# Andreas Dombret: Securing financial stability – the contribution of economic policy

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the New Year's Reception of Deutsches Aktieninstitut, Brussels, 27 January 2011.

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## 1. Introduction

Ladies and gentlemen,

Thank you for inviting me to your New Year's reception here in Brussels – the capital of Europe. It is a pleasure for me to speak to you today. The turn of the year lends itself to looking back and reflecting on the past year as well as to looking ahead to the new year. In this spirit I will start my speech with an overview of the economy in 2010 and the outlook for 2011 before addressing the issues of financial market regulation and the current debt crisis. I consciously refrain from calling the current debt crisis "European" since the strong accumulation of public debt is far from being a purely European problem – however, being in Brussels, I will, of course, conclude with some remarks on the necessary measures in the euro area.

## 2. The economy in 2010 and 2011

Economically the year 2010 brought a turn for the better. The world economy picked up considerably and the German economy in particular made an unexpectedly strong recovery from the stresses and strains of the financial crisis. Growth expectations from the beginning of 2010 were clearly outperformed during the course of the year. With GDP growth at 3.6%, Germany was able to make up a good portion of the 4.7% slump of 2009. In the process, Germany profited significantly from the rapid recovery of the global economy and global trade. However, more recently, domestic demand – which had already been an important stabilising factor at the height of the crisis – has gained momentum as well. The resilience of the German economy during the crisis in the face of an extraordinarily severe negative shock is, not least, the reward of major reforms that were undertaken in the first half of the last decade. Particularly the increased flexibility on the labour market helped Germany to come through the crisis in an acceptable shape, and not only stabilised private consumption but also allowed enterprises a smooth handling of the surprisingly vigorous increase in demand in the upturn.

However, not all countries of the euro area have weathered the crisis so successfully. Indeed, the spectrum of economic performance has been rather mixed. The euro area has seen heterogeneity in growth rates before, but now parts are reversed, as Germany currently occupies the role of growth motor in the euro area. These differences within the union should not be dismissed as purely cyclical: they are a consequence of the structural adaptation crisis affecting several countries of the periphery. When one considers the difficulties these countries are currently facing as well as the possible consequences for the euro area as a whole, it becomes evident that the outlook for 2011 and beyond depends on drawing the correct conclusions from the crisis and, from there, taking the right decisions. The expectation at the moment is that the global recovery will continue in 2011, albeit at a slower pace than in the past year. Under this assumption, the Bundesbank in its December Monthly Report forecast GDP in Germany to grow at a rate of 2% in 2011 and 1.5% the year after. This means that the pre-crisis level of production would be reached at the end of 2011, and production would be back to full capacity at about the same time. Indicators that have been released since then support the picture of an ongoing recovery and have even tended to surprise to the upside.

Developments on the capital markets during the past year were affected by the loss of confidence that emerged during the course of the debt crisis. The initial uncertainty of market participants about the economic course of major industrialised countries as well as the uncertainty about the capability of several states to service their huge accumulated debt manifested themselves in highly volatile stock prices. Even so, financing costs for enterprises were only moderately affected. Compared to their five-year average, they actually decreased. Stock market developments, however, were rather diverse among industrialised countries. While the Japanese Nikkei ended the year with a loss of 3%, the American S&P 500 and the German CDAX recorded increases of 13% and 14% respectively. Even their optimism only gained the upper hand during the course of the second half of the year – at the same time as the economic outlook brightened.

## 3. Financial market regulation

The crisis has clearly demonstrated the need for stricter financial market regulation, especially as the financial sector was at the heart of the crisis. Safeguarding financial stability has therefore rightly been a top priority on the policy agenda. The G20 agenda and the summit in Seoul in November testify to the global dimension of the task of financial market regulation. A number of crucial reform measures designed to secure financial stability have already been approved or at least got underway in the past year. The increase in capital requirements in quantity and quality, commonly termed “Basel III”, is the most prominent achievement. The tightened requirements comprise a significant increase in minimum capital requirements, which will be introduced in stages over a sufficiently long transition period from 2013 to 2015, and the introduction of an extra buffer, which will be phased in from 2016 to 2018. These measures are intended to enable financial institutions to better cope with possible losses themselves and thus lower the probability of an institution becoming insolvent – which can be viewed as a first line of defence.

Measures that target systemic risk comprise a second line of defence that will come into play if the first line is broken and an institution becomes insolvent. In this regard, the Financial Stability Board (FSB) currently develops strong regulatory and supervisory policies in the interests of financial stability. On a national level, Germany has recently passed a law on the restructuring of insolvent financial institutions. This is certainly a welcome step, although, as in other areas of regulation, national restructuring mechanisms will only be fully effective if they are mutually compatible, ie if the approach for their implementation is internationally coordinated. On an institutional level, the European Union recently established the European Systemic Risk Board (ESRB) – which began work last week – to conduct macroprudential analysis and monitoring that aims to detect systemic risks at an early stage.

Other measures to address systemic risk are currently being developed and will accompany us throughout 2011 as they require either further discussion or at least ratification. As systemic risk is a complex area, the issue requires a multi-faceted approach. This includes the question of how exactly to deal with institutions that are “too big to fail” or the improvement of corporate governance, eg via the implementation of the FSB’s international compensation standards. Further topics discussed with regard to increasing the transparency of financial market operations are the mandatory registration of institutions that currently operate in the shadow banking system as well as the standardisation of contracts and handling of derivatives. Regulation of the core area of the crisis will keep this year’s agenda busy.

## 4. Public debt crisis

However, in spite of all the progress that has been made with respect to economic recovery and regulatory reform, the year 2010 will be remembered most for the public debt crisis in the euro area which marked the beginning of the third phase of the crisis. During the course of the financial and economic crisis, many countries had accumulated a large amount of debt via guarantees or costly fiscal policy measures that had been implemented to prevent vital markets from collapsing during the financial and economic turmoil, in particular after the Lehman insolvency. However, this was the case in most member states, and so the reasons why only some of them suffered a serious loss of market participants' confidence in their capacity to bear the debt burden lie further in the past: In these countries, fiscal and economic policy omissions in the years before the crisis led to an accumulation of explicit or implicit liabilities in the state's budget and a significant loss of competitiveness. Consequently, the driving forces behind the increase in perceived sovereign risk were not speculative forces on the financial markets but poor fundamentals.

When the loss of confidence culminated for the first time in May, comprehensive support measures for Greece – where the situation was particularly dire – were taken to avoid risks for the stability of the euro area as a whole. Financial support was tied to a tough, closely monitored adjustment programme aimed at restoring the sustainability of public finances in Greece. In addition, a rescue scheme financed by the IMF, the European Union and its member states was set up to deal with future intensifications of the crisis. Again, financial support is granted only if a member state undergoes a tough adjustment programme that secures public solvency. This conditionality is crucial: Financial support can buy some time, but confidence in the sustainability of public finances will only return if substantial structural improvements in the respective countries – be it in Greece or in Ireland, which called for support from the EFSF, EFSM and IMF in November after the fiscal burdens related to supporting its oversized financial sector became overwhelming.

For the financial system's future stability and effectiveness, it is indispensable to ensure that confidence in the stability of public finances remains intact. To achieve this, not only a credible consolidation of public finances is needed but also improvements in economic governance in EMU that ensure prudent fiscal policies in the medium to long run. Against this background, the current discussion about – and even calls for – euro bonds must be viewed critically. Euro bonds would render all euro-area countries jointly and severally liable, thereby eroding each state's own fiscal responsibility. The incentive for consolidating public finances would be reduced, along with the credibility of and confidence in the state's ability to service its debt – which is certainly the opposite of what is needed.

## 5. Conclusion

Ladies and gentlemen, although the financial sector has been at the heart of the crisis, the third phase of the current crisis, which emerged in 2010, clearly demonstrated the importance of sound economic and financial policy, as confidence in a state's solvency also plays a substantial role in securing financial stability. For the time being, the euro area has the necessary measures to deal with the debt crisis at its disposal. I hope that this speech has highlighted the clear necessity of

- a swift and ambitious budgetary consolidation in order to restore confidence in public finances,
- strengthening the Stability and Growth Pact in order to prevent states from manoeuvring into destabilising situations that can cause a crisis,
- a surveillance and early warning mechanism in order to have the ability to take counter measures at an early stage if necessary,

- a crisis resolution mechanism that permits the euro area to deal with a country in crisis without undermining the no-bail-out principle and hence the incentives for responsible, stability-oriented fiscal policies, and the necessity of
- implementing a national “debt brake” to keep budgets in balance once they are consolidated.

The crisis has painfully demonstrated several weaknesses in the regulatory system and imperfections in our economic and fiscal policies. If we manage to improve the regulatory framework for the financial system and maintain well-disciplined government budgets, we will be in a good position to ensure financial stability in the future. This is the important task we must address in 2011.

Ladies and gentlemen, Europe is more than just economy and currency. Based on its tradition, culture and diversity, Europe is currently on its way to a new unity. We are all called on to help achieve this goal. There are many problems lying ahead of us. However, with courage, openness and honesty we can overcome these problems.

I wish you personally health and happiness for 2011 and I wish Europe, in particular, continuing success. It is worth working for.

Thank you very much for your attention.