Ewald Nowotny
Governor
Oesterreichische Nationalbank

SPEECH

Vienna, March 8, 2011

Check against delivery!

Achieving Financial Stability – the Role of the EU, the Euro and the ECB

Opening Remarks, Salzburg Global Seminar: "New Rules for Global Finance: Which Kinds of Regulation are Useful and which are Counterproductive?"

1. Introduction & Welcome to the Salzburg Global Seminar

Ladies and Gentlemen:

It is a great honor for me and the Oesterreichische Nationalbank (OeNB) to host the **Salzburg Global Seminar** and to do so in **Vienna** for a change. Let me extend a warm welcome to all of you, in particular the **high-ranking decision makers** and **high-profile experts** coming from all over the world.

The Salzburg Global Seminar was **founded** in the immediate **post-war period,** when visions were rare, by three young men from Harvard University to provide a forum for **intellectual exchange** in the **heart of Europe**. More than half a century later, it has developed into one of **Europe's foremost forums** for the discussion of **global issues**. It brings together **future leaders** from around the world with **prominent individuals** from virtually every **field of human activity**: politics, economics, social and environmental concerns, the arts and academia.

The **next three days** are devoted to an issue which has **shaped my life** at least for the **last three years: "New Rules for Global Finance**: Which kinds of regulation are **useful** and which are **counterproductive**? "In order to answer this tricky question, we need to learn the lessons from the recent **financial and economic crisis**. But even if the **financial sector** is at the core of our considerations, they also go far **beyond**. It is our **whole economic model** which needs to be checked.

Let me present you **my views** on some of these topics.

Verleger, Herausgeber und Hersteller:
Oesterreichische Nationalbank
Für den Inhalt verantwortlich:
Mag. Günther Thonabauer
Sämtliche in Wien 9., Otto-Wagner-Platz 3
Postfach 61, 1010 Wien, ÖARB 005 3 06

2. Sequencing of the Financial and Economic Crises

Popular perception of the crisis origins: falling prices in the U.S. housing market led to disturbances on the interbank market and finally to the **financial crisis.**

Actually, a complex set of **conditions**, **causes** and **trigger** factors made the crisis possible:

- First, **basic conditions: disequilibria** evolving over the last years:
  - **Global imbalances** inducing financial flows from emerging to advanced economies;
  - Increasing **weight of the financial industry** in the economy; in the U.S.A. the share had doubled since 1980, reaching about 8% of GDP in 2008[1];
  - **Global interest rates** – arguably at least for some time too low;
  - Related dynamics in household **indebtedness**, partly fueled by policies expanding homeownership to the poor[2];
  - Insufficient framework and rules of the international financial system;
  - Trend towards income and wealth **inequality** within advanced economies[3];
  - **Oil shock** until mid-2008 seems to have contributed to recession[4].
- Second, more immediate **causes:** asset market **bubbles:**
  - Bubbles started with **financial innovations** – turning mortgages into liquid assets;
  - These innovations led to bubbles that were fostered by a huge, unregulated **shadow banking sector** – excessive leverage;
  - Intransparent products of "financial industry" attracted **risk-loving investors**[5]**;**
  - False **management incentives** favoring short-termism.
- Third, the **triggering factors** that helped the bubbles burst:
  - Massive defaults in the U.S. **subprime** mortgage market;
  - In a second step, the bankruptcy of **Lehman Brothers.**

Preliminary conclusion: The financial crisis has been caused by a **market failure**. In actual fact, misjudgment of the underlying risks was a major **policy failure**,

- reflecting inadequate **regulation and supervision** of financial (and housing) markets;
- as well as overly loose global **monetary policies.**

---

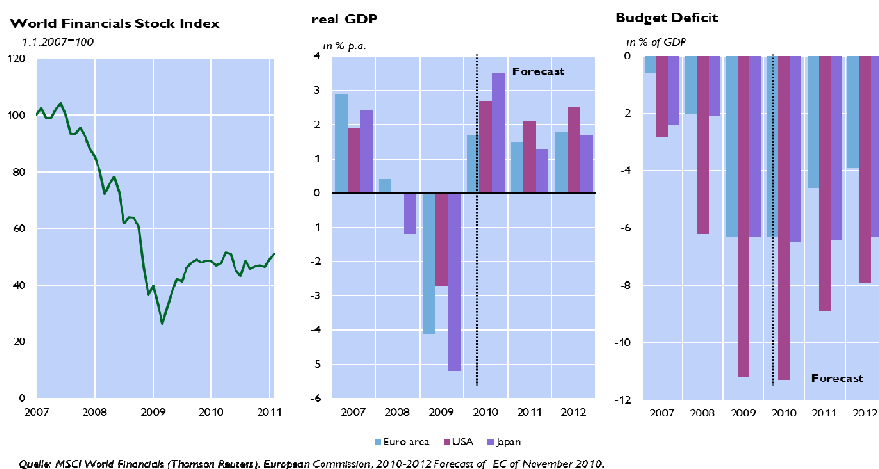
[1] Bank for International Settlements. 2010. BIS Annual Report 2009/10, 28 June. Basel, 75ff.
[2] Rajan R. 2010. How Inequality Fueled the Crisis. Project Syndicate. 9 July. http://www.project-syndicate.org/commentary/rajan7/English
[3] OECD 2008. Growing unequal - Income Distribution and Poverty in OECD Countries. October, Paris.
[4] Hamilton, J. 2009. Causes and Consequences of the Oil Shock of 2007–08. Brooking Papers on Economic Activity. Spring
[5] Sibert, A. 2009. ‚Why did the bankers behave so badly?'. VoxEU.org. 18 May. http://www.voxeu.org/index.php?q=node/3572

The dynamics of the crisis

Sequencing of Crises

ONB

Financial Sector ⇨ *Real Economy* ⇨ *Public Finances*



Quelle: MSCI World Financials (Thomson Reuters). European Commission, 2010-2012 Forecast of EC of November 2010.

www.oenb.at - 2 - oenb.info@oenb.at

- First, the **banking sector** was immediately hit by liquidity shortages:
  - The interbank market dried up;
  - Banks resorted to asset **fire sales** for refinancing (asset meltdown).
- Second, the crisis reached the real economy → **Great Recession**:
  - Dramatic drop in confidence;
  - Plunge of international trade and manufacturing.
- Third, a truly **global crisis**:
  - No decoupling of emerging economies (they were, however, the first to recover).
- Finally, domino effects affecting the economy as a whole:
  - Rapid **deterioration of budgets** (anti-crisis measures & automatic stabilizers);
  - **Structural vulnerabilities** of several economies got evident;
  - **Liquidity problems** endanger the refinancing of public debt;
  - **Perceived** risk of sovereign **insolvency**;
  - **Overshooting** of risk premia on bond interest rates created self-fulfilling prophecy effects.
- **Greece** is a case in point, but also a very **special case**:
  - **Fraud** of budgetary statistics – **loss in confidence;**
  - Greece's **fiscal situation** worse than that of any other EU Member State (public debt around 140% of GDP in 2010; deficit now **improving:** 9.6% in 2010);
  - **Interest rate spreads** to German 10-year bonds above 900 basis points;
  - **Rescue package** of EMU MS and IMF (strong conditionality!): EUR 110 billion for 3 years:

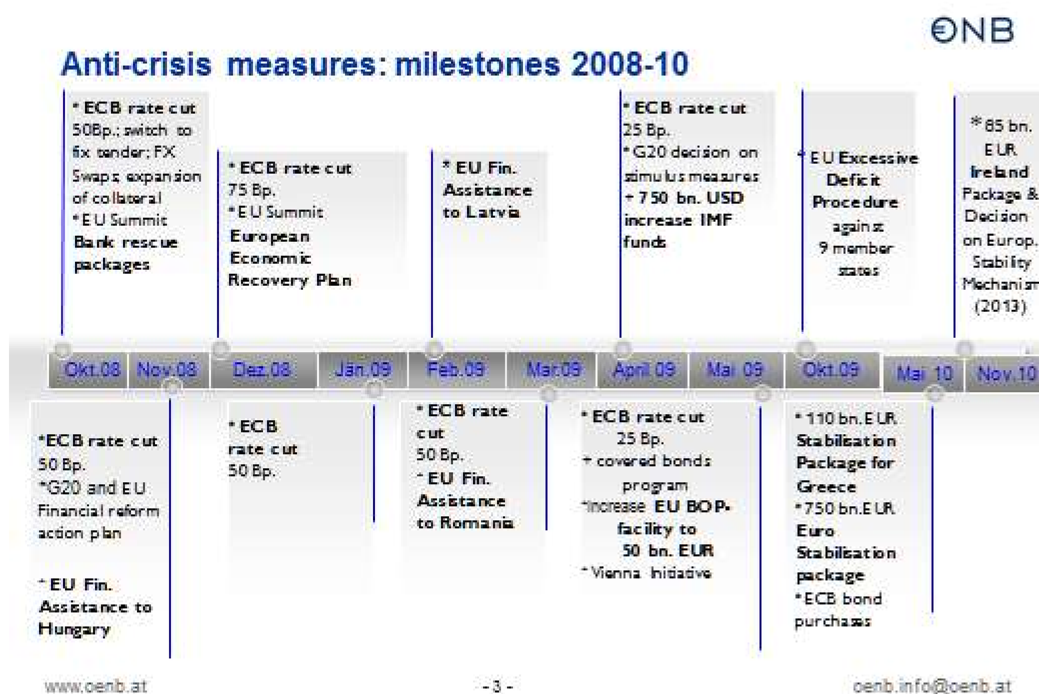
- Eliminated liquidity risk;
- Bought time to reduce (perceived) sovereign solvency and (derived) financial market risks.

– **Ireland** is a different case (10-year spreads above 600 basis points)**:**
  - Always **obeyed** to the **Stability and Growth Pact**: Fiscal surpluses instead of deficits;
  - Problems arouse from **overextended financial sector** hit by a housing bubble;
  - Mistake in crisis management: **state guarantee** of whole banking sector;
  - **Public debt exploded** fourfold within 3 years (from around 25% in 2007 to almost 100% in 2010);
  - EU/IMF financial assistance: EUR 85 billion.

– **Other countries not comparable:** (10-year spreads only around 200 to 400 basis points)
  - **Portugal**: problems less severe and different: competitiveness problems but no housing bubble! Nevertheless, meager growth prospects and high interest rates make Portugal susceptible to refinancing risks.
  - **Spain**: low initial debt level (40% of GDP), in 2010: 64% - still below Germany's debt ratio (76%), but strong dynamics; relatively sound banks despite housing bubble;
  - **Italy**: low liquidity risks, high saving rate, low external debt (but high overall debt).

– **A euro crisis?**
  - **Misperception**: the crisis did not originate in the euro area; the euro area suffered **contagion effects** from the global crisis;
  - **Exaggeration**: a break-up of EMU or the **end of the euro** is not an issue! (Too costly for all participants);
  - What we have got is **not a crisis of the euro** but a **crisis of** some euro area **countries**: Greece and Ireland in the euro area are much like California and Illinois in the U.S.A., whose financial problems do not affect the US dollar;
  - The **euro remains a success story**!
    - Euro area = **stability area**: Over the last decade, average **inflation** exactly matched ECB's definition of price stability (below, but close to 2%), despite a heavy oil shock;
    - Euro = at least as **strong** a **currency** as the Deutsche mark:
      - Stronger against the USD than when the euro was launched (around 1.18 EUR/USD in 1999);
      - Marginal devaluation of the effective exchange rate = relief for our exporters, after years of appreciation.
    - With the global crisis the euro has **passed its hardest test**:
      - **Elimination of exchange rate volatility** – beneficial for small member states: "in turbulent financial waters it is better to be on a large, solid and steady ship rather than on a small vessel," (ECB President Trichet);

- Europe proved its solidarity and **ability to act** – (recovery plan, financial assistance, reform debate);
- ECB **reacted swiftly** and effectively – preventing a collapse of the whole economy:



providing boldly **liquidity** to banks:

  - **No inflationary impact** as long as credit demand is low;
  - Exit already underway.

– **Securities Market Programme** – temporary purchases of bonds:

  - **No state financing** – only to calm markets;
  - Temporary intervention in secondary markets, for very limited amounts;

- **Recovery** on its way (but slow and bumpy): 2010: 1.7%; forecasts 2011: around 1.6%);

- Nevertheless **national adjustment challenges** still exist: structural reforms + fiscal discipline.

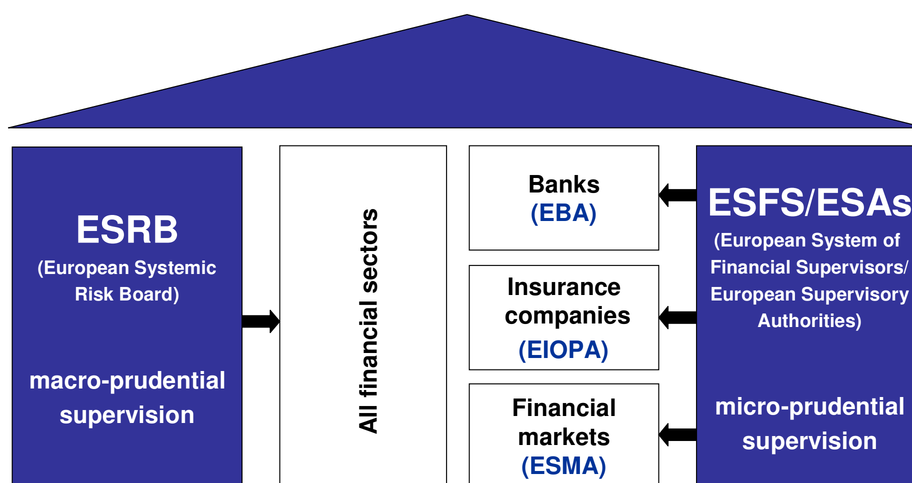
3. Crisis lessons

A. Financial sector stability

- **Macro-prudential perspective:** importance of systemic risk, better understanding of interconnectedness in financial system – turbulence can arise from relatively modest initial shocks.
- **Central banks role in financial stability:** independence and anchor of stability;
    - ✓ **Austria: important improvements already in 2008:** The Financial Markets Authority (FMA) and the OeNB assumed joint responsibility for the micro-prudential supervision of banks.

ONB

Gradual Progress in the Europeanization of Financial Supervision



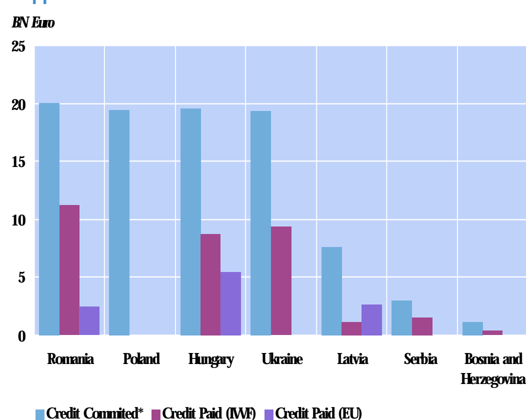
www.oenb.at - 4 - oenb.info@oenb.at

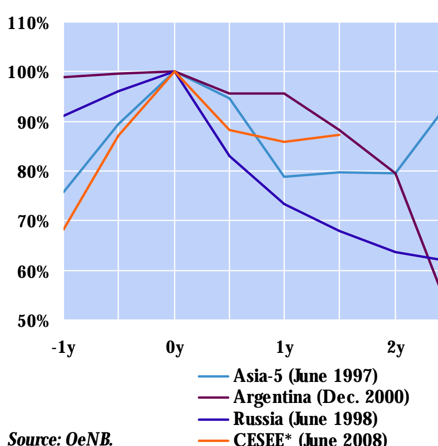
- ✓ **European supervisory architecture.** European Systemic Risk Board to identify emerging systemic risk, to publish early warnings as well as to make recommendations to the competent authorities;
- ✓ **Micro-prudential supervision:** three European supervisory authorities (banks, insurances and securities).
- ✓ **Various EU directives** on detailed regulation issues: rating agencies, hedge funds, manager bonus payments, etc;
- ✓ **Basel III:** Reducing bank leverage and pro-cyclical risk management;

Examples of macro-prudential policies

- Austrian authorities active in **reducing foreign currency loans** (exchange rate risk)**:**
  - ✓ October 2008: publication of enhanced **minimum standards** for foreign currency loans → share of foreign currency loans to households in Austria has declined since then (to 29.5% in early 2011);
  - ✓ Complementary action: launch of **CESEE foreign currency loan initiative,** relevant for the activity of Austrian banks in the CESEE region.
- **"Vienna initiative"** aimed at stabilizing activity in the CESEE region:

„Vienna Initiative" Minimized Contagion in CESEE





www.oenb.at - 5 - oenb.info@oenb.at

  - ✓ Launched during the peak of the global financial crisis in early 2009;
  - ✓ Platform for **cooperation** between **home and host country** supervisors, the European Commission, IMF (and other international financial institutions) and banks;
  - ✓ Resulted in stabilizing **commitment of foreign banks** in the region;
  - ✓ Over the medium term CESEE countries expected to return to **continued catch-up growth path,** although at a **lower level** compared to the pre-crisis period.

- *Background:* *The* ***aggregate exposure*** *of Austrian banking groups (domestically owned) to CESEE amounted to around* ***EUR 212 billion*** *in the second quarter of 2010;*
  - ***More than 70% of this exposure*** *relates to* ***EU Member States****;*
  - *Claims of Austrian banks to Hungary account for EUR 26.7 billion.*

B. Sound public finances

- Public finances: **deteriorated substantially** during the crisis
  - driving factors: shortfalls in profit- and asset-price-related taxes, automatic stabilizers and stimulus measures (figures: deficit and public debt ratios from EC Forecast[6]):

Development of Public Finances in Selected Countries

Public Finances 2007 and 2010				
	2007		2010	
	Deficit	Public Debt (in % of GDP)	Deficit	Public Debt (in % of GDP)
Euro Area	-0.6%	66%	-6.3%	84.1%
Austria	-0.4%	59.3%	-4.3%	70.4%
Ireland	0.0%	25%	-32.3%	97.4%
Greece	-6.4%	105%	-9.6%	140.2%
Hungary	-5.0%	66.1%	-3.8%	78.5%

- **Timing of consolidation** and structural reforms is crucial:
  - In **some** countries, concerns about fiscal **solvency** – immediate tightening of fiscal policy necessary;
  - However, the majority of euro area countries performed a **delicate balancing act.** avoiding premature and abrupt fiscal tightening;
  - Currently, **window of opportunity:**
    - Demand side: Relatively **weak euro** and high growth in **emerging markets**;
    - Supply side: Expected decline in the working-age population has not started yet. (In Austria, the decline will start around 2020.)
  - Packages for Greece and Ireland and measures ECB to stabilize bond markets have **bought some time** to undertake substantial reforms;
  - Consolidation measures **announced as soon as possible** to convince financial markets.
- Consolidation should focus on the **expenditure side**, especially where the fiscal burden is already high (like Austria).
- However, given the size of consolidation needs, supplementary **tax increases** necessary in many cases:

[6] Debt-to-GDP ratios in brackets.

- **Less distortive taxes**, for instance on energy or wealth – to prevent undermining long-term growth potential;
- Reforms of the **tax structure** – to enhance growth and labor market participation.

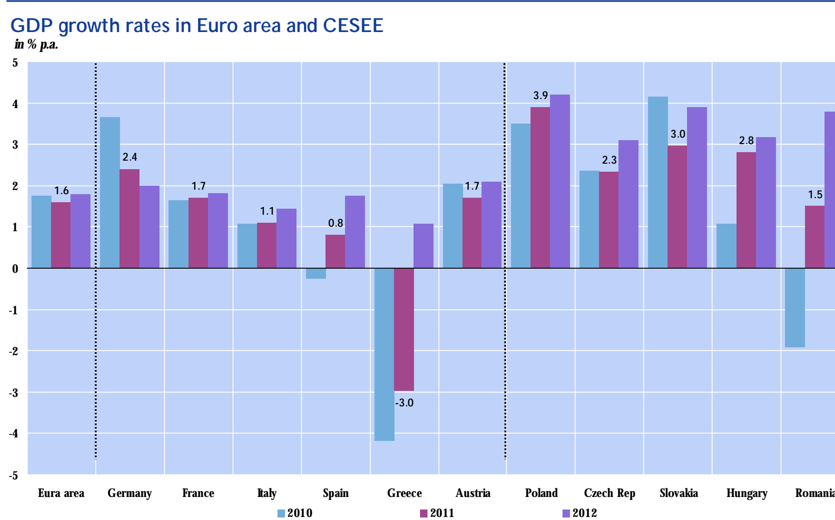
C. Structural reforms

Rebalance economies of the euro area.

– **Greece,** Italy, Portugal and Spain: **Competitiveness losses** in the past and/or high fiscal and external deficits.

ONB

Heterogeneous developments in Europe



www.oenb.at - 1 - oenb.info@oenb.at

- Significant **adjustment needs** on the part of these ***periphery countries***:
  - Short run: **Cost cutting**, wage moderation;
  - Long run: Reforms to strengthen **productivity** growth.
- But every **imbalance has two sides:** Surplus countries (Germany, Netherlands, Austria) should strengthen domestic demand (2 ways):
  - Structural reforms to enhance **investment** (ECB/Bundesbank view);
  - Income and tax policy to strengthen **consumption** (FT view);
  - Otherwise, deflationary drag – cannot be compensated by loosening monetary policy ("pushing a rope").

– Crisis lesson: Structural reforms go beyond efforts to restore the proper functioning of markets.

- Eliminate **conditions that favor bubbles**: imbalances, inequality and over-indebtedness;
- Reflected in the new **EU 2020 strategy**: smart, sustainable and inclusive growth;
- **Economic Governance Reform** in the EU to address the high degree of economic inter-dependence while preserving national responsibilities.

Van Rompuy Task Force - 5 proposals (accepted by the European Council):

1. Greater **fiscal discipline:**
   - Reinforce **compliance** with EU fiscal rules in euro area countries;
   - **Preemptive** part of Stability and Growth Pact;
   - Focus on **debt** sustainability.
2. Broadening **economic surveillance**:
   - **New mechanism** for macroeconomic surveillance (annual assessment);
   - **Alert** on risks of macroeconomic imbalances and vulnerabilities;
   - ***Excessive Imbalance Procedure*** with s**anctions** (including excessive surpluses?);
   - Indicators to be specified.
3. Deeper and broader **coordination: European Semester**
4. Robust framework for **crisis management:**
   - **European Stability Mechanism** (ESM) to succeed temporary financial assistance mechanisms from mid-2013 onward.
   - Part of a credible **crisis resolution** framework;
   - Details under discussion at the European Council.
5. Stronger **national institutions:**
   - New public institutions to provide independent analyses, assessments and forecasts on domestic fiscal policy matters.

D. Monetary Policy

- **internal and external stability:**
  - Price stability = primary objective;
  - = (necessary but insufficient) condition for stable exchange rate and balanced current account.
- **inflation vs. deflation**
  - deflation no immediate concern in the euro area;
  - HICP in January 2011: 2.3% (energy, food and taxes); HICP in February 2011 (flash): 2.4%
  - Eurosystem forecast (March) for 2011: between 2.0% and 2.6%;
  - Inflation expectations firmly anchored: below, but close to 2% over the medium term;
  - Risk: commodity prices (wheat, oil, etc.);
  - But expansive **monetary policy not inflationary** – can easily be reversed!
- **Crisis lesson**: monetary policy's role (Jackson Hole Consensus):
  - Preserving both price stability and financial market stability;
  - "Leaning against the wind": difficult in practice;

- Broader range of tools (blurring boundaries between monetary policy and regulation);
- **Price stability = sine qua non for financial stability** (but not sufficient).

ONB

Increasing Inflation

Country	2009	2010	2011
Euroarea	0.3	1.6	2.2*
EU-27	1.0	2.1	2.5*
Germany	0.2	1.2	2.2*
France	0.1	1.7	2.0*
Italy	0.8	1.6	2.2*
Spain	-0.2	1.8	2.4*
USA	-0.4	1.6	1.1
Japan	-1.4	-0.7	-0.7

Source: *Interim forecast from EC of February 2011, forecast of EC of November 2010

www.oenb.at - 8 - oenb.info@oenb.at

4. Conclusion

- Despite criticism, **reform progress** has been **substantial**.
- Enough to **avoid future crises**? Certainly **not**, but hopefully enough to render crises less severe.
- Remaining **reform workload is huge**.
- Changes in the regulatory framework are **not technical matters alone;** they require more than a button to be pressed by a benevolent social planner.
- **Resistance from vested interests** and lobbyists endangers the success of reform agenda.
- **Policymakers need support** for their ambitious project of securing future economic stability in Europe and elsewhere.
- A **more balanced development path** will enable our peoples (Europeans, Americans, Asians and all other world citizens) to **prosper in a sustainable manner**.