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Introductory Remarks

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1 Introduction

Ladies and Gentlemen,

Mr Chairman

Thank you for the opportunity to speak to you here on the global economic crisis and the challenges it poses. These issues can be discussed from very different angles, many of which are equally interesting.

However, my perspective is that of a central banker within the Eurosystem and I will therefore focus on the macroeconomic dimension of the two main topics raised in the announcement to this plenary session. They are, broadly speaking, a stock-take of the economic environment, including the short-term outlook, and the long-term implications of the crisis for economic policy and the science of economics.

However, I would like to add another point which I regard as a linchpin between these two areas. It is the question of how to get from the state we are currently in to a hopefully more stable equilibrium, in which the lessons from the crisis have been learnt. The issues that need to be discussed in this third, medium-term field are, in particular, exit strategies for the

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various policy measures taken during the crisis. In my view, the way we tackle these challenges in monetary policy, fiscal policy and at the level of the IMF will be at least as important for future growth as the changes in the architecture of the financial system, adjustments to monetary policy or improvements in economic theory. But let me start with the state of the world economy.

2 Where does the global economy stand?

The financial crisis caused very serious disruptions on the financial markets after the collapse of Lehman Brothers, and only far-reaching interventions by governments and central banks worldwide prevented a collapse of the whole financial system. Despite this coordinated action, we entered the deepest global recession since the Second World War.

However, after an economically devastating winter half year, we have seen a remarkable stabilisation around the world in recent months. In the euro zone, the decline in GDP almost came to a standstill in the second quarter, and a slight increase quarter-on-quarter is likely in the third quarter. Germany even delivered a positive surprise in the second quarter, when GDP grew by 0.3% on the quarter; the outlook for the third quarter is even better given a rebound in industrial activity and the levelling-out of the de-stocking cycle.

There are several factors, in the euro zone as well as in other major economies, that point to a fairly benign outlook and that make a double-dip recession very unlikely:

- An important part of economic policy stimuli is still in the pipeline for 2010.

- The improvement in confidence, not the least on the financial markets, is increasingly being supported by hard facts.

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- The task of monetary policy-makers has become a little easier because deflationary fears as a result of the massive correction on the commodities markets in combination with deteriorating economic conditions have all but disappeared in recent months, while inflation risks are still very limited or non-existent in the short run.

However, forecast risks are still elevated, and there is no reason to be overly optimistic given the fragility of the recovery and the existence of important downside risks such as a foreseeable deterioration in labour market conditions and the second-round effects that the crisis is likely to have on bank balance sheets due to the recession. Although I expect a global recovery across the major world regions by 2010, the pace of growth should be much more moderate than in the past. In particular, it is not realistic to expect a speedy return to pre-crisis trend levels of output.

On the financial markets, optimism seems to be even more widespread: Market conditions as measured by stock prices, spreads and bond yields have improved significantly in recent months, in fact even more so than the real economy, but the situation is still fragile and temporary backlashes are likely. This is because the stabilisation is due not only to better-than-expected macroeconomic developments and a levelling-off of risk aversion, but also to unprecedented stabilisation measures by governments and central banks, which cannot be maintained forever.

In addition, banks are still exhibiting some weaknesses, and some risks to corporate earnings are going to materialise over the coming months. This, combined with ongoing high levels of uncertainty and volatility on financial markets, also make exuberant forecasts inadvisable.

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3 Lessons learnt and still to be learnt from the crisis

Still, it is safe to say that we have overcome the worst. This makes it all the more pressing to reach an international agreement on the reforms to be implemented in the financial sector to make the whole system more resilient to shocks and less prone to aberrations such as those that led to the current crisis. The dire consequences of the crisis have created a sense of urgency and a willingness to act that must now be put into action. We owe this to the public given the immense cost the financial crisis has imposed on public finances and future generations, who will have to bear part of this burden.

The financial crisis has demonstrated that banks remain the primary link between the financial system and the real economy. While it is true that regulation and oversight have to be extended to all systemically important financial institutions, better regulation of banks is therefore an even more important building block in a stable financial system. For this reason, it is essential to further improve banks' risk management and to review their capital and liquidity requirements. My co-panelist Baron de Rothschild will probably elaborate on these banking-related issues.

In addition, supervision has to be taken one step further if we want to fully address the causes of the current financial crisis. It is not sufficient to safeguard the stability of each individual bank; instead, systemic risk has to be identified and combated. And obviously central banks must and will play an integral part in this macroprudential supervision.

What is important to note is that these and other problems, such as internationally comparable accounting standards, can only be resolved at an international level. Fortunately, the G20 have made a strong commitment to reaching such solutions. Now we must flesh out the general agreement made in Pittsburgh with more detail. Specific

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implementation is often very intricate and requires careful analysis, which is why the specialists – eg the Basel Committee on Banking Supervision and regulators and legislators at the national level – need time to formulate the new rules properly and to create a consistent framework.

Another lesson from the crisis is that global imbalances must be reduced in order to achieve sustainable long-term growth. This has led some to propose a coordination of economic policies, where countries with current account surpluses actively prop up demand.

To be frank, I am deeply sceptical about such a strategy. Even persistent current account surpluses are not per se an indication of imbalances. They require careful analysis to determine whether they merely constitute a market outcome, such as a high external saving rate in an aging society, or are due to policy interventions eg on the foreign exchange markets. As long as market adjustment mechanisms work, I am not concerned with rebalancing the sources of growth. Instead of trying to manage global demand, efforts should be concentrated on freeing up clogged adjustment channels. The euro area is certainly not at the forefront of the debate on impediments to more balanced growth. This is not to say that the necessary global adjustment process will not have repercussions on surplus countries like Germany. But these processes – which are currently going on to a significant extent (Germany alone will nearly halve its net exports by roughly 80 bn euros) – should also remain market-driven. Fine tuning regional demand with pre-crisis global growth rates as a benchmark will not prove successful in my view.

From a political economy perspective, it seems that the debate about reigning in imbalances through more surveillance and policy coordination risks drawing political commitment away from the efforts to reform financial markets I have just outlined. If this were to happen, we would have cause to be truly concerned.

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4 Imminent challenges: Exit from the rescue measures

Finally, I would like to make a few comments on the question of exit strategies. Given the macroeconomic outlook, there is surely no need to rush for the exit at the current juncture. However, to stabilise expectations and to safeguard public confidence it is essential to develop a credible exit framework now. The challenge in terms of communications will be to make clear the difference between developing and implementing an exit framework.

As a central banker, I would like to stress first that maintaining price stability has always been and will continue to be the primary objective of monetary policy in the Eurosystem. Hence, the monetary policy stance is determined by risks to price stability, which are fortunately currently not present at the policy relevant time horizon. Our non-standard instruments allow a flexible exit which takes into account any remaining fragility on financial markets, if needed. Therefore, I am fairly confident that monetary policy in the euro area will manage an orderly exit.

Given the enormous rise in public deficits and the strain this will put on future budgets, the fiscal exit strategy will have to kick in as soon as the recovery has firmed up, which means no later than 2011. Reigning in deficits will require significant improvements in the structural balance ratio. Within the European Monetary Union, the Stability and Growth Pact will play an essential role in guiding fiscal consolidation. And even after correcting excessive deficits, rapid consolidation will have to continue to reach medium-term budgetary objectives and to substantially reduce debt ratios from their earlier extraordinarily high levels.

We must not forget that early and decisive consolidation is not an end in itself: It will help to restore and maintain confidence in financial markets, recreate fiscal room for manoeuvre before the next downswing and help to prepare budgets for the foreseeable fiscal burdens associated with an aging population.

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5 Conclusions

Given time restrictions, I will not raise the issue of exit strategies for the IMF or for government involvement in the financial sector. We may discuss these in more detail afterwards, so I will leave it at that for the moment. Thank you for your attention.

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