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Global reforms and the market economy system

Welcome address at the reception given by the Deutsche Bundesbank
at the Annual Congress of the Verein für Socialpolitik
in Frankfurt am Main
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1 Welcome

Ladies and gentlemen, members of the Verein für Socialpolitik,

On behalf of the Deutsche Bundesbank, I would like to warmly welcome you to this reception. I am especially delighted to accept the role of host at the Bundesbank's reception once again this year.

The Bundesbank is a true friend and supporter of the Verein für Socialpolitik – and not without a certain degree of self-interest. The Bundesbank considers science and research to be fields of great importance, since the work of central banks is today – more than ever – research and knowledge-based. Time and again, research work has been the starting point for central bank policy decisions. Conversely, problems we are currently witnessing in the central banks' various areas of operation stimulate new research projects. Moreover, central banks offer an attractive research environment. I am therefore convinced that a close exchange with research institutions and universities benefits all concerned.

The Bundesbank maintains contacts and works together with a wide range of institutions and academics at the Goethe University. One such example is the Institute for Monetary

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and Financial Stability; it is financed by the Monetary Stability Foundation, which in turn is run by the Bundesbank. But cooperation also takes place on a less formal level, for instance with the Center for Financial Studies and the Graduate School here in Frankfurt, to name but two examples.

2 Lessons from the crisis – comments on the G20 agenda

The topic of this year's congress is *"The order of the world economy: Lessons from the crisis"*, and the scope of the programme demonstrates the range of the related questions and answers.

What are the right lessons to be learned from the crisis? This question was the subject of debate even before the first escalation of the crisis, namely the collapse of Lehman Brothers in September 2008. Initially, it was thought by more than just a few that technical improvements in financial market regulation – notably concerning the securitisation market – would be a sufficient response to the crisis.

However, when the most severe global economic crisis in decades took hold in the autumn of 2008, two points became obvious. First, reforms must be more broadly based in order to make the world economy and the global financial system more robust and crisis-resistant, thereby reducing the scale and the frequency of future crises. And second, intelligent and consistent reforms of the economic framework can only be achieved through global cooperation.

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Despite – or perhaps precisely because of – the need for reforms, there is a not inconsiderable risk that policymakers will make decisions which are difficult to reconcile with principles of a market economy. Those who are already sceptical about the market economy system and about globalisation, and who believe the current crisis to be the result of market failure rather than political failure, may even welcome this. In my opinion, however, measures that boil down to protectionism, continuous direct market intervention or more extensive macroeconomic fine-tuning are the wrong answers to the crisis. Instead, the regulatory framework needs to be adjusted in such a way that the focus is again put more squarely on market-economy principles such as individual responsibility and private liability. The current sovereign debt crisis and its background serve as a strong reminder both of the limits and pitfalls of supranational economic policy cooperation and of the disciplinary effect of market signals, incomplete though that effect may have been prior to the crisis.

At institutional level, considerable progress has been made since the outbreak of the crisis. For example, the G20 has assumed the role of predominant international forum for financial policy. The Financial Stability Forum was expanded to become the Financial Stability Board, with a significantly widened range of tasks and members, and is a key driver of the reform of financial market regulation. Within the European Union, too, institutional consequences were taken in the wake of the crisis. A European System of Financial Supervisors was set up, comprising supervisory authorities for banking, insurance and securities markets, to achieve closer cooperation in European financial supervision, as well as the European Systemic Risk Board, or ESRB for short. The ESRB represents the first time that macroprudential surveillance has been established at European level. The central banks of Europe have a vital part to play here because of the expertise they possess.

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It is at the global level that, in some cases, widely diverging ideas on the role of economic policy collide. Occasionally we experience joint commitment to the principles of free and open markets, only to find that effectively implementing reforms is a good deal more difficult. The G20 agenda clearly demonstrates that. It features a framework for strong, sustainable and balanced economic growth, more stringent regulation of the international financial system and the reform of the international monetary system including the role of the IMF.

The objective of the framework – strong, sustainable and balanced economic growth – is surely undisputed. In addition, a process was launched on the basis of which G20 economies can assess each other's macroeconomic policies. Through this Mutual Assessment Process (or MAP), member states report on the implementation of their respective political agenda in terms of their shared goal. Beneficial though a peer review of this kind may be, it must not become a back door for macroeconomic fine-tuning.

That may already be reflected in the selection and design of the indicators used for the assessment. For instance, in the first stage of the "assessment of external sustainability" within the MAP, a specified set of indicators is observed which are intended to identify macroeconomic imbalances. This procedure would appear, initially, to be an appropriate means of filtering for more precise analysis in the second stage. For instance, no one would deny that persistent current account imbalances pose a problem. But it is not clear why current account surpluses should be dealt with in the same way as deficits – symmetry of statistics does not imply symmetry of causes and risks.

In this context, the economic policy implications are also the subject of contentious debate. Besides the outright rejection of pronounced positive or negative current-account balances, the Bundesbank takes a dim view, in particular, of endeavours to reduce such balances by

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direct political intervention. Current account positions are not to be condemned *per se*, especially when – as in the case of Germany – they result from market processes and make sense given the demographic changes that are underway. More important and lasting effects would be achieved by eliminating barriers to an endogenous adjustment of current account balances, such as pegging exchange rates at levels which are difficult to justify in terms of fundamentals. But focussing on mere balances and thresholds tends to deflect attention from such topics.

Considerable progress has already been made in financial market regulation. And given that weaknesses in regulation were one of the main reasons for the financial crisis, this was, in my opinion, a matter of priority. Of course, mention must be made of the reform of the capital rules – also known as Basel III – which will lead to a quantitative and qualitative improvement of banks' capital and, as a result, increase their loss absorbency capacity. The more losses the banks' investors can and must bear themselves, the lower the danger that the taxpayer will again have to come to the rescue. At the same time, the phenomenon of systemically important financial institutions shows that Basel III cannot be the final step. Supplementary rules for dealing with the "too big to fail" problem must follow and are at the top of the reform agenda, along with the even more complex monitoring and, where necessary, regulatory treatment of the shadow banking system.

One major milestone was certainly the decision taken by the Group of Governors and Heads of Supervision on 25 June of this year. The oversight body of the Basel Committee agreed on key procedures for dealing with global systemically important financial institutions. In future, these banks will be subject to additional capital surcharges ranging between 1 and 2½ percentage points depending on their degree of systemic importance. This will better enable companies to price the economic cost of – or any further increase in – systemic

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importance into their calculations. In my view, disincentives such as these are generally preferable to “hard” structural interventions such as explicit size limits.

A third topic on the G20 agenda that I would like to touch upon is the discussion on reforming the international monetary system. This is a very multifaceted topic ranging from the treatment of capital flows, the appropriate level of foreign reserves and the strengthening of IMF surveillance to the future role of the International Monetary Fund. The last-mentioned point, for example, concerns whether considerably more funds should be placed at the IMF’s disposal and global financial safety nets created under the direction of the IMF. In this way, financial aid could be granted more easily and under more lenient conditions than in the past.

Like many other IMF members, the Bundesbank is critical of these endeavours. There is no disputing the major role played by the IMF in, for example, providing analytical insight into the crisis and managing adjustment programmes. However, global financial safety nets without adequate conditionality would weaken rather than strengthen the financial responsibility of the individual countries. Particularly in light of the sovereign debt crisis, we consider this strategy unsuitable as a means of making the international monetary and financial system more resilient. Moreover, central banks’ monetary policy autonomy would be substantially restricted if the IMF were to become a “world central bank” or the global lender of last resort – which is what almost unlimited liquidity provision would in fact mean: for the IMF, unlike central banks, cannot itself create liquidity. Consequently, the national central banks of countries whose currencies are part of the basket of special drawing rights would be required to provide liquidity, whatever the amount.

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3 Conclusion

Ladies and gentlemen,

The financial and debt crisis is, unfortunately, far from over. This was made abundantly clear again this summer. I have deliberately disregarded current actions to cope with the crisis, focussing instead on lessons from the crisis and casting a sceptical eye on some aspects of the global reform agenda. Let it be understood that the Bundesbank certainly does not reject this agenda, since it addresses the areas that need to be addressed; moreover, reforms are crucial to establishing more solid foundations for the global economy.

However, it is important to avoid measures which hamper or prevent market-economy processes without recognisably reinforcing stability. Blind faith in the market lost its appeal, at the latest, with the onset of the crisis. Yet this does not mean that statism and government control are the right answers to the crisis. The cost of attempts to achieve politically desirable market results and structures is likely to be high – indeed, too high. The prime objective of the global reforms ought to be to identify weaknesses in the existing regulatory framework and to adjust the framework accordingly. In this admittedly often lengthy and arduous process, the Bundesbank sees itself in the role of committed advocate and constructive admonisher.

Thank you very much for your attention. I wish you an enjoyable evening at the Deutsche Bundesbank's reception here at the Goethe University in Frankfurt.

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