“The current sovereign debt and banking crisis – ways forward?”[1]

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Introduction

It is an honour and pleasure for me to deliver this speech to the meeting of the German-Finnish Chamber of Commerce. Business and economic relations between the two countries have a long history and your organization makes a useful contribution to the continuous success of these relations.

The global financial crisis has now lasted over five years – it started in August 2007 – and the end is not in sight. My speech looks at the current stage of the crisis, in particular the euro area problems for sovereign debt and (a little bit) banking, and discusses recent moves toward possible resolution of the crisis. Solving the crisis is necessarily a long process and major uncertainties continue exist.

My speech is divided into the following parts. First, I will provide an overview of the economic situation in the crisis countries. We will see that the crisis countries are adjusting in the right direction, but the adjustment is probably far from complete. Second, I will consider the framework for crisis management. Third, I will review steps that have been taken or are possibly emerging from the recent economic decisions about the future fiscal framework and the plans for a banking union in Europe.

Economic situation in the crisis countries

I now start my review of the economic situation in the crisis countries. Macroeconomic imbalances are my first focus. **Slide 1** shows the level of general government primary expenditures from 2002 to 2011 as index numbers for Ireland, Greece, Spain, Italy and Portugal as well as the euro area average for comparison.[2] Recall that in particular, primary expenditure excludes interest payments on public debt and also capital transfers are excluded. It can be seen that in particular, Ireland and Greece have significantly reduced government spending in recent year. The same is also true of Spain and Portugal to lesser degree.

General government debt as percentage of GDP is nevertheless increasing in all these countries as indicated in **slide 2**. The rates of increase in public debt to GDP ratios seem to be slowing down, but

[1] Views expressed are my own and do not necessarily represent views of the Bank of Finland.

[2] The slide also shows the data for Cyprus, which has very recently run into problems and seems to be entering a crisis.)

the countries are not yet starting on the path of debt reduction. To achieve debt reduction, it is necessary to achieve a sufficiently big primary surplus, i.e., a surplus without interest expenses. Currently, only Italy and Portugal have primary public surpluses, as shown in **slide 3**. These surpluses are not yet sufficient to reduce the debt levels in Italy and Portugal, though Italy's debt to GDP ratio is forecasted to go down slightly in 2013.

Slides 1 – 3

Continuing with an overview of the economic adjustment, **slide 4** shows the current account balances relative to GDP in the crisis countries from 1999 to 2012. It is seen that Greece, Portugal and Spain had significant current account deficits already before 2005, i.e., well before the start of the financial crisis. In contrast, the current account in Italy and Ireland turned into deficit only in the middle of the previous decade. The CA deficits dramatically worsened in the second half of the decade. The worsening began during the overheating period just before the financial crisis. In most recent years the CA deficits have gotten notably smaller, with Ireland even back to a small CA surplus.

I may recall here that before the euro crisis it was commonly thought that current accounts within a monetary union are largely unimportant and that balance-of-payments crises are largely impossible. We know now that sovereign countries within a currency union are leveraged entities and can be subject to a run. Thus, the monetary union alone does not shield from a BOP crisis.

Looking next at GDP developments, it is seen from **slide 5** that all of the crisis countries have experienced a decline in GDP and in most cases the decline continues at present. Ireland is the notable exception: the fall in GDP stopped in 2010 and there has been modest growth in 2011.

The final slide about economic adjustment in the crisis countries looks at cost competitiveness. **Slide 6** shows the unit labor cost in Italy, Spain, Greece, Ireland and Portugal as well as the euro area average in the period 2000 – 2013, measured as index numbers.[3] It is seen that, with the exception of Italy, unit labor costs have fallen significantly in these countries. In Italy unit labor cost continues to increase. The decline in unit labor costs suggest that the crisis countries are gradually improving their price competitiveness, which is one part of the necessary economic adjustment for countries with significant current account and public deficits.

Slides 4 – 6

I conclude from this overview that the crisis countries are carrying out the required downward adjustment in GDP, are reducing public and current account imbalances and are making improvements in the cost competitiveness. However, the adjustment processes are not complete since problematic trends continue for several indicators. As we have seen, current account deficits continue to exist and primary public balances are in deficits or in insufficient surplus, which implies that public debt to GDP ratios continue to rise.

Crisis management

The sovereign debt crisis has now lasted nearly three years as the problems in Greece become visible towards the end of 2009 after the formation of the new government. You may recall accouncement by

[3] Unit labor cost measures the average labor cost per unit of output.

the government that the public finances were much worse than previously told. This came as a shock on top of the difficulties that the European banking sector was experiencing.

A variety of measures and policies have been taken since the start of the sovereign debt crisis. Gradually, the framework for crisis management and the division of responsibilities in the policy responses have gradually obtained greater clarity. It is now possible to say that the framework has three important elements. They are (i) policies in the crisis countries, (ii) EU/IMF programmes, and (iii) ECB actions. I next discuss these three elements.

Policies in the crisis countries

As regards policies in the crisis countries, my overview has just shown that the adjustments in the crisis countries are not complete, though Ireland appears to be getting past the worst. It is very important that the countries continue their adjustment programmes. Austerity measures cannot be avoided or ended as there is a need to consolidate public finances further. These measures have negative impact on economic growth in the short run. Improving competitiveness via structural policies is also crucial and policies that reduce of rigidities in labor and product markets need to be introduced or/and continued. Successful structural measures have scope to improve economic growth in the medium and long term. The measures can also improve legitimacy of governments and public administrations which in turn can improve the attractiveness of the country to foreign investments.

It is important to realize that achieving the positive effects from adjustment and reforms takes time. Achieving just a turn-round for rising public debt requires often three years or more. Big ships do not turn fast. Looking at the ongoing financial crisis, there are already some cases of probable success. They are Estonia, Latvia, Ireland and Iceland. **Slide 7** shows the development of the level of GDP in these countries. All four countries went through a very difficult period of sizeable GDP decline but appear to have resumed of positive economic growth. However, the environment for these countries continues be challenging, given that the current outlook for the world economy is bleak. Moreover, as shown by **slide 8**, government debt to DGP ratio continues to rise in Iceland and Ireland, so that challenges remain.

A second fact to remember about resolution of a sovereign debt crisis is that it takes a very long time to achieve a major reduction in public indebtedness. An example of this observation is shown in **slide 9**. The slide shows development of public debt to GDP ratio for Ireland and Greece from year 1970 to 2011. In the 1980's Ireland had major problem in this respect, as its debt to GDP ratio was over 120 percent in 1986 and 1987. It took twenty years for Ireland to reduce the debt-GDP ratio to about 20 percent, the level in 2007 – just before the new crisis erupted.[4] By comparison, Greece never carried out any major debt reduction. There was a small reduction from early 1990's to early 2000's when Greece entered the EMU.

Slides 7 – 9

EU/IMF programmes

[4] It may be mentioned that in the 1990s Nordic crises it took about 15 years for Finland and Sweden to halve their public debt to GDP ratios. These countries did not have full sovereign debt crises though.

EU/IMF programmes are a second element in the crisis management framework and, as you know, Greece, Ireland and Portugal have such programmes of adjustment. The funding provided by the EU and IMF via these programmes must be seen “bridge financing”. Its purpose is to achieve an organized adjustment of the countries’ economies back to macroeconomic balance and competitiveness. This kind of adjustment is much better than would happen in isolation when a country faces huge difficulties in financing its current account and public-sector deficits. Without an EU/IMF programme there would be disruptive and chaotic downward adjustment.

The details of EU/IMF programmes differ between countries, but one part is to facilitate better functioning of the financial system and re-building the productive base of the country. Quite obviously, conditionality and regular external monitoring of an adjustment programme are essential, as they put in place controls on moral hazard. A programme can also provide support for continuity of economic policies in a crisis country.

Role of the ECB

The ECB has also had to act during the financial crisis. Two aspects in the role of the ECB derive from standard central bank practices. First, central banks provide liquidity to the banking system. This liquidity is meant for banks that are solvent but need temporary funding. The same practice has also been true for crisis situations. It must be remembered that central banks require collateral from banks taking out liquidity from the central bank. Rules of the liquidity provision must be clearly distinguished from solvency issues that, in contrast, are under the responsibility of governments.

Second, central banks want to make sure that financial markets function properly and that monetary policy decisions are transmitted to the real economy. The fundamental objective here is one of monetary policy, i.e., maintenance of price stability in the medium term. During the current crisis, problems in monetary policy transmission have occurred and are occurring, as witnessed in **Slide 10** showing the spreads of 10-year government bonds in the crisis country and a AAA-country Finland.

Slide 10

The ECB has taken measures to address these problems. The objective of the OMT (outright monetary transactions) programme that was decided in the beginning of this month is to improve monetary policy transmission in the euro area. The yields of government bonds of the crisis countries are significantly higher than corresponding yields of the highly-rated euro countries, which hampers monetary policy transmission. The spreads also seem to contain an unacceptable premium about the reversal of the euro area.

Interventions in the secondary markets of government bonds are the concrete tool in the OMT programme and bonds with shorter maturities of 1-3 years are targeted. OMT is built on strict conditionality requirement: the country must have and follow an EFSF/ESM programme, which includes regular outside monitoring. The ECB will also make an independent assessment of the country before making decisions about OMT operations. No commitments about interest rates ceilings or the like or about purchased quantities have been set in the OMT.

Toward a longer-term solution?

While short-term crisis management is a necessary part in policies to counter the ongoing financial crisis, it is also important to start designing foundations that are deemed necessary for a longer-term solution of the crisis. Progress has been and is being made in two elements for these foundations.

Reforms in the fiscal framework

The institutional framework of a monetary union with national fiscal policies was known to be very challenging from the beginning. The sovereign debt crisis has made it painfully clear that greatly improved cooperation and control mechanisms for fiscal policies in the euro area (and more generally EU) are needed as an element of a robust longer-term framework. As you all know, there have been a number of reforms for the fiscal and macroeconomic framework and I will next describe their main features.[5]

The Six-pack and supplements

A set of improved and partly new measures, the so-called six-pack, were decided at the end of last year. The main elements of the Six-pack are as follows.

(i) Updated Stability and Growth Pact (SGP), which is now in its 3rd version. The new features include a tightened focus on high public debt with medium term objectives. If the debt-GDP ratio is above 60%, then 1/20 of the excess tightens the usual three-percent deficit limit. The limits for corrective measure have been made more concrete and sanctions for breaches are now decided through reverse qualified majority voting (RQMV). Thus, proposed sanctions are more difficult to turn down than in the previous SGP.

(ii) Excessive deficit procedure has also been reformed. The new requirements incorporate deficit targets over several years. Decisions about sanctions are made through RQMV, so that it is not easy to reverse a proposed sanction.

(iii) Procedures for economic policy coordination have been strengthened. Countries must formulate medium term objectives for their structural position. A new regulation concerns prevention and correction of macroeconomic imbalances. Scoreboards, alert reports and other studies are used to assess these imbalances.[6] Enforcement for correction relies on sanctions in case of persistent inaction or insufficient action.

Further fiscal rules have been agreed for euro area countries. The so-called Two-pack includes tighter monitoring of public finances and reinforces the Six-pack. Sanctions against excessively high budget deficits are made more automatic and can be avoided only with RQMV. A new Treaty on Stability, Coordination and Governance, the so-called Fiscal Compact, is a framework for public finances that is potentially important for the longer term. This treaty is in the process of ratification and will enter into force in the beginning of next year if ratified by 12 euro area countries. I will return to the Fiscal Compact in a moment.

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[5] For further details of the reforms in the fiscal framework, see e.g. Kurri (2012).

[6] The Scoreboard indicators for external imbalance are CA/GDP balance, net international investment position per GDP, real effective exchange rate, change in export market and change in nominal unit labor costs. For internal imbalances the indicators are change in real house prices, growth in private sector credit per GDP, private sector debt per GDP and unemployment rate.

Another major element is the European Stability Mechanism (ESM), which will replace the temporary European Financial Stability Facility. ESm is meant for crisis management, but it is also designed to be a permanent part of the system. The lending capacity of ESM is currently 500 billion euros. The ESM should become operational soon, given the recent decision by the German constitutional court.

Fiscal Compact

As already noted, the Fiscal Compact was created to tighten the procedures and rules for EMU countries. In particular, the aim is that the budgetary position of the general government should be balanced or in surplus. In the medium term structural budget deficit should not exceed 0.5 percent of GDP, though deficit below 1 percent is permitted for countries with debt ratio below 60 percent and low risks in terms of long-term sustainability of public finances.

The rules in the fiscal compact should be incorporated into the national laws and the provisions should be binding, permanent and preferably constitutional. Compliance with would ultimately be judged by the European Court of Justice. Another feature is that a correction mechanism is triggered automatically if there is a significant deviation as specified in the revised SGP.

A Banking Union?

The idea of a banking union was presented in the Euro Area Summit of June 29, 2012. It can be seen as a second major element to the longer-term framework to solve the euro area crisis. The general idea is to break the “vicious circle between banks and sovereigns”. This interconnectedness of banks and sovereigns is a serious fragility in the euro area since sovereign and bank default risks have increased in parallel. **Slide 11** shows the CDS prices of selected banks from the crisis countries and also for some banks from other countries. Comparing slides 10 and 11 visually, it is seen how the situation of the banks and sovereigns is closely connected in the crisis countries.

Slide 11

A banking union can also be motivated in terms of financial market integration, as integrated financial markets with regulation and supervision at national level is a potentially unstable configuration. During the crisis sovereign debt problems have elevated into financial stability concerns. Better institutions are required for banking supervision and crisis resolution.[7]

Creating a euro area or EU banking union is clearly a long project and is meant for the longer-term framework, but a credible vision about it can provide support toward solving the current crisis. Careful design is crucial for the success of this undertaking. A banking union can facilitate risk sharing but it should not be a tool for income transfers. It must be emphasized at the outset that past liabilities must remain countries’ own responsibility. One must also note that a banking union does not require a fiscal union.

At the moment designs of a banking union are far from complete. The Proposal from the EU Commission on September 12th, 2012 lays out some but not all building blocks for a banking union. I will discuss the Commission proposal little later. Before doing this, I provide a general sketch of the main parts of a banking union, see **slide 12**.

Slide 12

[7] See e.g. Pisani-Ferry et al (2012) and Pisani-Ferry and Wolff (2012) for discussions of the idea of a banking union.

A banking union is seen to have three necessary parts:

(i) Micro supervision of financial institutions, which relies on an administrative function and for which the costs are small.
(ii) Resolution of failing banks can also be done through an administrative function. “Bail-in” from investors and owners are a part of the process. This process is not mean to include bank support (“bail-out”).
(iii) Deposit insurance can also be an administrative function. One possibility for financing is through fees from banks.[8]

It is important to note that these three parts do not require finance from government budgets. A very good example of this kind of arrangement is the Federal Deposit Insurance Corporation in the United States. It has powers of supervision, resolution and deposit insurance and its activities are not financed from the government budget.

A systemic banking crisis would most likely pose challenges to the preceding framework with parts (i)-(iii). Such a crisis may well require some common fiscal backing because, for example, a deposit insurance scheme financed by bank fees is most likely going to be insufficient if a number of banks begin to fail at the same time.

It must be emphasized that large-scale support of banks from government budgets must be kept outside a banking union and it is not included in parts (i)-(iii) above. “Bail-out” of banks by tax-payers’ money is expensive and politically difficult. These are discretionary case-by-case decisions and a separate institution with political decision-makers should be in charge of such bail-outs. The TARP scheme in the United States is an example of this kind of the system. It was created using a discretionary political decision and with financing from the federal budget.

EU Commission proposal, September 12, 2012

The Commission recently presented their proposals for some parts of a banking union. The main parts of the proposal include:

(i) A Single Supervisory Mechanism (SSM). The proposal is that the ECB should have the main responsibility for SSM and national supervisors are to carry out the day-to-day supervision. The role of the ECB includes some powers of early intervention.
(ii) Modifications to regulations about the European Banking Authority. In particular, EBA is seen to have the responsibility over developing a Single Supervisory Handbook.
(iii) The proposal also contains a communication about Commission’s overall vision for the banking union covering, in addition to SSM and the Rulebook, some next steps about involving a bank resolution mechanism.

The proposal envisages that the SSM would cover euro area banks, so that other EU countries can cooperate but cannot join. The scheme is meant to cover all euro area banks, but obviously there is need to distinguish the role of the ECB-level and national supervisions. The latter would have the major role in dealing with the wide array of national banks, while the ECB supervision function would focus on systemically important international and national banks.

A very tight time table for adoption by the start of 2013 was proposed. In addition, there is a call from the Commission to adopt regulations about a single rulebook to include capital requirements (CRD

[8] Deposit insurance can probably be introduced at somewhat later stage. Many countries already have national schemes to protect bank deposit up to a limit.

IV), harmonized deposit protection scheme and a single European recovery and resolution mechanism.

Final remarks

Where do we stand in the sovereign and banking crisis in the euro area? The economic adjustment downward is ongoing and the adjustment is clearly incomplete. There is clearly a significant way to go in most cases as fiscal and current account imbalances continue in most cases. The recent developments concerning the short-term crisis management have improved the current economic climate, but this situation can easily take a turn for the worse. The present slowdown in aggregate economic activity seems to affect most economies in the world and is creating additional uncertainties about the future. The slowdown and likely recession may create additional challenges to the managing of the sovereign debt and banking crisis in the euro area.

As was discussed above, progress seems to have been achieved in clarifying the responsibilities in short-term crisis management. There is also some progress in laying out the foundations for a long-term framework for the euro area. The strengthening of the European fiscal framework is a positive development, though its performance remains to be tested. I interpret the reforms of the fiscal framework as moving toward a "Maastricht plus" system and not a fiscal union. In particular, the requirement for fiscal balance in the medium term broadly corresponds to a system in which each country has the responsibility of its own economy. This matches the lessons from the US fiscal developments in the early decades of the 1800s in which there were at first numerous bail-outs of states but in 1840s this was stopped and the states learnt the meaning of hard budget constraints.[9]

Creation of a European banking union can also be a useful part in building a long-term framework for Europe. It can help by making it possible to separate the sovereign debt concerns from banking problems, so that each crisis can be tackled separately. The plans are far from precise at present and the design of a banking union faces numerous challenges.

References

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[9] See Sargent (2012) and Bordo et al (2011) for overviews of the 1800's fiscal developments in the United States.