Axel A Weber: Growth prospects after the crisis

Speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the 21st European Business School (EBS) Symposium, Oestrich-Winkel, 17 September 2010.

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1. Introduction

Professor Jahns,
Ladies and gentlemen,

I am delighted to have been asked to assume the patronage of the 21st EBS Symposium and thus to have the opportunity to speak to you today. Occasions like this which provide a platform for students to meet professionals are an agreeable complement to academic study. This symposium has traditionally been organised by first-year students who, I must say, appear to have done very well in performing their task.

2. Growth and the financial system – some general remarks

The topic of this year's symposium is "Growth – A Future Without Boundaries". Economic growth is widely associated or even equated with prosperity, and in light of the current crisis the topic is receiving a lot of attention: After all, the crisis not only resulted in the most pronounced downturn since World War II, for many it also cast doubt on the path of economic activity once the crisis is over. Nevertheless, if we wish to make a sound and comprehensive judgement it is not advisable to look only at current gross domestic product (GDP). Economic growth is a concept that embraces a longer-term perspective and we would be well advised to look beyond the current crisis. The concept of potential output permits a calm and objective view of the matter. Abstracting from cyclical fluctuations, it covers the medium to long-term trend of GDP and links it to the driving factors for such a time horizon.

To be more specific and to focus our minds on the lasting economic impact of the crisis, it helps to take a simple textbook model of economic growth as a starting point. In this stylised model, growth is determined by three factors: capital, labour and technical progress. How are these three factors, in turn, affected by the financial system? The first factor – capital – points perhaps most obviously to the importance of the financial system. After all, the financial sector is not only a part of the economy with a distinct value added, it also plays a crucial role in capital accumulation. However, especially in highly developed economies that typically boast sizeable and sophisticated financial sectors, the role of the financial system goes far beyond that of mere capital accumulation. In such economies, the financial system plays a key role in identifying and funding innovations, thus helping to advance the state of technical knowledge and promoting technological progress. For these reasons – and leaving aside additional effects due to the labour force and investment in human capital – an efficient financial system is indispensable for growth and necessarily becomes more complex with each advancing stage of economic development.

In a sense, even the crisis with its massive repercussions for the real economy and its enormous costs illustrates how important the financial system and its stability are for economic performance and welfare. Consequently, financial stability has become a top priority on the global policy agenda. But stability is not an end in itself. Historical record tells us that financial crises have always been an element of market economies. Therefore, the objective should not be to avoid them entirely but rather to contain their consequences. Put differently, the challenge for regulatory reforms is to strike the right balance between the stability of the financial system and its efficiency. And, given the experience of the past few years as well as the channels through which the financial system affects economic growth, the two objectives are, to a significant degree, complementary. This means that the trade-off between stability and efficiency should not be seen as a zero-sum game. Well-designed regulatory reform should make the financial system more stable without cutting into sustainable growth.

3. The crisis, regulatory reform and future growth

The strength and scale of the financial crisis were unforeseeable. There had been warnings about various exaggerations and undesirable developments. But perceptions of where these might lead fell well short of the reality when it actually materialised. Prior to the crisis, the global economy had been growing at a rapid pace. This was due, not least, to the fact that emerging markets were becoming increasingly integrated. This set free a large labour potential, provided high-yielding investment opportunities, and led to significant growth in per capita income. Another driving factor behind growth was less benign, however. In too many areas, capital was not always channelled into the most productive areas. Consider the housing market in some advanced economies as a point in case. An environment in which interest rates were exceptionally low as well as loopholes and weaknesses in the regulatory framework acted as catalysts for these undesirable and, ultimately, unsustainable developments. Eventually, the underlying imbalances erupted and suddenly came to the surface – with the well-known costs. The situation in which the global economy found itself was comparable to a rose bush that had sprouted too many new buds too quickly. The new rosebuds had many attractive blossoms but as soon as it started to rain, most of them had no support and broke off.

Against this background, what are the deficiencies of the financial system that have to be remedied? At the microeconomic level, a whole cocktail of different factors led to the financial crisis. These included a general lack of transparency, insufficient capital buffers, the development of a scarcely regulated shadow banking system, and moral hazard in various forms – owing to ill-designed remuneration schemes, for example, or insufficient risk and liquidity management at the level of individual institutions. At the macroeconomic level, in particular, the pivotal role of certain agents and their influence on financial markets – in other words, their systematic importance – was underestimated for too long.

In order to prevent the rose bush from sprouting too many weak buds and blossoms again, reforms at both the micro and macro levels are needed to make the financial system more resilient to future shocks. As a first line of defence, the microprudential level of regulation needs to be strengthened. The measures that have been proposed include higher capital and liquidity requirements. These are intended to lower the probability of an institution's insolvency by enabling it to cope better with losses. Proposals for reform were published by the Basel Committee on Banking Supervision (BCBS) in December 2009. The discussion is well advanced. A final proposal was adopted last weekend, and the G20 meeting in November will yield a final decision. As a result, financial institutions will be requested to hold not only a higher quantity of capital in their books but also capital of increased quality: minimum core capital requirements will go up from 2% to 4.5%, for Tier 1 capital from the current 4% to 6%. This will be supplemented by an additional buffer of 2.5% built up of common equity. This is designed to enable banks to absorb losses during periods of economic and financial disruptions. Furthermore, a stricter definition of core capital will be applied.

Yet, this first line of defence needs to be supplemented. In a market-based economy it is neither possible nor desirable to entirely prevent the failure of individual enterprises. Thus, a second line of defence has to be drawn at the macroprudential level of regulation in order to contain the impact of individual bank failures on the financial system as a whole and to make the financial system more transparent. This part of the reform process is being dealt with by the FSB. Major topics on its agenda are the handling of systemically important financial institutions and the "too-big-too-fail" problem, resolution regimes, the role of rating agencies, harmonising accounting standards, and rolling back trading in OTC derivatives. Even though these issues seem to have attracted less attention than Basel III, I am confident that we shall see significant progress in this area by the time of the G20 meeting in November as well.

Once implemented, the reforms at the microprudential and the macroprudential levels will have a profound impact on the financial system, increasing its resilience and hence its stability significantly. But, going back to what I said earlier, do the reforms also strike the right balance between stability and growth? I am certain they do. True, the development of the new Basel III proposals has been accompanied by concerns that such tighter regulation might have a negative impact on economic performance by severely restricting access to credit. Several studies on the potential effects of the new regulatory requirements on the economy have been published recently. A comprehensive cost-benefit analysis has revealed that such fears of a significant negative impact on growth are unfounded. This is all the more the case given that there will be the transition period before the new requirements enter fully into force, which will give banks sufficient time to strengthen their capital base.

This favourable overall assessment of the macroeconomic impact of well-designed regulatory reform highlights the fact that there is no inherent conflict between the G20 agenda's objectives of a more stable financial system and of ensuring strong and sustainable growth. And, in terms of the general future outlook for growth, we should bear in mind that the financial crisis has not impaired major drivers of growth. Emerging markets, for instance, will still make great efforts to catch up, and technical progress will continue. Thus, the crisis certainly does not mark the end of economic growth. Rather, what it *has* done is highlight the importance of *sustainable* growth and the need for supportive policies – in financial regulation, but also in many other policy areas.

4. Conclusion

Ladies and gentlemen, the events and implications of the current financial crisis have clearly demonstrated how vulnerable our financial system has been. The necessity of reform cannot be denied, financial stability has to and will be reinforced. However, as said earlier, enhancing financial stability is not an end in itself nor is it an obstacle to growth. Rather, it is a major prerequisite. Regulatory reform along the lines currently proposed lowers the probability of crises occurring as well as their impact, but does not unduly hamper access to funding for consumers and firms. The outcome will be a significant improvement in welfare in the long run.

Thank you for your attention.