

## Jörg Asmussen: The global crisis – lessons for international policy cooperation

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the Kiel Institute for the World Economy, Kiel, 23 June 2013.

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Sehr geehrter Herr Ministerpräsident,  
sehr geehrte Frau Oberbürgermeisterin,  
sehr geehrter Herr Professor Snower,  
dear laureates,  
meine Damen und Herren,

It is my pleasure to be here today in Kiel and warmly congratulate Gro Harlem Brundtland, Joseph Stiglitz and Mohammed Ibrahim for winning the 2013 Global Economy prize. This prize has high reputation at the ECB where we believe that international cooperation and openness are crucial for improving people's standards of living. Some of you might recall that the prize was awarded in 2011 to former ECB President Jean-Claude Trichet.

I would like to focus my intervention today on some lessons that can be drawn from the global financial crisis for international policy cooperation. I will start with a question. Does the crisis call for a substantial change in the approach to international policy cooperation?

My answer is yes, for the following three reasons:

**First**, the world has become more interconnected and shocks are transmitted more rapidly across countries. Consider the following figures on global financial integration:

Total foreign assets and liabilities of advanced economies rose from 68% of GDP in 1980 to almost 450% of GDP in 2010.

The synchronisation of a severe economic and financial downturn, after the failures of major financial institutions in 2008, is a stark reminder of the significant interdependence of our economies. In 2009, 40 out of the 50 largest economies in the world experienced severe recessions.

**Second**, we need a new approach to international cooperation because the potential sources of shocks have multiplied. Alongside domestic shocks, countries are now more exposed than in the past to external financial shocks and global shocks to confidence. Keeping one's "house in order" is no longer sufficient to fully insulate domestic economies from these shocks.

**Third**, we need a new approach to international cooperation because the crisis has unveiled structural vulnerabilities in the global economy. In particular, our current institutions were designed for the economic system of the 20th century. They are not suitable for the global challenges of the 21st century. Global economic cooperation is needed to design better institutions.

For these three reasons, we have to take the crisis as a serious opportunity to tune global policy making to today's interconnected world.

The stakes are high, because the economic and social cost of the crisis has been large. Unemployment, especially youth unemployment, has significantly increased since 2008. As many as 73 million young people are estimated to be unemployed globally in 2013, especially in advanced economies – including the euro area – the Middle East and North Africa.

Would reversing globalisation solve the problem?

My answer is no. Being in northern Germany today, with its long tradition of openness and free trade ever since many of the cities along the Baltic coast joined the Hanseatic League, is a stark reminder of the benefits of global and European integration. And perhaps the case of Germany shows these benefits even more clearly:

- The share of Germany in global exports stood at around 8% in 2012. This makes Germany the largest global exporter after China (10%) and the US (9.8%).
- Exports of goods and service from Germany to the rest of the EU increased from around 20% of German GDP in 2000, to around 30% of GDP in 2012.
- Exports from Germany to the rest of the world increased from around 30% of GDP in 2000 to more than 50 % of GDP in 2012.

Protectionism would clearly harm Germany and Europe. Therefore, we should not turn our back on globalisation. We should rather learn to better reap its benefits and make it more inclusive, in ways such that benefits are also fairly shared.

The crisis offers an opportunity to learn from past mistakes. At the domestic level, it shows the importance of addressing imbalances with sound policies and structural reforms. At the global level, it shows the real cost of non-cooperative attitudes and policies. It therefore calls for a substantial change in institutional and governance frameworks for international policy cooperation.

Let me first identify past mistakes by considering the main vulnerabilities unveiled by the crisis, both at the global and European level.

On the global front, the crisis mainly revealed the existence of global economic governance failures and weak surveillance mechanisms.

Global imbalances led to the accumulation of fragilities in the global financial system and to unsustainable global macroeconomic outcomes.

For example, long term interest rates in the US and globally did not respond as expected to the Federal Reserve tightening cycle which started in 2004. This unusual behaviour of long term interest rates, which reflected the global savings glut, was labelled "Conundrum" by Federal Reserve Chairman Alan Greenspan. Persistently low long-term interest rates led to an aggressive search for yield and capital misallocations in the financial system.

How the impact of domestic policies could spill over to other countries was not sufficiently appreciated. And the need for stronger international cooperation on this front was not recognised that much before the crisis either.

In 2007 the IMF attempted to broaden the focus of bilateral surveillance to the implications of domestic policies for external sustainability. The attempt failed because some countries resisted to having their exchange rates labelled as "fundamentally misaligned" and to adjust their policies accordingly.

A forum for global economic governance tuned to the economic realities of the 21st century was missing. Institutional frameworks to create sufficient peer pressure at the global level to prompt systemic players to act were weak. Thus, global economic governance and multilateral surveillance were not fully equipped for the new challenges of a globalised world.

But the crisis also revealed acute failures in the global financial system.

While financial sectors became increasingly international, supervision and regulation remained largely national in scope and only loosely coordinated at the international level. This encouraged regulatory arbitrage, the creation of large, complex financial intermediaries, and poor risk management practises.

Several of these features also characterised our European continent. The crisis revealed fragilities in the governance, surveillance frameworks and financial architecture of the euro area.

The rules and governance framework associated with the Stability and Growth Pact were not sufficiently enforced and, therefore, respected. Efforts to promote structural reforms, for example under the Lisbon Agenda, were weak. As we know now too well, macroeconomic imbalances within the euro area grew unabated. Competitiveness developments across Member States diverged to an unsustainable extent.

For instance, a harmonised indicator of price competitiveness shows that between 2000 and 2008 Germany became almost 20% more competitive in real terms vis-à-vis the rest of the euro area average. Over the same period, price competitiveness decreased by around 10% in Italy and Spain vis-à-vis the euro area average.

In addition, despite the unprecedented level of financial integration in the euro area, banking supervision remained domestic. Cross-border resolution frameworks, in turn, did not reflect the increasing complexity and interconnectedness of the European banking system.

Overall, inappropriate policies in one country in the euro area could create negative externalities for other euro area countries, and possibly destabilise the monetary union as a whole. The crisis hence revealed that the euro area needs much stronger mechanisms to correct inappropriate domestic policies. It also revealed that the euro area's ability to absorb shocks, especially asymmetric ones, and its frameworks for crisis management and resolution need to be significantly strengthened.

What has been done so far to address the global and European vulnerabilities that were revealed by the crisis?

Let me start with the global perspective.

Economic governance and surveillance mechanisms have been strengthened appreciably. The G20 was upgraded to the Leaders' level, replacing the G7 as the premier forum for international economic cooperation. This made governance more encompassing and legitimate.

The G20 represents 65% of the world population (including the EU), while the G7 represented slightly more than 10% of it. The key emerging market economies are now at the table.

The first three G20 Leaders' summits (Washington, London and Pittsburgh) led to important achievements, including a coordinated policy response to the cyclical downturn, a solemn commitment to keep the global economy open and more resources to the IMF.

The G20 also gave political impetus to a broad agenda for financial reform to make the global financial system more stable and more resilient. Work is under way in different fora to fill regulatory gaps, make regulation more consistent across countries, limit the possibility for arbitrage, improve supervision of cross-border institutions and facilitate their resolution.

The crisis has also led to radical changes in the European institutional and governance framework.

In little less than four years, we have created the European Stability Mechanism (ESM), a permanent crisis resolution mechanism for the euro area. We have also strengthened euro area economic governance, for instance through the "Fiscal Compact" and the Macroeconomic Imbalance Procedure. The creation of the single supervisory mechanism (SSM) at the ECB is also under way. It will make supervision consistent with the level of banking integration in Europe. These are essential elements needed to break the adverse feedback loop between banks and sovereigns.

What needs to be done to finish the job and make the global economic and financial system more stable and resilient to reap the benefits of globalisation fully? We still have a long way to go, admittedly, and this is still not the time to rest on our laurels.

Let me hence sketch what issues remain unsolved.

The global reform agenda has lost momentum, as the sense of urgency imposed by the crisis has vanished.

On the global financial reform front, for instance, progress has slowed down in several respects. This has generated frustration and led to country-specific regulatory initiatives. These initiatives should not create market distortions, harm global and European financial integration or lead to regulatory arbitrage.

Progress on the front of global economic policy-making has also slowed down. The G20's effectiveness is now being questioned. Being larger than the G7, it is also more heterogeneous in terms of values and represented interests. Therefore, reaching an agreement at the negotiation table is more challenging. Also, the G20 might appear distant to citizens, which is not helpful for legitimacy, as the latter is intrinsically linked to local proximity. Finally, not all countries are at the table. An entire continent like Africa is only represented by one country, namely South Africa.

Despite its limitations, the G20 remains essential for global economic cooperation insofar as there is no obvious alternative. Returning only to the G7 or the G8 is not an option. At the same time, it was premature to conclude that the former formats are dead with the rise of the G20. The conclusions of this week's G8 Summit in Northern-Ireland on fighting tax evasion and on world trade for example showed that the smaller formats can stimulate important momentum for the G20 and other fora like the WTO.

Where do we stand on the European front?

An essential lesson from the crisis is that the Economic and Monetary Union is an incomplete project. The "Four Presidents" Report outlined the necessary steps to move towards a genuine monetary union, which I strongly support.

**First**, we need to complete with great urgency the banking union. We need a clear and transparent assessment of the conditions of the banking system ("asset review") before the Single Supervisory Mechanism takes over. We also need a strong commitment towards an effective Single Resolution Mechanism (SRM) which is an indispensable element of the banking union and a necessary complement to the SSM. The SSM would allow for a smooth winding down of banks, especially those with large cross-border activities. It needs to entail both a strong Single Resolution Authority (SRA) as well as a Single Resolution Fund (SRF). The latter should be financed with ex-ante risk based levies on the banking sector. These arrangements would enhance the credibility of the system and ultimately break the link between banks and sovereigns.

**Second**, we need to further strengthen and integrate our economic governance frameworks to make our economies more competitive and resilient to asymmetric shocks. One front on which European governance can greatly improve relates to structural reforms. Ultimately, structural reforms benefit the many at the expense of the few. A recent OECD Report called this the "Double Dividend" of structural reforms: they increase growth, and if implemented properly, decrease inequality.

One way to create incentives for Member States to engage in structural reforms could be the provision of temporary financial assistance to alleviate the short-term costs of reforms, in exchange of a contractual agreement to complete them. The contract would entail clear goals in line with EU policies and measurable targets. These contracts could be useful in several instances, especially in the presence of "reform and bailout fatigue", and constrained public finances.

**Third**, the increasing level of integration within Europe calls for a new institutional design to ensure legitimization, accountability and democratic control. On the one hand, Governments should ensure that national parliaments are appropriately informed and involved in decision processes. On the other hand, national parliaments are often not in the best position to incorporate the EU common interest in their decisions. Therefore, European institutions should be strengthened, in particular the European Parliament which could maybe also

convene in a euro area format. This would ensure that the level of accountability matches the level at which decisions are taken.

It is time for me to conclude,

Globalisation has lifted out of poverty and improved the living standards of millions around the world. It has greatly benefited Germany and the rest of Europe. It has benefited emerging Asia. And it is now benefiting large parts of Africa. We should not reverse globalisation. We should rather elevate our game and adapt our toolkit to the new realities of the 21st century. This will enable us to reap the full benefits of globalisation and share gains more fairly.

Stronger international policy cooperation would help to deliver stronger, more sustainable and balanced growth globally. It is the best means to avoid currency wars. It would help to make growth more inclusive and decrease unemployment, especially among the youth. It would increase peer pressure, thereby improving governance, especially in developing countries. Stronger international policy cooperation would also help to make growth models more compatible with the scarcity of natural resources and environmental constraints.

The crisis has offered an opportunity to learn from past mistakes. This opportunity should not go wasted. As the sense of urgency imposed by the crisis vanishes, the risk is that complacency slows down reforms, while the road that lies in front of us is still long. But the decision to complete the global reform agenda through enhanced international cooperation is entirely in our hands.

This is why I believe that the Kiel prize for the Global economy is a reminder for us of the importance of globalisation and international cooperation. Therefore, I want to conclude with warm congratulations to the winners of the prize.

Thank you for your attention.