Axel A Weber: Strong, sustainable and balanced growth – the contribution of financial market regulation

Speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the 11th WHU New Year's Conference, Vallendar, Rhineland-Palatinate, 14 January 2011.

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1. Introduction

Ladies and gentlemen

Thank you for the invitation to be keynote speaker at your 11th New Year's Conference. It is a pleasure to be here once again. The beginning of a new year lends itself to looking back and reflecting on the past year which turned out satisfactory – all the more so as the economic outlook has brightened considerably.

This is not just true for Germany but also for the euro area in general. Hence, even though for the euro area risks for the economic outlook are still tilted slightly to the downside, the recovery should continue. Against this background, the recent increase of inflation in the euro area above 2% has attracted some attention. Whilst this is largely the result of short-term upward pressure on prices, mainly owing to energy prices, inflationary pressures over the policy-relevant medium term are expected to remain contained and in line with price stability. Therefore, the Governing Council yesterday confirmed that the current key interest rates still remain appropriate. Nevertheless, risks to the medium term outlook for inflation which are so far still broadly balanced could well move to the upside. Thus, price developments have to be monitored very closely.

In spite of the favourable economic outlook, the financial and economic crisis is not over yet, and even though Germany fared much better during the crisis than many other advanced economies, the welfare losses have been huge. Thus, one of our top concerns must be to ensure that measures are taken to prevent the occurrence of another crisis of this scale. But first, I would like to address the issue of regulatory reform on financial markets. So let us take a look back and cast a look at the interlinkages between the real economy and the financial system and at how the crisis originated.

2. The financial system – driver of growth, but also the origin of the worst crisis in the post-war period

The state of the real economy and economic well-being are usually measured in terms of economic growth. As you will probably recall from your macroeconomic courses, simple textbook models basically identify three determining factors of economic growth: capital, labour and technological progress. Of those three, the one most obviously affected by the financial sphere is the first – capital. Considered on its own, the financial sector not only plays a crucial role in capital accumulation but is also a part of the economy with a distinct value added that contributes to an economy's growth. Beyond that, however, the financial system performs another very important task with regard to economic growth: it not only funds innovations but also helps in identifying them. The financial system therefore helps to further the state of know-how and promotes technological progress. Sound economic growth relies upon an efficient financial system. With each advancing stage of economic development, the financial system also refines and increases its complexity together with advancements in the real economy.

The massive repercussions and enormous costs for the real economy during the current crisis have demonstrated impressively how important financial stability is for economic performance and welfare: The second phase of the crisis, that is after the Lehman Brothers

insolvency in September 2008, not only marked the point of conversion to a systemic crisis, causing transactions on the interbank market to virtually ground to a halt, stock prices to plummet and investors to flee to the safety of government bonds. The disruptions of the financial system were also passed on to the real economy. Financing conditions for enterprises and households tightened, and as consumers and firms feared what was still to come, expectations in the private sector as well as the outlook for the world economy deteriorated sharply. As a result, manufacturing and trade were at the heart of the crisis and suffered globally, and particularly in the advanced economies, output dropped at rates hitherto unseen in the post-war period.

Financial stability has therefore rightly become a top priority on the policy agenda, and the increasing role of the G20 testifies to the global dimension of this task. Yet the objective is not to avoid financial crises completely. Historically, these crises have occurred regularly over time and can be viewed as an element of market economies. In this context, attempts to increase financial market stability should therefore not be understood as an attempt to avoid crises altogether, but as an attempt to increase the system's resilience and, by doing so, to limit the dire consequences.

The usual fear is that stricter regulation may introduce additional frictions and hamper economic growth. The challenge policy makers face when reforming the regulatory framework of financial markets lies in striking the right balance between the stability of the financial system and its efficiency. Luckily, both intentions are to a significant degree complementary, and the context is not that of a zero-sum game. Well-designed regulatory reform can make the financial system more stable without cutting into sustainable growth. In order to construct regulation wisely, it is first necessary to understand the underlying reasons for the current crisis. Otherwise regulation runs the risk of curing the symptoms but not the cause.

Prior to the crisis, the global economy grew at a rapid pace. The integration of rapidly catching-up emerging markets contributed largely to this significant upturn. The labour potential, that is the number of people who are readily available to the labour market, increased greatly in these economies and they presented plenty of high-yielding investment opportunities. Both led to a significant growth in per capita income. However, the phase before the crisis was also characterised by extremely favourable financing conditions and a high propensity to take risks. As a result, capital was not always channelled into its most productive use, and in various countries this fostered an unsustainable asset price increase that led to high private-sector debt and excess domestic demand; the housing markets in several advanced economies are a prominent example. These undesirable developments were further encouraged by loopholes and weaknesses in the regulatory framework. Eventually, the underlying imbalances erupted and came to the surface; we still have to deal with those consequences.

The deficiencies of the financial system that reinforced the unhealthy development were many and encompassed the microeconomic as well as the macroeconomic level. On the microeconomic level the factors that led to the financial crisis were a lack of transparency, insufficient capital buffers, the unhampered development of a scarcely regulated shadow banking system and moral hazard, for example in the form of ill-designed remuneration schemes or an insufficient risk and liquidity management at the level of individual institutions, to name but a few. Furthermore, the systematic importance of certain agents, ie their crucial role they played for whole financial market segments, had been underestimated for too long.

3. Regulatory reform as a lesson to be learned from the crisis

Where the causes are multilayered, multilayered regulation is the appropriate measure. As a first line of defence, the microprudential level of regulation will be strengthened. The measures that policy-makers set up in September 2010 and agreed on at the G20 summit in Seoul, commonly termed "Basel III", comprise higher capital and liquidity requirements which

are intended to enable an institution to better cope with losses itself and thus lower the probability of it's insolvency. In this context, higher capital requirements mean both, a higher quantity of capital as well as a higher quality. Particularly, the minimum core capital requirements will rise from currently 2% to then 4.5%, plus an extra 2.5% that will be introduced in stages from 2016 on. Tier 1 capital requirements will increase from currently 4% to then 8.5%. Furthermore, a stricter definition of core capital is to be implemented.

Yet, this first line of defence is not sufficient and needs to be supplemented. In market-based economies the failure of individual enterprises, including banks, should not be ruled out *a priori*. Thus, a second line of defence will be drawn, on the macroprudential level, which will only come into play if an institution breaks the first line of defence and becomes insolvent. Its aim will be to curtail the impact of individual insolvencies on the financial system as a whole and to increase the financial system's transparency. The European Union only recently established an institution for macroprudential analysis and monitoring in order to recognise systemic risks early on, the European Systemic Risk Board (ESRB). Germany passed a law on the restructuring of insolvent financial institutions last autumn, which is certainly a step to be welcomed. However, the various national restructuring mechanisms will only be fully effective if they are mutually compatible. As in other areas of regulation, this requires an internationally coordinated approach.

Additionally, measures of macroprudential oversight are currently being developed and implemented also to address systemic risk. Dealing with systemic risk is complex and requires a multi-faceted approach. It should encompass systemically relevant financial institutions, markets and infrastructures, while transparency is crucial.

Topics that either still need further discussion or at least ratification include, for example, the question of how exactly to deal with institutions that are "too big to fail". Stricter regulation and more intense supervision lead, not least, to the internalisation of otherwise negative external effects of these institutions. The improvement of corporate governance, not least the implementation of the FSB's international compensation standards, is also the subject of debate. Further topics on the agenda are the mandatory registration of institutions that currently operate in the shadow banking system, and the standardisation of contracts and handling of derivatives. All these topics need to be concretised further. Once implemented, these measures will have a profound impact on the financial system. They will increase the system's resilience and, with that, its stability.

Especially with Basel III there have been concerns that the increased capital requirements will have a potentially negative impact on economic performance. However, studies have revealed that these fears are not well-founded. In anticipation of the new rules banks have already started to increase their capital. Additionally, the transition period before the new requirements fully enter into force has been set with a long horizon. These are clear signs that policy-makers have found the right balance between regulation for stability and ensuring strong and sustainable growth. In fact, there is no inherent conflict between the G20 agenda's objectives of a more stable financial system and of strong, sustainable and balanced growth.

What we have to be careful with is public debt. The (sadly) new feature of the current crisis has been its third phase, the debt crisis, which hit us hard in May 2010. Towards the end of 2009, investors and rating agencies were increasingly turning their attention to the financial risks that the government sector worldwide had already incurred or was likely to incur. The default risk of these countries' government debt securities had until then been considered safe. However, with deteriorating public debt through fiscal programmes and guarantees to financial institutions in particular as rescue measures, the default risk was revalued on a more differentiated basis. As a result, intra-euro-area yield spreads widened significantly – especially to the detriment, above all, of periphery countries like Greece, Ireland and Portugal. Although this third phase of the crisis has so far not impacted significantly on euro-area economic developments, and financial markets have continued to recover, too, the

sovereign debt crisis still poses a serious challenge for the euro area as a whole that needs to be resolved before it potentially becomes a more serious threat to the recovery. Policy-makers have already taken important first steps in this regard, both to embark on ambitious and timely consolidation as well as to strengthen the institutional framework within the EU. Keywords in this context are a strengthened Stability and Growth Pact, better enforcement measures to correct excessive macroeconomic imbalances and a crisis resolution mechanism that helps to deal with future crises but does not undermine the incentives to rein in public deficits.

4. Conclusion

Ladies and gentlemen, the major drivers of growth for the world economy have not been impaired by the financial crisis. Emerging markets are still undertaking great efforts to catch up, and technological progress will continue. As I pointed out, even the regulatory measures already implemented, as well those measures that will be implemented once the discussion process has come to an end, will not hamper fundamental economic growth. The crisis has warned us of the risks of exaggerated growth and has painfully demonstrated some major weaknesses of the regulatory system. But the crisis does not mark the end of the world as we know it. If we manage to improve the regulatory framework for the financial system and maintain well-disciplined government budgets, we will be well on the way towards strong, sustainable and balanced growth in the future.

Thank you for your attention.