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Reflections on the financial and economic challenges in the euro area and beyond

Ladies and gentlemen,

The euro area continues to face a number of unprecedented challenges. Bond and equity markets have been highly volatile and the degree of uncertainty in financial markets has increased. It can be said that Member States have largely recognised the gravity of the situation and have already implemented or are in the process of implementing various major reforms. These are generally directed at fiscal consolidation and the enhancement of competitiveness and growth, and include significant labour market reforms, as in Spain, and reform of the public administration, as in Italy. Ireland and Portugal are on track in the implementation of their EU-IMF programmes.

But the tensions in the debt markets are clearly not over yet. Despite the efforts being made by policy makers across the European Union, the sovereign debt crisis continues and its ramifications are still uncertain. The recent rise in Spanish yields and the turbulence in Greece are evidence of this.

The main problem is that fiscal consolidation has to be effected at a time of an economic slowdown. Recessionary conditions slow down GDP growth and compound the difficulties that are encountered in the reduction of the fiscal deficit and debt.

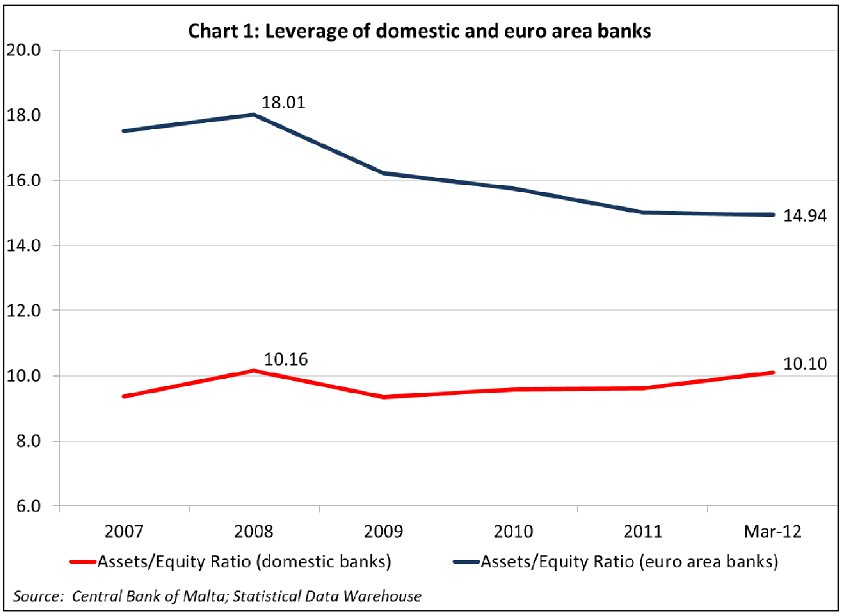
In this presentation I will cover various dimensions of the sovereign debt problem, and conclude with some observations that are of particular relevance to Malta.

The effectiveness of monetary policy

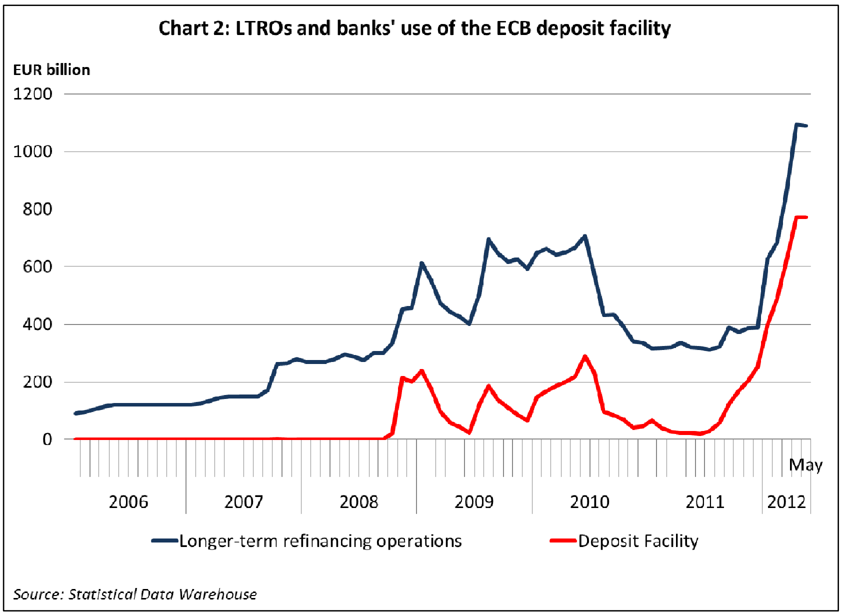
In the wake of risk re-pricing by the markets, financial institutions have tended to unwind their holdings of public and private sector debt. This can be seen in Chart 1, which shows the resulting reduction in the leverage of Euro area financial institutions.

It is true that deleveraging reduces financial imbalances and corrects past excesses in the banks' accumulation of assets. However, the process also slows down the return to normal macroeconomic growth.

The assets-to-equity ratio in the euro area (shown as the blue line in Chart 1) stood at 14.9 in March 2012, almost three percentage points below its peak of 18 in 2008. (By way of comparison, the same ratio for Malta's domestic banks has been lower and more stable, as can be seen from the red line. It stood at 10.1 in March, almost unchanged from 10.2 in 2008. I will come back to the Maltese situation later.)



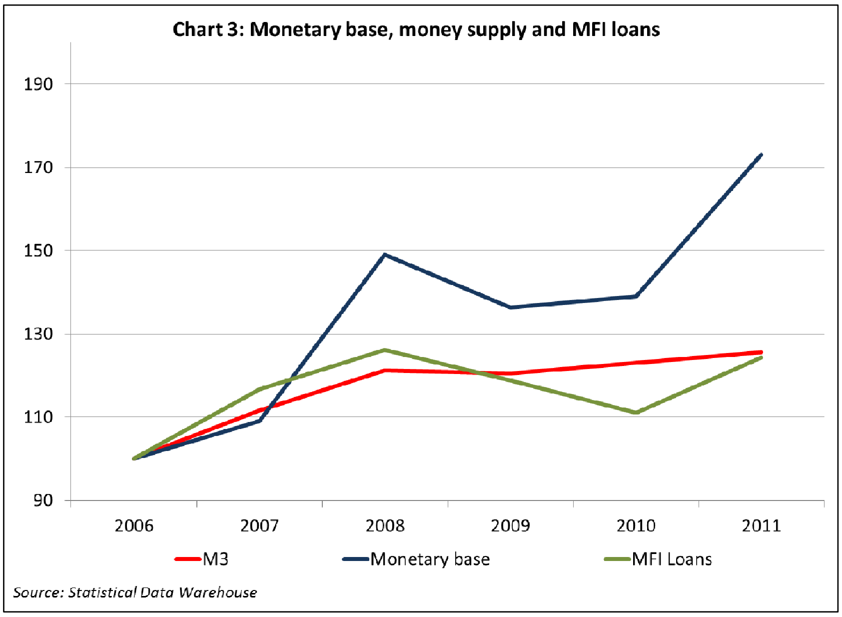
The European Central Bank (ECB) has sought to avert a credit crunch and a bank funding crisis via a number of measures, including the two 3-year Longer Term Refinancing Operations (LTRO) launched last December and February. These have been provided on a full allotment basis and at the average Marginal Refinancing Operations (MRO) rate over the three year term.



These operations have helped to stabilise bank lending to the private sector as well as the banks' holdings of government securities. However, the effectiveness of these operations has been reduced, as banks have preferred to place a substantial part of the additional funds with the ECB's deposit facility.

In fact, in Chart 2, the blue line shows the sharp increases in the volume of bank liquidity provided by the ECB through its longer term operations over the course of the crisis. The red line shows the increases in the volume of funds placed by the banks with the ECB deposit facility. The inflow of funds into the ECB's deposit facility has neutralised a substantial part of the added liquidity. This reflects a persisting lack of activity in the interbank market and a hesitation on the part of the banks to provide more credit to households and businesses.

This accumulation of excess liquidity comes at a cost to the banks, currently amounting to 0.75% - the difference between the 1% MRO rate charged by the ECB on the LTRO and the 0.25% paid by the ECB at its deposit facility.



In a similar manner Chart 3 shows the path followed by various monetary aggregates during the crisis. The monetary base – shown as the blue line – includes mainly bank deposits with the central bank. The base consists of those central bank liabilities that form the foundation for expansion of the money supply – M3, represented by the red line.

The sharp rise in the monetary base reflects the scale of the injected liquidity. On the other hand, the banks' tendency to hold on to their liquidity has resulted in a growth rate in bank loans (and investments) that is considerably slower than that of the monetary base. The result is that the growth rates in bank loans (represented by the green line in the chart) as well as in M3 have been substantially slower than that in the monetary base.

A return to a fully functioning monetary transmission process will increase the volume of lending that would support the resumption of economic growth. This, however, remains a challenging task while tensions continue in the sovereign debt markets.

Importance of a prudent fiscal policy

The creation of the euro reduced the cost of borrowing, as credit spreads narrowed and the exchange rate risk on intra-euro area borrowing was eliminated.[1] The reduced cost of financing public as well as private debt led to higher government debt and private sector leverage. With the benefit of hindsight, it

[1] Lorenzo Bini Smaghi, "Eurozone, European crisis and policy responses", Goldman Sachs Global Macro Conference – Asia 2011, 22 February 2011.

is clear that the first seven years of the euro would have been an ideal time for governments to engage in fiscal consolidation. Instead imbalances and vulnerabilities were further aggravated. [2]

In some Member States, institutional characteristics also played a major role. Seeking to explain the sources of the Greek crisis, my former Greek colleague at the European Court of Auditors, Ioannis Sarmas, has pointed to the lack of a culture of effectiveness that holds the Greek government accountable for its policies.[3] He also refers to the absence of an effective internal control system in the Greek public sector, and to the lack of adequate powers in the hands of the auditing authorities that would permit them to focus more on the efficient use of public funds. While the auditing process scrutinises compatibility with the laws and legislation, it pays insufficient attention to other important criteria like value-for-money and effectiveness.

Fiscal consolidation across most of the euro area carries the risk of downward macroeconomic adjustment. In today's circumstances, there is the danger of a negative macroeconomic spiral. Weak economic growth leads to reduced government revenue that in turn raises the deficit and debt ratios, and therefore may require further budgetary tightening and austerity measures.

The higher the debt-to-GDP ratio, the more difficult it becomes to take corrective action, especially during periods of slow economic growth. And the higher the debt ratio, the greater the risk of a situation where the debt dynamics become unsustainable, such as when the growth rate of the economy falls short of the interest rate paid on the debt.

At the same time, structural reforms are not easy or popular to implement, especially during a slowdown or a recession. Structural measures include those that address the relative size and effectiveness of the public sector and those that promote competition in resource as well as in product markets.

It takes time for these competitiveness-enhancing measures to reap the so-called macroeconomic dividends – including more rapid economic growth and faster employment growth. As a result, the rapid correction of the excessive debt ratio, as demanded by financial investors, often requires a sharp fiscal correction which leads to a slowdown in economic activity. In other words, the distress caused by austerity measures is relatively immediate, while the benefits need a longer period of time to materialize.

One has to recognise that in the current circumstances, the pursuit of a lower deficit by financially stressed countries is inevitable and brings about a short term slowdown in the economy. The issue that arises is whether it would be possible to alleviate the negative effects on incomes and employment. Some of the impact may be alleviated through a judicious mix of government spending and revenue options so as to reduce the depth and duration of the slowdown. For example, an increased recourse to EU cohesion and solidarity funds may help alleviate the structural adjustment necessary and make the economy of the programme countries more competitive at the same time. Given the extent of the downturn in some member states, this option is likely to require a strengthening of the EU budget which in turn needs to be financed. However, not all member states are in a stressed environment, and it may be possible to consider other financing options, especially where bond interest rates in some member

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2 Ludger Schuknecht, Philippe Moutot, Philipp Rother and Jürgen Stark "The Stability and Growth Pact, Crisis and Reform" ECB *Occasional Paper Series*, No. 129, September 2011.

3 Ioannis Sarmas "The Greek financial crisis from an auditor's point of view" *Cour des comptes européenne, Journal* July-August 2011; "The game between sovereign states and financial markets" *Cour des comptes européenne Journal,* December 2011.

states are rather low, even below the inflation rate. EU level solidarity and cohesion assistance may prove a crucial catalyst to the required structural changes.

One has to also keep in mind that governments are increasingly accountable not only to their parliaments and electorates, but also to investors in the financial markets, and pressure from the financial markets becomes more acute when a country is in financial distress.[4] In addition, financial markets take a very comprehensive view in their scrutiny of the sustainability of a country's finances. Even compliance with the Maastricht criteria may not be enough as there could be other imbalances that would undermine market confidence.

For example, in the case of Ireland prior to the financial crisis, the country was doing well according to the Maastricht criteria. Government finances were quite healthy, with low public debt and a low deficit to GDP ratio. The turning point came with the collapse of the housing market starting in 2007. A drop in banks' share prices led to a deposit run on the banks. The scale of the problem snowballed after the Irish government guaranteed all the obligations of the largest banks. This transformed the house price crash into a sovereign debt crisis, with the evaporation of the markets' confidence in Ireland's ability to honour its obligations. Irish borrowing costs rose abruptly, requiring an EU/IMF bailout.

Strengthening governance

As I have already mentioned, the ECB played an important role in the policy response to the crisis. In addition to the conventional interest rate tool, the ECB introduced a number of non-standard measures (such as the three-year LTROs that I mentioned earlier, and a reduction in the required reserve ratio) to facilitate the transmission of monetary policy to the economy.

The events of the last few years have provided important lessons for the construction of a whole new approach to European economic governance. The aim is to go beyond the short-term responses, such as the Greek bailouts, and tackle the problem before the situation has become critical.

To provide better support where necessary, the European Financial Stability Fund will be replaced by the European Stability Mechanism, which will be a permanent rescue fund with added firepower and a stronger mandate.

In the medium term, it is also important to set up governance changes that first, limit government deficits and debt, and second, protect national competitiveness.

On the subject of fiscal consolidation, there is a broad recognition across the EU that fiscal governance has to be strengthened and that the Stability and Growth Pact should be reinforced. The current thinking is that, to avert the recurrence of the crisis, fiscal consolidation should be enshrined in the governance structure of every country. To this end, the well-known Fiscal Compact obliges all euro area countries to run a structurally balanced budget each year. Surveillance will be enhanced and the monitoring of economic policies will also be comprehensive.

In particular, the problem of sustainable budget planning was addressed by introducing a country-specific medium-term budgetary objective, which involves a cap on growth of public expenditure that is in line

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[4] Ioannis Sarmas, *ibid.*

with the medium-term rate of growth. The Fiscal Compact will also accelerate the excessive deficit procedure by introducing sanctions when the debt and deficit to GDP ratios are excessive.

Concerning the second issue (the enhancement of competitiveness), an excessive imbalances procedure seeks to identify and correct macro-imbalances and shortfalls in competitiveness. Preventive recommendations will be made to member countries at an early stage in the formation of imbalances.

On the financial stability side, European authorities have strengthened the financial sector surveillance framework. The European System of Financial Supervisors, which also includes the European Systemic Risk Board (the ESRB), is a new supervisory architecture requiring the National Supervisory Authorities to cooperate with the European Supervisory Authorities in the identification and analysis of systemic risks. The objective of the ESRB is to address one of the most important weaknesses identified during the financial crisis, as highlighted by the de Larosière Report – the lack of an adequate pan-European monitoring, assessment and mitigation of systemic risk.

In line with the ESRB recommendation to enhance macro-prudential governance in each Member State, in the case of Malta, it is the intention to replace the current Standing Committee by a joint committee on financial stability. This committee, which will include representatives from the Central Bank of Malta and the Malta Financial Services Authority, would be mandated to monitor and assess risks to financial stability. Its objective is to formulate policy recommendations to the Boards of the two institutions, designed to safeguard financial stability, strengthen resilience of the financial system and minimise systemic risk.

The recently announced changes to the Depositor Compensation scheme are a welcome change and help increase the resilience of the domestic banking sector. They are also in line with the recommendations of the latest IMF report.

Given the importance of addressing the risks stemming from systemically important financial institutions, it is necessary for regulators to reduce and if possible eliminate the prospect that a systemically important financial institution would find itself in difficulties in the first place. This consideration also brings up the need of supervising better shadow banking, [5] which consists of those parts of the financial system that are not visible to regulators and hence not under their direct control and supervision.[6]

Basle III goes a significant way in narrowing the gaps in regulation that result from recourse to shadow banking.[7] It does so by incorporating off-balance sheet exposures in the leverage ratio and by including in the liquidity, regulatory and supervisory standards a range of risks stemming from shadow banking. Thus, stronger banking regulation and supervision will go a long way towards containing the risks of the shadow banking sector.

The situation in Malta

I will now take a closer look at some key issues relating to the domestic economy and financial system, particularly the fiscal situation, international competitiveness and financial stability.

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[5] Thomas F. Huertas, *Crisis Cause, Containment and Cure,* 2e, Palgrave Macmillan, 2010.

[6] Andrew W. Lo, "Reading about the financial crisis: A twenty-one-book review" *Journal of Economic Literature* 2012, 50:1, pp. 151-178.

[7] Stefan Walter, "Basel III: Stronger Banks and a More Resilient Financial System", Financial Stability Institute, 6 April 2011.

The outlook for the fiscal situation calls for continued vigilance and caution. Official projections of the deficit ratio for 2012 and 2013 have been revised downward, remaining below the Maastricht threshold of 3%. However debt forecasts have been generally revised moderately upward, to levels projected above the 70% level in 2012 and 2013.

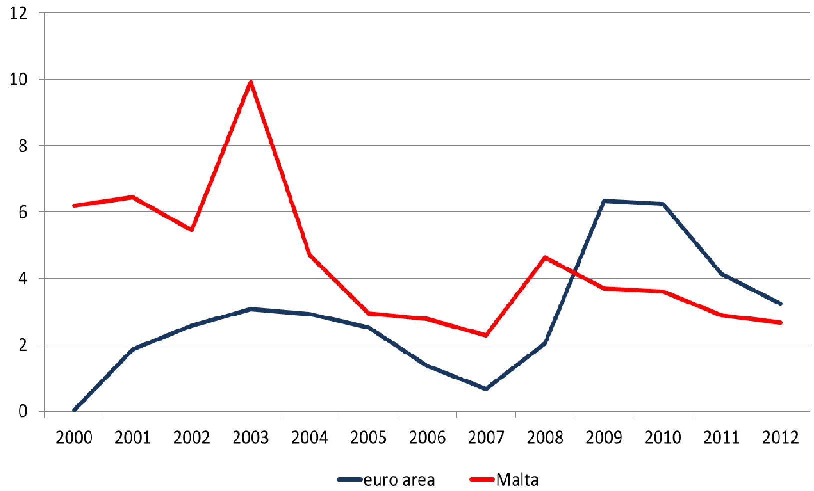
During the last decade, Malta's fiscal deficit ratio followed a mostly downward path from levels that exceeded the euro area, as shown in Chart 4. The decline was interrupted during two particular years – 2003 and 2008. Both were the result of one-off events.

The budget deficit ratio has fallen each year from the high of 4.6% reached in 2008. One also notes that since 2009 the deficit ratio for Malta has been below the euro area's average, though one has to keep in mind that the average for the euro area has been heavily influenced by the high deficit levels in those Member States facing difficulties (Chart 4).

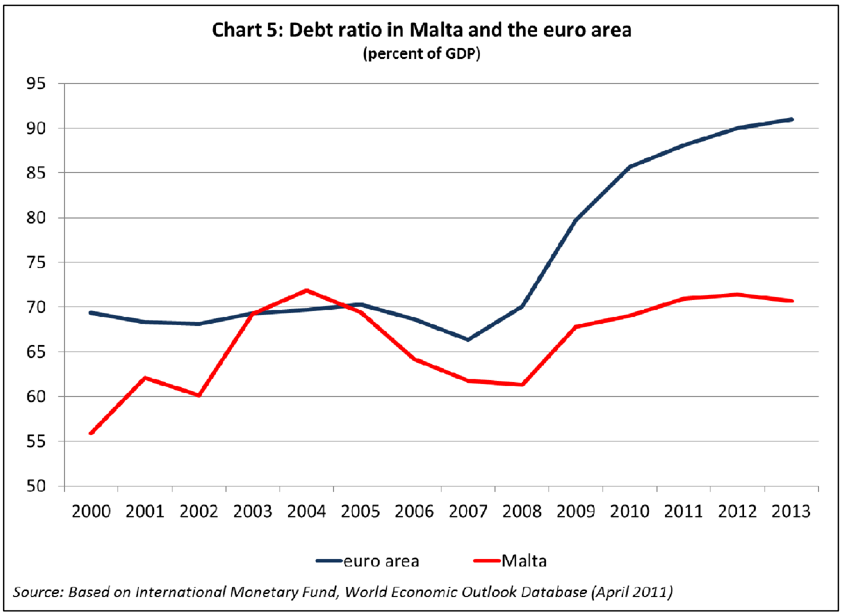
On the other hand, official forecasts of the debt ratio have been revised upward. With a government debt ratio that is expected to exceed 70% in 2012 and 2013, it has become even more important to bring this ratio down at a fast pace (Chart 5). A strong case can be made for continued caution in Malta's fiscal policy and for further measures that would help to ensure the achievement of the government's targets.

The recent IMF Article IV Report for 2012 acknowledges that "Malta has taken effective action to correct its excessive deficit, shoring up confidence in Malta's public finances", but also recommends a return to a fiscal balance in the medium term. One has to keep in mind that low deficit and debt ratios leave more room for the application of countercyclical measures in the event of an economic slowdown without breaching the European rules.

Chart 4: Deficit ratio in Malta and the euro area
(percent of GDP)



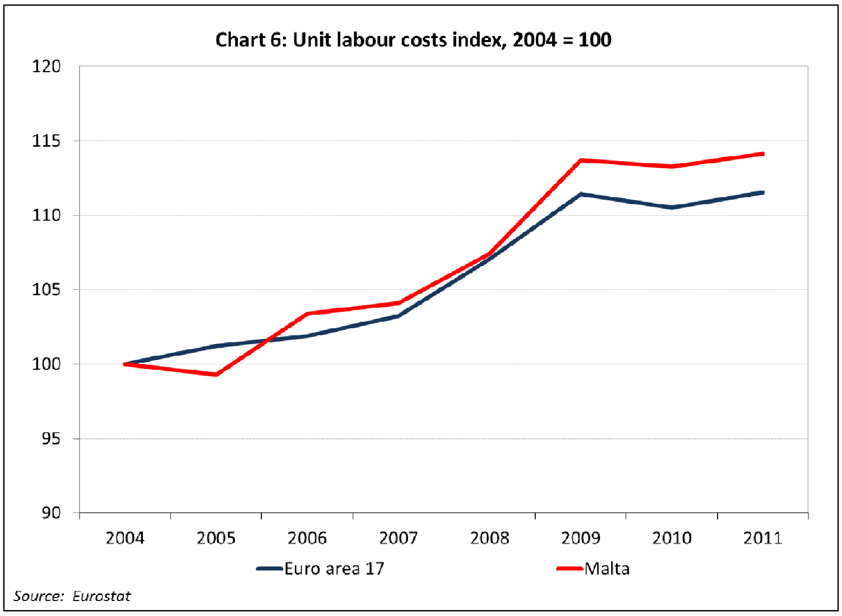
Source: Based on International Monetary Fund, World Economic Outlook Database (April 2012)



The optimal way to reduce the ratio of the deficit to GDP is through economic growth. In turn, faster growth calls for improvements in productivity. In this respect, there needs to be a greater degree of public awareness of the importance of productivity and competitiveness, and a consensus on steps that can be taken with minimal social disruption to enhance the country's international competitiveness.

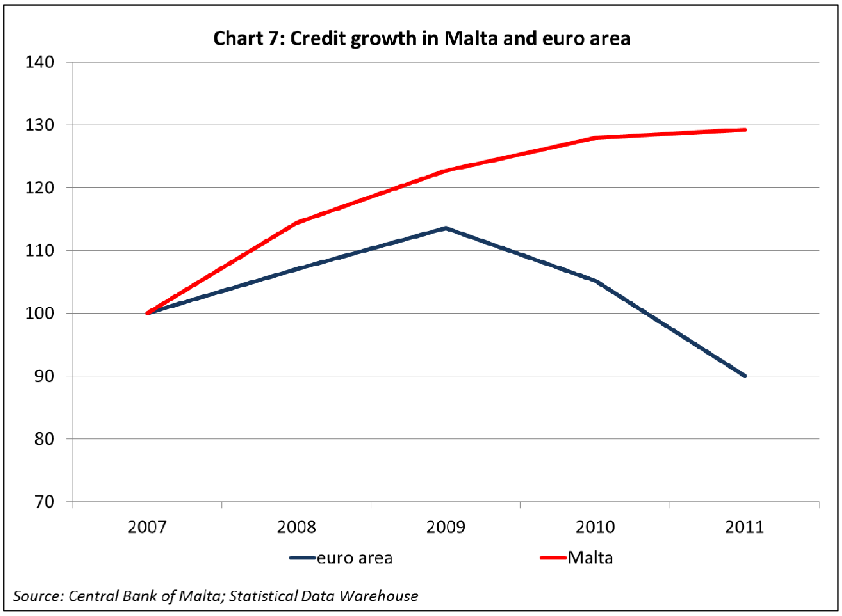
As you know, competitiveness depends on the relationship between changes in productivity and changes in costs, including wages. I have to note that unit labour costs (ULC), which are based on the relationship between compensation and productivity, have generally moved in line with those in the euro area. However, in recent quarters, Malta's unit labour costs have pulled ahead of those in the euro area, as shown in Chart 6.

In this respect, the wage setting process and efficient labour market practices are of critical importance. The fact that collective agreements in Malta are negotiated at the level of the individual firm helps to ensure that wage growth is compatible with the realities of the markets where the firm sells its products. Still, further steps could be taken to improve productivity levels and increase the employment rate. Also, as I argued recently, COLA increases should not be superimposed on wage increases agreed in collective agreements, but should form part of the negotiation process, so as to ensure that firms are able to match all wage increases with productivity increases. Faster productivity growth depends on many factors, including investment, the infrastructure, the quality of the human resources and hence the quality of the educational system and its ability to meet the skills requirements of a growing economy. Measures that increase the employment rate could include further policies that incentivise a higher female participation rate, as well as measures that facilitate more flexible work conditions, including part-time employment.



A further requirement for economic growth is the smooth functioning of the financial system. Particularly during these turbulent times, continued economic growth depends also on the uninterrupted supply of credit by the financial sector to firms and households, and to that end the stability of the financial system is essential.

It is important to note that although its rate of growth has declined, bank credit has continued to increase in Malta, unlike the situation across the euro area, where widespread deleveraging by financial institutions has led to a contraction in the volume of credit, as shown in Chart 7.



The recent IMF report that I mentioned earlier noted the strong performance of Malta's financial sector but also stressed the importance of strengthening the resilience of the sector.

The elevated levels of credit and concentration risks call for stronger financial buffers, through higher provisioning and retention of profits. Such measures would strengthen the banks' ability to absorb potential shocks and would also allow them to prepare themselves for compliance with stricter Basel III regulatory requirements. On the positive side, credit risk is being mitigated by prudent credit standards and cautious lending behaviour on the part of the banks.

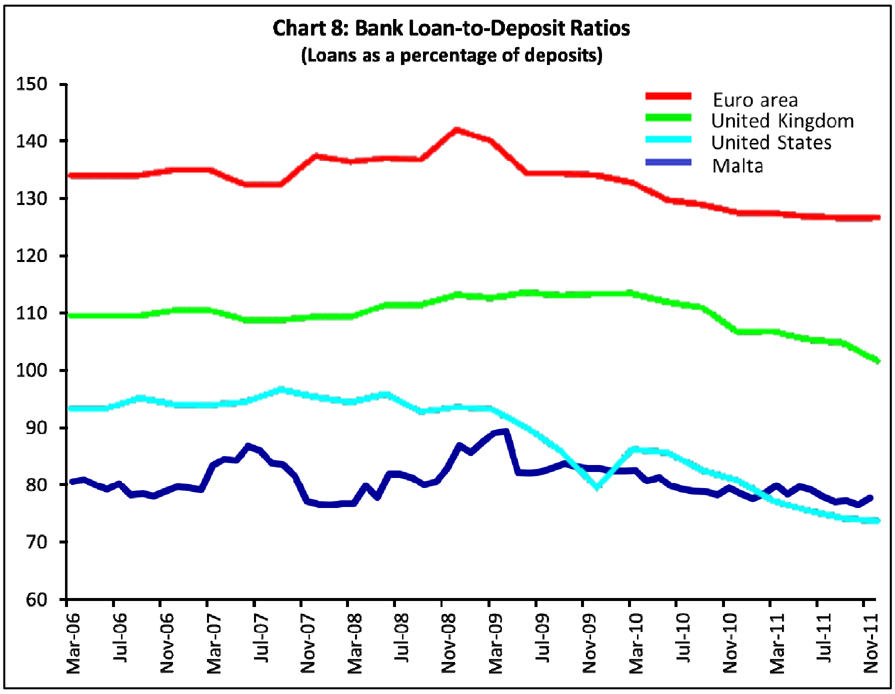
On the funding side, the resilience displayed by the banking system in the face of adverse international conditions is explained by the business model that has been a traditional characteristic of domestic banks, which rely strongly on retail deposits.

Another indication of the overall prudent bias of the Maltese domestic banks is evident in the first chart presented earlier, which shows that leverage ratios of Maltese banks are considerably lower than in euro area in general. While the euro area average has declined on account of widespread deleveraging, the ratio remains significantly higher than the Maltese ratio, which has been quite stable.

A further indication of the traditional funding model is the loan to deposit ratio, as shown in Chart 8, which is significantly low when compared with the major economies.

This business model has served the domestic banking sector well. The traditional sources of funding have proven to be very stable, including at a time of heightened tensions in the international financial markets. While taking on the changes that are needed to remain competitive and improve efficiency, the domestic banking sector must also continue to build upon the strengths of the traditional model.

Among the many lessons that may be drawn from the experience of the international financial crisis, one that stands out is the importance for each banking institution to keep a prudent mix of dependable sources of funding, to limit the level of financial leverage and to maintain a sound balance sheet.



Source: Central Bank of Malta; International Monetary Fund

Conclusion

In summary I would like to conclude by stressing the need for further efforts to maintain international competitiveness and continued vigilance in the banking sector, in the context of recurring uncertainty in international financial markets and in the world economy. With this in mind, one has to acknowledge that although the relative performance of the Maltese economy has been encouraging, the challenges ahead are to be treated seriously and with caution.

A further lesson from recent experience is that fiscal prudence has to be a continuous endeavour, especially in the light of the recent upward revisions in the public debt projections for 2012 and 2013. Further fiscal consolidation becomes more challenging in an environment of weak external demand. The choices that must be made between the various national priorities have to be compatible with the economic and fiscal limits, and these limits can become less constraining only through improved competitiveness and faster economic growth.

Thank you for your attention