Lessons from the recent past and the road ahead

The euro area is currently addressing the challenge of a number of interacting problems: the economic slowdown, the sovereign debt crisis and financial sector instability. The sovereign debt crisis has been aggravated by the impact on fiscal balances of slower economic growth and, in many countries, government support for distressed banks. In turn, sovereign debt problems have damaged the balance sheets of euro area banks and impaired the supply of credit to the economy.

The fact that this monetary union is made up of sovereign and autonomous Member States shows up at various levels. Looking at national fiscal and structural policies in the recent past, one notices sharp differences in the extent to which different countries have exercised budgetary caution and preserved their international competitiveness. Other national differences can also be observed. In the case of Greece, for example, the country's problems were compounded by the statistical understatement of the budget deficit and debt. In the case of Ireland, as another example, it was imprudent bank lending policies, particularly to the real estate sector, which led to a massive rise in the debt burden of the state.

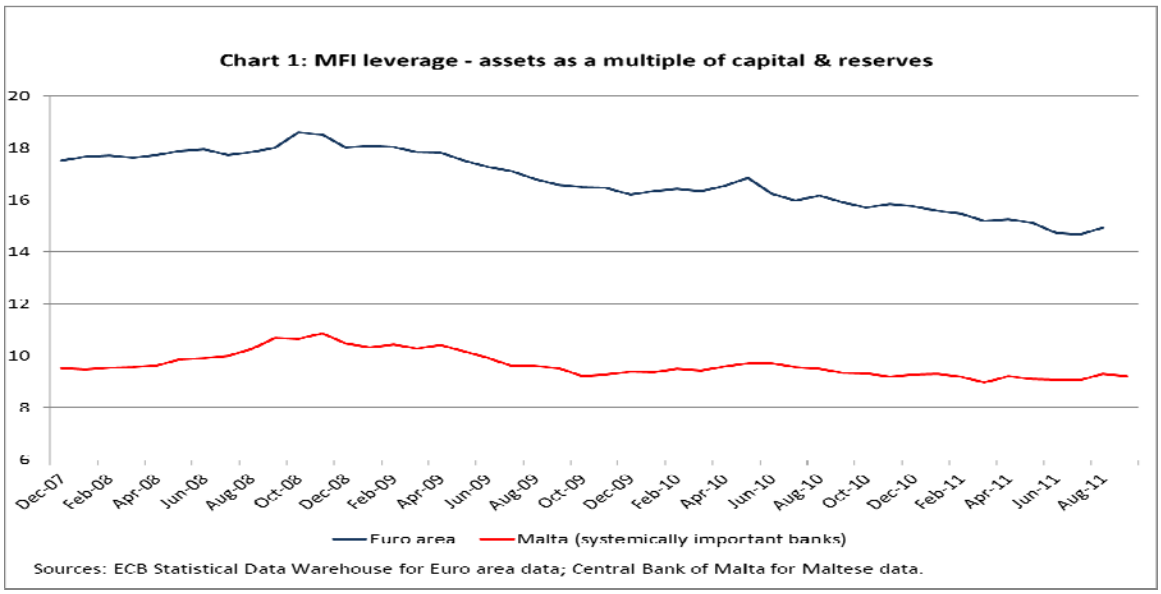
Of course, determined efforts are required on the part of EU governments to reach a consensus on improvements in governance – particularly on the rules governing budgetary policy in the monetary union – and on the provision of bail-out funds. While the discussion and decision process surrounding these matters are often regarded as a weakness in the governance structure, it must also be recognised that the changes involved represent significant levels of assistance to programme countries and also touch directly on issues related to sovereignty.

It is perhaps ironic that current problems are in part a side effect of the success of the monetary union, and the benefits it brought about. More precisely the crisis has also been triggered by the misuse of the benefits of monetary integration.

The new currency reduced the cost of borrowing in several countries, as credit spreads narrowed and exchange rate risk on intra-euro area borrowing was eliminated.[1] The reduced cost of financing public as well as private debt was reflected in higher government debt and private sector leverage.

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

In the wake of risk repricing by the financial markets, there is now the strong tendency for market operators to unwind their holdings of public and private sector debt. This can be seen in Chart 1, which shows as an example the ensuing reduction in the leverage of monetary and financial institutions. The deleveraging process could set the stage for a deterioration in economic conditions. However it also serves to correct past excesses.



In looking for the origins of the crisis, one also observes instances of fiscal indiscipline, which caused problems at the euro area level.

In some member states, as for example in the case of Greece, EU funds were not put to proper use and in some cases ended up imposing a burden on future government finances. In my previous appointment at the European Court of Auditors, where I was responsible for coordinating the overall audit report on the spending of the EU budget, in almost every report during my six-year term, Greece was invariably singled out because of its problems and serious deficiencies in the spending of EU funds. Greece often had to pay back to the EU budget funds that it badly needed. It is evident that such weaknesses in the administrative and political structure put an unnecessary burden on Greece's fiscal position.

A recent study describes the first nine years of the euro, between 1999 and 2007 (that is, the pre-crisis period), as "'wasted good times' during which the foundations were laid for the present crisis … Almost as soon as the euro had been introduced, consolidation fatigue set

in".[2] Moreover, governance at the EU level was weak. The application of the corrective arm of the Stability and Growth Pact was softened through intervention at the political level in 2003. The ensuing reform of the Pact in 2005 thus ushered in a greater degree of tolerance, and political influence was permitted in dealing with EU member states' fiscal imbalances.

It is true that the average deficit ratio in the euro area improved through 2007, aided by the upswing in economic conditions. However, only a few countries earnestly engaged in substantial budgetary consolidation efforts. At the same time, financial market scrutiny was mild, and as a result the less fiscally-responsible governments were able to meet their borrowing requirements at a relatively small spread on the benchmark interest rate.

This changed after 2007, when the onset of the financial crisis found several Member States poorly prepared for what lay ahead. It became difficult to undo the accumulated imbalances and vulnerabilities. The debt burden worsens when the interest rate exceeds the growth rate of the economy. This is reinforced when the primary balance is in deficit, in which case the dynamics of servicing the debt could easily make the debt burden unsustainable.

Fiscal consolidation, which is necessary even in less serious circumstances, carries the risk of downward macroeconomic adjustment. In today's circumstances, there is the danger of a vicious cycle in the form of a negative macroeconomic spiral. This is because weak economic growth leads to lower government revenue that raises the fiscal deficit ratio, and therefore requires further budgetary tightening.

Similarly meaningful structural reforms are not easy or popular to implement during a recession. Since it takes time for these microeconomic measures to generate the so-called macroeconomic dividends, correction of the excessive debt ratio often requires a sharp fiscal correction, which brings in its wake a slowdown in economic activity.

The lessons to learn from this experience are that fiscal prudence and the safeguarding of competitiveness have to be an ongoing and constant endeavour. It becomes difficult to apply fiscal discipline and structural reforms when the need becomes urgent or during an economic slowdown.

[2] L. Schuknecht, Ph. Moutot, P. Rother and J. Stark "The Stability and Growth Pact, Crisis and Reform" ECB *Occasional Paper Series*, No. 129, September 2011.

As a number of countries have grossly breached the deficit and debt rules of the Stability and Growth Pact, they have not only threatened their own economic sustainability but also undermined the stability of the euro area as a whole.

As a result, 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 once again. There is the search for mechanisms that would ensure the effective and concrete intervention of the European Commission when Member States breach the deficit and debt rules as set out in the Pact. Of course, the eventual changes in the system have to be decided through negotiations.

Perhaps it is worthwhile to take heed of recent comments by the outgoing President of the ECB, Mr Jean-Claude Trichet, who recently expressed his personal view on this subject. He suggested the design of a body that "would exert direct responsibilities" in a number of domains, including "the rigorous surveillance of both fiscal policies and competitiveness policies with the capacity, in exceptional cases, to take decisions immediately applicable in a particular economy that puts the euro area financial stability in danger."[3]

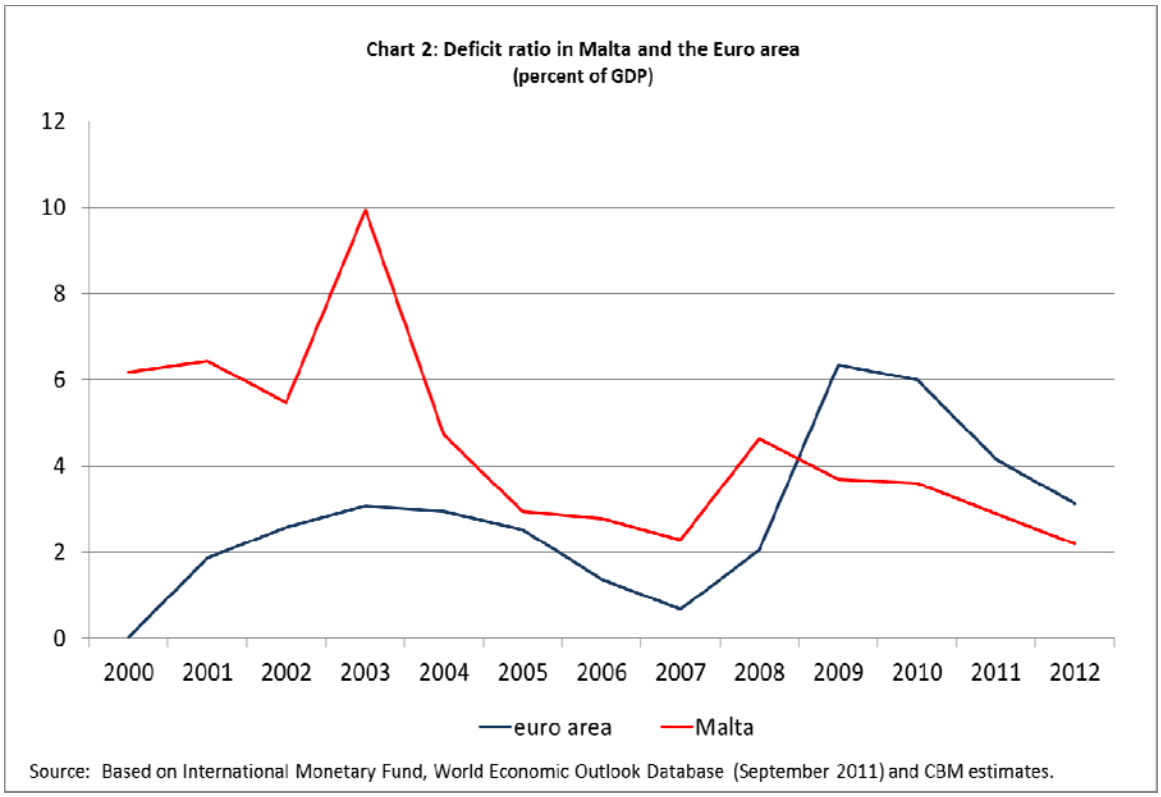
Where does Malta's fiscal situation and more generally the broader Maltese economy, fit into all this?

Malta's fiscal deficit ratio followed a generally downward path during the last decade, though the decline was interrupted during two particular years – 2003 and 2008 – each explained by particular events.

More recently, the budget deficit ratio has fallen each year since the high of 4.6% that was recorded in 2008. A large outlay was incurred during that year for the restructuring of a government-owned enterprise. This outlay however brought to an end the provision to the same enterprise of further government subsidies, which would otherwise have added to future deficits.

The ratio eased to 3.7% and 3.6% in 2009 and 2010, while the latest government projections, as indicated in the Pre-Budget Document, refer to a deficit of 2.8% in 2011 and 2.2% in 2012. Since 2009 the deficit ratio for Malta has been below the euro area's average, but it has to be pointed out that this average is heavily affected by the high deficit levels of the Member States facing difficulties (Chart 2).

[3] J. C. Trichet, "Remarks at the farewell event", Frankfurt am Main, 19 October 2011, p. 3.

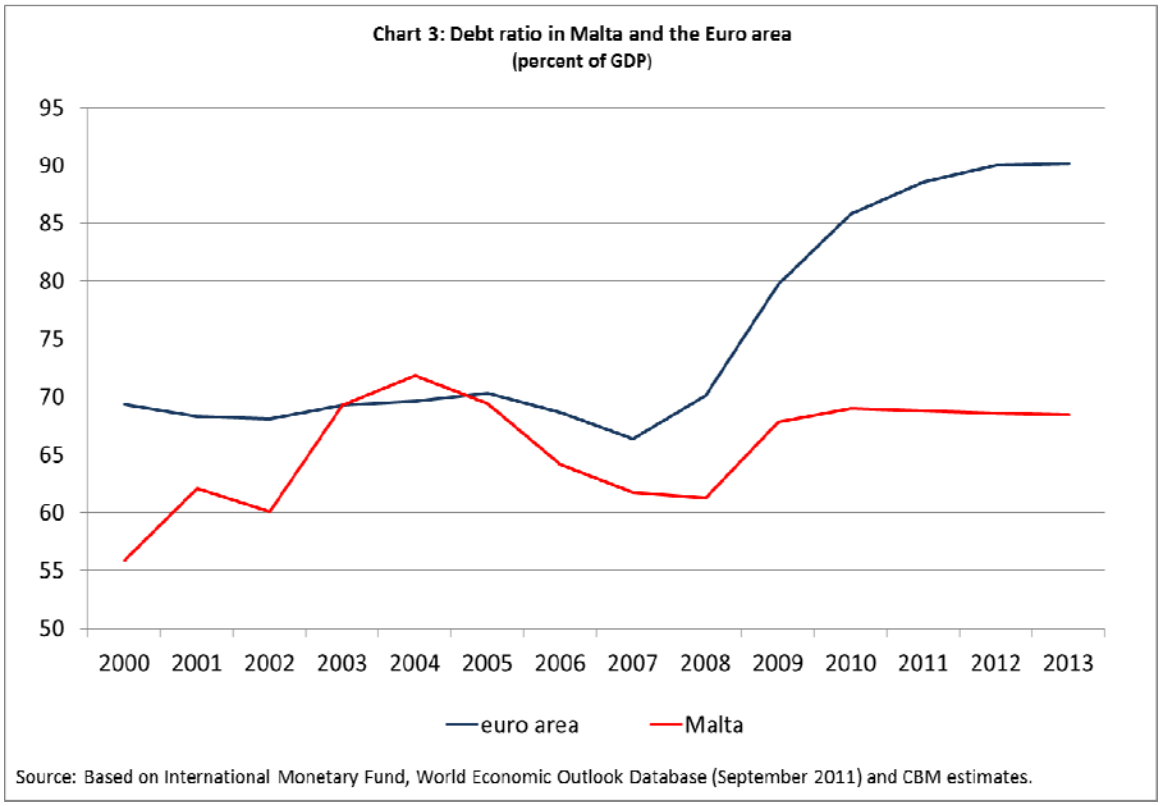


Thus although the fiscal imbalance is narrowing and returning back to the levels stipulated by the Maastricht Treaty a strong case can be made for continued caution in Malta's fiscal policy and for further measures that would help to ensure the achievement of the government's targets.

With a government debt ratio at around 69% in 2010 and 2011, it has become even more important to bring down this ratio at a faster pace (Chart 3).

Moreover, despite the weak external environment the economy continues to grow at a sustained rate and, as I referred to earlier, it is considerably easier to undertake further consolidation at a time of ongoing economic growth.

Reductions in the deficit ratio would also leave more room for manoeuvrability on the fiscal side in the event of an economic slowdown without breaching the European rules.



The least painful way to reduce the ratio of the deficit to the GDP is through economic growth. In turn faster growth can be achieved through improvements in productivity. In this respect, consensus needs to be reached on steps that can be taken with minimal social disruption to reduce the threat to, and ultimately enhance, the country's international competitiveness.

Competitiveness depends partly on developments in productivity and wages. The importance of the wage setting process and efficient labour market practices was evident in the statement, issued by the European heads of government in Brussels on October 26. In this regard, the statement specifically referred to commitments made by the Italian and Spanish governments with respect to structural reforms that included important changes in their labour markets. Spain will enact "labour market changes to increase flexibility at firm level and employability of the labour force …" Italy will "reform labour legislation and in particular the dismissal rules and procedures and … review the currently fragmented unemployment benefit system …"[4]

In the local perspective it is relevant to mention that collective agreements are negotiated at the level of the individual firm, and that helps to ensure that wage growth is compatible with the realities of the markets where the firm sells its products. Nevertheless, various steps could be taken to increase employment or enhance productivity. These could include

[4] "Euro summit statement", Brussels 26 October 2011, points 5 and 6.

measures that would encourage an increased participation rate, as well as measures to facilitate part-time employment and thereby increase employment rates.

Increased flexibility and productivity are also important in the public sector. Any wage increases negotiated need to be moderate, taking into account the current uncertain economic environment. They should also be backed by improvements in productivity, so that the burden on state finances is kept to a minimum and justified by enhancements in quality and quantity of services provided.

A further ingredient for economic growth is the smooth functioning of the financial system. This is an area of particular interest to the Central Bank of Malta, since one of the Bank's main responsibilities is macro-prudential stability. 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.

The recently published *Update* of the Central Bank of Malta's *Financial Stability Report* provides a cautious but generally positive picture of developments in the banking sector since the last full report, which was published in June 2011.[5]

The information relates to those banks that are closely integrated in the domestic economy, often referred to as systemically important banks in a local context. Though large, the remainder of the banking sector is detached from the economy and interacts only marginally with these systemically important banks.

The *Update* pointed to an increase in bank profits, mainly because of higher net interest income. Meanwhile, liquidity and solvency ratios remained positive and significantly above the regulatory requirements.

Commenting on consumer credit, the *Update* observes a reduction in the overall non-performing loans ratio for households. The ratio of non-performing loans for consumer credit transactions decreased while that for mortgages remained stable. As a result of favourable conditions in the labour market, there was also a slight reduction in household loan repayments that were classified as being in arrears.

[5] Central Bank of Malta, *Financial Stability Report Update - June 2011*, 17 October 2011.

It also noted a slight deterioration in the corporate non-performing loan ratio as an increase in the ratio for certain sectors, particularly construction and real estate activities, was offset by an improved ratio in other sectors.

The *Update* noted that credit risk is being partly mitigated by tight credit standards and cautious lending behaviour on the part of the banks. However, it also expressed concern that credit and concentration risks remain elevated while provisioning levels remain inadequate.

In that light, the Central Bank of Malta continues to urge the banks to make higher loan loss provisioning - especially for loans related to construction activity - and to strengthen their capital base. These measures would not only enable the banks to meet potential shocks but would also allow them to prepare themselves better for compliance with stricter Basel III regulatory requirements.

On the funding side, the resilience displayed by the banking system in the face of adverse international conditions is attributable to the prudent traditional business model that has been a historic characteristic of domestic banks, one that places a strong reliance on retail deposits.

This business model has served Malta well as the traditional sources of funding have proven to be very stable, including at a time of international tension. It is therefore essential that, while staying abreast of innovations in the financial world and taking on the changes that are required to stay competitive and improve efficiency, the domestic banking sector must also continue to build upon the strengths of the traditional model.

By contrast, the financial turmoil of recent years has had a negative effect across many countries, particularly on financial institutions that rely on wholesale funding sources. In response to the rapid drying up of the interbank markets and with liquidity abruptly disappearing in many key financial markets in the euro area, the Eurosystem has for the past three years been implementing a broad programme of enhanced credit support.

In particular, the Eurosystem has been providing liquidity on a fixed rate and full allotment basis and has also extended the maturity of its re-financing operations. These non-standard measures have been instrumental in avoiding a credit crunch and supporting financial stability. These measures are designed to ensure an effective transmission of monetary policy – to maintain the flow of credit to the real economy, avoiding liquidity problems and supporting growth in productive activity.

However, there may be instances where the availability of these funding sources may induce some credit institutions to embark on alternative business models where access to central bank funding becomes the primary source of funding. I would like to make it very clear that the Central Bank of Malta is not prepared to support such ventures. When the conditions are favourable a higher leverage ratio increases the return on capital. However when the acquisition of high yielding assets is funded from short term sources, the financial institution is not only exposed to losses on the asset side but also to adverse changes in funding costs. In such a situation, the Central Bank of Malta finds itself in a position where it is more exposed to losses on collateral.

Whereas the Central Bank of Malta will be constantly prepared to provide the necessary liquidity to the banking system to perform its intermediation role, the Central Bank of Malta expects that credit institutions will be looking primarily to the market for their funding requirements.

Among the many lessons that may be drawn from the experience of the international financial turmoil, 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.

The merits of traditional banking practices are echoed in the recent remark by the German Finance Minister. He said, "I believe it is in the interest of the financial sector itself that it should concentrate more on its proper role of financing the real economy, and ensuring that capital is allocated in the most intelligent way, instead of banks conducting the bulk of their trading on their own account".

Such considerations provide the foundations for drawing the desired roadmap for the future evolution and growth of Malta's domestic banking sector and the preservation of financial stability.

In summary I would like to conclude by emphasising the need for fiscal prudence, further efforts to maintain international competitiveness and continued vigilance in the banking sector, in the context of ongoing uncertainty in international financial markets and in the global economy.