Jürgen Stark: Economic and financial situation – where do we stand? (Speaking notes)

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the 2. Zeit Konferenz “Neue Architektur der Finanzwirtschaft“, Frankfurt am Main, 3 September 2009.

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- We have witnessed two years of severe financial distress, with adverse effects on the euro area and elsewhere. We have experienced the trough of global and euro area negative growth around the turn of 2008/2009. Recent data are increasingly encouraging. We have just been observing more and more signs of economic stabilisation. Looking ahead, economic activity is likely to recover gradually in the course of next year.
- But uncertainty remains high and incoming data on economic activity are likely to remain volatile. Concerns regarding the outlook for a recovery in 2010 mainly relate to renewed increases in international commodity prices, intensification of protectionist pressures and a disorderly correction of global imbalances.
- Regarding price developments, annual HICP inflation in the euro area has temporarily dropped into negative territory, but is expected to turn positive again in the remainder of this year and evolve in line with price stability. Deflation risk, if there were any, have disappeared. Inflation expectations remain in line with price stability. Monetary and credit developments confirm the assessment of low inflationary pressure over the medium term. We therefore consider risks to price stability broadly balanced and mainly relating to the outlook for economic activity, higher than expected oil prices, as well as higher than expected indirect taxation and administered prices.
- Since the beginning of the year, financial conditions have continued to improve gradually with corporate bond spreads, stock market volatility, money market term spreads and government bond spreads declining. Is this improvement genuine or is it due to policy measures by governments and central banks? If the latter was true this would be a classical case of moral hazard. These measures cannot be sustained for ever. In this sense, there is no room for complacency. There is rather the risk of a re-emergence of moral hazard once temporary measures by governments and central banks are perceived by financial market participants as permanent.
- Where do we stand with financial sector adjustment? Several estimates have been made, both by private and public sector institutions, of the potential losses to be absorbed by the financial system as a consequence of the crisis. Let me illustrate the situation with some key figures: for euro area financial institutions, we estimate the total losses over the period 2007-2010 to be around USD 650 bn. Write-downs on securities have so far amounted to over USD 200 billion. Banks have provisioned and written off over USD 150 bn of their loan exposure. Therefore we estimate further potential losses to be a little below USD 300 bn. Half of the losses worldwide are estimated to be borne by US banks, a quarter by euro area banks, and another quarter by banks located in Switzerland and the UK.
- If we want to re-establish economic and financial stability, we need to develop the lessons from the crisis. To this end it is important to recall what triggered the crisis. Low inflation rates and robust growth in the context of global imbalances, as well as abundant liquidity, were the main drivers at the macroeconomic level. At the level of the financial system it was regulatory arbitrage, deterioration in credit standards and increased reliance of banks to fund their assets in short-term markets.

- Thus, the crisis is a consequence of a combination of failures both in financial markets and on the part of regulatory authorities. Despite market failure having been one factor, we must not forget that market participants have simply behaved in line with the incentives provided by regulatory authorities. In this respect, improved regulation and oversight of financial markets will be crucial to ensure economic and financial stability. In particular, sound balance sheets, solid risk management and transparent and robust business models are key in strengthening the financial soundness of banks and their resilience to shocks. The first line of defence of financial stability is with market participants. To provide for the right incentives, market participants must be liable for their actions. This is an essential condition for sustainable economic growth and financial stability.
- At the same time, we need to develop the financial system further. To enhance transparency, we need to reduce the complexity of the financial system, institutions and products.
- The crisis has painfully shown that ensuring solvency of individual financial institutions does not ensure stability of the financial system as a whole. When funding markets shut down, both solvent and insolvent institutions are hit. Neglecting such wider systemic issues has been one of the glaring inefficiencies of prudential regulation. Too great an emphasis has been placed on micro-prudential rather than macro-prudential aspects. Initiatives are now being taken to close the gap that exists in this respect, especially in Europe, where cross-border supervision is still a challenge.

Where do we precisely stand today in improving regulation and oversight?

- At their meetings in November 2008 and April 2009, heads of states of the G20 countries have agreed on what are the most important challenges for improving regulation and oversight: (i) strengthening transparency and accountability, (ii) enhancing sound regulation, (iii) promoting integrity in financial markets, (iv) reinforcing international cooperation and (v) reforming the International Financial Institutions.
- Overall, improvements in accounting, capital regulation and macro-prudential supervision feature high on the agenda. The leaders of the G20 called on the IMF and FSB (Financial Stability Board) to produce guidelines on how national authorities can assess the systemic importance of financial institutions, markets, or instruments.
- Over the past months good progress has been made in the various areas and the momentum needs to be maintained to establish a sound regulatory framework. Work has been completed on a number of issues (e.g. enhancements of Basel II, as mentioned below) while other areas still need more consideration before they will be finalised by the end of 2009 or at the beginning of 2010.
- The Basel Committee on Banking Supervision (BCBS), which is the driving force regarding initiatives in the area of micro-prudential regulation, issued in July 2009 a final package with measures to improve the Basel II framework.
- On accounting the IASB (International Accounting Standards Board) is taking various initiatives and shows openness to collaboration with regulatory authorities. A couple of important projects are under way.
- But significant challenges remain. Again: International bodies and governments must not lose momentum in their efforts to strengthen financial regulation and supervision. All the aforementioned issues equally deserve due consideration and should be addressed as a matter of urgency.

The world economy after the crisis

The crisis is not over yet. However, it is worthwhile discussing some preliminary reflections about the world after the crisis.

- First, beyond these regulatory and supervisory challenges, a successful crisis resolution will also impinge on economic structures world wide. The global growth model of the last 15 years has failed. We have seen an exceptionally long period of strong growth in the world economy, but that growth was based on large and unsustainable global imbalances. For growth to be sustained, it must be more broadly balanced, both geographically and across economic sectors.

- Second, the current crisis may dampen economic growth in the future, reduce growth in the capital stock and thereby lead to a prolonged reduction in the level of output. The composition of output might change as well. I would not be surprised if the financial sector, the car industry and the construction sector were to shrink regionally. The economies that will be affected the most are those where the financial sector has expanded significantly in the last 20 years. Especially in those countries the financial sector will obviously have to become smaller, because it has decoupled too much from the real economy and because experience suggests that banks may have become too big to fail, too complex to be managed and even too big to be rescued.

- Third, the simple statement that "if banks are too big to fail, they are probably too big to exist" is a reasonable rule. In any case, for large banks the capital should increase more than they increase in size. The post-crisis financial system should be more risk-averse, less leveraged, less complex. The prevailing business model will probably place greater emphasis on traditional banking activities, which tend to produce lower margins, but are also more robust, less risky and less volatile. In this respect, the crisis may well turn out to be a catalyst for a paradigm shift, transforming the global financial landscape for the better.

- Fourth, the process of globalisation that we have experienced in recent decades has been driven by an increase in global trade following the integration of emerging market economies into the world economy and the liberalisation of financial markets. This high degree of global economic integration has also been a major factor in the global financial turmoil and the highly synchronised downturn that we have been experiencing. This experience must not lead to protectionism. Although protectionist measures may seem attractive in the short run, they will only exacerbate the downturn, delay the recovery and reduce income potential for everyone.

- Fifth, the government's role in the economy and the question of what should be left to the markets will be key. The crisis has given governments a more prominent role in the economy. Governments have become heavily involved in the banking sectors of a number of countries, and in some countries they have also taken on a significant role in other sectors, such as the car industry.

Summing up: Have the parties involved learnt their lesson?

- The swift action taken by governments to rescue the banking sector and stimulate the economy has been key in stabilising the financial system and the economy. But exit strategies from this support need to be developed and consistently implemented to contain moral hazard, to forestall a rise in long-term real interest rates and crowding out effects, and to insure sustainability of public finances. If this challenge is not met, the current crisis is bound to be exacerbated by a sovereign debt crisis.

- In the area of regulation a broad set of measures is under way and considerable progress has been made. But as signs of stabilisation in the financial system and the economy are emerging, reform appetite is waning and there is a risk of missing the opportunity of a paradigm shift in the financial system.

- Especially as the crisis intensified, central banks took immediate and unprecedented action by lowering rates to historically low levels and providing ample liquidity.
- Keeping interest rates too low for too long may well lay the basis for new imbalances and instability. Central banks need to prepare for credible strategies to phase out their support and stand ready to prepare financial markets when they come to unwind their credit support measures.
- In academic circles the financial crisis has revived the debate whether central banks, in the conduct of monetary policy, should pay more attention to financial variables, and specifically, whether inflation targeting strategies do not focus too narrowly on economic developments alone. Relative to this the ECB's monetary policy strategy has proved to be robust. The monetary pillar provides for discipline not to ignore risks to price stability stemming from imbalances in money and credit developments.
- Initiatives are now being taken to close the gap in the area of cross-border supervision and between micro- and macro prudential supervision. The envisaged establishment of the European Systemic Risk Board (ESRB) which the ECB will support analytically and logistically marks an important step in this direction. The ESRB will monitor systemic risk and provide risk warnings and recommendations. Effective cooperation and leadership at the European level will be crucial to make the ESRB successful in the pursuit of its mandate.
- Is the current improvement in some financial market segments genuine or driven by governments and central banks? When the crisis took hold and risk aversion spread, leading to de-leveraging and a sharp decline in securitisation public attention focused on executive pay as an area for regulation. In fact improving corporate governance remains a key area for regulation. Bonus systems need to be changed so as to make managers liable for their decisions and provide them with the right incentives to focus on longer-term sustainability of their business models rather than short-term profit.
- But corporate governance is just one area where regulation needs to be improved. As just discussed significant challenges remain in establishing capital requirements that are sufficient for the financial system to withstand adverse shocks, in improving the accounting framework, in developing leverage ratios, and, finally, in closing the gaps that exist in the area of macroprudential and cross-border supervision. Notwithstanding the current economic and financial stabilisation the momentum needs to be maintained to move towards a sound regulatory framework.