Jürgen Stark: Monetary, fiscal and financial stability in Europe

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the 11th Euro Finance Week, Frankfurt am Main, 18 November 2008.

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1. Introduction

"Error repeats itself endlessly in deeds. Therefore, we must repeat the truth tirelessly in words"

(Johann Wolfgang von Goethe)

Ladies and Gentlemen,

I would like to thank the organisers for having invited me here today to share with you my thoughts on the prerequisites for economic, financial and price stability in Europe.

We are all aware that these are the most challenging times since the introduction of the euro nearly ten years ago. The financial crisis, which originated in the United States, has now spread across the globe. In so doing, it has greatly affected the outlook for short-term economic growth in Europe and elsewhere. Moreover, the need to address past macroeconomic imbalances has clouded the medium-term outlook for potential output growth not only for the United States but also for a number of European countries. Persistently high current account deficits and excessive increases in house prices have not been limited to the United States but have also been characteristic in some euro area and many non-euro area EU countries. These imbalances will need to be corrected, suggesting that a period of slower economic growth may lie ahead.

The correction of macroeconomic imbalances will be orderly if, and only if, macroeconomic policy-makers retain a medium-term to long-term focus. In particular, the prevention of future crises needs to receive at least as much attention as short-term crisis management. In addition, all monetary and fiscal policies need to remain committed to their respective medium-term objectives, i.e. price stability and sound public finances. This was, is and will remain the best contribution monetary and fiscal policies can make for financial stability.

However, although sound macroeconomic policies are only a necessary condition for a functioning market economy and for economic and financial stability, they are clearly not a sufficient condition. This insight is hardly new but seems to have been forgotten to some extent over time. It was most clearly expressed in Walter Eucken's famous book *Principles of Economic Policy* (Grundsätze der Wirtschaftspolitik), which laid the intellectual foundation of Germany's economic model after the Second World War. This book has been a constant source of inspiration throughout my career. Eucken's main insight was that a market economy can only flourish in a sustainable manner if certain timeless principles are adhered to – and, importantly, all at the same time, because of what he called "the interdependence of orders". Let me enumerate these principles:

- the primacy of price stability;
- the promotion of perfect competition on all markets;
- the protection of property rights;
- the freedom of contract;
- unlimited liability; and, finally,
- stability-oriented economic policies.

Moreover, there is an “interdependence of international orders”, suggesting that these principles should be adhered to around the globe. At the time of writing his book, Eucken could not foresee the recent wave of globalisation and rapid financial market integration, which has reinforced the need to account for this international interdependence.

Have all these principles been adhered to properly in the run up to the current crisis? My answer is a clear “no”. Before elaborating on this answer, let me briefly mention that the school of thought Eucken belonged to – which has been called “ordoliberalism” by some and “German neoliberalism” by others (at a time when “neoliberalism” was not yet a swear word) – is very different from both state interventionism and laissez-faire capitalism. While Eucken recognised that activist economic policies are a major source of distortion and should therefore be avoided, he still saw an urgent need for government action in the field of establishing the rules. In the absence of such rules, private agents would have the incentive to undermine the disciplining forces of free competition.

I will now turn to the origins and causes of the financial crisis and I will show how valuable Eucken’s insights are for understanding the genesis of the crisis and for devising preventive measures.

2. Diagnosis: the origins and underlying causes of the financial crisis

As regards the origins and underlying causes of the current financial crisis, I will focus on three aspects: the role of macroeconomic policies, the role of microeconomic policies including regulation and the role of financial market participants themselves. I can be brief because much has been said on these aspects over the past months.

First, turning to the role of governments, it is clear that expansionary **macroeconomic policies** around the globe have contributed to the build-up of macroeconomic imbalances. These policies have facilitated the strong credit expansion, excessive house price increases and the build-up of large current account imbalances, in particular in the United States but also in other regions, including some euro area countries. Although the degree of policy expansion was not the same across world regions, in sum excess liquidity emerged at the global level. The fact that global excess liquidity did not immediately show up in consumer price inflation gave a false sense of security to financial market participants, encouraging increased risk-taking. Moreover, while expansionary policies could not eliminate the need for an adjustment of macroeconomic imbalances, they were able to postpone the adjustment by several years, thereby encouraging the further growth of imbalances.

Second, inadequate **microeconomic policies** including lax regulation facilitated the emergence of financial market excesses. The most obvious area of policy failure is the setting of inadequate incentives in housing markets in some countries. A policy of maximising the number of houseowners, irrespective of affordability, is simply not sustainable. In addition, the absence of regulation in some areas of the mortgage market together with the emergence of the originate-to-distribute model created incentives for the provision of loans beyond sustainable levels. Also, the design of capital adequacy requirements and accounting standards resulted in procyclical lending behaviour, which acted as an automatic *de*stabiliser of the financial system. Another aspect that will have to be carefully studied in the coming years is to what extent there is a causal relationship between financial deregulation and subsequent financial crisis. While financial deregulation is intended to promote innovation and thereby economic growth, it can, if ill-designed, result in imprudent behaviour instead.

Finally, **financial market participants** themselves have been an important factor driving the financial excesses of the past few years. The introduction of largely unregulated and intransparent financial instruments together with the rapid increase in off-balance sheet activities has undermined the trust in the financial sector. Some of the new activities have clearly not been undertaken with a view to making financial markets more complete and to increasing risk-sharing opportunities. Instead, they helped to circumvent regulated areas and to maximise short-term profits. Ill-designed compensation schemes played an important role in this shortening of horizons among financial market agents. The incentives provided by these compensation schemes were such that short-term benefits translated into huge compensation increases while there was no liability at all for long-term losses. This asymmetry created incentives for the excessive risk-taking that we have witnessed over recent years. In addition, deficiencies in financial institutions' risk-management models and the sad role played by credit rating agencies, wrongly signalling decreasing risk during the boom, amplified the tendency towards excessive leverage and procyclical lending behaviour. As regards procyclical behaviour and the shortening of horizons, I see a clear analogy with the area of fiscal policy, where in the absence of appropriate rules there is also a strong incentive for procyclical behaviour, especially during economic booms.

To sum up, a diagnosis of the crisis reveals that governments have played a role in two different ways: first, by pursuing macroeconomic policies which are too expansionary; second, by at least partly neglecting their rule-setting role. The financial sector has abused the loopholes in the regulatory framework. The interdependence among these factors should also be clear. For example, the lack of adequate regulation might at least be partly due to regulatory capture, i.e. the influence special-interest groups – here the financial sector – tend to exert on the regulator to their own benefit but at the expense of the economy at large. Eucken's emphasis on interdependence teaches us that crisis resolution and prevention have to tackle all these elements in a comprehensive and mutually consistent way. Neither laissez-faire nor blind trust are an option in terms of appropriate government action.

3. Treatment I: crisis management – the response to the financial crisis

Given the diagnosis, what is the appropriate treatment? It should be clear that the treatment needs to encompass the entire economic body. If we treat only certain infected organs, such as credit default swaps, we will have unintended side effects on the rest of the body. In the remainder of my remarks I will split the treatment into two stages, namely crisis management and crisis prevention, noting that these two stages are interdependent. Poor crisis management has the potential to undermine any preventive measures intended to avoid future crises. Policy-makers should always have this on their mind when addressing financial or other crises.

As regards crisis management, let me first turn to the area I know best, i.e. central bank responses to the financial crisis. The ECB has stressed from the outset that it would make and maintain a clear distinction between the monetary policy stance and the provision of liquidity to financial institutions. The mandate of the ECB is to maintain price stability over the medium term. This mandate must be adhered to both in normal times and in times of crisis. The monetary policy stance appropriate to fulfil our mandate depends exclusively on our assessment of the balance of risks to price stability, and nothing else. There is absolutely no reason to deviate from this approach during times of crisis. This being said, the ECB, in cooperation with other central banks, has shown remarkable flexibility in terms of liquidity provision. This flexibility was necessary in order to avoid the breakdown of the interbank market, which is a very important transmission channel for monetary policy. Let me finally mention that our recent interest rate cuts were fully in line with our monetary policy strategy. With the intensification and broadening of the financial crisis it became increasingly clear that the upside risks to price stability were diminishing when the downside risks to economic growth in the euro area and elsewhere were materialising. This created room for cuts in interest rates, based on and fully in line with our monetary policy strategy. I can assure you that, looking ahead, we will continue to base our assessment and our actions on this strategy, which has served us very well over the past ten years.

Let me now turn to fiscal policies, an area that is of the utmost importance and one with which I am also familiar. Similar to monetary policy, it is important that fiscal policy-makers in the euro area see the benefits of adhering to a kind of separation principle. Fiscal policies in the euro area need to be committed to the long-term sustainability of public finances, also in times of crisis. Does this mean that fiscal policies should remain inactive? No, but it gives guidance as to the kind of intervention that is appropriate for managing financial crises. The rescue packages recently enacted by euro area governments to stabilise the banking sector were clearly necessary, timely and well-targeted. The design of the rescue measures ensures that taxpayers in the euro area will not be burdened in the long run. There are, of course, downside risks to government budgets but there are also upside risks, suggesting that the net effect on the long-term sustainability of public finances could be very limited. Short-term increases in government debt associated with these rescue measures are to be accepted.

However, the more recent plans of euro area governments to set up discretionary expansionary measures to stimulate the economy at large are totally different in nature. There is a substantial risk that the mistakes of the 1970s will be repeated, which led to an unprecedented increase in government liabilities and ultimately in taxes, thereby hampering economic growth. I really cannot see why discretionary fiscal policies, which have been proven to be ineffective in the past, should work this time. At the current juncture, fiscal policies in the euro area would be well-advised to let automatic stabilisers operate freely but to otherwise maintain a medium-term orientation. Let us not forget that the crisis originated from the shortening of horizons in financial markets. Macroeconomic policies would be ill-advised if they followed suit and likewise adopted a short-term horizon. This would mark the return to a mistaken past in which macroeconomic policies themselves were a source of instability and crises.

Finally, adjustments in financial market regulation in response to the crisis will bear fruit mainly over the medium term. Exceptions are changes in accounting standards regarding the valuation of instruments in inactive markets, which are geared towards stabilising banks' balance sheets, thereby complementing the efforts of central banks and fiscal policies to revive financial intermediation. The financial crisis has exposed deficiencies in financial regulation. Adapting financial regulation will be an important element of the second stage of the treatment: the prevention of future crises, to which I will now turn.

4. Treatment II: crisis prevention – getting incentives right or "The need for a Global Financial Stability Pact"

When I talk about crisis prevention it should be clear from the outset that I do not believe that, regardless of the measures to be taken, the international community will be able to eradicate financial crises forever. What can be realistically achieved is to reduce the likelihood of financial crises and to dampen the amplitude of financial cycles. Fifty years ago there was a consensus that discretionary monetary and fiscal policies geared towards fine-tuning the economy would mark the end of the business cycle. This belief resulted in what we now call the great inflation of the 1970s, a period of significant instability. The lesson we learned in Europe was that fine-tuning policies are ineffective and produce very poor and undesirable results.

When the decision was taken in the early 1990s to introduce a common currency in Europe it was clear that this joint venture could succeed if, and only if, macroeconomic policies were permanently committed to price stability and sound public finances. This is reflected in the institutional set-up of EMU with an independent central bank and the Stability and Growth Pact. This marks a paradigm shift in economic policies in Europe. The commitment to price stability and sound public finances is the best contribution monetary and fiscal policies in the euro area can make to financial stability. There is no trade-off between price stability and financial stability and there is also no trade-off between sound public finances and financial stability. If monetary and fiscal policies became distracted from their medium-term objectives they would themselves become a source of volatility and would thereby destabilise, rather than stabilise, financial markets. Stability orientation of macroeconomic policies is as crucial today as it was sixty years ago when Walter Eucken worked on his landmark study.

So much for macroeconomic policies. But what about financial markets themselves? How can we redesign the financial market architecture in such a way as to reduce the likelihood and cost of future financial crises? Even the most fervent champions of unregulated financial markets have been forced to recognise that there is a need for appropriate rules. Needless to say, there is a need for a realistic assessment of the costs and benefits of tighter regulation. But the current crisis has made it clear that the benefits of tighter regulation are larger than thought in some quarters. Still, we need to avoid excesses in the direction of excessive regulation. Moreover, new regulation needs to be in the spirit of Eucken, i.e. setting general principles rather than drawing up long lists of individual measures, which are necessarily incomplete and invite renewed regulatory arbitrage.

Let me give you a concrete example of what I have in mind. Some financial market participants argued before the crisis that the enormous rise in their bonuses during the financial boom was justified because they had to be seen as financial entrepreneurs. Indeed, financial innovation shares many characteristics of innovation in other markets. Successful innovation in those markets means that the respective entrepreneur can become extremely rich, possibly even in a very short period of time. Yet, the analogy ends there. An unsuccessful entrepreneur will lose his or her entire fortune. History has plenty of examples of entrepreneur bankruptcy, including one of the world's most famous business cycle theorists, Joseph A. Schumpeter, who provided one of the most convincing theories of the process of innovation and its importance for economic growth. Yet, this did not prevent him from bankruptcy in his personal commercial endeavours, nor should it have.

So, what is the difference between these entrepreneurs and the self-proclaimed financial "entrepreneurs"? An important element has been missing in financial markets, one of the core principles devised by Walter Eucken necessary to sustain a functioning market economy: the concept of liability. I think that the CEOs of large financial institutions are right in seeing their role as one of entrepreneurs. However, this implies that they should assume unlimited liability for their decisions. Would this hamper financial innovation? I don't think so. But it would certainly be a strong safeguard against excessive risk-taking and procyclical behaviour during financial booms.

More generally, any preventive measures that will be decided upon in the coming months should be guided by some simple principles. First, create incentives that strengthen, not weaken, the disciplining forces of competition. Second, do not try to draw up a list of measures that seemingly cover all possible states of nature but rather devise general rules that provide automatic stabilisers for the financial system. Third, do not forbid certain financial activities but signal to those who engage in intransparent financial activities, e.g. by moving activities off-balance sheet, that they will be held liable if the risks associated with these activities materialise.

You will have noticed the similarities with fiscal policies. The Stability and Growth Pact is designed to lengthen the time horizon of policy-makers, to create the room for automatic stabilisers to operate freely, to counteract the incentives for creative accounting and to sanction governments that do not abide by the rules. These building blocks should also be an important part of the new financial architecture, which could quite naturally be named a "Global Financial Stability Pact". Stability-oriented macroeconomic policies would be one cornerstone of this Pact, enhanced regulation would be the other.

5. Concluding remarks

Let me conclude on a positive note. There is strong agreement among governments throughout the world that the international financial system needs to undergo fundamental reform. A few days ago the G-20 Summit on Financial Markets and the World Economy agreed on a number of important orientations. If these orientations, after having been translated into concrete measures, fully reflect the key principles I have outlined in this speech, then I am convinced that the world economy will come significantly strengthened out of the current crisis. While history is full of episodes of learning and unlearning of key lessons of the past, there are numerous institutions around the world that have been designed so that the lessons of the past are not forgotten: I am proud that the European Central Bank is one of those institutions. You can also be assured that we at the ECB will continue boring you with these lessons on numerous occasions in the future. As Johann Wolfgang Goethe said, "Error repeats itself endlessly in deeds. Therefore, we must repeat the truth tirelessly in words."

I thank you for your attention and look forward to an interesting panel discussion.