EUROPEAN CENTRAL BANK

EUROSYSTEM

Crises: past, present and future –

A euro area perspective

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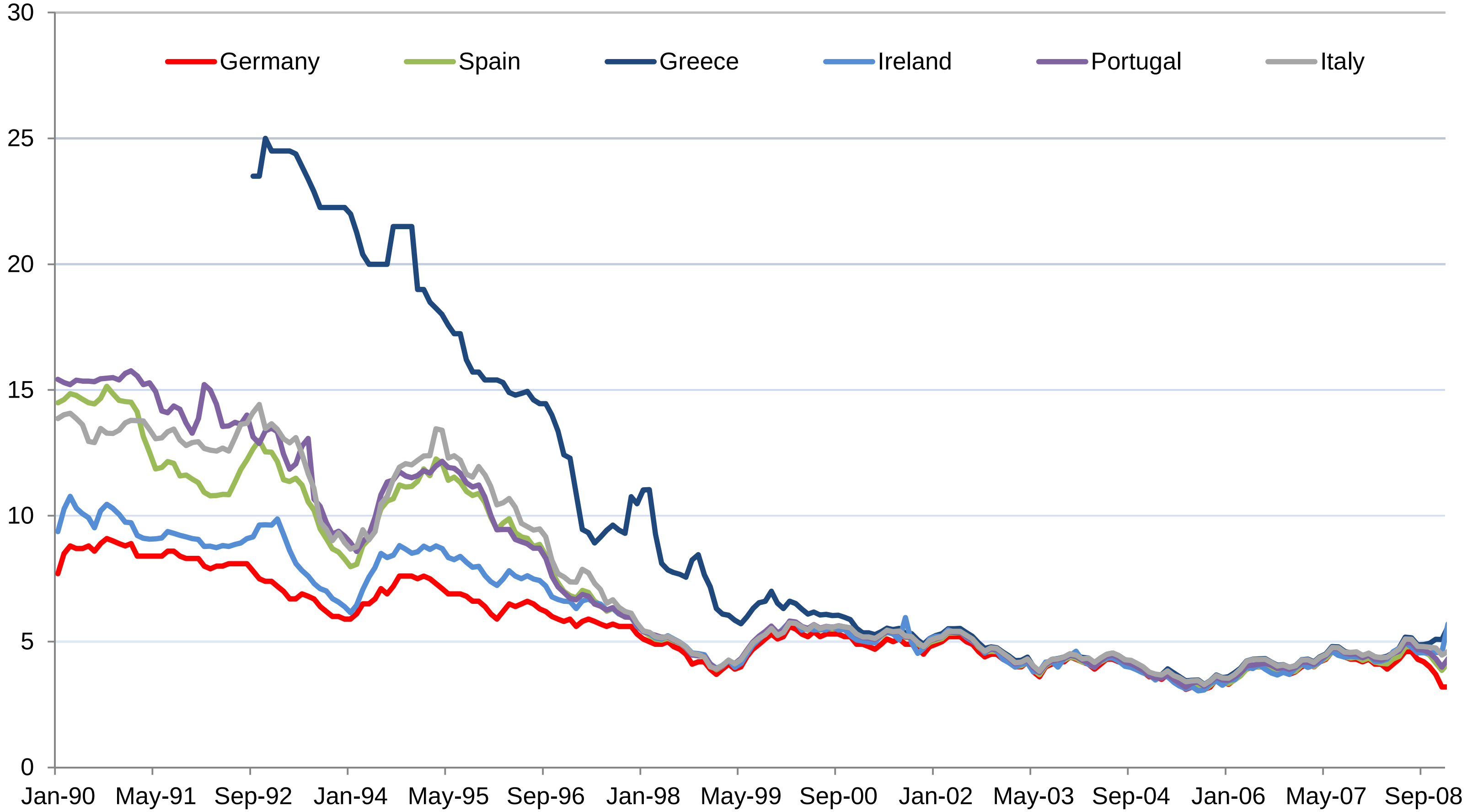
The global financial crisis was fuelled by an underpricing of risk in financial markets, also in the euro area

Ten-year government bond yields, 1990-2008 ***(%, monthly)***

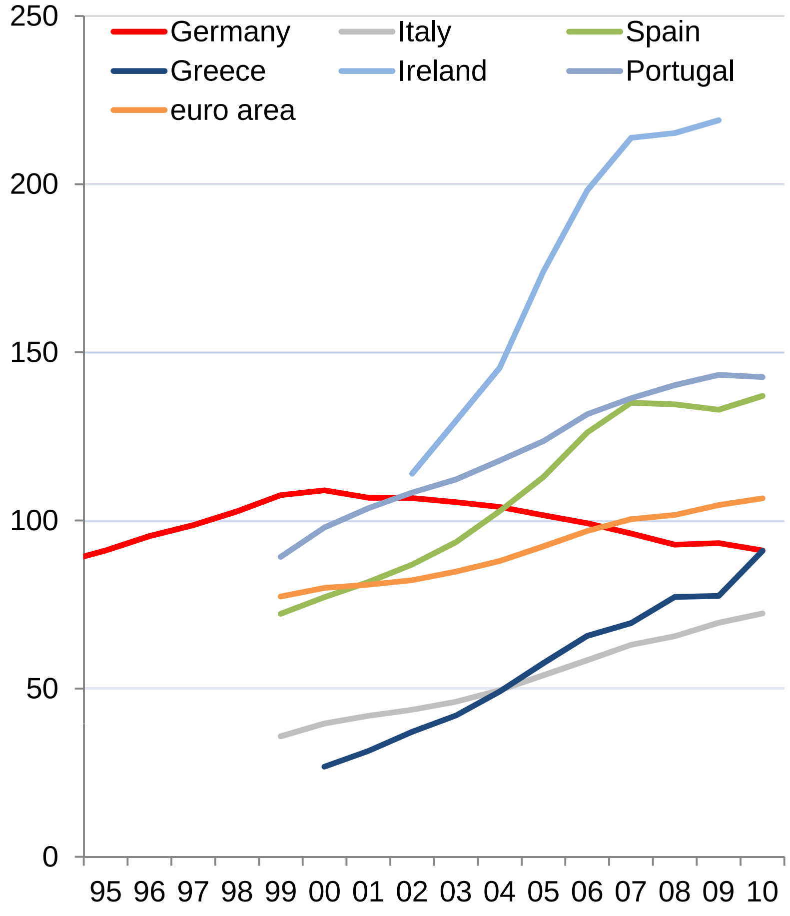


Note: Last observation refers to December 2008

Source: Haver Analytics, National Sources and ECB Staff Calculations.

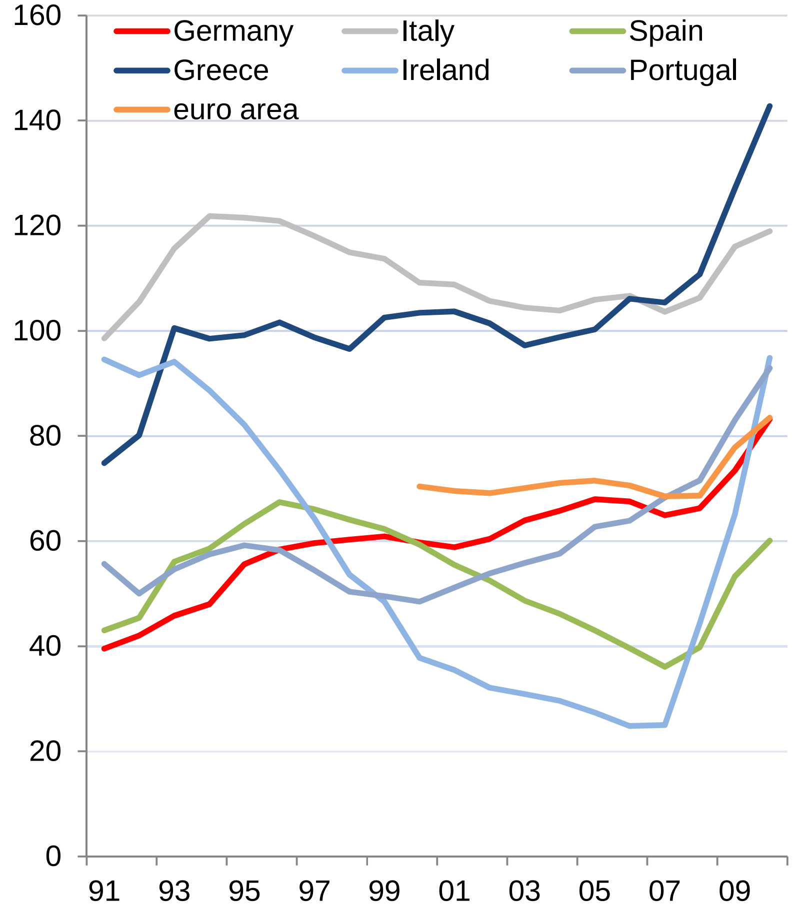
Which has led to overleveraging in some sectors …

Household debt to disposable income ratio *(%, annual)*



Note: Last observation refers to 2010.
Source: National sources and ECB Staff Calculations.

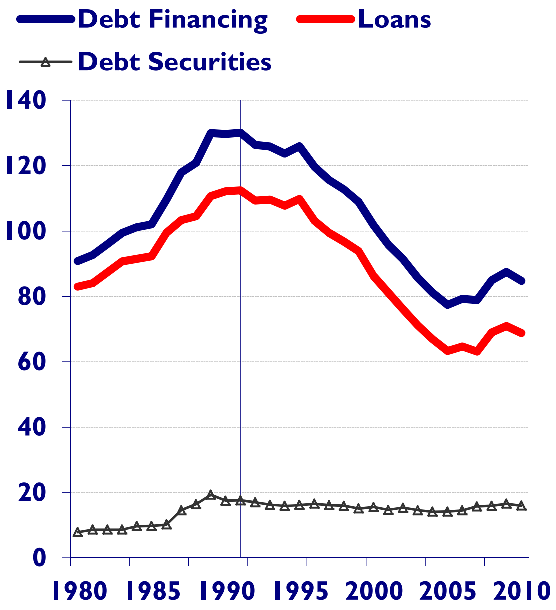
General government debt ratio *(%, annual)*



Note: Last observation refers to 2010.
Source: IMF Fiscal Monitor and ECB Staff Calculations.

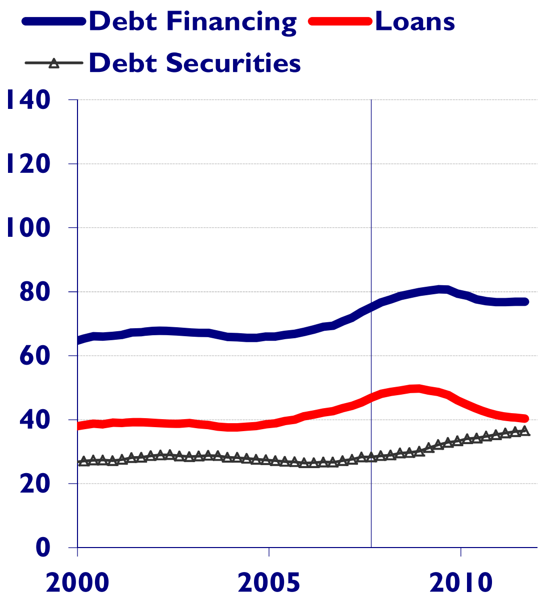
although the bank-based financial system did not show excessive expansion in the euro area as a whole

Japan
(percentage of GDP)



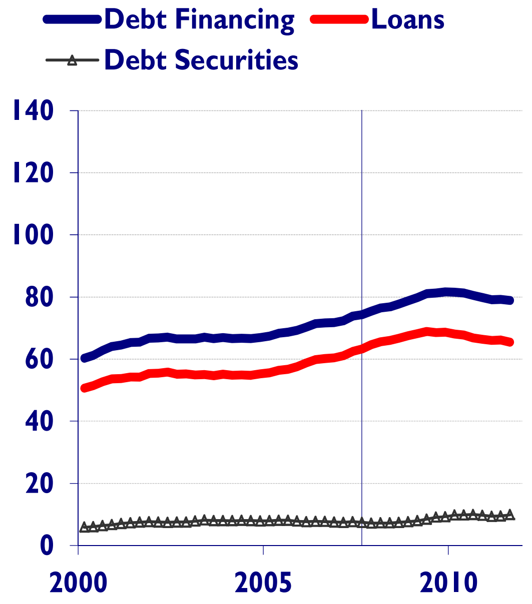
Source: Bank of Japan, ECB staff.
Notes: Debt financing corresponds to credit market instruments in the Japanese flow of funds data. Last observation refers to 2010. The vertical line refers to 1991 Q1, the onset of crisis.

US
(percentage of GDP)



Source: Board of Governors of the Federal Reserve System, ECB staff.
Notes: Debt financing corresponds to credit market instruments in the US flow of funds data. Last observation refers to 2011 Q3. The vertical line refers to 2007 Q3, the onset of crisis.

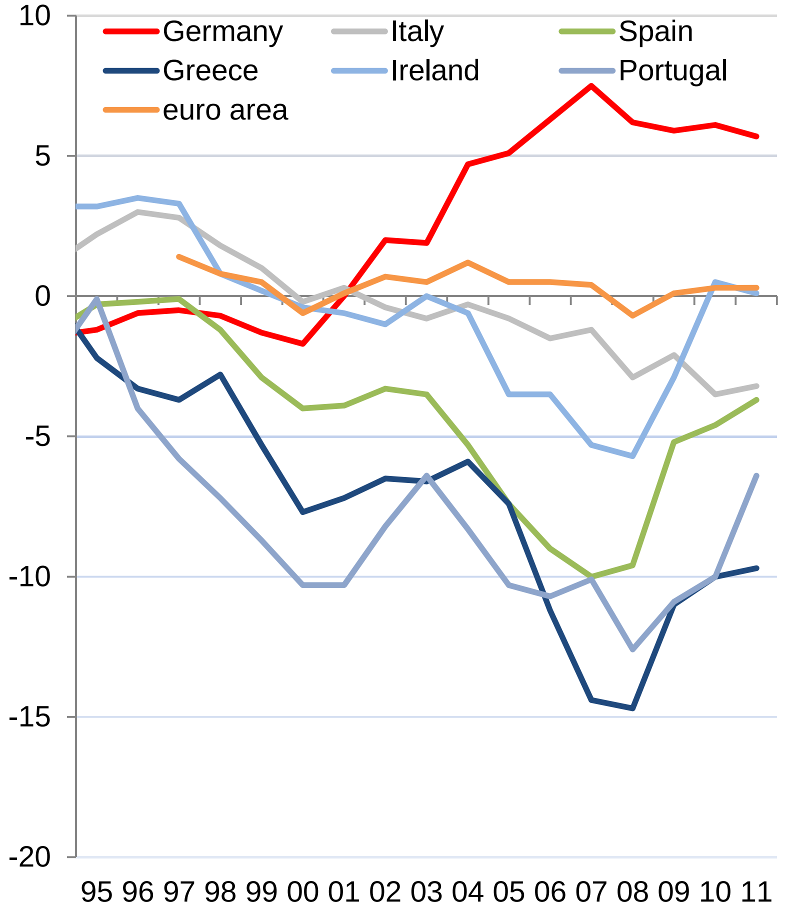
Euro area
(percentage of GDP)



Source: ECB, ECB staff.
Notes: Debt financing of euro area non-financial corporates is reported on a consolidated basis by netting out inter-company loans from the original non-consolidated data and includes pension fund reserves. Last observation refers to 2011 Q3. The vertical line refers to 2007 Q3, the onset of crisis.

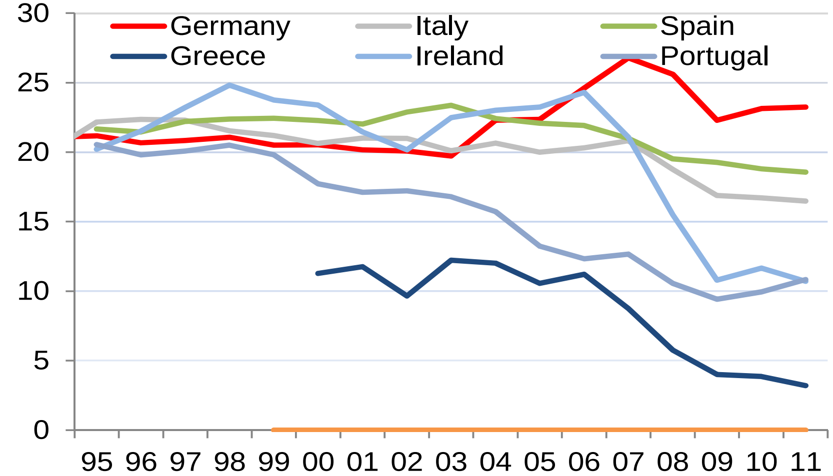
But macroeconomic imbalances grew within a well-balanced euro area aggregate

Current account balance *(% of GDP)*

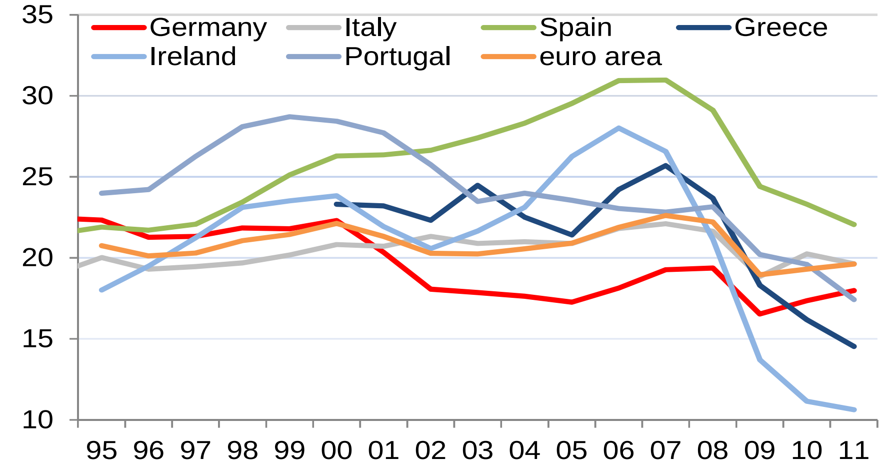


Note: Last observation refers to 2011.
Source: IMF WEO and ECB Staff Calculations.

Gross Savings to GDP ratio *(%)*



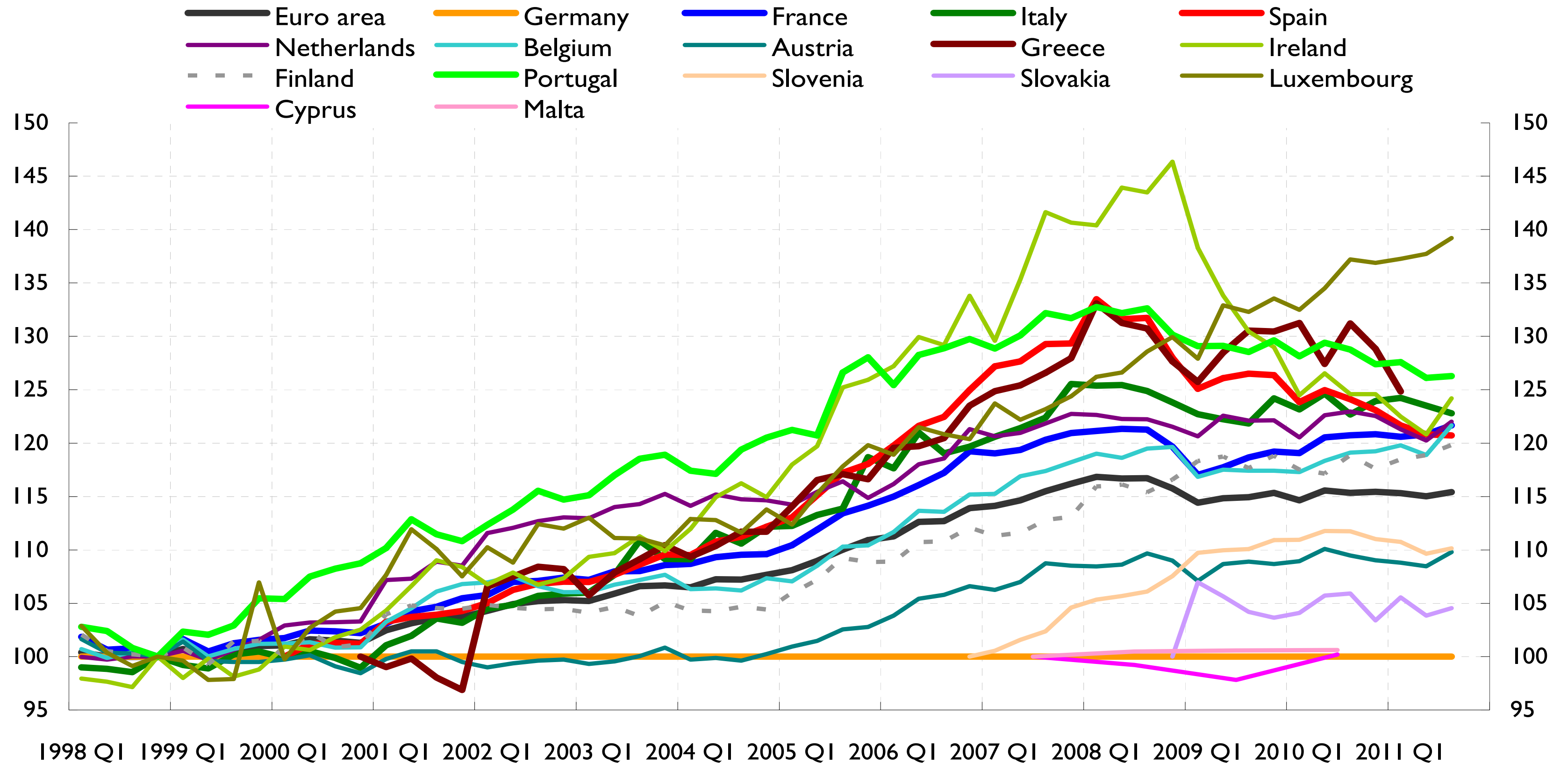
Investment to GDP ratio *(%)*



Note: Last observation refers to 2011. Source: Eurostat.

… fuelled also by of cost competitiveness divergences

Unit labour costs in selected euro area countries, nominal
(index 1998 Q4 = 100, relative to Germany, based on sa data)



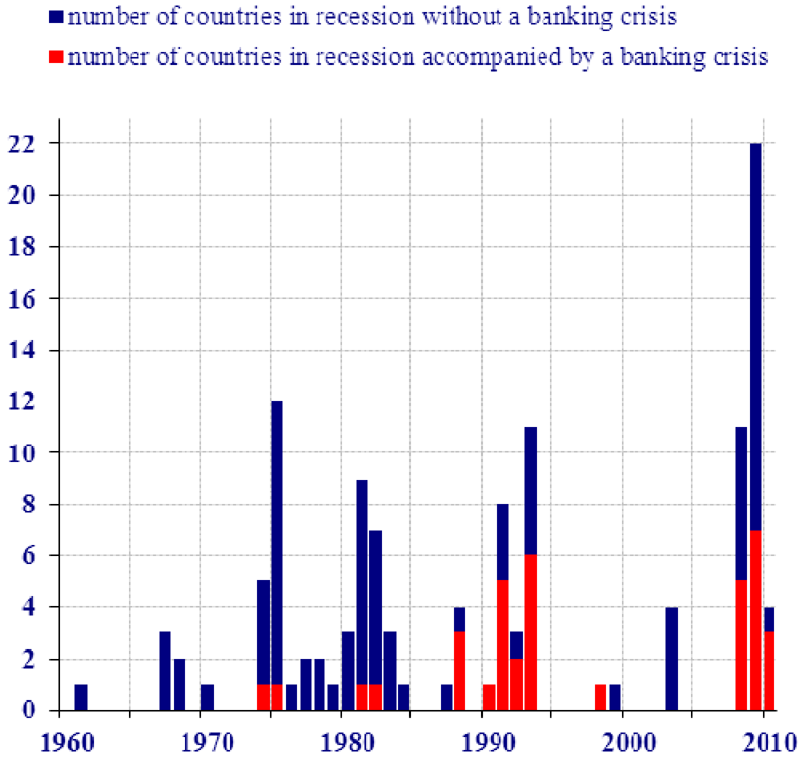
Source: Eurostat. Quarterly data up to Q3 2011 for all countries except Greece (Q1 2011). Cyprus and Malta are based on annual data, up to 2010.

Note: The ULC indices are set to 100 in the last quarter before the euro area accession of the respective country.

The ULC developments presented for Greece and Portugal might differ from the calculations made by the National Central Banks. The quarterly pattern in Greek ULC is affected by substantial volatility in quarterly compensation of employees figures.

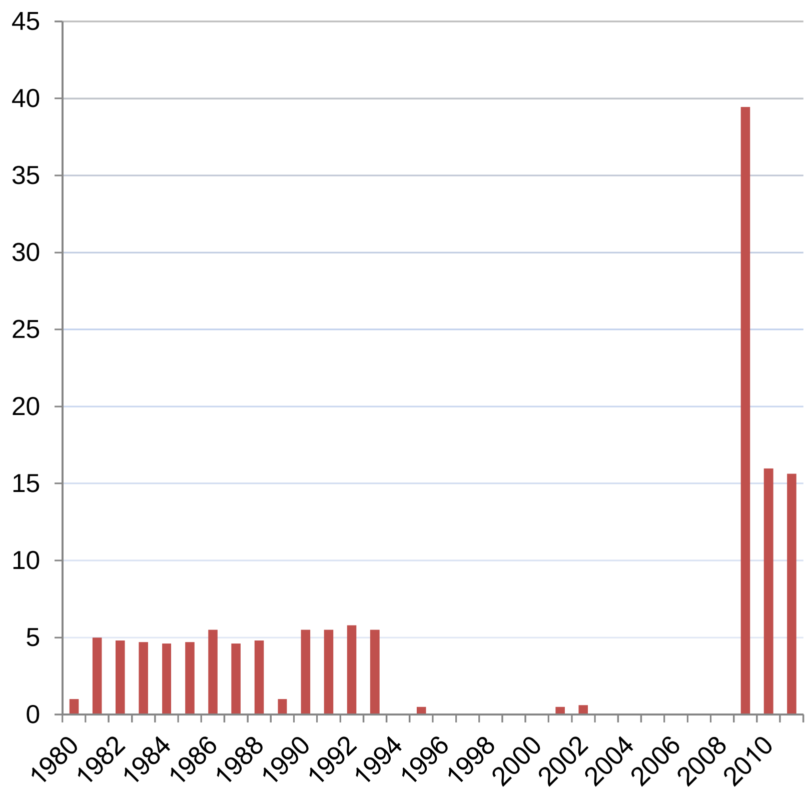
The situation was further worsened by the 2008 global financial crisis

Recessions and banking crises in OECD countries, 1960-2010 ***(number of countries)***



Sources: ECB, European Commission and ECB calculations.
Note: 23 OECD countries are considered: 12 euro area countries and 11 other OECD countries.

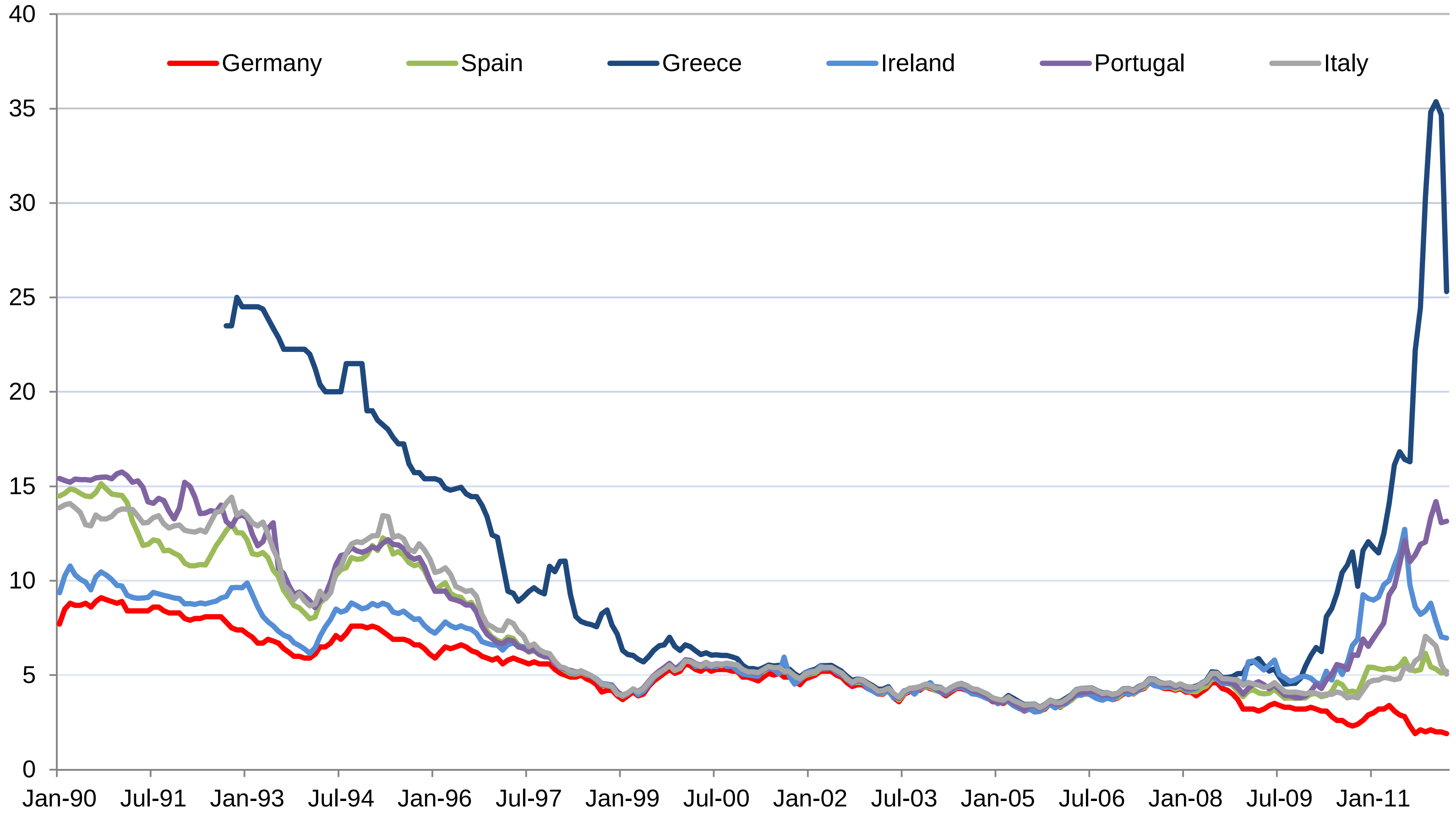
Share of global GDP of countries with fiscal deficits of 8% of GDP or more ***(%)***



Sources: ECB Staff Calculations.
Note: Last observation refers to 2011.

Which led to an overpricing of risk

Ten-year government bond yields, 1990-2008 ***(%, monthly)***



Note: Last observation refers to March 2012.
Source: Haver Analytics, National Sources and ECB Staff Calculations.

And which caught the euro area ill-prepared

The situation in the euro area before the crisis

I. Incomplete economic governance

- Ineffective fiscal rules to compensate for the absence of fiscal union, weak enforcement by the Commission and euro area Member States (EA MS)
- Lack of awareness of the importance of ensuring convergence *after* EMU entry, no mechanism to monitor and address structural imbalances within the euro area

II. Fragmented financial supervision

- No common macro-prudential supervisory structure to detect build-up of systemic risk in the financial sector
- Framework for managing cross-border banking dependent on soft coordination between national supervisors

III. Lack of financial firewalls for euro area countries

- EU Balance of Payments assistance available only for non-EA MS
- Financial assistance between EA MS was only contemplated in the Treaty in case for natural disasters

A broad-based EU/euro area crisis response: a stronger focus on fiscal and structural adjustment needs (I)

Strengthening of fiscal discipline

- New Community legislation to reinforce the fiscal rules of the Stability and Growth Pact, with a stronger enforcement mechanism and a new debt reduction rule
- All EA MS (except the 3 countries under IMF/EU programme) committed to deficits below the 3% of GDP threshold by 2013 at the latest
- A Fiscal Compact (intergovernmental Treaty) to enshrine balanced budget rules in national legislation with an automatic correction mechanism

Paying more attention to structural adjustment needs and growth

- Launch of a Macroeconomic Imbalances Procedure to monitor and address the potential build-up of unsustainable imbalances on the basis on an agreed set of indicators (e.g. house prices, unit labour costs, credit growth)
- More ownership of the national (structural) reform programmes as a means to foster implementation of the Europe 2020 strategy
- Better targeted Community investments in growth

A broad-based crisis response: a more convergent approach to financial sector repair (2)

From soft coordination of the national responses to the initial phase of the post-Lehman crisis

- Pricing of national recapitalisation measures and bank funding guarantees aligned by the Commission, with input from the ECB
- Agreement on minimum thresholds for deposit guarantees and eventual harmonisation of levels (at EUR 100 000)

To a new EU supervisory framework

- European Systemic Risk Board coordinates (for first time) macro-prudential supervision at the EU level – can issue warnings on emerging systemic risks and make recommendations for remedial action
- Three European Supervisory Authorities (for banking, insurance and securities & markets) improve coordination of micro-prudential supervision
- Commission pushing for harmonisation of national supervisory practices in the context of the transposition of the Basel III framework in the EU
- EBA playing a central role in the organisation of EU regular stress test exercises (and the one-off capital exercise)

A broad-based crisis response: a better structured financial assistance framework (3)

From an urgent ad hoc response in the case of Greece

- *Greek Loan Facility (GLF)*: EA MS provide EUR 80 bn in bilateral loans, on an intergovernmental basis, together with EUR 30 bn from the IMF

Via the creation of two temporary loan facilities of which currently 3 euro area countries are benefitting

- *European Financial Stabilisation Mechanism (EFSM)*: EU facility with lending capacity of EUR 60 bn backed by the EU Budget – currently EUR 22.5 bn committed to Ireland and EUR 26 bn to Portugal. Expires mid-2013
- *European Financial Stability Facility (EFSF)*: intergovernmental facility with lending capacity of EUR 440 bn backed by guarantees from EA MS – currently EUR 17.7 bn committed to Ireland, EUR 26 bn to Portugal and EUR 144.6 bn for Greece. Expires mid-2013

To the establishment of a permanent euro area mechanism

- *European Stability Mechanism (ESM)*: established via an international treaty with a lending capacity of EUR 500 bn, backed by paid-in and callable capital, and disposing of a range of loan facility instruments

A broad-based crisis response: a stronger governance framework (4)

A stronger preparatory structure for the Eurogroup

More independent analysis in the Commission and a stronger role for the Commissioner in charge of economic and monetary affairs

Structured involvement of the Commission and the ECB in exercising surveillance over countries receiving financial assistance or experiencing financial tensions

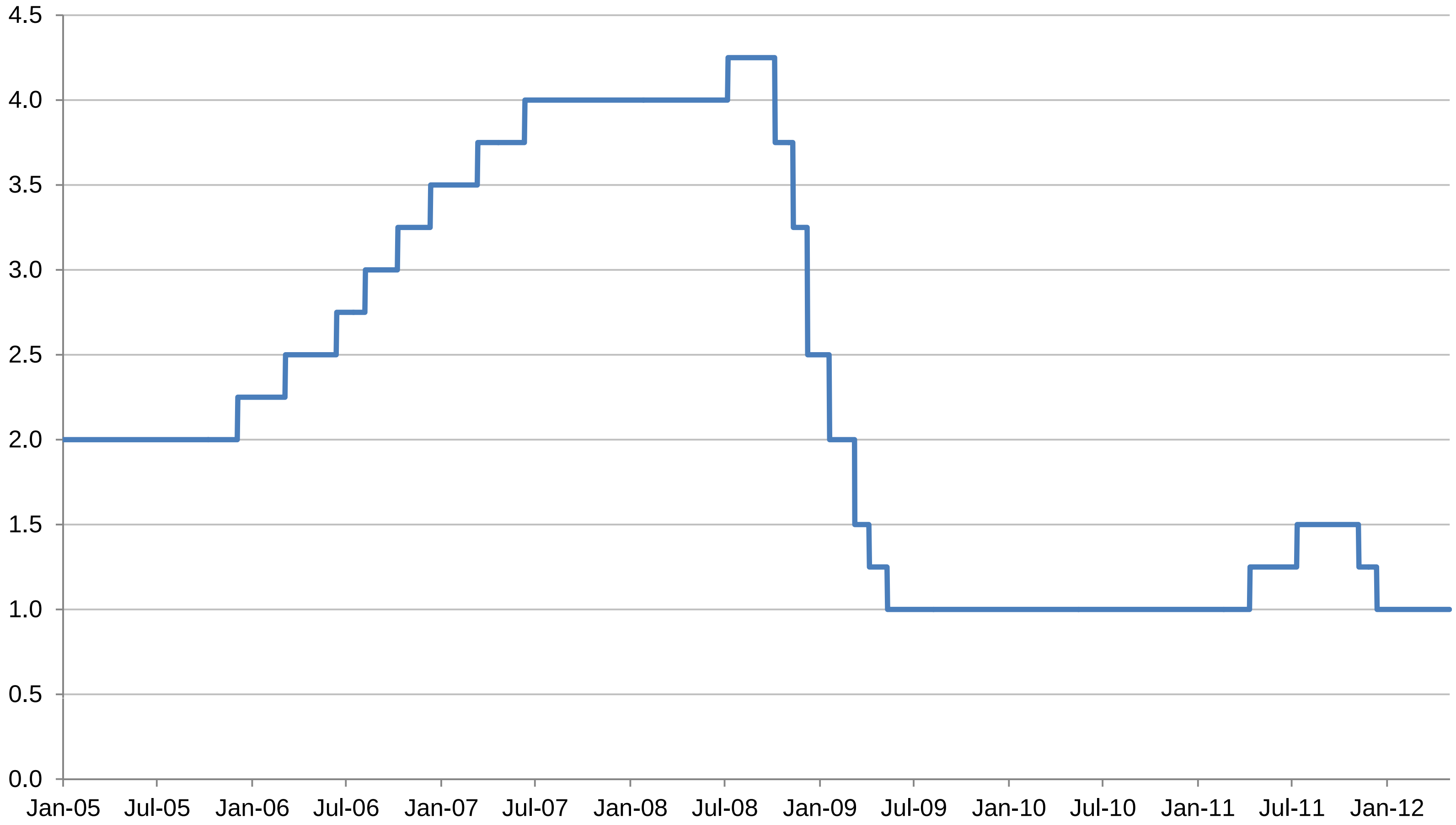
A more stringently operating European Semester framework

More regular Euro Summits

Closer links between the EU/euro area and the national frameworks

The ECB's crisis response – standard monetary policy for the euro area as a whole

Interest rate on the main refinancing operations ***(%, daily)***



Note: Last observation refers to 2 May 2012.
Source: ECB.

The ECB's crisis response – non-standard monetary policy action to address malfunctioning market segments

I. Interbank market

- Fixed-rate full allotment mode in all refinancing operations (since October 2008)
- Lengthening the maturity of the refinancing operations (1, 3, 6, 12 and 36 months)
- Extending the list of eligible collateral (and not fully relying on rating agencies)
- Extending liquidity directly in foreign currencies (USD and CHF)
- Reducing reserve requirements

II. Covered bond market

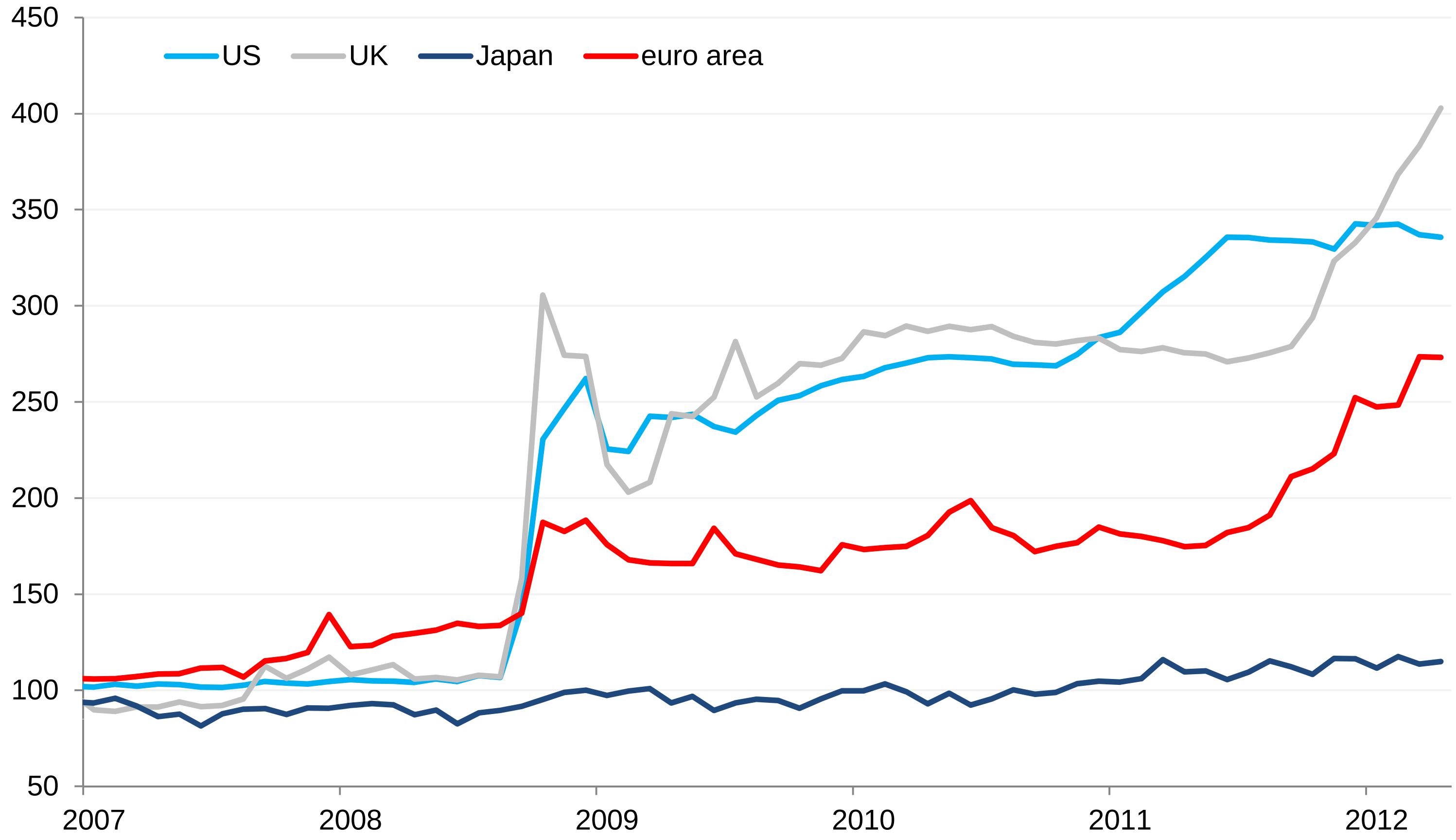
- **Objective:** Easing of funding conditions and encouraging institutions to maintain or expand lending, as well as supporting market liquidity in private debt security markets
- Covered Bond Purchase Programme 1 (CBPP1) EUR 60 bn purchased from July 2009-July 2010; CBPP 2 under way for EUR 40 bn (until November 2012)

III. Sovereign bond market

- **Objective**: to restore the monetary policy transmission mechanism
- Securities Markets Programme (launched in May 2010)

Crisis response – International comparison

Evolution over time of the size of the central bank balance sheet *(May 2006 = 100)*



Note: Last observation refers to30 April 2012.
Source: ECB.

Further scope for better preparing the euro area for future crises

I. Towards a closer economic union

- Better coordination of fiscal and structural policies in view of large potential spillovers
- Build and implement a more sophisticated system of sticks and carrots

II. Transferring cross-border financial sector competences to the euro area level

- Move towards a euro area deposit insurance corporation
- Build a special framework for the supervision of the euro area regionally systemic banking institutions
- Decrease the relative importance of the banking sector in providing market-based risk sharing to the advantage of financial markets

III. Enhancing the flexibility of the euro area regional financial arrangement

- Further develop the effectiveness of the tool box of the ESM
- Further develop the collaboration between the global (IMF) and the regional (euro area) surveillance and financial support mechanisms

The euro area sovereign debt crisis: my seven lessons for the rest of the world

I. Spillovers can be more important than one believes ex ante, hence collaboration is more useful than anticipated

II. Large countries have a systemic responsibility, not only because of the size of their potential spillovers, but also for making the system work credibly

III. Acting in a preventive manner is always better than waiting for the corrective approach to be applied; hence mutual surveillance is highly useful

IV. Financing needs can be very large if adjustment needs are large or need to lead to results quickly

V. Trying to substitute for markets or trying to override them can both prove costly; guiding markets by assisting them in finding the right equilibrium is key

VI. Financial development and innovation can foster economic growth, but a too big or too rapidly growing financial sector can become a danger for sustainable growth

VII. The morphing of financial problems into real economic ones and eventually becoming political ones should be reversed as soon as possible