly defined debt reduction rules, sanctions in case of non-compliance and a new surveillance procedure monitoring the emergence of macroeconomic imbalances. In addition, fiscal coordination and surveillance was further strengthened through the ex-ante co-ordination of fiscal and structural policies of member states of the euro area.

- Moreover, the “Fiscal Compact”, agreed by the euro area and some EU member states, in March 2012 further strengthened fiscal governance. The treaty, which entered into force at the beginning of 2013, requires structural deficits limited to 0.5% of GDP and the introduction of fiscal rules in each country’s national legislation.

- Furthermore, the euro area, as well as some EU member states agreed in March 2011 on the “Euro Plus Pact”, a commitment to undertake additional reforms, on top of the EU-wide “Europe 2020” obligations, to promote competitiveness, employment and productivity.

- In the meanwhile, the European Financial Stability Facility (EFSF) provided financial assistance to sovereigns which faced temporary liquidity shortfalls caused by the impairments in the sovereign bonds markets. The EFSF was succeeded in 2012 by a permanent backstop mechanism, the European Stability Mechanism (ESM).

- Finally, let me turn a bit more at length, to, perhaps the most ambitious EU initiative, the Banking Union, which was finalized during the Greek Presidency of the Council of the European Union in the first half of the current year.

- The Banking Union was initially agreed at the European Council of June 2012 in an effort to deepen Economic and Monetary Union.

- Five years after the outbreak of the euro area crisis, it is important to understand why the interconnection between banks, the real economy and sovereigns were so strong in the euro area and why a banking union is necessary.

- First, the size of the banking sector in the EU, measured either in absolute terms or as the share of banks’ assets in GDP, is about five times larger than in the US. These data underline the importance of banks as financial intermediaries in the EU. Firms in the euro area are much more reliant on

bank credit compared to the US, where capital markets play a much more important role in the financing of investment.

- Second, although large banks in the euro area and the US are of roughly similar size, large banks' balance sheets in the euro area represent a much larger share of any individual country's GDP in the euro area. This implies that bank failures in the euro area can easily call into question state solvency.

- Third, euro area banks typically hold large volumes of national government bonds in their portfolios, making them more vulnerable to sovereign crises. And the capital flows from the core to the periphery that characterized the early years of monetary union also led to the concentration of peripheral sovereign risk in the core.

- One of the consequences of the crisis and the negative feedback loops between banks and sovereigns was the so-called "Balkanization" of the euro area banking system, i.e. the retreat of banks behind national borders. As a result, financial conditions diverged between euro area member states. The fragmentation of financial markets deepens the gap between core and periphery, hinders the smooth transmission of the common monetary policy and is harmful to real economic convergence.

- The foregoing analysis clearly highlights the need for a centralized, European responsibility for financial market and banking supervision; the establishment of the European Banking Union was perceived as a logical next step in the advancement of the Economic and Monetary Union.

The three pillars of the Banking Union

- The Banking Union is built on three pillars: The Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and a harmonised system of Deposit Guarantee Schemes.

- The Single Supervisory Mechanism gives the European Central Bank (ECB) responsibility for supervision over banks in the euro area and the EU countries which participate in the banking union. This will ensure the application of a common supervisory model for all banks.

- As of November 2014, the ECB assumed the direct supervision of 120 significant banking groups which represent 82% (based on the assets) of the euro area banking sector. For all other 3,500 banks the ECB will also set and monitor the supervisory standards and work closely with the national competent authorities on the supervision of these banks, ensuring a level playing field in the supervisory requirements to be met by banks.

- The ECB ensures a truly European supervision mechanism that is not prone to the protection of national interests, will weaken the link between banks and national public finances and will take into account all risks to financial stability.

- A necessary complement to the single supervision mechanism is the resolution framework to deal with non-viable banks.

- The Single Resolution Mechanism constitutes the second pillar of the Banking Union. Orderly and prompt resolution of non-viable banks is

essential in order to avoid costly rescues by sovereigns that may impact on their fiscal position.

- The SRM Regulation creates a Single Resolution Board, responsible for the resolution of banks in the euro area and in the participating Member States in order to ensure swift and effective resolution decisions, especially in the case of large and complex cross-border banking groups.

- From the 1st of January 2016 onwards, any resolution of a euro area bank will be decided within the context of the SRM.

- Resolution also needs a credible back-stop. This back-stop is provided by the Single Resolution Fund. The Fund will be financed via ex-ante and ex-post contributions by the banking sector, which will be gradually mutualised. The SRM will thereby reduce the link between domestic banks and their sovereigns and it will contribute to a level playing field for banks. The use of the SRF funds is conditional on the application of the bail-in tool, thus ensuring that shareholders and creditors are the first to carry the costs of a failing bank.

- A prerequisite of the Single Resolution Mechanism is the Bank Recovery and Resolution Directive (BRRD), which provides for a complete framework for the crisis management of banks in the EU and lays out specific measures for bank recovery and resolution.

- The third pillar of the Banking Union is the EU harmonized framework for the European deposit guarantee schemes, which includes certain provisions to ensure the establishment of sufficiently robust national

deposit insurance systems in each Member State, and an appropriate degree of depositor protection in the European Union.

Where we stand now

- Since the outbreak of the euro area crisis, policy makers have managed to correct considerably the internal and external imbalances of the past. Significant structural reforms and fiscal consolidation efforts have taken place at a national level. As a result, since 2010, the euro area fiscal deficit has improved from 6.1 per cent of GDP to 2.9 per cent of GDP in 2013.

- Substantial fiscal adjustment has taken place particularly in member-states with economic adjustment programmes. In Greece, the fiscal deficit was reduced by 13 percentage points of GDP between 2009 and 2013, the largest fiscal consolidation recorded in history in such a short period. The primary budget deficit [10.2 as a per cent of GDP in 2009] turned into a surplus exceeding 1 per cent of GDP in 2013. The cyclically-corrected adjustment of the primary balance was close to 20 per cent of GDP at the same period. The rest of the programme countries have also undertaken substantial adjustment efforts. What makes these achievements especially impressive is that they have taken place in a contracting economy.

- Member-states in economic adjustment programmes have also made substantial progress towards eliminating their external imbalances and improving their competitiveness. Between 2008 and 2013, the current account balances as a percentage of GDP of Ireland, Portugal and Greece

improved by between 10 and 16 percentage points. Relative unit labour costs have also fallen significantly, since 2008 (in Greece by over 20%).

- As a result, current account deficits in these countries have turned into surpluses in recent years.
- Substantial structural reforms in the product and labour markets and in public administration have also been implemented by member-states in economic adjustment programmes, facilitating the gradual adjustment of euro area economies.

Challenges and risks

- Despite the considerable progress made since the global financial crisis, the economic recovery has been fairly slow. Global GDP growth is expected to be relatively low in 2014 for the third consecutive year. Meanwhile, the recovery in the EU has been sluggish and fragile, with low GDP growth and persistently high levels of unemployment, as noted by EU leaders in October.
- Political and geopolitical risks will continue to negatively affect the recovery going forward.
- However, the efforts made to improve the institutional framework and to promote productivity in the euro area have also created favourable conditions for a sustainable recovery.

- The ECB's accommodative monetary policy stance and the non-standard measures it adopted have helped to preserve financial stability, which is a necessary condition for growth.

- The Comprehensive Assessment of banks' balance sheets—which comprised the Asset Quality Review (AQR) and the stress test components—exposed the areas in the banks and the financial system that need improvement, helped banks to strengthen their balance sheets, enhanced transparency and built public confidence in the banking sector.

- Growth will also benefit from the consequences of the Banking Union for the reversal of the fragmentation of EU financial markets, which was observed after the crisis. This reversal is necessary to create the conditions for further integration. Through common supervision, trust among cross-border banks will increase, enabling them to operate more efficiently across borders, to the benefit of consumers and firms.

- Moreover, banking union may reinforce the consolidation dynamics in the EU banking system, leading to a restructuring of the European banking sector, while enhanced cross-border competition through integration in the retail banking sector will lead to better prices and services for the consumers.

- However, key challenges remain. A key characteristic of the euro area economic recovery is the continuing decline in loans to the private sector. The recovery is so far "creditless" at both the euro area as a whole and, in many cases, in individual countries.

- Because the euro area economy is bank-based, bank lending is especially important for companies and, in particular, for SMEs, which produce the bulk of goods and services and account for a large share of employment.

- Consequently, the on-going credit contraction raises the question: Can the recovery be sustained in the presence of negative loan growth?

- Throughout the crisis, the Eurosystem has adopted both standard and non-standard monetary policy measures with the objective of increasing confidence and further restoring the smooth operation of the monetary transmission mechanism. The latest such non-standard measures, the targeted longer-term refinancing operations (TLTROs), the purchase of asset-backed securities (ABSPP) and covered bonds (CBPP3) and the intention to bring the ECB balance sheet at the level observed at the beginning of 2012, aim at bringing inflation at levels consistent with price stability and support lending to the real economy. For a number of distressed economies potential lack of collateral could limit the usefulness of such measures. The ECB and the respective national Central Banks are paying special attention to this important issue.

- Overall, there is still work to be done. This is where the Banking Union again comes in. The banking union represents a crucial step towards restoring confidence in the banking sector.

- Restoring confidence in the banking sector will, in turn, greatly contribute to financial and economic stability in the future. Lower volatility in the real economy will have a positive impact on economic growth. This is in line

with evidence of the growth theory literature which documents a negative correlation between growth and economic volatility.

- One lesson of the global financial crisis is that disruptions of financial intermediation play an important role in business cycle fluctuations. Credit constraints amplify economic fluctuations and banking crises contribute to the deepening of economic recessions. This is particularly true in bank-based economies, where capital markets are less developed.

- Eliminating the fragmentation of financial markets will loosen tight credit standards in the member states of the periphery, allowing banks to finance investment. Financing corporate investment is currently of outmost importance for economic growth both in the euro area as a whole and in the periphery countries, which have suffered particularly from deep and prolonged recessions. Remarkably, private investment in the euro area has declined from 20% of GDP in 2008 to 16% of GDP in 2013. The decline was much more pronounced in periphery countries such as Greece, Spain and Portugal, where private investment declined by between 6 and 9 percentage points of GDP.

- In the longer term, economic growth will benefit from deeper financial integration and development. Financial market integration will boost long-term economic growth by broadening the pool of available funds and supporting an efficient credit allocation process. This will contribute to a better allocation of physical resources in the economy, boosting in the long term total factor productivity and potential output.

Ladies and Gentlemen,

Today we witness a containment of systemic stress, despite intermittent financial market turbulence. And this is the result of the aforementioned coordinated actions.

However, this should not make us complacent. The search for yield in a very low interest rate environment, the growing use of leverage in the non-bank financial sector, the persistent pressures on bank profitability in a weak and uneven macroeconomic recovery, the re-emergence of sovereign debt sustainability concerns amid low nominal growth, the wavering policy determination for reforms, and the signs that some investors may underestimate the potential for losses and volatility going forward, are issues of major concern.

The probability of a systemic threat is currently low but increased vigilance is required. In this environment, macro-prudential policies need to ensure that financial intermediaries can withstand a potential reversal of risk premia, while at the same time further initiatives are needed to monitor and assess vulnerabilities in the shadow banking sector. I believe that the lessons we have learned so far will prove valuable in addressing those potential risks and in safeguarding financial stability.

Finally, and with reference to the Eurozone, we should not forget one of its most pronounced characteristics: that it is almost fully integrated in the monetary side, less so in the financial side despite recent progress, and much

less so in the fiscal and economic sides. Until this asymmetry is eliminated its overall economic performance will tend to remain below potential.