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# Economic and Financial Stability: Challenges on the Road Ahead

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## Content



# 1 Introduction

Professor Weder di Mauro,

Professor Stark,

Ladies and gentlemen,

It is a pleasure for me to speak to you today. Although the crisis is not over yet, making 2010 the fourth year of the crisis, the recovery of the global economy got underway in spring 2009 and remains on track. It is therefore all the more important for firms and policymakers alike to focus on what will come after the crisis and the challenges on the road ahead. The key question now has to be how to get the economy back onto a path of strong, balanced and sustainable growth.

Our session is entitled “Economic and Financial Stability in Europe: The Road Ahead”. With this brief in mind, I would like to focus on two core issues on the way to an environment that supports solid growth. First, the ongoing reform of the financial system, as only a robust financial system provides a basis for sustainable growth. The financial sector is more than just a part of the economy; it also plays a crucial role in capital accumulation. In particular, financial stability is a prerequisite for an efficient allocation of capital. Second, the lessons



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the euro area should learn from the crisis, especially from its most recent phase which is characterised by a government debt crisis. The sustainability of public finances is essential for the confidence of market participants such as consumers and investors. And a sound macrofinancial environment is key for financial stability, as the last months have demonstrated.

## 2 Providing a Basis for Sustainable Growth: A More Robust Financial System

The current crisis originated as a pure financial crisis. However, over its course, the financial crisis spilled over to the real economy and thereby demonstrated very plainly the strong interconnection between the financial and the real spheres and how vulnerable the real economy is to disruptions to the financial system.

At this point in time, discussions about concrete financial reform measures are well advanced. The G20 have proposed a comprehensive plan to overhaul financial regulation. This agenda shows that many lessons from the crisis seem to have been understood and that essential aspects of the regulatory framework are currently being improved. The overall purpose is to come up with a system that is more resilient to shocks. As a first line of defence at the microprudential level, the reform measures aim to tighten capital requirements, both in terms of quantity and quality. The significant enhancements made to the original Basel II framework will lead to a new set of rules that has therefore rightly been termed Basel III. After the promising consensus achieved at the summit in Seoul, the task is now to transpose the G20 agreement into national law.



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Of course, the increased requirements are associated with adjustment costs for financial institutions. Yet, a number of studies have been conducted. The investigations have shown these costs to be manageable, not least due to the lengthy transition phase that will attenuate the adaptation process. Even the distinctive features of the tripartite German financial system have been taken into due consideration. The sector's profitability will probably decrease, yet so will fluctuations, thereby supporting continuous growth. Impacts on cost of credit and thus on the real economy will, however, be limited. Fears of dire consequences therefore appear exaggerated, and banks should instead embark on the task of adjusting to the new requirements at an early stage.

However, the increased risk buffer in the shape of higher capital requirements is no panacea. It is a central lesson from the crisis that a second line of defence is needed to prevent individual banks that still fail from triggering a systemic crisis. This issue is particularly acute in the case of systemically important financial institutions (SIFIs). The discussion of how best to treat them is still ongoing, but the contours of the future framework are taking shape now that the G20 Summit has endorsed the FSB's SIFI recommendations: a core policy instrument are resolution regimes that are tailored to the particularities of the financial system and that allow to resolve even systemic financial institutions without endangering the functioning of the financial system. Higher capital requirements in a variety of forms are a suitable instrument to increase the loss absorption capability of SIFIs and, at the same time, to counter moral hazard by pricing in their externalities. However, important details of these SIFI recommendations and corresponding policy measures still need to be agreed on, and some questions remain unanswered. One important issue is how to measure systemic relevance and how to translate this into regulatory and supervisory action.



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The crisis has also demonstrated that systemic risks have been shifted out of the regular and therefore regulated banking sector into the so called shadow banking system. This underlines just how important it is to complement traditional microprudential institutional supervision by macroprudential oversight. Yet for this new type of surveillance to be effective, information loopholes have to be closed by gathering more information on areas of the financial system that have been rather opaque up until now. The guiding principle should be that function matters more than form – something that looks like a bank and acts like a bank should also be treated like a bank.

All these reform efforts require internationally coordinated action. Otherwise, a shift of business activities into less regulated countries could result in a by-passing of regulation. Individual countries should not seek advantages by reluctantly implementing the internationally agreed reform agenda.

Reluctance would also be the wrong attitude with regard to my second core issue: the road ahead to regain sound public finances and rebuild confidence in states. Though the problem of unsustainable government debt is basically an international one, strengthening EU governance is of the outmost importance in the current situation.

## 3 Providing a Basis for a Strong and Stable Monetary Union: EU Governance

After the financial crisis had grown into a full-blown economic crisis at the end of 2008, the state had to ride to the rescue. It supported ailing companies and institutions whose failure might have triggered a chain reaction with guarantees or capital injections. The pivotal role that fiscal policy played in stabilising the economy and the financial system can be attributed



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to the high degree of creditworthiness that governments enjoy – much higher than that of most private debtors. It is based on their ability to fund themselves by levying taxes – ie the ability to force others to make a financial contribution and not having to rely on their powers of conviction. However, the severity of the crisis resulted in a sharp deterioration in public finances, which had in many cases not been in good shape even before the crisis. Ultimately, this led to a reassessment of sovereign risk, and investors lost confidence in the public finances of some countries, particularly at the periphery of the euro area. This loss of confidence in the state constituted the third phase of the crisis and culminated in the debt crisis in May 2010.

The current reform efforts must therefore extend beyond the financial system and include the body of European rules and regulations. These rules were not sufficient to ensure solid public finances in all member countries. Given the spillover effects in a financial market as closely integrated as that of the European Monetary Union, the risk of contagion for other euro-area member states and beyond implied a substantial risk – including for the global economy. Far-reaching *ad hoc* countermeasures had to be taken earlier this year. Therefore, restoring the sustainability of public finances is key in the quest for a sustainable growth path – across the world, but particularly within the euro area. With the Stability and Growth Pact (SGP), and especially its debt criterion, the euro area already possesses the right instrument. Yet, implementation has been slack to date. The SGP's rules need to be tightened – in its preventive arm as well as in its corrective arm – and measures must be taken to ensure that member states abide by them. At the end of October the European Council adopted proposals to change the SGP. These changes would be an improvement compared to the *status quo*. However, a firm establishment is still to come and, judging from past experience, we would have wished for more far-reaching suggestions. Alongside the



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changes of the fiscal framework a more intensive macroeconomic surveillance is to be installed to diagnose erroneous developments early on.

This reflects that especially the countries hit hardest by the debt crisis have posted persistent current account deficits. Still, the focus on the current account can easily lead to the wrong conclusions. Even persistent and sizable current account positions are not a problem in themselves. Technically, a surplus or deficit reflects the difference between domestic saving and investment. For countries with an ageing population it is only rational to save more today rather than invest domestically, as the number of profitable investments is declining and households want to maintain their level of consumption in old age. Conversely, countries that are catching up in terms of economic development have ample opportunities for investment but are short of domestic capital. By allowing economies to separate domestic absorption from output, current account imbalances enhance welfare. Consumption is smoothed over time and capital directed into its most efficient use.

However, current account imbalances are less benign when they are caused by distortions. When they reflect underlying barriers to economic growth they can add an element of instability, not only domestically but also in other economies. A number of deficit countries did not always invest capital inflows efficiently. In some cases, this allocation increased domestic demand and, with inflexible labour markets, wages outpaced productivity. The results were a loss in price competitiveness and a further widening of the current account deficit. Here macroeconomic surveillance could help detect problematic developments with the potential to destabilise the currency union as a whole at an early stage. This is particularly important in cases when these developments are not immediately reflected in deteriorating public finances which would already be dealt with under the SGP.



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However, we should refrain from macro fine-tuning – be it at the European or at the national level. Such efforts would definitely overburden economic policy and raise expectations that are bound to be disappointed. Instead, reasonable macroeconomic surveillance should confine itself to the early detection of harmful domestic imbalances that have significant negative spillover effects on other member countries or even the euro area as a whole. This in principle also precludes the symmetric treatment of current account surpluses and deficits: divergences within the euro area were caused by distortions and the inefficient use of capital in deficit countries. Hence, the brunt of the adjustments has to be borne by these countries, whereas - as studies demonstrate - additional stimuli by surplus economies would do little to ease this burden.

At the current juncture, the fundamental characteristics of the macroeconomic surveillance procedure are still very vague. In my view, the details need to be worked out first. Only once this has been done, can we decide whether it makes sense to complement the procedure with sanctions and what these sanctions might look like.

## 4 Conclusion

Ladies and gentlemen, the economic and financial crisis has demonstrated that there is ample room for improvement and need for reform in our financial system as well as in the area of EU governance. A look at the global agenda shows that the main messages that the crisis has taught us seem to have been understood. As the recovery proceeds, it is of the essence not to relent in our efforts to implement the necessary measures. If the momentum for structural reforms in the various fields of economic policy can be maintained, we will



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have made significant progress on the path towards strong, balanced and sustainable growth.

Thank you for your attention.

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