# Andreas Dombret: Sino-German Financial Stability Forum – concluding remarks

Concluding remarks by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Sino-German High Level Workshop, Frankfurt am Main, 11 July 2011.

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Dear Mr YI Gang, dear guests, after a long day of intensive discussion, concluding remarks should be short. So let me only briefly point to some consensus and challenges ahead.

Despite different stages of development of both countries, the discussion at the workshop has shown a broad consensus on the importance of price stability as the primary objective of monetary policy, that fiscal stability is not only a prerequisite for a balanced and sustained economic growth but also for national and global financial stability and that a sound and a stable banking system is the first line of defense against financial crisis.

But the discussion has also highlighted and underlined important challenges ahead. I will briefly go through some of these challenges and structure my further remarks by the main surprises during the financial crisis:

- The dynamic of contagions and market dynamics,
- the spillovers into the real economy and
- the vulnerability of countries.

Turning to the ***first point***, the financial crisis has shown an unexpected strong and fast transmission of the US sectoral financial shock around the globe. Despite the fact that significant progress has been achieved to measure and identify risk exposures of globally acting banks and the shadow banking system, for example, by enhanced network analysis, important challenges remain. Beyond an intensified monitoring of these risk exposures on this more microprudential level, global monitoring of capital flows and changing financial transmission channels of external shocks have to be enhanced. Moreover, we should not only focus our monitoring on the ups and downs of exchange rates, interest rates and CDS, but even more on the underlying reasons for these movements. Therefore, an extended monitoring should also have a close eye on the significant structural changes of the financial markets and systems, which build the most important base for different response patterns to financial crises across time and countries.

In my view, it might also be fruitful to intensify the discussion about an appropriate assignment of roles in this regard on a global, regional and national level. There are no doubts that the IMF has a significant comparative advantage on the global level, due to its broad country coverage. The IMF should use this potential in an intensified bottom-up and top-down approach in collecting relevant data and information and using this kind of information for enhanced in-depth analysis – in close cooperation with the BIS. The European Systemic Risk Board and the Asian+3 Macroeconomic Research Office with a Chinese official as a first head of this office will play a significant role on the regional level. And of course, the national monitoring and assessment of risks by the People’s Bank of China and the Deutsche Bundesbank in their own countries remain the first and most important pool of information on financial stability.

This broad variety of institutions in evaluating financial stability raises the question, whether and to what extent there is a necessity for international cooperation in the communication of these assessments. Two different aspects have to be balanced in future discussions: Conflicting views and comments could confuse markets more than contribute to its stabilization. On the other hand, it is important to guarantee independent analysis and communication in financial stability.

The ***second*** challenge I would like to highlight, is the unexpected strength of spillovers into the real economy around the globe. Nearly all international financial institutions and national research institutes underestimated the dampening effects of the financial crisis on the real economy. I support all efforts which are focused on a better capturing of financial structural changes in macroeconomic models. Some commentators are rightly pointing to the fact that textbooks and models are lagging behind reality. But it appears that the distance has become too large.

Moreover, in further developing macro-stress tests we currently need to incorporate these financial changes. Only some years ago, macro-stress tests were pre-dominantly focused on real shocks and its impacts on the stability of the banking system, while now most shocks have been stemming from the financial sector.

My ***third*** brief remark is focused on the unexpected and high vulnerability of countries. This has been also true for those countries with a stable and sound macroeconomic framework. If macrostability is an important necessary condition, but not sufficient to weather the initial financial shock, what then should be the appropriate response to this experience? How could we enhance the protection against these shocks? This is still a quite open question.

In my view, we should put our focus more on effective prevention than on building safety nets, which is more an element of crisis management than of prevention and could enhance excessive risk taking and moral hazard. The more the risks of individual decisions in the financial sector are backed by the state or global safety nets, the higher is the probability of a misallocation of financial resources by individual investors. We need just the opposite, a greater sensitivity of the individual manager to financial risks, to bring financial markets back to its important role of being an efficient judge and jury of misguided macropolicy. Since political mechanisms failed to be this kind of an effective mechanism of sanctions – the Stability and Growth Pact is only one example – then it is even more important to strengthen market disciplining forces.

Again, what we need first are in-depth analysis on the underlying reasons of significantly changing transmission mechanism which effect even countries with sound and stable macroeconomic frameworks. The IMF in close cooperation with other relevant financial institutions can play an important role also in this regard. The so called "Issing Committee" – advising the German Government on financial stability issues – has pointed to the necessity to build up a global risk map, which would be an important element of an extended global monitoring by the IMF and other relevant institutions. Professor Issing, former member of the executive board of the European Central Bank is heading this Committee and we feel much honored that he has accepted our invitation to present an overview of the recommendations of this Committee this evening.

But let me first hand over to Mr YI Gang and his concluding remarks with the perspective of the People's Bank of China.