EUROPEAN CENTRAL BANK

EUROSYSTEM

Transmission embargo until 9 a.m. CET on Monday, 15 November 2010

"Catching-up strategies after the crisis"

Keynote lecture
at the Conference on European economic integration
organised by Oesterreichische Nationalbank

by

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Vienna, 15 November 2010

Check against delivery.

Distinguished guests, ladies and gentlemen,

It is a great pleasure to be here today to share some thoughts with you on the challenges to the process of European economic integration in the aftermath of the global turmoil. The financial crisis has exposed widely-held views on large domestic and external imbalances as having several shortcomings, which has led to an overall reassessment of the associated risks.

With regard to the process of European economic integration, the financial crisis has undermined the staunch belief in a "development model", whereby low income countries in central, eastern and south-eastern Europe (CESEE) could achieve rapid growth simply by: (i) engaging in market-oriented reforms; (ii) liberalising trade; (iii) having access to foreign capital markets via debt flows and foreign direct investment (FDI); and (iv) allowing the entry of foreign banks. The associated growing imbalances were judged as temporary phenomena associated with the catching-up process.

I will argue today that this development model should not be abandoned, but refined, as the push towards market reform has engendered significant benefits. However, the global crisis has shown that economic convergence in Europe should not be viewed as an automatic process. In fact, stability-oriented policies and careful risk management should accompany and support convergence efforts. With this in mind, I will focus on the following three aspects, which highlight the role of policy in ensuring a sustainable development model:

1. A review of the growth experienced in CESEE countries in order to determine if any general lessons can be drawn.
2. The role of the foreign banking sector in CESEE countries, which despite having been beneficial overall for the catching-up process, may have contributed to increasing domestic imbalances in some countries.
3. The establishment of a new macro-prudential and regulatory framework in the European Union (EU).

1. The experience of growth in the CESEE region

Before the global financial crisis erupted, the CESEE region was experiencing an economic boom, with rapid GDP growth that could be attributed to domestic and international factors.

The widespread and enduring process of convergence of living standards and prices towards euro area levels prompted considerable optimism about the future. Market-oriented reforms were a key feature of the development model that was followed in almost all EU CESEE countries from the mid-1990s, spurring productivity gains and access to foreign technology and capital. However, in most non-EU countries in the region, typically the catching-up process gained speed only later. There was mounting evidence of a link between these market reforms and long-term growth.[1]

However, developments in the region were not homogenous: over time a growing number of countries showed increasingly visible signs of vulnerability. In particular, over the past decade several countries recorded a deterioration in their current account deficits and price competitiveness indicators. To a large extent, these developments were viewed as having been predicted by economic theory and were thus often downplayed. The explanations generally advanced to explain these developments were as follows:

- capital is expected to flow "downhill" to countries where the rate of return is higher. From an inter-temporal perspective this appears to be a reasonable argument. Tapping foreign savings and accumulating external debt allows a country to finance investment, smooth consumption, import technological know-how and expand the ability of the export sector to penetrate foreign markets. The trade deficit is eventually expected to turn into a surplus as exports rise and imports of capital goods decline, leading to a gradual stabilisation and eventually to a fall in external debt;
- based on economic theory, a country is expected to experience real exchange rate appreciation during the catching-up phase. This point is typically expressed in terms of the Balassa-Samuelson effect or equilibrium exchange rate analysis, suggesting that prices may converge to euro area levels if fundamentals improve. This benign assessment was also reinforced by pointing to rising export market

[1] See Falcetti et al. (2005).

shares, which was seen as evidence that overall competitiveness might even have improved.

While these and similar arguments had their appeal, in a sub-set of countries, inflation and current account imbalances reached such high levels that an orderly self-adjustment mechanism seemed increasingly unlikely. Nevertheless, access to international capital markets continued without disruption and the cost of external financing remained low, thus contributing to rapid credit growth. The risk of economic overheating was also fuelled by low or, in some cases, negative real interest rates. It was particularly challenging to deal with these phenomena in countries that had fixed exchange rate regimes, given the lack of an autonomous monetary policy.

On the eve of the global financial crisis, different countries had accumulated different degrees of external and internal imbalances. Taken as a whole, most of the CESEE region was characterised by a sizeable contribution of private consumption to growth and an increasingly negative contribution of net exports.[2] The underlying causes of the shift from the tradable sector to the domestic sector were rather country-specific. In some cases, it was related to foreign funding, through bank lending or FDI, while in others, the main underlying factor was domestic, in the form of rising government spending or a domestic credit boom. As a result of both external and domestic forces, in some countries the situation appeared out of control: inflation even surged to double digit levels, wages increased far above gains in labour productivity and there were remarkable increases in asset prices, notably in housing markets.

Let me now turn to the global financial crisis, which has made it clear that the risks associated with growing imbalances such as those described above cannot be neglected. In fact, after some initial resilience, the CESEE region was affected by the crisis particularly strongly, even though it was not directly exposed to US markets.

As access to international capital markets was impaired, countries that were most in need of external financing experienced larger welfare losses. A number of economies in central and eastern Europe were affected less seriously, but recessionary forces were stronger in the Baltics and south-eastern Europe, suggesting that it was the

[2] See Gardo and Martin (2010).

countries with the larger imbalances that were typically most affected. In countries with fixed exchange rates with limited room for manoeuvre through monetary policy, the adjustment process proved even more challenging. In the absence of nominal exchange rate flexibility, prices and, in particular, wages eventually had to be adjusted downward amid rapidly rising unemployment.

Looking back at what has happened since the crisis hit the region, it can be seen that a considerable stabilisation effort has taken place. National and, in some cases, international responses prevented the crisis from having a more disruptive impact, as the prevailing exchange rate regimes were preserved and the banking sector showed considerable resilience. Indirectly, unlimited liquidity provision by the ECB to banks established in the euro area helped to secure funding to the region. The policy response to the crisis also varied significantly depending on the scope for manoeuvre on both the fiscal and monetary front. Fiscal policies have been tightened in some cases, financial conditions have stabilised and there are now clear signs of a recovery in economic activity in most countries.

However, the impact of the global crisis and the years of exuberance proved very costly, leading to a general sharp contraction in national output and a corresponding steep rise in unemployment. Moreover, the ongoing de-leveraging process, the need to repair household and corporate balance sheets, tighter bank credit standards, as well as rising long-term unemployment could all slow the pace of the catching-up process in many CESEE countries in the coming years. In the most severe cases, the process of unwinding of external vulnerabilities is still underway.

Although the crisis has not undone the progress achieved on convergence over the past two decades and past reforms have helped the stabilisation effort, important lessons should be learned. The good parts of the development model pursued so far should be retained. Countries in the region should not lose their appetite for structural reform and progress on enhancing labour market flexibility, improving the business environment and preserving free access to trade and financial markets. There is still a fundamental need to increase productivity, promote innovation, as well as raise capital and labour participation. At the same time, the crisis has clearly revealed that the catching-up process must go hand-in-hand with macro and

financial-oriented policies, while specific challenges remain for countries that maintain hard pegs, which require adequate support measures.

2. The role of the foreign banking sector in CESEE countries

Let me now turn more specifically to the "parent bank" model in CESEE. At a broader level, it is still controversial whether international financial integration and foreign banks have an unambiguously positive effect on economies that are in the process of catching up.[3]

On the one hand, it is argued that the presence of foreign banks in the region has ensured the availability of credit to the real economy and improved the efficiency of financial intermediation process. In addition, the lending activities of foreign banks appear to be more resilient to local shocks than those of domestic banks.[4] It has also been found that the region's resilience to capital outflows is related to a high level of financial integration and the presence of foreign banks.[5]

On the other hand, other observers have argued that financial stress originating in EU parent banks may have been transmitted to the CESEE region during the early stages of the crisis.[6] Some also hold the view that parent banks from western Europe were fuelling local credit booms and encouraged the use of unhedged foreign currency borrowing.[7]

As the crisis erupted, region-specific arrangements made CESEE countries more resilient to the risk of sudden stops in capital inflows: under the umbrella of the International Monetary Fund, the European Bank for Reconstruction and Development and the EU, the European Bank Coordination Initiative – also known as the "Vienna Initiative" – enabled a dialogue between parent banks, home and host supervisors, and relevant governments. This initiative, in which the ECB participated as an observer, ensured that parent banks kept their exposure to CESEE countries with large imbalances. Together with a strong commitment on the part of home governments backing parent banks and thus indirectly the CESEE region, the Vienna

[3] See Agénor (2003).
[4] See ECB (2010) and De Haas and van Lelyveld (2010).
[5] See Herrmann and Mihaljek (2010).
[6] See Popov and Udell (2010).
[7] See EBRD (2009).

Initiative helped to maintain confidence in the banking sectors across the region. I should like to take advantage of this occasion to congratulate those of you who were actively involved in this initiative. In addition, I would like to emphasise the fact that the Vienna Initiative has become a vehicle for public-private sector coordination, which could serve as a promising model for overcoming the problems associated with collective action.

However, from a policy perspective, a number of challenges lie ahead. In particular, it is important to assess the extent to which parent banks may have contributed indirectly to financial stability risks via lending in foreign currency.[8] Lending in foreign currencies to the non-financial private sector is not an entirely new phenomenon in Europe, and in most countries of the region such activities account for a significant proportion of the total lending by banks. In some countries, lending in foreign currencies has led to a substantial build-up of currency mismatches on private sector balance sheets. The increasing share of foreign currency in total lending in countries in the CESEE region, in particular euro-denominated lending, but also loans denominated in Swiss francs and Japanese yen, was accompanied by a strong expansion in overall credit amid strong inflows of foreign capital attracted by expectations of dynamic economic convergence.

Let me briefly elaborate on the implications of high dependence on foreign currency lending. At the turn of 2008-2009, all countries with flexible exchange rate regimes experienced rapid depreciations of their currencies vis-à-vis the euro. This inflated the local currency value of foreign currency loans, and thus weighed on private sector balance sheets. However, low market interest rates on foreign currency loans mitigated, to some extent, the increase in the debt-servicing burden of borrowers. In an environment of rising interest rates on foreign currency loans, this could have affected a significant proportion of the private sector and could have posed a systemic financial stability risk in countries where foreign currency loans accounted for a large share of total domestic lending. In addition, the major role played by foreign currency lending has posed some challenges for the conduct of monetary policy. In particular, the existence of a large stock of loans denominated in foreign currency has weakened the ability of monetary policy to influence the economy through the interest rate channel. Furthermore, central banks might have become

[8] See, for example Brown, Kirschenmann and Ongena (2010).

hesitant to alter their policy stances in the light of the possible adverse implications for financial stability stemming, for example, from a downward pressure on the exchange rate.

A number of countries in the region have made attempts to address the risks related to rapidly expanding foreign currency lending to unhedged borrowers. As standard policies aimed at decreasing interest rate differentials and developing domestic funding markets might take too long to achieve this goal, some countries in the region have introduced different monetary policy, regulatory and administrative measures[9] to address the risks stemming from increased foreign currency lending. Practical experience with these measures reveals that their effectiveness has been somewhat limited for a variety of reasons. In particular, persistently wide differentials between interest rates on loans in domestic currency and those in foreign currency have fostered demand for foreign currency loans, while shortages of domestic savings denominated in local currency together with intense bank competition underpinned their supply.[10] In fact, as parent bank financing continued to be mainly denominated in foreign currency, local subsidiaries avoided currency mismatches on their own balance sheets by lending in foreign currency. In addition, when domestic lending in foreign currency was made more costly, it was circumvented by cross-border lending. Recently, authorities in some European countries (e.g. Austria and Hungary) introduced stricter measures to limit further increase in foreign currency lending to domestic households. These measures are mostly of an administrative nature and set limits on customer eligibility to obtain a loan in foreign currency. However, these measures do not preclude domestic customers in these countries from obtaining foreign currency loans directly from banks domiciled in other countries.

It appears, therefore, that the issue of foreign currency lending requires a supranational approach – at least at the EU level. More generally, in order to make the financial system less prone to crises and ensure long-term sustainable growth,

[9] Examples of these are: (i) a differentiation between minimum reserve requirements on bank liabilities in domestic and foreign currency; (ii) higher risk weights and provisioning rates on loans in foreign currency; (iii) restrictions on loan-to-value and payment-to-income ratios; and (iv) tighter eligibility criteria for borrowers to obtain a loan in foreign currency.

[10] See, for example, Luca, Petrova (2008) and Rosenberg, Tirpak (2009).

we are setting a broader policy agenda for the EU as a whole by means of Basel III and the creation of a new macro-prudential supervisor in the EU.

3. Basel III and macro-prudential policy in the EU

During the recent crisis several gaps in the regulatory and supervisory framework for financial institutions were revealed. It became apparent that the quality and quantity of the capital base of many financial institutions were insufficient to withstand severe shocks. In addition, the abundant liquidity that characterised the financial system in the years preceding the crisis suddenly disappeared, exposing several institutions to liquidity shortages. To avoid a complete financial meltdown, governments provided an unprecedented amount of financial support and central banks had to significantly increase their provision of liquidity during the initial stages of the crisis.

These events led to many different policy responses, resulting in a major overhaul of the regulatory and supervisory framework. Under the aegis of the G20, a tremendous amount of work has been done by the Financial Stability Board and the Basel Committee to reform the regulatory and supervisory framework in order to address the core causes of the crisis. A major component of this reform was the revision of the Basel II framework with the aim of strengthening the capital base of banks and introducing stricter liquidity risk requirements and an absolute leverage ratio.

The revision of micro prudential regulation - Basel III

The recent agreement reached on the Basel III framework and its full endorsement by the Group of Central Bank Governors and Heads of Supervision is an important piece of work that delivers on global financial reform and constitutes a cornerstone of the new regulatory system.

The five main elements of the new framework are as follows.

First, under the new definition of regulatory capital, both the quality and consistency of the capital base will be improved. This will help to ensure that sufficient high quality capital is available when it is most needed, namely at times of stress.

Particular emphasis will be placed on the core elements of Tier 1 capital. Tier 2 capital elements will be simplified, and existing Tier 3 capital will be abolished. Enhanced disclosure requirements will further improve the transparency of the capital structure of banks. Overall, I am confident that stricter conditions for what should count as regulatory capital will contribute to restoring confidence in the ability of banks to weather future periods of stress. This in itself will substantially reduce the probability of future banking crises, thus improving long-term economic and social welfare.

Second, the introduction of counter-cyclical capital buffers should protect the banking sector from periods of excessive credit growth. As witnessed during the crisis, the build-up of excessive credit levels in an economic upturn is often followed by large losses on this outstanding credit when economic conditions deteriorate. These losses may in turn have a destabilising effect on the banking sector. The buffering mechanism consists of two elements. First, a capital conservation buffer range – equal to 2.5% of risk-weighted assets and made up of Tier 1 common equity – would be established above the minimum. The second element, currently under development, consists of the possible extension of the buffer range up to an additional 2.5% in periods of excessive credit growth (known as a "counter-cyclical buffer"). An important additional benefit of this measure would be that it might mitigate the credit cycle.

As a complementary measure to improving the quality and quantity of the capital base, the third element of the framework consist of the strengthening of the risk coverage of the capital framework by revising the prudential rules on securitisation and trading book activities, and by putting forward proposals for the revision of the counterparty credit risk framework. This would imply higher risk weights and thus result in higher capital requirements for these activities.

Fourth, the planned introduction of a non-risk based leverage ratio should serve as a credible supplementary measure to the risk-based requirements to contain the build-up of excessive leverage and address model risks associated with the risk-based capital framework.

Last, but not least, since it constitutes a building block in the new framework, is the development of a liquidity risk framework aimed at improving banks' resilience to

liquidity shocks. The liquidity risk framework consists of two main measures: a short-term measure (Liquidity Coverage Ratio) establishing a minimum level of high quality liquid assets to withstand severe stress over a one month period and a long-term measure (Net Stable Funding Ratio) designed to ensure that the maturity structure of assets and liabilities are better matched, requiring banks to fund long-term assets with more stable types of liability. Work is underway on the important details and precise calibration of these ratios.

All of these new measures, which will be introduced over the agreed transition period, should not have any unduly severe implications for the national banking system and will thus support the nascent economic recovery.

Further work ahead

Although the agreement on Basel III constitutes a robust conceptual framework, much remains to be done. Aside from the ongoing work concerning the introduction of counter-cyclical buffers, more work also needs to be carried out on other important elements of the framework.

In this respect, the potential implications of the leverage ratio and the liquidity risk framework still need to be assessed. An observation period has therefore been agreed upon in order to carefully monitor the potential implications for certain banking sectors, business models and the real economy. Full use of the observation period should be made to identify any such implications and to prevent the new measures from having any unintended consequences.

Furthermore, since the leverage ratio is largely based on accounting information, the accounting standard-setters should strengthen their efforts to eliminate existing accounting differences. This is essential in order to ensure a level playing field.

Work is also still underway on ensuring the loss-absorbency of all regulatory capital at the point of non-viability. The Basel Committee has also decided at the level of Governors and Heads of Supervision that systemically important financial institutions will be required to have a higher loss absorbency capacity than the other institutions that are subject to Basel III. To achieve this, banks would be permitted to use new instruments such as 'contingent capital' (coco) or bail-in bonds, which raises some

issues. First, on a general level it is necessary to assess whether these instruments can really provide a feasible funding alternative and foster a robust investor response. If this is deemed the case, the precise features of these instruments will need to be determined. Key design features include the event that would trigger the conversion of the instrument, as well as the conversion price and ratio.

I should like to stress that a strengthened regulatory framework is necessary, but consistent implementation and application of Basel III at the global level is of the essence to ensure a level playing field and to avoid regulatory arbitrage causing any disruption in the future. In this respect, I would like to underline the importance of adhering to the agreed transition period, which was based on the outcome of the impact assessments and country-specific considerations. In order not to compromise the economic recovery, any market pressure to accelerate the implementation of Basel III would be detrimental to the overall objective of the regulatory reform package.

Potential impact of Basel III

Allow me to say a few words on the potential impact of the Basel III framework on banks. It is expected that banks engaged in different business activities will be affected differently. The consensus view among market participants seems to be that the new stricter capital requirements will have a bigger impact on universal banks, mainly as a result of the limits imposed on the recognition of minority interest and the application of most regulatory adjustments to and deductions from common equity Tier 1 capital. As a consequence, banks that have significant holdings in other financial institutions and insurance companies will most probably have to adjust to the new rules either by strengthening their capital base or by revising their business activities. In this context, given the sizeable share of large, internationally active universal banks in the region, the potential impacts of the new measures on the financial systems and economies in CESEE have to be carefully explored and assessed.

The new macro-prudential framework - ESRB

In parallel with the revision of the micro-prudential framework, extensive work is being carried out at the regional, country and global levels on developing consistent macro-prudential policy frameworks. The financial crisis has illustrated the importance of having an effective macro-prudential oversight function to safeguard financial stability by proposing timely policy responses. Macro-prudential oversight taking a system-wide perspective should complement micro-prudential supervision, allowing the relevant authorities to assess and address potential systemic risks.

The European Systemic Risk Board (ESRB) has been entrusted with responsibility for macro-prudential oversight at the EU level, alongside other initiatives at the national and international levels in this field. Under the new legislation, the ECB has been entrusted with providing the ESRB with a Secretariat, as well as logistical, administrative and analytical support. Similar frameworks were also created in the United States and the United Kingdom with the close involvement of their respective central banks.

The macro-prudential oversight function of the ESRB is aimed at linking systemic risk analysis with appropriate policy responses to address potential risks identified as material. It therefore comprises both an analytical and a policy component. The analytical part focuses on identifying, measuring and assessing the impact of potentially systemic risks, while the policy part entails the calibration of policy instruments that could be implemented to address the identified risks or mitigate their consequences.

More specifically, the first task of the ESRB will be to identify systemic risks. This will require a broad and deep information basis, aided by a wide range of tools to process the relevant data. Important ingredients for the analysis include market intelligence, rigorous monitoring of financial stability indicators and financial market and economic developments at large. It is important at this initial stage to cast the net as wide as possible to ensure that no risk is overlooked. This type of analysis could be supported by early warning models and indicators based on current data on financial or macro variables in order to identify early on where imbalances may be building up.

Its second task will be to assess the severity of the risks identified and to evaluate the ability of the financial system to absorb shocks. In this context, macro stress-testing models can be used to assess the resilience of the financial system, as can contagion and spillover analysis to evaluate propagation mechanisms and their potential impact on the financial sector or the real economy.

Finally, the ESRB will use the outcome of the risk assessment for possible risk warnings or policy recommendations, which will need to be concrete and well targeted.

The ESRB will be in a good position to perform all of these tasks and to address in a timely fashion potential systemic risks, such as those related to the rapid expansion in foreign currency lending to unhedged borrowers in the CESEE region. Addressing the problem at the EU level will allow different measures to be implemented on a consolidated basis, thus addressing all of the relevant financial sector players active in the region, ensuring that macro-prudential policy across the EU is consistent and minimising cross-border and cross-sectoral policy circumvention.

In short, the establishment of the ESRB will introduce a new policy function at the EU level with great potential for enhancing the ability of European and national authorities to safeguard the stability of the EU financial system as a whole. It is recognised that the design and implementation of this new EU macro-prudential policy function pose a considerable challenge. However, with the necessary preparations, which are currently underway in close cooperation with all involved parties, the ESCB is assured a smooth start in 2011.

Ladies and gentlemen, let me conclude by saying that the crisis has revealed that the catching-up process in CESEE countries must go hand-in-hand with prudent macro and financial sector policies, and this lesson also applies to all countries in the EU. The achievement of high rates of growth cannot be detached from stability-oriented policies and careful risk management. To this end, policy-makers will be engaged in the task of designing coherent policy frameworks for some years to come.

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