

## **Axel A Weber: International risk sharing and global imbalances**

Concluding remarks by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Bundesbank Spring Conference on “International Risk Sharing and Global Imbalances”, Eltville, Germany, 28 May 2010.

\* \* \*

### **1. Introduction**

Ladies and gentlemen,

Before this spring conference on “International Risk Sharing and Global Imbalances” comes to an end, I would like to thank you for your contributions, your interesting papers and your enlightening discussions. For me as a central banker and a former academic, the conference was highly stimulating. The topic of the conference was well chosen, as there is a continuing debate on the role of global imbalances and international financial integration as an amplifier or even a cause of the current financial crisis.

There is no doubt that the degree of international financial integration has determined the size of the crisis and the speed with which it has spread. The quick spillover of the financial turmoil from the US housing market, where it started in the summer of 2007, to financial markets all over the world and the fact that virtually all industrialised countries have been affected are unprecedented. A more subtle question is the extent to which financial integration and global imbalances contributed to its emergence. However, this question cannot be addressed without looking at deficiencies in the structure of the financial market such as developments in the risk transfer process and regulatory failure, which have been rightly identified as the major causes of the financial crisis. Let me therefore first address the interdependencies between financial market integration, global imbalances and the financial crisis. Thereafter, I will briefly comment on the global reform process, which is under way.

### **2. Global imbalances in the light of the financial crisis**

Opinions differ greatly on the extent to which global imbalances have contributed to the financial crisis. Whereas some economists believe that the imbalances are not closely linked to the financial crisis, others argue that they have been one of its main causes. These are both extreme positions and, as is often the case, the truth may lie somewhere in-between. The line of argument put forward by Obstfeld and Rogoff is fairly convincing, namely that global imbalances and the financial crisis have common causes and that international financial integration was an important factor contributing to the build-up of global imbalances. It is these causes, not the resulting current account positions, that we should focus on.

Of course, without the integrated financial system, deficit countries would not have been able to maintain the persistently high private and public spending we observed in the decades before the financial crisis. By implication, export-oriented countries accumulated unprecedented amounts of wealth abroad, even though the underlying mechanisms were quite different. Naturally, in this global setting, financial innovation went hand in hand with the transfer of huge amounts of funds from surplus to deficit countries. It is important to note that the emergence of current account deficits and surpluses is not bad per se. For an economy with an ageing population, for example, current account surpluses and the associated accumulation of net foreign wealth might well be a reasonable and efficient market outcome as its consumption rate is expected to grow in the future. As long as the global distribution of production and consumption reflects undistorted saving and investment decisions that put capital to the most productive use, it contributes to global growth and prosperity. In the same vein, financial innovation generally has positive effects, as it provides access to high-yield investment projects and thereby allows better risk sharing and lifecycle consumption smoothing.

However, we know that in reality both processes have not always functioned that well. The undervaluation of exchange rates due to fixed exchange-rate regimes in some emerging market economies as well as the false perception of wealth which accompanied the emergence of asset price bubbles have distorted the global distribution of production and consumption and caused a build-up of global imbalances. In addition, the financial crisis has revealed serious deficiencies in the process of financial innovation and international risk sharing, which were not only harmful and inefficient per se but also further promoted the build-up of global imbalances. Instead of reducing risk and increasing transparency, the process of global capital transfer via highly structured products encouraged savers to accumulate more risk than they were aware of and than they could afford, which in turn reduced borrowers' discipline rather than ensuring it. The paper by Mendoza and his co-author "Financial Innovation, the Discovery of Risk and the US Credit Crisis" presented at this conference sheds light on the underlying mechanism by which insufficient knowledge about the true riskiness of the financial environment – which was, as we know today, the rule rather than the exception in the years preceding the financial crisis – can lead to a period of over-optimism in the financial markets. In this situation, investors are inclined to underestimate the deterioration of economic fundamentals and to over-borrow. The following readjustment, by contrast, may cause a credit crunch, a surge in private savings and therefore a collapse in consumption.

In the course of the crisis, many of these effects along with a serious economic downturn could be observed in most industrialised countries. Moreover, global trade declined dramatically when the financial crisis spread to the real economy, a development which also hit the previously fairly unaffected emerging market economies. Overall, the extent and the depth of the recent crisis have raised awareness that the ongoing global integration of financial markets and economic activities increases the vulnerability of the whole system despite the unquestionable positive effects with which it is associated. With the stabilisation of the markets and the incipient recovery, the focus has therefore shifted from managing the current crisis to preventing future crises. Given the international dimension of the crisis, this process is rightly taking place at the international level. In the following, I would like to outline the main elements of the reform process initiated by the G20 in order to create a more stable financial system.

### **3. Elements of the regulatory reform process**

A cornerstone of the attempt to create a more stable financial system is the reform of banking regulation. Thereby we should begin with the individual bank – that is, on the microprudential level of regulation. The relevant regulatory framework on this level are the Basel II rules, which have been implemented by a large number of countries. As the crisis revealed some shortcomings of the Basel II framework, the G20 commissioned the Financial Stability Board and the Basel Committee on Banking Supervision to work towards a reform of the current rules. A first set of relevant measures was published in the summer of 2009 as a direct reaction to the subprime crisis. Among others, these measures include stricter capital requirements for market risk and securitisation as well as heightened risk management requirements. Additional proposals were put forward in December 2009. Aiming at enhancing the resilience of the banking sector, these proposals include a new liquidity standard as well as a revised definition of capital, which should increase its quality, consistency and transparency. Apart from that, the introduction of countercyclical capital buffers should help to mitigate procyclicality. Furthermore, the introduction of a leverage ratio is planned to alleviate a problem which is addressed in another paper presented at this conference. Tille and his co-authors highlight the danger which highly leveraged institutions present for financial and macroeconomic stability in their paper "Rational Risk Panics". Throughout 2010, the proposed measures will be calibrated on the basis of an extensive quantitative impact study. The fully calibrated set of measures will then be issued by the end of 2010 and

the new standards will be phased in by the end of 2012 provided that economic recovery is assured.

Although the envisaged reforms will strengthen the existing rules, they will not change their underlying principles. In essence, the Basel II framework seeks to limit banks' risk-taking behaviour by making it more expensive and thus less attractive. Against this backdrop, recent proposals to prohibit certain risky activities altogether pursue a more radical course. One fundamental problem of such an approach is that the complete prohibition of certain activities is a very far-reaching market intervention, especially since these activities do not necessarily have zero economic value-added. Contrary to the Basel II approach, the penalty imposed on risky activities would become infinite. Thus, given the inherent trade-off between the efficiency costs of intervention and its benefits, a reformed Basel II framework might provide a more balanced solution. This is also the case with regard to the introduction of an additional tax for the banking sector. Even though such a tax could be useful in recouping some of the costs of the crisis, it is an inferior instrument in terms of internalising the effects of risky activities on financial stability. Hence, the reform of the Basel II framework is rightly given preference by regulators and should be implemented with priority by policymakers.

Regardless of its actual design, the general objective of regulation on the microprudential level is to have a first line of defence by reducing the likelihood of individual bank failures. However, given our globalised and interconnected world and the interdependence of financial institutions and markets, even the failure of a single institution might lead to systemic disruptions. Thus, it is necessary to complement a strengthened microprudential regulation with a macroprudential stance which as a second line of defence takes into account the stability of the financial system as a whole. One major aspect of macroprudential regulation would be the treatment of systemically important financial institutions. Although the revised Basel II framework is part of a solution to this problem, broader reforms are necessary. These might include capital surcharges for systemically important institutions, better resolution regimes as well as a stronger market infrastructure.

On the whole, the G20 agenda is a very ambitious endeavour to strengthen the resilience of the financial system. Many of the regulations I have mentioned are highly complex, and the right calibration is very important. Therefore, economic research plays a crucial role in ensuring the success of the initiated reforms. This is particularly true of the design of procyclical capital buffers and surcharges for systemically important financial institutions. But of course there are many other very interesting strands of research, some of which have been covered at this conference. Quite a few papers aim, for example, to create a deeper understanding of systemic risk and contagion mechanisms, which are surely key issues when it comes to dealing with future crises. In their paper "Structural Estimation of Systemic Risk: Measuring Contagion in the Sub-Prime Crisis", Rigobon and his co-authors have developed a measure of international contagion which allows us to assess the role of systemic risk for the global economy.

#### **4. Conclusion**

Ladies and gentlemen

Addressing the broader context of global developments which have contributed to the financial crisis and in particular the role which global imbalances have played, you have dealt with an interesting but also very complex issue at this conference. This question is far from being resolved, and I am sure that it will occupy researchers for quite some time to come. That is not less the case for those strands of research that deal with how to strengthen the financial system. Seen in this light, times have seldom been as exciting for economic research as they are right now. I would like to encourage you to continue with your work and wish you much success.

Thank you for your attention.