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Introduction

The Financial Crisis: The Way Forward

Keynote Addresses
Horst Köhler
Jean-Claude Trichet

Hans-Werner Sinn

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Globalization and the Crisis

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Panel 2

Managing the Crisis

Keynote Address
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Panel 3

Banking Regulation

Keynote Address
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Trends

Statistics Update

Jointly organised with BMW Foundation Herbert Quandt

9th Munich Economic Summit

INTERNATIONAL POLICY FORUM

ORGANISED BY

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CESifo Group Munich

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Keynote Address by

Horst Köhler
Former President of the Federal Republic of Germany

Imagine that your energy provider installed a new supply system that gave you excellent profits but also a power failure every four weeks. Imagine that farmers got rich on a new cultivation method that resulted in a failed harvest every seven years. Imagine the water works made potable water particularly tasty but then as a result of this innovation suddenly no water comes out of the taps. Imagine that in these three cases the situation was both foreseeable and predicted. Then you would inevitably ask: is it not the task of the democratic state to protect its citizens? And wouldn't the government have to do everything in its power to ensure that a branch of business never again increases its profit and growth hand-in-hand with the risk of many others having to suffer as a result? The answer can only be 'Yes!'

The 9th Munich Economic Summit addresses 'The Financial Crisis: The Way Forward'. We will be able to find this way forward only if we think well beyond the current crisis. We must not let the crisis go to waste, but instead learn from it. It has raised some very fundamental questions. I think three responses to it are called for. First, we need to have the financial markets submit to the primacy of democratic politics and act at the service of the overall economy. Second, we need an economy that is at the service of the entire society. And third, we need a social cohesion that everyone contributes to. Such tasks require courage on the part of politicians, the understanding of the citizenry and the willingness to self-determination.

With its so-called financial innovations, the international financial industry drove its profits to dizzying heights with total disregard for risk. In the process it triggered a crisis that without governments' bailout measures would have led to the collapse of the global financial system. Governments, parliaments and central banks had no choice but to respond with unprecedented financial stimulus packages and comprehensive guarantees for financial institutions. They had to accept an explosion of public debt and the resulting liability for taxpayers, today and in the future.

A bailout of this sort cannot be repeated – neither financially nor politically. Isn't it imperative that the democracies of the world do everything in their power to avoid a repetition of such a crisis? The answer can only be 'Yes!' Citizens all over the world want to be protected from irresponsible activities in the financial markets. The next serious crisis of the financial system would not only question the viability of our economic and social model but also its credibility. It is thus imperative for democracies – as communities of values and protection – and their political representatives to counteract this threat.

The summit conference of the heads of the G20 states in Pittsburgh has laid the proper foundation. The international financial industry and its lobbyists will leave nothing undone in their efforts to water down the agreed measures. At the same time the betting continues, new financial bubbles are developing, and while the countries and their citizens continue to fight the consequences of the crisis, the financial institutions have once again approved gigantic bonuses for their employees. Have the people concerned understood what is at stake? It is clear that the practices of today's prevailing financial capitalism cannot be a model for us. It operates primarily with bets and debts. It boosts its profits without considering whether it benefits the well-being of nations. The pattern of the present crisis, where a few pocket the profits while the public bears the losses, is simply not acceptable.

There is a better model. Twenty-five years ago Ralf Dahrendorf referred to it when he distinguished between capitalism oriented towards borrowing and capitalism oriented towards saving. The latter implies the creation of enduring values instead of betting, the financing of real goods and services instead of building virtual financial pyramids. Savings-oriented capitalism is dominated by real economic investment and property and it encourages responsibility, not short-

term thinking and speculation. It focuses on a stable monetary value and respects those who save to provide for the future. An economy based on this model improves the living conditions for everyone. It aims at sustainable prosperity for everyone.

The role of the financial markets is to serve an economy that follows this model. They should act as a trustworthy mediator between those who save and those who invest, instead of jeopardising everything. This serving role is their justification for existence, and holding them to this role must be the central goal of a reordering of the financial markets. Politics has to regain its primacy over the financial markets. Financial market actors were given too much unregulated leeway. That was one reason the financial crisis arose. The state was then in a position to be blackmailed – and it still is. This must not happen again.

It is imperative that simple, firm rules are set for the financial industry. Clear limits must be imposed so that freedom does not destroy itself. Four consequences resulting from the crisis are of prime importance:

1. The core free-market principle of liability must once again have universal validity, especially by requiring financial institutions, regardless of what they call themselves, to hold sufficiently high equity buffers; this would entail including, for example, hedge funds and private-equity firms.
2. No bank or financial actor should be allowed to become too large to fail. This will require special insolvency rules for internationally operating financial institutions, including the possibility of subjecting them to a temporary state-administered receivership.
3. We need the greatest possible transparency for the so-called derivatives and an end to shadow banking. An international procedure for obtaining permission for financial innovation should be set up, and derivatives should only be allowed to be traded on public exchanges.
4. The G20 government heads should insist on the financial industry paying a 'fair and substantial contribution', as was stated in Pittsburgh, to help cover the costs incurred by the crisis. I personally think that a tax on international financial transactions would be the best way of doing this.

The German federal government is planning the right steps – this can be seen in the key points they have agreed upon for a new regulation of the financial markets. It is also good that there has been close co-operation with our French partners. I would like to see the German-French partnership show even greater leadership. Because as necessary as it is to have a new global financial order, in political terms we are still far from establishing one. Shall we just continue to wait? President Obama gave a strong impulse to the American debate in his speech on financial reform and I wish him success. He rightly said, "a free market was never meant to be a free license to take whatever you can get, however you can get it". But even if the reform in the United States moves forward, Europe should not assume a wait-and-see attitude. I think that the Euro Group would do well to present its own, strong suggestions for a new set of rules. It should not be afraid to simply forbid some financial instruments, such as naked short selling or highly leveraged over-the-counter transactions. For this type of 'weapons of mass destruction' we also need disarmament. And Europe needs an efficient, central supervisory agency that watches over cross-border institutions, and a European rating agency. This would be consistent with our commitment to a stable euro.

Today I only want to say the following about the euro and the situation in Greece: the euro has so far performed well for Europe. If we do not make serious mistakes it will continue to do so and be an anchor of stability in the world's currency system. It would only distract us if we once again take up the battles of yesterday. Greece must now accept its responsibility. But it also, understandably, expects assistance to help itself. The participation of the International Monetary Fund is to be welcomed because that way we can tap the experience this institution has with handling debt crises. It is also in Germany's own interest to make its contribution to stabilisation. And all the members of the Euro Group and the European Commission have to learn from the crisis. The European Economic and Monetary Union needs to co-ordinate the national economic and financial policies and to put in place an effective mechanism to counteract unfavourable developments in member states in a timely and sustainable manner. The federal government is right in working towards these goals.

Even if the European Union and other countries were to provide a proper regulatory framework, this alone would not suffice. Paraphrasing a famous saying of Ernst-Wolfgang Böckenförde: also the free-market economy lives from preconditions that the

state cannot guarantee. It counts on economic actors following not only the letter of the law but also its spirit, orienting their behaviour towards values and attitudes that the state cannot simply impose. In business, for example, these would be the values and attitudes of an honourable businessman. The more managers that take this role model to heart, the freer the market can be.

If freedom, good rules, creative diligence and integrity come together, then sustainable economic success and social cohesion can develop. That is our experience after 60 years of a social market economy. That is why on our path out of the crisis the following question is important: how do we maintain the strength of the market economy? I think that every country first has to look at its debit and credit balance. Let us look first at public debt.

To prevent the world economy from collapsing, the industrialised countries have increased their public debt dramatically – within three years by 20 to 30 percent of their GDP. The OECD expects the debt of the industrial countries to surpass their national income – i.e. 100 percent of GDP – next year. This has consequences. New research shows that public debt levels considerably lower than the present ones mortgage the development of the economy and society. Historically, financial crises have primarily been debt crises. This is also true for the present crisis. The bitter truth is that, even long before this crisis, most Western societies have been living beyond their means.

And Germany is not an exception. Our explicit debt is almost 1.8 trillion euros or around 74 percent of our entire GDP. If we include the implicit debt, that is all financial promises that the government has made for the future, such as the financing of social security benefits and pensions, the entire debt is considerably higher. Up to now we have assumed that economic growth will help take care of the debt problem. Some experts even recommend that we go more deeply into debt. I think that is not good advice to follow. It would lead us into a hopeless situation because for the developed economies the limits to growth can no longer be ignored.

Germany's potential growth– as well as that of most other industrial countries – has continuously declined in the last few decades. It is now around one percent. A slightly better growth scenario for Germany is still possible, and desirable, for a while. Success will depend on our strength to carry out structural reforms. But I am just as convinced that we cannot rely on growth and growth policy alone to solve the debt problem. We must also take into consideration the rapid decline in population. In 2050 Germany will probably have 10 million fewer inhabitants. Fewer and fewer people will have to service the growing mountain of debt if the situation stays the way it is now. These prospects for the future of Germany are not good. And I can only warn against seeking 'a solution' to the debt problem in 'controlled inflation'. To the contrary: there is not doubt that the central banks are committed to reining in the current excess of monetary liquidity in the markets – one of the main causes for the present crisis.

My advice for Germany is as follows: to secure long-term stability and reinvigorate our social market economy it is imperative that consolidation of the public budget be the most important and decisive task of the government for the next ten years. This is not only a constitutional obligation, but a moral one as well. Consolidation will only be successful if the government's expenditures and subsidies are lowered.

I suggest that the mending of public budgets be connected with an effective reform of our tax and transfer systems. These mutually additive systems are full of inconsistencies, and due to their complexity it is extremely difficult to determine whether they even achieve their political goals. I think that a great deal can be achieved just by simplifying them and removing their inconsistencies. I also plead for a savings policy that clearly states where savings are not appropriate.

We should not save in the spheres of education, research and innovation. We need to invest more, not less in our educational system, in our universities and research institutes and in a social climate in which education and endeavours to achieve an education are respected. A concerted effort to achieve these goals is the most important contribution to the future development of our country. Good education for everyone is the pre-requisite for social integration and for high-grade jobs. It is at the same time the most important response to the question of social equality. Children from immigrant families, children from low-income families and low-education backgrounds face poorer educational opportunities than their peers. That is an outrageous injustice that has a devastating impact on our economy and social existence. Also our vocational education, universities and research institutes

urgently require greater investment. The agreement between the federal government and the federal states to gradually increase expenditure on education and research to ten percent of GDP by 2015 is a step in the right direction. This intention must, however, be implemented into reality. Achieving this goal is worth a tax hike if necessary.

World-class educational systems and research institutions are necessary for the conversion to an ecological social market economy. We have no alternative. In 1800 a billion people lived on the earth, in 2000 there were more than 6 billion and in forty years there will be over 9 billion. But the raw materials and biosphere cannot grow in line with these numbers. Thus the world needs a third revolution – after the steam engine and the microchip – a revolution in environmental sustainability, a revolution in the economical use of resources and the progressive development of renewable energies. This revolution has already begun, and Germany is a leader in the field. But we cannot rest on our laurels.

I advocate that we set systematic and comprehensive goals for a future-oriented policy of transformation. This means that we will have to accept far-reaching changes in the economy and our life style. But it will be change that we ourselves shape – not change we have to suffer. And it will be worth it: experts tell me, for example, that today we could reduce the use of resources in Germany by 30 to 40 percent if we are more efficient. I am convinced that the 'green revolution' will secure not only jobs and income for the future but it will also improve our quality of life. I would like to encourage economists to think more about how the market pricing mechanism can be used for a future-oriented ecological transformation policy. I believe, for instance, that the ecotax deserves more self-confident political advocates – as numerous studies show.

Achieving more with limited resources also applies to our welfare state in general. We should view it from the perspective of its goal – from the individual. It is essential to invest in the individual's abilities, to foster and promote his strength of self-determination and self-provision. I call that the 'investing' welfare state. Professor Sinn speaks of 'activating' welfare state. We mean the same and we have, I believe, a very similar view of human beings – we believe in the individual taking responsibility for himself. Agenda 2010 was a step in the right direction. We have not yet reached our goal.

To ensure that our welfare state is well-prepared for the 21st century we have to ascertain whether it is investing sufficiently in fostering the responsibility and autonomy of its citizens. Only then can it achieve what it aims to, without continuously expanding – and it must also become more efficient in view of the dramatic demographic change in our country. The expenditure in social transfers is very high in Germany – around 750 billion euros yearly, almost one-third of GDP. But we often achieve considerably less than other countries. In some cases we don't even know what we are achieving. One example: almost 190 billion euros are spent on promoting marriages and families. How much of that actually encourages people to start a family, how much of that actually provides children with a good future, no one can really say. At least this question is now being properly investigated.

The best social security is help to self-help, the best social movement is upwards mobility through self-achievement, and what tastes best is self-earned bread. This is why we should demand from our social welfare state that everyone who wants to work must be able to and earn enough from it to live on. These tenets can be realized when we consider that in Germany we are facing a paradigm shift. In just a few years demographic development will lead to a shortage in highly qualified workers. Businesses are already responding with their efforts to keep skilled workers despite declining orders. That is positive, but we can still do more.

Above all we have to develop the market for people-oriented services, especially since demand is growing. The population is getting older and that means ever more people will need help and nursing care. And an increasing number of households will need or want both partners to work. That means that demand for childcare and household-oriented services will increase.

This indicates that we will not run out of work in Germany, and this offers a chance for all those who seek work to feel needed and appreciated. Both the Institute for the Future of Labour and the Institute for Labour Market and Vocational Research of the Federal Employment Agency have made noteworthy proposals for a future-oriented labour market policy. I agree with them that full employment is possible in Germany. Why don't we finally make this our goal? An investment-strong social welfare state and an

economy that serves the entire society – these goals can be achieved!

Now, what is the third step that will enable us to leave the financial crisis behind us? What kind of society should the economy aim to benefit from? I can only touch on this question here. But it is important for us to always keep it in mind. I advocate a free and fair society of citizens committed to solidarity. A society that excludes no one, helps all citizens to develop their talents and live a life that they themselves determine, and that brings people together.

It is important to recognise that such a subsidiarity society is dependent on a sound political implementation of the national framework. Small-scale groups, such as families and villages, should not have to conduct government businesses just because the government does not have the money for such activities. Rather, such groups' own responsibility has to be appreciated as a value in and of itself, one that can also serve the common good.

This assumes a new relationship between committed citizens and the state. Where committed people take on social tasks on their own initiative, the state should not seek to take over in these areas but to support them and give them the freedom to do so while recognising and fostering their strength and ideas. I have met so many people in our country who are active in self-help groups, in sport clubs, in parent associations, in parishes and in citizen initiatives. These people are already searching for solutions to new questions; they are creating social cohesion, solidarity, a sense of belonging, and trust. In the economy, capital is often a keyword. What is created here is social capital. It is at least as valuable as financial capital.

The Financial Crisis – The Way Forward: if politics can rein in the financial markets, if we can transform our social market economy to make it ecological, if we can shape our social welfare state and strengthen social cohesion, then we will not have wasted the financial crisis. We will have used it to create something new. That is worth the sweat of our brow.

Keynote Address by

JEAN-CLAUDE TRICHET
President of the European Central Bank

In my introductory remarks I would first like to reflect on the lessons that I believe we can draw from today's financial and economic crisis. In the second part, I will touch on the current situation, and describe the three key steps that I believe we need to take to return to the path of economic stability.

Lessons of the financial crisis

The financial crisis has taught us painful lessons. It has revealed fundamental weaknesses in our global financial system. In the years that led up to the crisis, the European Central Bank was among those institutions that warned against the under-pricing of risk in financial markets. But the growing complexity of the global financial system and specifically its international linkages made it difficult to predict how and when developments would turn.

With hindsight we know a great deal about the causes of the crisis. Financial innovation led to the development of new instruments that were intended to expand the diversification of risk for savers and investors. In retrospect, we know that instead they contributed to a common exposure to systemic risk.

Gradually, the focus of finance shifted in the recent past. From its traditional role of helping the real economy to cope with economic risk, finance became a self-referential activity. The notion of 'financial engineering' is a striking illustration of the shift of attitudes that spearheaded the changing focus of finance. When I started my professional career, no one would have used this expression. Engineering is about building tangible structures that support human endeavours. Some of the structures that were invented in finance turned out to be neither tangible nor helpful to society.

Nevertheless, the vast expansion of the financial sector would not have been possible without both supportive macroeconomic conditions and inadequate prudential regulation. Global current account imbalances have generated large financial flows, as large developed countries sucked in massive capital flows from oil exporting and emerging economies. Seemingly bright macroeconomic prospects combined with deregulation and global conditions of over-extended credit.

The crisis has shown that deregulation does not always pave the way for greater efficiency and greater prosperity. Rather we have rediscovered the value of properly functioning regulatory and supervisory institutions. And we have also rediscovered the value of medium-term orientation, sustainability and stability.

Consequences of the financial crisis

The consequences to be drawn to minimise the risk of a comparable crisis in the future are numerous and wide-ranging. First, comprehensive regulatory reforms of the financial system have to be implemented with top priority. While some progress has been already made, major challenges lie ahead. Most importantly, the pro-cyclicality of the financial system must be mitigated. It is essential to change regulatory and accounting rules that tend to amplify the natural cyclical swings of our economies.

Second, we have to enhance the transparency of financial structures. That concerns rules of disclosure as well as market infrastructure. In particular, derivative market instruments need to be subject to greater transparency. But, beyond changes in financial governance, there needs to be a deeper economic assessment of the benefits of these structures to society. And third, incentives should be aligned. Remuneration schemes, for example, should support sustainable business rather than myopic trading.

There is one over-arching issue that I would like to highlight: the financial industry has to reconsider its role in the economy. Returning to a role of serving the

real economy would be desirable. 'Financial engineers' may prefer to create ever more 'sophisticated' financial products. But finance has to come back to the basics. Among the basic tasks of the financial industry is the supply of credit to the real economy. This too is a profitable business, the profits from which are justified because they are mirrored by the social value of the intermediation function. Businesses and individuals depend in particular on the steady supply of credit by banks.

The ECB and the national central banks of the euro area have taken comprehensive measures during the crisis to help commercial banks and other financial institutions. When the turbulence started in August 2007, the ECB was the first central bank to step in by frontloading liquidity.

After the intensification of the crisis in the autumn of 2008, we tackled the paralysis of inter-bank transactions in the money market. In addition to a swift and substantial reduction of our policy rate, in line with our primary objective of maintaining price stability over the medium term, we decided to implement a set of non-standard measures, which we collectively refer to as 'enhanced credit support'. These measures have significantly helped to maintain banks' liquidity. But we did not pursue this policy with the ultimate goal of reconstructing banks' profitability. Rather, the purpose of our enhanced credit support has been to ensure the transmission of monetary policy transactions to the broader economy.

Global economic governance

The crisis has important implications for economic governance, and here remarkable efforts have been made or are under way. On the global level, the G20 has become the main forum for international cooperation, and a strong consensus has emerged within this group not only about the causes of the crisis but also about the appropriate policy responses. The G20 has been highly effective in addressing the global crisis.

The more technical questions concerning regulation and financial stability are mainly delegated to the Financial Stability Board (FSB). The extension of both the membership and the range of tasks of the previous Financial Stability Forum have pushed the FSB into a leading role when it comes to coordinating the reform of financial regulation.

The European regulatory response to the crisis will include a new body that will provide macroprudential oversight and focus on the avoidance of systemic risk in the financial system of the European Union as a whole. This is the European Systemic Risk Board (ESRB), the establishment of which intends to make macro-prudential oversight operational at the European level.

While the ECB and the national central banks of the EU will be heavily involved in the ESRB framework, it is essential to make a clear separation between macro-prudential oversight and monetary policy. The primary objective of euro area monetary policy will remain the maintenance of price stability.

Financial stability lays the conditions for the central bank to pursue its task of maintaining stable prices. It is also the outcome of an environment of steady macroeconomic prospects and confidence, which only stable prices can ensure.

Current challenges for European integration

Although the financial crisis did not originate here, it has profoundly challenged the European economy – and it is continuing to do so. Economic and Monetary Union – in short: EMU – is a union based on two foundations: economic and monetary. These are two foundations that reinforce one another. Responsibility for the 'M' is centralised and assigned to the Eurosystem with the ECB at its core, aiming to ensure price stability in the euro area over the medium term. We have defined price stability as an average annual inflation rate below but close to 2 percent over the medium term.

How have we performed against this objective since the introduction of the euro? Based on current staff projections for this year, by the end of 2010, the average inflation rate in the euro area since the introduction of the euro is estimated to be around 1.95 percent. Beyond the ups and downs of the economic cycle since 1999, despite the swings in the international prices of raw materials, monetary policy has managed to keep its inflation record faithful to its strategic aim. I am satisfied that we have fulfilled our mandate. For Germany I would like to recall that the average annual inflation rate in this country was 2.2 percent in the 1990s compared to 2.9 percent in the 1980s. Given the initial promise made to all people of Europe that the euro would be

as credible, reliable and as good a store of value as were the best of the national currencies, based on these figures, I can say that with an estimated average annual inflation rate of 1.95 percent for the first twelve years, the euro is in terms of safeguarding purchasing power *'stark wie die D-Mark'*.

In a nutshell, the 'M' has done its part. The main current challenges for our union originate in the 'E'. Economic union is based on responsible national policies: fiscal policies, wage policies and structural policies. At the core of the economic union is the Stability and Growth Pact.

The crisis has revealed some of the shortcomings of national policies to comply with the requirements of an economic union. In particular, in a number of cases, national policies that are responsible for domestic public finances and for the competitiveness of member economies have not achieved their objectives.

But the crisis has also revealed weaknesses in the peer surveillance process and in the implementation of the Stability and Growth Pact. Thus another major lesson of the crisis is the need to strengthen the institutional framework of the economic union.

Of course, the deterioration of public budgets has partly been due to a 'migration' of risk from the financial sector to the public sector. Public budgets have been called on to absorb the excessive risk that the financial industry had been creating during the booming years that led up to the crisis.

Partly, however, the deterioration of public budgets is also due to some short-sighted fiscal and economic decisions in the brighter times that preceded the crisis. Before the crisis, weak public finances had combined in some countries with inattention to domestic competitiveness and a lack of long-term strategies to prepare national economies for competing successfully in the challenging – but rewarding – environment of the internal market. In Greece, in particular, past fiscal irresponsibility and inattentiveness to domestic competitiveness made the national economy extraordinarily vulnerable to a sudden turn in confidence.

As I have implied, after the crisis, the main players in the world economy will be judged by a new yardstick. Private players will be held accountable to new and stricter standards of economic integrity and prudent management. And governments, the world over – and in Europe in particular – will have to show self-discipline and trustworthiness to gain respect and preserve confidence.

That is why financial reform will have to go hand in hand with fiscal reform. Fiscal reform will reinforce confidence. In the current situation, we have to – and we do – stand firm on these principles.

Speculation on more and more elevated sovereign risk has been one factor behind spreads being driven to very high levels. This is why it was very important that the heads of state and government declared on 11 February 2010 that they were ready to "take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole". I said, on behalf of the ECB, that I approved this important statement.

In this respect let me stress the following facts: loans are not transfers, and loans come at a cost. They come not only at a financial cost, but also with a strict conditionality. This conditionality needs to give assurance to lenders, not only that they will be repaid but also that the borrower will be able to stand on its own feet over a multi-year horizon. In the case of Greece, this will require courageous, recognisable and specific actions by the Greek government that will lastingly and credibly consolidate the public budget.

Other countries in the EU and elsewhere have gone through times that were no less difficult, and they have emerged from a determined adjustment stronger and more competitive than in the past. These countries have demonstrated that a clear U-turn in national policy governance is achievable. After making the turn, they have reaped large payoffs.

I will not comment on the negotiations that are currently taking place in Athens. Again they have to be concluded by a courageous, comprehensive and convincing multi-year programme. And I am confident as regards the results of these discussions between the Greek government, the European Commission, the ECB and the International Monetary Fund.

Let me add a word about Germany and the current public debate here. I very much appreciated the invitation by Finance Minister Schäuble on 28 April 2010 to speak to the floor leaders of all political parties represented in the Bundestag. I said in Berlin that I had found this meeting – in which Jürgen Stark and I could respond to all questions of our interlocutors –

extremely important. My main message was that a fast parliamentary procedure was highly recommended in the present circumstances.

What we need most at this time is a strong sense of direction. We need a sense of direction that can guide us on how we can emerge from these turbulent events and how we can return to the path of economic stability.

In my view, this sense of direction can be provided in three steps: first, in the case of Greece, a strong and credible programme, negotiated among the European Commission, the ECB, the IMF and the Greek government. Second, the support I have mentioned that will avoid the materialisation of financial risks for the euro area as a whole. And third, a giant step forward in our own framework of surveillance, peer pressure and policy adjustment within the monetary union.

Speaking in the presence of Federal President Köhler, who played such a decisive role in creating monetary union and the former Finance Minister Theo Waigel, the father of the Stability and Growth Pact, I must say that I count on the contribution of Germany with regard to the third step – the leap forward in policy surveillance and policy adjustment.

Fiscal adjustment alone will not be sufficient to ensure sustainability. Structural reforms that will lead to more balanced growth are also vital to rebuild the resilience of our economies. The result must therefore be a renewal of the Stability and Growth Pact and the incorporation of a framework of surveillance for national policies of competitiveness. I hope that considerable energy will be devoted to this area in this country, so that a central outcome of the present demanding episode will be to strengthen the foundations of our monetary union.

Conclusion

Europe has reacted with speed, energy and determination in the financial crisis. We have to stay on this path. We continue to need wise and sound, rapid and determined action by all countries.

We need to resolutely improve the effectiveness of the peers' surveillance of fiscal and economic policies. The weak points of past multilateral surveillance will be corrected, and the Stability and Growth Pact will be reinforced and rigorously applied in its letter and in its spirit. It has to spot at an early stage and to correct deviant behaviours. The overall scope of peers' surveillance should be resolutely broadened to include the competitiveness as well as structural reforms of individual countries, so as to maintain healthy and sustainable growth as the ECB has constantly asked for during the past year.

In doing so we will pave the way for a European economy which will have a higher level of growth potential, and which will be prosperous, stable and resilient.

The introduction of the single currency represents the greatest achievement to date in the history of European integration – a process that has ensured six decades of peace and prosperity in Europe. Countries that share a common currency share a common destiny.

Introduction by

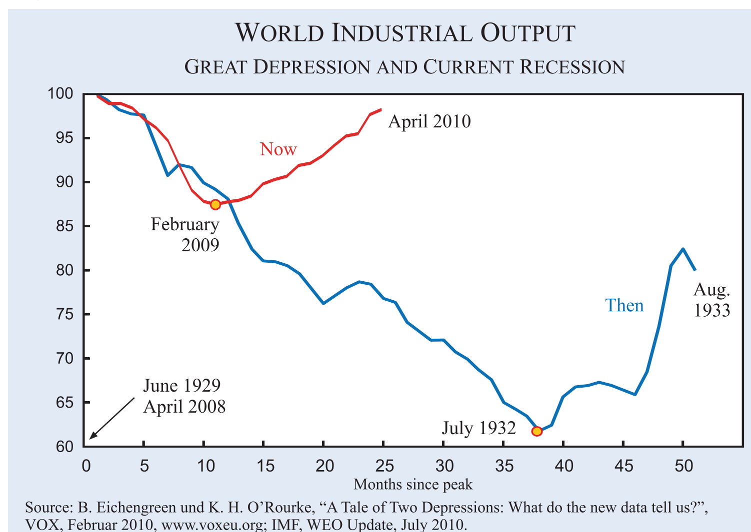
Hans-Werner Sinn
President of the Ifo Institute and CESifo*

Dear President Köhler, dear President Trichet,
Ladies and Gentlemen,

The recession is over. The lowest point of the business cycle was reached in February 2009. Thereafter the economy began its recovery and has since followed an upward trend. Figure 1, compiled according to Barry Eichengreen, shows the collapse of the world economy between June 1929 and 1932 in comparison with the recent crisis. The figure shows that the first eleven months were basically identical. Fortunately, we did not have to undergo another Great Depression. Why? Because the governments of the Western World took decisive action, implementing bank rescue packages amounting to 7 trillion US dollars and Keynesian rescue programmes worth 1.4 trillion US dollars – gigantic amounts that we can hardly imagine. Before the crisis such a policy was unthinkable, but it was in fact what helped us.

* Text of the speech held on 29 April 2010. Data cover the period up to that date, corrected for recent revisions of the official statistics.

Figure 1



Source: B. Eichengreen und K. H. O'Rourke, "A Tale of Two Depressions: What do the new data tell us?", VOX, Februar 2010, www.voxeu.org; IMF, WEO Update, July 2010.

The problems of the United States

The damage that this crisis has caused – or even just made obvious – is gigantic. The United States, in particular, now has a huge problem. The real estate market collapsed – house prices fell by one-third. They are now showing a sideward movement, and it is not clear whether they will recover or fall further. Danger still lurks. In the commercial area prices are still falling, and in an official document prepared for the US Congress it has just been reported that hundreds of US banks may still go bankrupt because of the continued decline in the prices of commercial real estate. The construction industry also collapsed with a drop of about 80 percent in residential construction.

The main problem, which is closely connected with the real estate crisis, is the huge US current account deficit, with its parallels to Greece, which I shall discuss later. Figure 2 shows US net capital exports, or better imports, relative to GDP. In the last few years the net export share amounted to around – 5 percent, i.e. there were capital imports of 5% of GDP. In absolute, but also in relative terms, this share is the highest since the Great Depression. Even in 2008 – just before the crisis – net capital imports amounted to 808 billion US dollars, which, as economists know, is the same as a current account deficit of that size. Imported goods exceed exported goods; people live beyond their means and rely on credit to finance their life style. The Americans not only sold goods to finance this but also securities.

There are two possible interpretations of this situation. Ben Bernanke, the Federal Reserve Chairman, has said that there was a savings glut in the world. Investors wanted to invest and Americans generously opened their doors and let the investors come in, letting them participate in their superb investment opportunities, offering exceptionally good rates of return. That is the

Figure 2

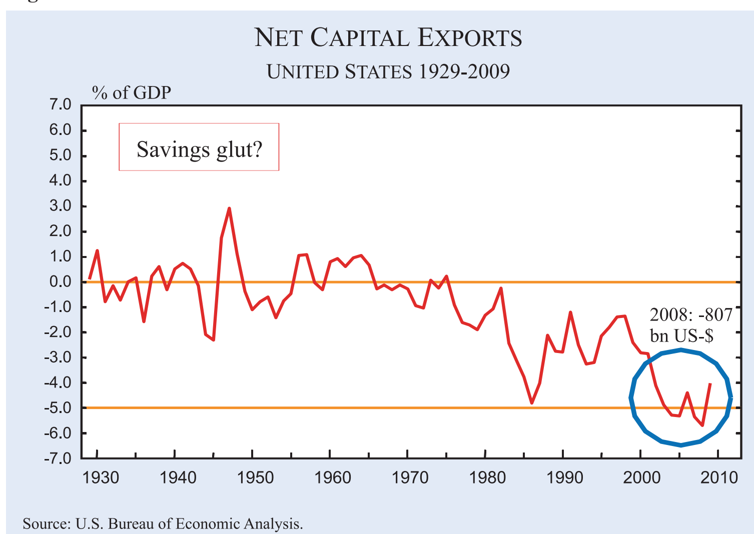


Figure 3

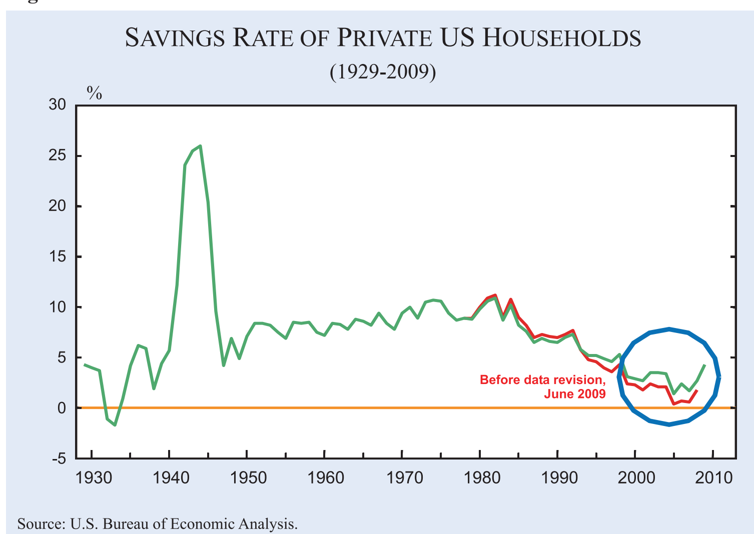
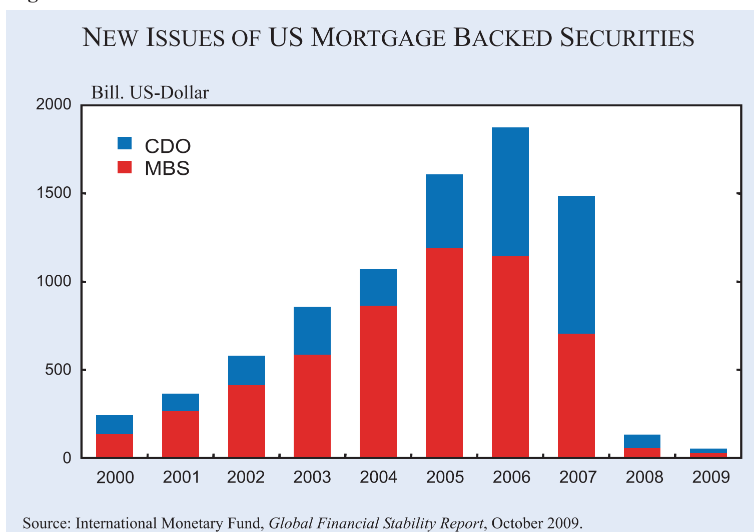


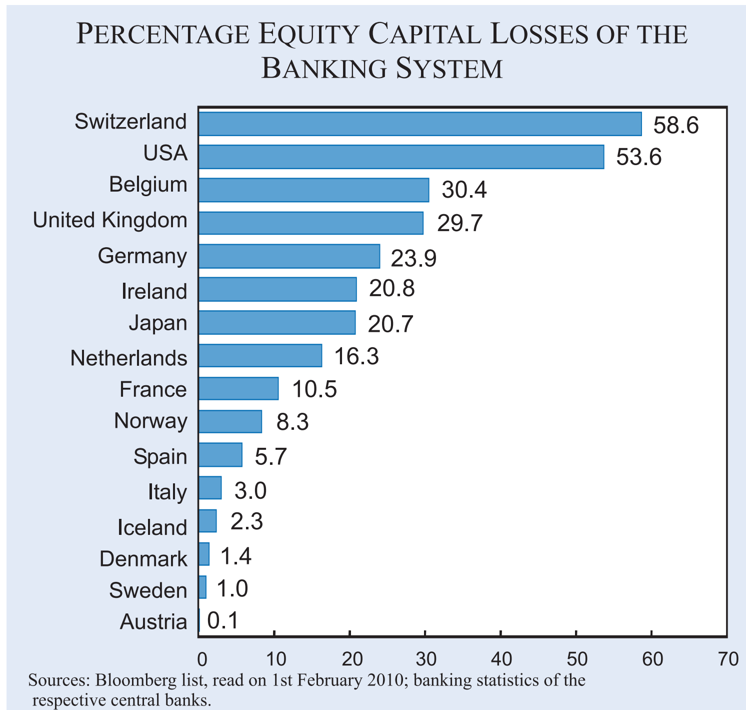
Figure 4



so-called 'savings glut theory'. In my opinion this theory was just propaganda. Figure 3 illustrates the savings rate of private US households from 1930 until now. For a long time, the rate of savings was around 10 percent, but since 1980 the rate has dropped dramatically, approaching zero in the years before the crisis. The Americans have not been saving at all, which is the reason why a lot of capital had to be imported. The US government needed money; US investors needed money and they could not get it from domestic savers. Instead the money came from the rest of the world via this huge current account deficit.

How were these capital imports achieved? To a large extent, by issuing mortgage-backed securities but also derivatives that were based on real estate – the so-called CDOs (collateralized debt obligations). In 2006, as Figure 4 suggests, there was an annual emissions volume of 1,900 billion US dollars! But the figure also shows that by 2009 the market had disappeared – there was a decline of new emissions by 97 percent. The entire market for mortgage-backed securitization disappeared. No other number reflects the US financial crisis as clearly as this one. If securitization is no longer possible, where does the money for real estate come from? It comes from the government. Three state-run institutions – Fanny Mae, Freddy Mac and Ginny Mae – securitize 95 percent of the real estate mortgages of the United States. They then sell them largely to the Fed that pays for them with newly printed money. There are hardly any non-securitized mortgages. We used to call an economy, in which real estate was financed to 95 percent by the state, socialist.

Figure 5



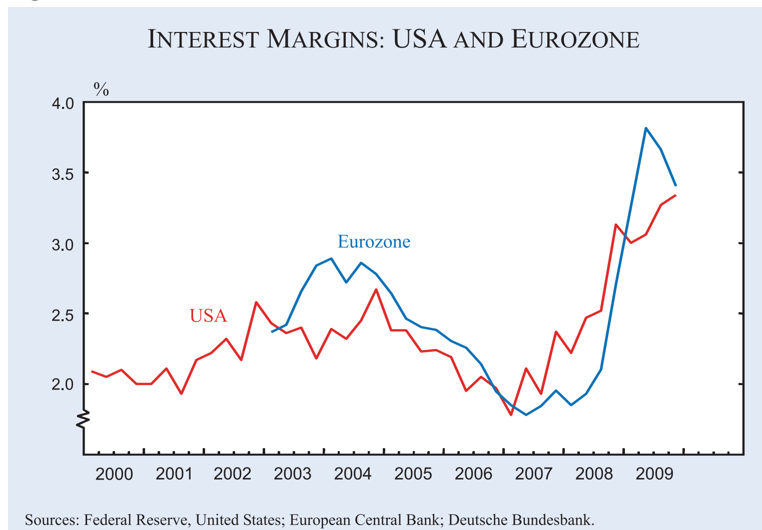
Sources: Bloomberg list, read on 1st February 2010; banking statistics of the respective central banks.

This may be provocative, but what is really provocative are the numbers.

The mortgaged-backed securities sometimes were not worth the paper they were printed on. Overly positive ratings by the agencies and complex calculating methods, which proved to be wrong, led to huge write-off losses in the balance sheets of investors and in particular in those of banks, which is why today no new securities of this kind are being floated. If we add up these losses, based on the Bloomberg list, divide them by the former equity capital of the American banking system or the banking systems of all countries, we end up with astounding figures. Switzerland, for example, lost around 59 percent of its equity capital, not net losses – new equity sources were found – but gross losses. In the United States, at the beginning of February 2010, the losses amounted to as much as 54 percent. In Germany the losses totalled 24 percent. And there will be more to come; there are still numerous losses that have not yet reached the balance sheets (see Figure 5).

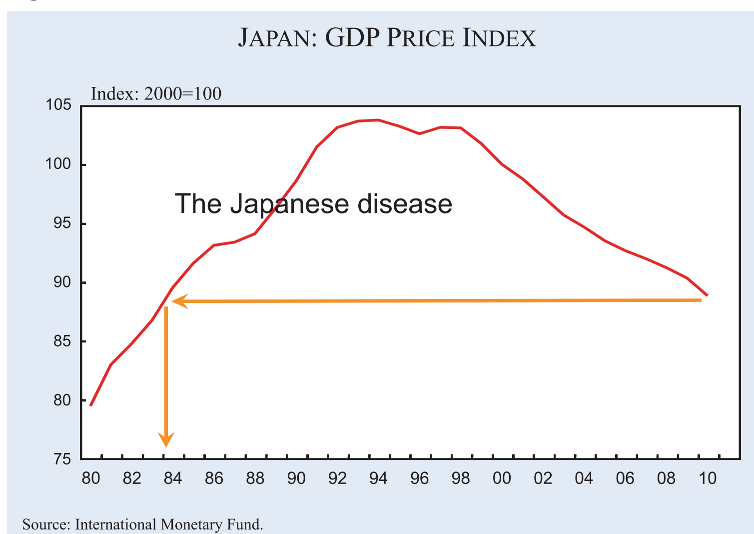
If the banks lose capital, they have to reduce the volume of their loans. The capital of Deutsche Bank declined from 2.3 to 1.5 trillion euros during the crisis, a drastic deleveraging with a negative impact on the amount of private loans given to firms. A credit crunch is thus a necessary consequence of such losses. The credit crunch does not mean that it is impossible to obtain credit from a bank but that the interest rate is considerably higher than it otherwise would have been with the same central bank policy. To measure the extent of the credit crunch, we can look at the interest margins. The interest rate for short-term credit provided by the American banking system less the interest rate that the central bank charges for its loans to the banks is at a historical high, as depicted in Figure 6. The same is true for Europe. The banks cannot handle all the loans demanded, because they do not have the required equity capital. Credit is tight and that means there are high margins and high rates of return on what remains of the banks' equity capital, with the consequence – the good news – that the banks are now gradually regaining the capital they lost and that they will later again be able to offer more credit. Of course, the credit crunch is not so noticeable if firms don't want to invest anyway but it is a potential impediment to the upswing that is now in progress.

Figure 6



Sources: Federal Reserve, United States; European Central Bank; Deutsche Bundesbank.

Figure 7



Source: International Monetary Fund.

It may also not be noticeable everywhere in Europe, as the interest spreads between the countries are also widening. Germany, for example, may not suffer from a credit crunch even though its banks are deleveraging, because the European confidence crisis is driving a wedge between the rates of Greece, Portugal and Ireland on the one hand and Germany on the other.

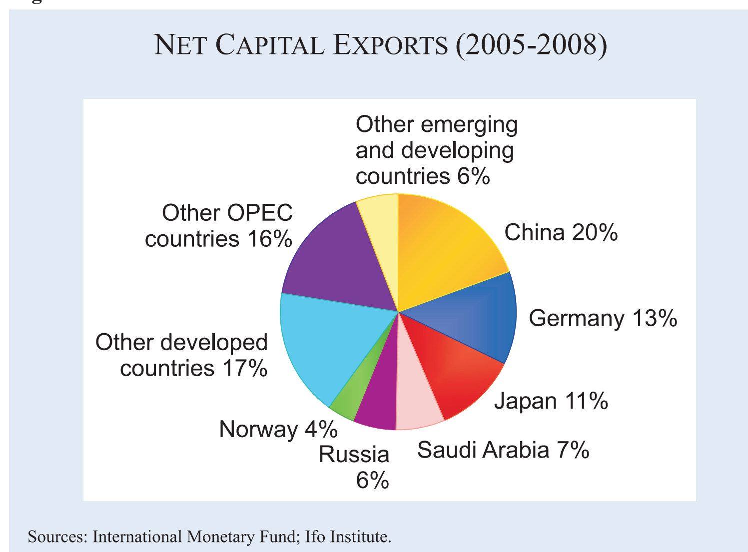
With that qualification, the situation is reminiscent of Japan in the1990s: when the real estate bubble burst, huge bank losses were incurred resulting in a credit crunch. A long recession ensued although, from 1997, an extremely easy monetary policy was implemented with interest rates falling to zero. In 1997/98 40 percent of the banks went nearly bankrupt and had to be nationalized, among them practically all the large banks. Despite these measures, Japan was unable to overcome the long-lasting crisis and since then has had the lowest growth rates of all OECD countries. Despite the fact that the Japanese central bank has flooded the country with money, Japan has suffered from chronic deflation. The GDP price index shows that since 1998 there has not been one year in which prices have not fallen (see Figure 7). The price level today stands at the level of 1984. Alvin Hansen, the great economist and contemporary of Keynes, once referred to this situation as 'secular stagnation', an on-going deflation, a downward spiral that is practically impossible to stop. I hope that this does not happen to us and this is not meant as a forecast; I merely want to point out that deflation is the true risk and not inflation, again with the qualification with regard to the interest spreads between the countries.

A crack in the German model

The German business model is the mirror image of the American one: where there is a deficit on one side, there has to be a surplus on the other side. The financial crisis has also had a negative impact on the German system. There is a crack in the German model. Germany also received strong criticism from abroad, especially from Christine Lagarde, the French Finance Minister, who thinks Germany has exported goods at the expense of its neighbours.

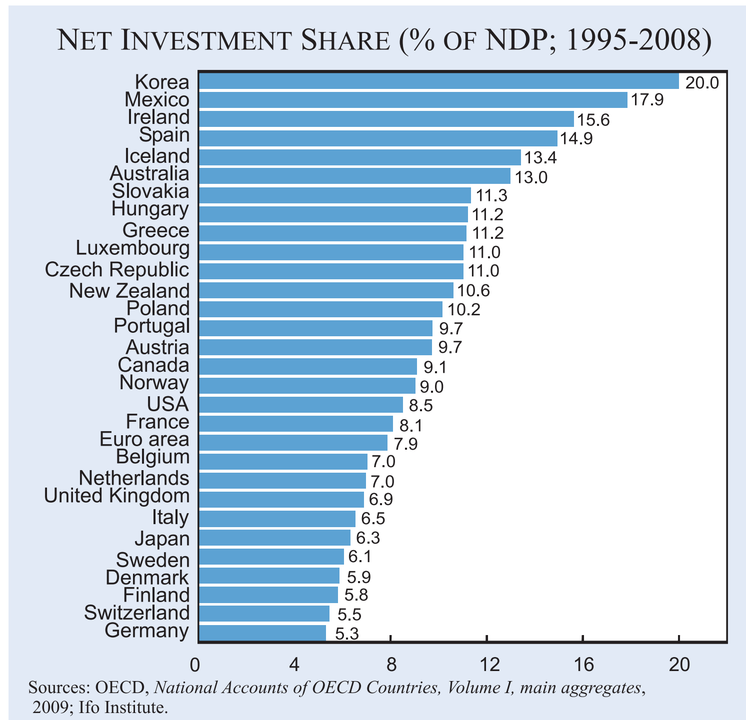
It is true that Germany has been the world's second biggest net exporter of goods after China in the years before the crisis. However, net exports of goods equal net exports of capital. Indeed, Germany was the world's second biggest exporter of capital in 2005–2008 (see Figure 8), because there was only little investment at home. In 2008 aggregate German savings calculated over all sectors, i.e. including firms, households and the government, amounted to 259 billion euros. Although so much was available for net

Figure 8



Sources: International Monetary Fund; Ifo Institute.

Figure 9

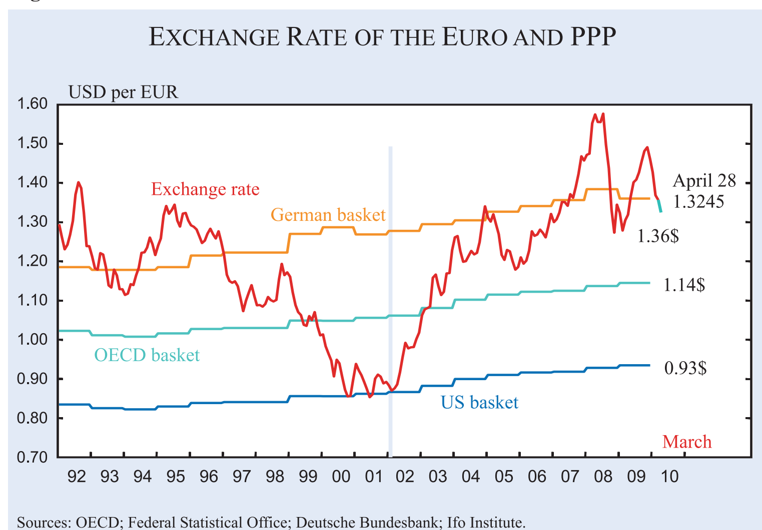


Sources: OECD, *National Accounts of OECD Countries, Volume I, main aggregates*, 2009; Ifo Institute.

investment in Germany, only a mere 92 billion euros was in fact invested. The largest share of German savings, 167 billion euros, went abroad. By definition this equals the surplus in Germany's balance on current account.

Only the naive consider this as positive. We are doing something wrong here. As Figure 9 reveals, Germany's domestic net investment share in net national product on average has been the lowest of all OECD countries in the period from 1995 to 2008. No other OECD country has spent such a small share of its economic output on the accumulation of capital and the expansion of its production capacities. Instead of selling German machinery to foreign countries on credit, these same machines could have been sold to domestic medium-sized firms on credit, which would then have increased their production capacity here in Germany. The machinery and equipment producers would have had the same number of orders, but jobs would have been created in Germany and, what is more, the investors, who provided the finance, would get their money back. Selling machines in exchange for Lehman Brothers certificates was not the right business model.

Figure 10



Sources: OECD; Federal Statistical Office; Deutsche Bundesbank; Ifo Institute.

The euro in the financial crisis

Let me now turn to how the euro performed in this financial crisis. The good news is that during the crisis the euro has protected us against the risk of exchange rate turbulences. The eurozone offers its member countries monetary stability. During the deutschmark regime, Germany's inflation rate averaged 2.7 percent p.a. Under the euro the German inflation rate has averaged only 1.5 percent. And even in the entire eurozone, including the countries with weaker economies, the average rate of inflation was only 2.0 percent, and thus less than the German inflation rate under the deutschmark.

Despite the crisis, the euro has remained strong. Figure 10 shows that the value of the euro is high in terms of various purchasing power parities. The euro has retained its strength despite the Greek crisis and today is actually overvalued rather than undervalued.

The bad news is that the Stability and Growth Pact was not taken seriously. Government debt is high in many euro countries, higher than the 60 percent of

Figure 11

NATIONAL DEBT (LEFT) AND BUDGET DEFICITS (RIGHT), % OF GDP, 2009

Source: European Commission, *Economic Forecast*, Autumn 2009; OECD, *Economic Outlook*, No. 86, December 2009; Eurostat.

GDP, permitted by the Maastricht Treaty. As Figure 11 shows, Italy's public debt amounted to 116 percent by the end of 2009 and Greece's to 115 percent. By the end of 2010 Greece will have a public debt in the order of 125 or 130 percent, the highest of any euro country. Germany's public debt amounts to 73 percent, still low compared to the US debt that will reach 100 percent in the not-too-distant future. Countries that live beyond their means cannot take on even more debt – they must begin to save. They did not do this in the recession, and rightly so, but now is the time for consolidation, and I hope that no new crisis in the Mediterranean countries will touch off a recession and prevent consolidation.

Figure 11 also shows the forecast, according to Eurostat, of government deficits this year (2009): 3 percent of GDP is allowed, but almost all euro countries are violating the 3-percent criterion, with Ireland and Greece at the top: 14.3 percent of GDP for Ireland, despite its promises to reduce it by 3 percent, Greece at 13.6 percent. The United States deficit is projected at 12.5 percent and Britain's at 11.5 percent. These figures are of great concern for the stability of the Western World and well beyond what the Stability and Growth Pact viewed as the upper limit of an acceptable deficit. The Pact was really never taken seriously after Germany exceeded the deficit limit three years in a row – no wonder the Greeks did not take it seriously either.

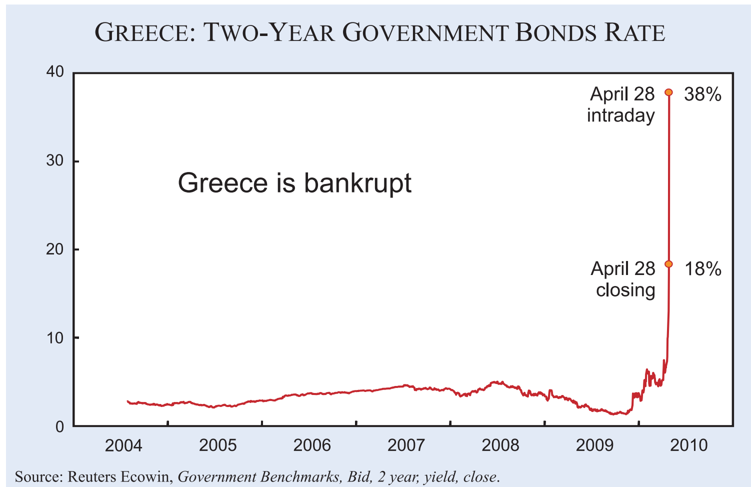
Figure 12

TEN-YEAR GOVERNMENT BOND RATE
(JANUARY 1994 - MARCH 2010)

Source: Reuters Ecowin, *Government Benchmarks, Bid, 10 year, yield, close*.

The crisis manifests itself in the ten-year government bond rates. Figure 12 shows the rates before the euro was introduced on the left-hand side and the current rates on the right-hand side. In the middle it shows the introduction of the virtual euro, the irrevocable fixing of exchange rates, which led to a convergence of interest rates because there was no longer a risk premium for exchange rate fluctuations. Everything went well until the crisis, which we see on the right-hand

Figure 13



Source: Reuters Ecowin, *Government Benchmarks, Bid, 2 year, yield, close.*

side of the figure, and then the range widened again. Greece joined the euro later. The reference year was 1999, for which the Greeks claimed that they had a government deficit of 1.8 percent. But it turned out to be 3.3 percent, according to Eurostat. And even this number was revised. Today some say 6 percent, but there is no official figure. Eurostat has stated that Greece intentionally falsified the figures.

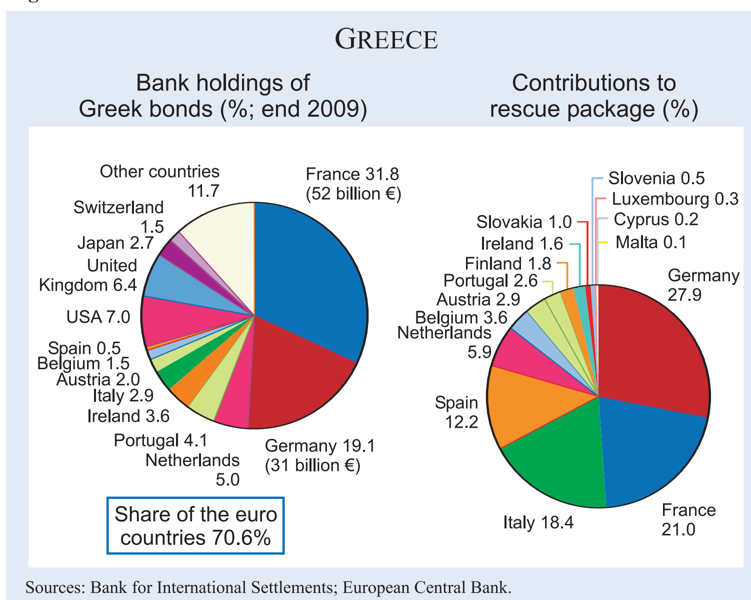
Looking at the right-hand side of the graph, the stable countries come first – Germany and France – followed by Italy, Spain, Ireland, Portugal and Greece. With a bond rate of around 10 percent for Greece, we have a span similar to what we had before the euro was introduced. The divergence is even more obvious when we look at the two-year Greek government bond rates: 38 percent interest in the afternoon of 28 April 2010, which by evening had fallen to 18 percent (see Figure 13). Nevertheless, the conclusion is evident: Greece is bankrupt. This must be accepted by policy-makers and insolvency proceedings should be started.

Greek bankruptcy

We will help – the decision has been made – but whom are we helping? Are we saving Greece's creditors or Greece? That depends on who will be serviced first. In bankruptcy proceedings it is usually the most recent creditor who has priority over old capital – in this case a haircut would have to be accepted – but politicians see this differently. They think the money that is going to Greece should be used to satisfy the old creditors. Where is the money going and who is paying? Figure 14 presents the distribution of bank holdings of Greek government bonds: 52 billion euros are held in France, 31 billion euros by German banks, and smaller amounts in other countries. The banks in the euro countries hold a total of 70 percent of Greek government securities. Those who are participating in the rescue package are primarily Germany, France, Italy, Spain and then, to a much smaller degree, the other euro countries.

Even if we solve the present crisis, we still have a long-term problem, namely that many of the southern European countries, especially Greece, do not have a business model. Figure 15 depicts the current account balances relative to GDP in the euro area. Greece is at the bottom with a current account deficit and thus capital imports of 11.2 percent of GDP. Portugal at a 10 percent deficit and Cyprus at 8.3 percent are also at risk. Spain is not so much endangered. The Greek share of 11 percent cannot be eliminated by wishful thinking or by reducing the budget deficit to zero. The problem will remain and there are really only three ways to overcome the situation, which are all problematic. The first possibility is to provide continuous transfers from the other euro countries to Greece, i.e. the

Figure 14

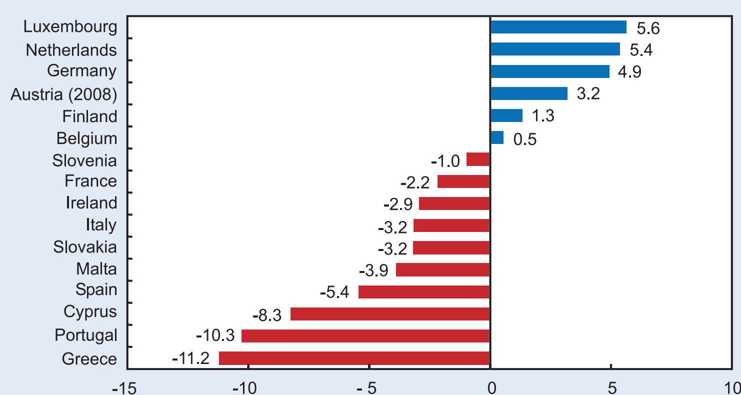


Sources: Bank for International Settlements; European Central Bank.

other countries give Greece the goods it imports in excess of its exports. The second possibility is that Greece remains in the eurozone but devaluates internally. Goods will become cheaper, the deficit in the current account will disappear, tourism will become more attractive and holiday apartments will be sold, which is always what happened in the past when Greece had problems. The third possibility is that Greece leaves the eurozone and then devalues its currency. This would lead to a bank run and destroy the Greek banks. It would, of course, also have serious implications for Portugal and other countries with large current account deficits. The second possibility, internal devaluation, i.e. a reduction of wages and prices perhaps by one third, is not really feasible as it would risk pushing Greece to the brink of civil war. Although the first possibility would be the most pleasant for Greece, it is not really an acceptable option for the rest of us. This means there is no real solution for Greece, which is a tragedy.

Figure 15

CURRENT ACCOUNT RELATIVE TO THE GDP IN THE EURO AREA (2009)



Source: Eurostat.

Greece and the EU have now decided on the second solution: internal devaluation by reducing wages and prices. But how can we ensure that Greece does not go into debt in the future? That is the decisive question. If Greece stays in the eurozone and we want a stable euro, then a new Stability and Growth Pact must be introduced that is more rigorous than the one we had.

What should this new Stability Pact look like?

- The maximum deficit-GDP ratio would have to be inversely related to the debt-GDP ratio. That means that if a country has a national debt of over 60 percent, it will have to accept a smaller budget deficit ratio. And *vice versa* if a country saves more and has less debt than 60 percent of GDP, then in a crisis it can have a budget deficit that is higher than 3 percent.
- There should also be an automatic enforcement of the Pact. We cannot have the offenders judging each other and deciding whether a penalty should be issued or not. The Ecofin Council is not the right institution to determine how high the penalties should be. We need a fixed formula for an EU penalty tax on excess debt. The penalties must be high and they should go to the non-offending EU countries.
- When the offending countries do not have enough cash, they can pay with covered bonds, collateralized with privatizable government debt.
- A European public prosecutor or enforcement agency is necessary to ensure that the authorities are working properly, that there is no deception as was the case in Greece, and that Eurostat does not turn a blind eye to the truth.
- We also need *ex ante* budget control for the offenders. If a country violates the debt criteria, it must have its deficit approved by the EU.
- An upper limit should be set on the help to countries in need. A maximum EU loan of 10 percent of GDP should be allowed. If that is not enough, the country would have to leave the eurozone.

Only a credible and absolutely reliable strategy, which determines how the EU should react to offenders, can prevent countries from becoming future offenders.

Panel 1

Globalization and the Crisis

Barry Eichengreen
University of California, Berkeley

Hans-Werner Sinn has asked me to consider the connections between globalization and the crisis. He did so, I suspect, because I am an international economist and there are international economics who will claim that globalization is at the root of recent events. I hate to disappoint, but the roots of the crisis, in my view, lie elsewhere.

Fundamentally I see the crisis as the result of flawed regulation and perverse incentives in financial markets. Regulators bought into the arguments of the regulated that financial institutions could safely operate with a thinner capital cushion. They accepted the premise that capital adequacy could be gauged on the basis of the banks' internal models and, where these were absent, ratings of securities provided by commercial credit rating agencies, notwithstanding the incentives for the proprietors of the former to tweak their models to minimize estimated risks and capital requirements and the tendency for the latter, as investment advisors as well as issuers of ratings, to fall prey to conflicts of interest. The regime that resulted was capital poor and dangerously procyclical. Regulators neglected liquidity, assuming away problems in wholesale money markets. Banks were allowed to hide risks in conduits and structured investment vehicles and window dress their balance sheets. Agency problems flourished at each stage of the originate-and-distribute process. Mortgage brokers had no fiduciary responsibility to homeowners. Banks not keeping a participation in the complex derivative securities they originated felt no responsibility to investors. The structure of compensation encouraged bank executives to roll the dice, disregarding the implications of their actions for the survival of the firm. And the regulators averted their eyes. If you want my summary of the crisis, there you have it, in one paragraph.

Of course, this summary goes only an inch below the surface. The deeper question is how these indefensible circumstances were allowed to arise. Here I would cite a powerful ideology of deregulation stretching back to at least the Reagan-Thatcher years. I would cite excessive confidence in quantitative methods of risk management, Value at Risk, and of asset pricing, the Black-Sholes model. I am not acquitting the academy, in other words; we too fell prey to a powerful collective psychology. I would cite the intensification of competition, with the Glass-Steagall restrictions starting to crumble even before passage of the Gramm-Bliley-Leach Act in 1999, encouraging banks to take on additional leverage in their desperation to maintain normal returns. Finally, I would cite the conscious policy of the Bush Administration to starve the regulators of human and financial resources. It is hard to understand the pre-crisis behavior of the Securities and Exchange Commission any other way. There's my summary of the deeper causes of the crisis, again in one paragraph.

What about globalization, which is what I was in fact asked to talk about? There are two connections. The oblique connection is between globalization and the competitive pressure that encouraged excessive risk taking. Financial institutions stretched for risk and gambled for survival as their profit margins were squeezed by growing competition. The intensification of competitive pressure reflected the increasing ability of commercial and investment banks to infringe on one another's turf. It reflected the growing overlap between banks and markets resulting from the dual processes of securitization and disintermediation. But another source of pressure was international competition, as finance was globalized, and in Europe in particular as the single market led to increasing in cross-border competition. It is no coincidence that previously sleepy Landesbanken were so heavily invested in toxic securities. I regard this as an indirect but important consequence of financial globalization.

The subsidiary connection is between global imbalances and the asset bubble. As I have said, the match that ignited the fire lay elsewhere, in lax regulation and perverse incentives in financial markets. But glob-

al imbalances poured fuel on the blames, leading to a once-every-hundred-year firestorm. With significant amounts of foreign capital (official capital in particular) flowing toward the United States, long-term interest rates were lower than otherwise. This, of course, is Mr. Greenspan's own explanation for his now notorious bond market 'conundrum'. The low level of long-rates encouraged households to assume additional mortgage debt. It encouraged portfolio managers to stretch for yield. It encouraged additional risk taking by fund managers who found it increasingly difficult to meet historical benchmarks.

The question is how much difference the capital flows associated with global imbalances made for the course of the crisis. I regard them as secondary factors – which is not to dismiss them but only to put them in their place. Empirical studies put the impact of foreign inflows on US treasury yields in 2004–2006 at 50 to 90 basis points (Warnock and Warnock 2009; Craine and Martin 2009). The incentives created by this fall in long rates no doubt encouraged the excesses that culminated in the crisis. Still, I would ask: how different would the crisis have been had US long rates been 50 or 70 or even 90 basis points higher? Not that different, I would submit. Agency and regulatory problems in financial markets, in conjunction with what would have still been a relatively permissive credit-market environment, would still have produced a major bubble and then significant dislocations when it burst.

What do I expect now in terms of regulatory reform? I expect a drawn-out process. In the United States, we have now passed the Frank-Dodd financial-reform bill, and President Obama has signed it. But it now falls to the Securities and Exchange Commission and other agencies to draft the regulations required to apply the law. The Basel Committee on Banking Supervision has issued a proposal for countercyclical capital buffers, but without indicating how countercyclical or how big. The Basel Committee has indicated that capital requirements will be supplemented with a simple leverage ratio, but it hasn't specified the ratio in question.

The difficulties of reaching agreement and coordinating regulation across countries suggest that there may be pressure to make finance a more national affair. Cross-border financial institutions will be tolerated only where the risks they create can be safely managed. And they can be managed only where there is agreement on the risks requiring regulatory cooperation. In practice, however, national officials continue to disagree about the nature of the problem. European officials see hedge funds and private equity firms as significant threats to financial stability and recommend clamping down on their operations. US and UK officials disagree. The EU can go ahead and apply strict regulation to hedge funds and private equity firms, but the latter will then simply have an incentive to relocate in the United States. EU officials have indicated in this case that they will adopt regulations limiting the ability of European residents to invest in foreign-headquartered hedge funds and private equity firms. This is as good – or bad, depending on your view – an example of the dynamics of financial de-globalization as one can imagine.

And even where there is agreement, there are problems. There is consensus in both the United States and Europe, for instance, on the need for an orderly resolution mechanism as a third way, besides uncontrolled bankruptcy and bailouts, for dealing with troubled banks, bank holding companies, and nonbank financial firms. But many of our big banks, bank holding companies and nonbank financial firms are international, even global, in scope. The best efforts of the Basel Committee's Cross-Border Bank Resolution Group notwithstanding, there has been little progress in creating a global resolution mechanism.

If regulators are serious about creating an orderly resolution mechanism as an alternative to uncontrolled bankruptcy and bailouts, they have no choice for the time being but to do so at the national level. The geographical domain of big financial organizations will therefore have to be made to more closely coincide with the domain of the respective resolution authorities. I would note that the Cross-Border Bank Resolution Group recommends making large financial entities less complex and interconnected. By implication it is pointing to the need to make them less international.

Finally monetary policy and global imbalances: I suspect that the immediate future will resemble the immediate past to a greater extent than many observers stipulate. To paraphrase a familiar quip about the weather, everyone says that monetary policy should be reconceptualized to better deal with the risks posed by asset bubbles, but no one does anything about it. We have yet to move beyond statements of principle. Specifically, there is no agreement on whether central bankers can in fact identify bubbles, how they should do so, on the circumstances under

which they should lean against them, and on exactly how hard they should lean. Absent answers to these questions, I suspect that talk about adjusting monetary policy in response to asset market conditions will remain just that, talk.

Global imbalances will be smaller than they were at their pre-crisis peak, because US investment rates will be lower and because foreign finance for the US current account will be less freely forthcoming. But they are not going away. Surplus countries like China and Germany need to raise their consumption, while the United States needs to raise its saving in order to make further progress in rebalancing the world economy. This, and not the exchange rate, should be the focus of the rebalancing debate: what can be done to accelerate the rate of growth in consumption in China and Germany, and what can be done to accelerate the rise in saving in the United States. Chinese households, when they consume more, consume disproportionately Chinese stuff. US households, when the consume less, consume disproportionately less US stuff. So the price of Chinese stuff will have to rise relative to the price of US stuff. This is just another way of saying that the real exchange rate will have to adjust. It will have to adjust either through inflation in China and deflation in the United States, or else through a change in the nominal exchange rate. Personally, I prefer achieving the requisite change in the real exchange rate by allowing the nominal exchange rate to adjust.

This way of putting things has three implications. (There is a fourth implication, for the internal dynamics of the euro area, but I will resist the temptation to go there.) First, adjustment of the exchange rate goes together with the adjustment of spending levels: it is not the catalyst for them. But even if it is not the catalyst, exchange rate adjustment is needed to clear markets in general equilibrium.

Second, adjustment of the exchange rate will be slow and gradual rather than abrupt and discontinuous because the evolution of US and Chinese spending patterns will be slow and gradual rather than abrupt and discontinuous. It will take time for Chinese households to change their habits. It will take time for the Chinese government to build the social safety net that those households require to feel comfortable with lower levels of precautionary saving. It will take time to strengthen the governance of big state enterprises so that they pay out more of their earnings in wages, fringe benefits and dividends. And it will take time, like it or not, to narrow the gaping budget deficits that are now the main cause of low national savings rates in the United States, household savings rates already having risen.

Finally, because these adjustments will take time, the elimination of global imbalances will take time. They will be with us for years to come. In the short run, they are likely to widen out again as US investment recovers. That's bad news. The good news, such as it is, is that global imbalances were not the prime mover in the recent crisis.

Thank you very much.

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Panel

The European Editor of *The Economist,* **John Peet,** chaired the first panel and expressed praise for the organisers for the timing of the conference: after the Icelandic volcano had settled down and shortly before the British general elections, and only days after the Greek crisis had come to a head.

Martin Zeil, Bavarian State Minister of Economic Affairs, Infrastructure, Transport and Technology, pointed to the need for precise instruments for European fiscal policy with rules of the game that apply equally to all members and effective control systems in the eurozone. With regard to the criticism aimed at the German business model, he observed that the problem is not Germany's competitiveness but the loss of competitiveness in other European countries. Germany for its part must strengthen its domestic economy with structural reforms on the supply side that lead to sustainable growth from which all euro zone members would profit. Zeil also argued that there is no alternative to globalisation: protectionism is an illusion, not a solution. "Open markets are the life line of Europe, Germany and Bavaria".

For **Lady Barbara Judge** of the UK Energy Authority the role of globalisation in the financial crisis was more subtle than normally assumed. "It wasn't just

that you could buy Californian mortgages in Germany but it was that everybody was watching it". Everybody watched the lines in front of Northern Rock on television that helped build virtual lines of depositors that wanted their money back. This kind of globalisation turned the financial crisis into a pandemic; the dramatic effect of the media contributed to turning a local banking crisis into a global crisis. The global supply chain then exacerbated the banking crisis, turning it into an economic crisis. Fortunately there was no repeat of the Great Depression because the international community acted immediately, decisively and in a coordinated way, putting in place significant fiscal and monetary stimulus and restoring confidence quickly and effectively. "The recession was painful but not killing". Globalisation lifted millions out of poverty over the past 30 years and its advance cannot be stopped. What the financial crisis shows is that we were ill-prepared to manage our global economy; "putting in place the necessary mechanisms to run the global economy is not going to be easy" but there is no other option. We need regulation that is global and we must avoid a situation where regulatory arbitrage prevails.

Martin Blessing, Chairman of the Board of Managing Directors of Commerzbank, pointed out that globalisation and the free movement of capital did not cause the financial crisis but helped it spread around the globe. Financial markets must remain international, but better regulations are needed in line with the 4 points made earlier by President Horst Köhler. He was not in agreement, however, with a tax on international financial transactions as this is far too complex. "We need to think of other instruments that are easier to implement". On the euro crisis, Blessing stressed that Europe needs to move towards a more politically and fiscally integrated system. The euro was created as a force for economic and political integration. "Without political integration Europe will become more and more unimportant globally".

Theo Waigl, the German finance minister during the negotiations for the Stability Pact and the single currency, observed that globalisation is an irreversible process. The risk of contagion is higher, to be sure, but the 'smoothing mechanisms' are also stronger. The lessons to be learned from the crisis are that freedom needs order, i.e. financial regulation. We also need a 'convincing consolidation strategy' to follow on the effective but very expensive action to respond to the crisis. Can this work? It did in the Clinton administration, which focused on consolidation, bringing about a budget surplus and new jobs. With regard to the euro, Waigl stressed that the euro is now stronger than originally anticipated. Inflation is under control, the ECB is performing well. And Germany has benefited from this. With regard to Greece there was no choice but to put it under budget control, and fortunately the experts of the IMF are also involved. For states with excessive deficits, the temporary withdrawal of voting privileges would be a better disciplinary instrument than monetary fines.

In the discussion **Brian Carney** of *The Wall Street Journal* asked what the legal ramifications of going against the no-bail-out clause of the Maastricht Treaty are. Barry Eichegreen replied, "legal niceties notwithstanding" we have to deal with the facts that are there, and the courts will certainly see the need to have dealt constructively with the Greek problem. Theo Waigl asserted that although the euro countries are not obligated to assume the debts of others of its members, they are not prevented from helping these countries – 'under strict conditions'. This stance would also stand in the courts, he was convinced.

What is needed more than fiscal integration, according to Hans-Werner Sinn, is debt control. Martin Blessing replied that the present debt-control mechanisms in the euro area have not been effective. Stricter controls would of course infringe on national sovereignty and this may be necessary for further integration. Without the mechanisms to enforce fiscal discipline, he fears that the euro will not work. Martin Zeil pointed out that Germany contributed to weakening the Maastricht rules itself and this "has now caught up with us". **Axel Weber** emphasised that the stability-oriented policy in the euro area has been working well for 10 years. The problem is the implementation. "We focused too much on the deficit and not on the debt. We failed to consolidate in good times". The lesson for the future is to use the recovery to tighten budgets and to move to sustainable budgetary positions.

John Peet brought up the criticism of German policy expressed by French Minister Christine Lagarde that Germany is causing a problem for its partners by running a very large current-account surplus, forcing others in the euro zone to run current-account deficits. Theo Waigl stressed that Germany, faced with the huge costs of unification, chose a moderate wage policy and it cannot be faulted for this. Germany can

indeed improve its investment structure, especially with regard to research and education, but calling for higher wages to increase purchasing power is not very good advice. Martin Zeil pointed out that Germany cannot accept measures that would weaken its competitiveness on international markets. Axel Weber added that the high savings rate in Germany is motivated by its citizen's precautionary attitudes with regard to future security. In the United States, with its higher population growth rates, ordinary people tend to invest more in the stock market.

Panel 2

Managing the Crisis

Keynote Address by

Valdis Dombrovskis
Prime Minister of Latvia

The topic of this panel – Managing the Crisis – has been the leitmotiv of my term as Prime Minister of Latvia. In my remarks I will look back at the roots of the crisis in Latvia and highlight the features specific to our situation. I will also explain how we are emerging from the crisis, and what lessons can be drawn.

After joining the EU in 2004, until 2007, Latvia enjoyed a period of strong double digit economic growth. Cheap credit was available on international financial markets, which most of our commercial banks used to fund a generous crediting policy. Easily available credits fuelled domestic demand, which led to the economic boom. The Latvian government during those years adopted loose fiscal policies, despite repeated strong warning signals about overheating from the European Commission and the IMF. Nevertheless, Latvia neglected these warnings.

As a result, during the boom years Latvia built up large economic imbalances. Capital inflows in the non-tradable sector caused the real estate bubble to balloon and accelerated inflation. Meanwhile, strong wage growth undermined the competitiveness of Latvian producers and stalled export growth. As a result, the current account reached a record deficit of 22.5 percent in 2007. Regrettably, no thought was given to building up reserves during the boom years.

And then the crisis hit. The global financial crisis at the end of 2008 amplified Latvia's domestic imbalances, causing sharp economic contraction. GDP fell by 4.6 percent in 2008, after 10 percent growth in the previous year. GDP in 2009 was 22 percent down from 2007. Employment in 2009 was 12 percent down from the previous year.

In late autumn of 2008, Latvia had no choice but to request international financial aid. A sum of 7.5 billion euros was provided by the EU, the IMF and our regional neighbours. In order to bring the economy back on a sound and sustainable footing, it was crucial to implement a national programme, first, to withstand short-term liquidity pressures, second, to improve competitiveness, and third, to support an orderly correction of imbalances in the medium term. Latvia has now taken all necessary consolidation measures, predefined in the programme, by carrying out structural reforms and stabilising the situation in the financial sector.

As a small, open economy, Latvia was badly hit by a combination of three factors: first, the global financial crisis, second, irresponsible fiscal and macroeconomic policies, and third, a run on PAREX Bank. Latvia plunged into the deepest recession ever experienced by an EU member.

The international bail-out package came with strong conditionality, asking the Latvian government to commit itself to decisive structural reforms. As the saying goes, reforms begin where the money ends. My government took office in March 2009 after the failure of the previous government to make the necessary amendments to the state budget. From the beginning, we have been committed to major economic and social reforms.

Regaining national competitiveness was set as the over-arching priority. Here, we had a double objective. Short-term competeviness meant improving ratings by the largest international rating agencies as soon as possible. In parallel, we had to restructure from an inward looking economy, based on real estate and local services, towards an export-oriented economy able to compete on the European and global stage. To boost national competitiveness, we have chosen structural reforms based on three pillars – economy, social system and public sector.

Economic reform is happening mainly through EU Structural Funds, as no other financing was available for stimulating growth. The aim of our activities is to support enterprises in increasing the value added of their production, as well as their ability to export. To achieve this objective, we have put in place programs

promoting innovative products and services as well as the export credit guarantee schemes. On a more macroeconomic policy level, although the margin of manoeuvre is rather limited due to our commitments towards international lenders, we are looking at reshaping our tax system in the medium term.

One of the features of the Latvian social system was poor accessibility and inefficient targeting of social benefits. My government has put in place an emergency safety net, keeping a focus on active labour market programs and reviewing the benefit system. In 2009 and 2010 we consolidated the budget by 1 billion *lats* or over 10 percent of GDP. The challenge is to make the right decisions on social sector reforms to increase efficiency, but not jeopardize the economic growth prospects in the medium and longer term.

I have a large collection of news headlines from last year predicting total economic and financial collapse for Latvia. Also there were large speculations against the *lats* and I am glad to say that those predictions were wrong, and Latvia not only survived, but is recovering well. As the Wall Street Journal noted on 10 April this year, "the case of Latvia shows that with enough political will, it is possible to slash a fiscal deficit even when an economy is collapsing". The case of Latvia also shows that it is very difficult to apply a 'one size fits all' approach to economic problems, due to local conditions and culture. There is no magic remedy.

Managing the Sovereign Debt Crisis

Manfred J. M. Neumann
University of Bonn

The worldwide financial and economic crisis is over and a firm upswing is underway. The economic recovery appears to be less strong though than was to be hoped for after the severe recession of 2008/09. It had cut GDP back to 2006/07-levels for many economies. As regards financial stability, some larger European banks still are operating on shaky grounds given that they have not substantially raised their capital. The situation is aggravated by the fact that quite a few of them are sitting on large positions in domestic and foreign sovereign debt. Buying this type of debt had been attractive to many banks for long, given comparatively high yields to earn plus the regulatory benefit of having no capital at all to hold against asset positions consisting of public debt.

The alleged security of sovereign debt has come into serious doubt since the outbreak of the worldwide financial crisis and more so when many governments responded to the crisis by bailing out banks and pushing up deficits. As a result, since early 2010 the financial crisis looms again, this time as a solvency crisis of sovereign debt, predominantly of south European origin. While the crisis threatens the solvency of the debt holders, banks as well as other financial institutions, it is not a euro crisis. The euro has become a world currency. It is a currency of stable internal purchasing power that would not be affected by solvency problems of any member country, let alone Greece. The fact that the external value of the euro is moving in longer swings over time is normal under the regime of flexible exchange rates, hence must not be interpreted to be a crisis phenomenon.

In this note we focus on the solvency crisis of Greece, the rescue measures taken by Greece, the EU and the ECB, and on the consequences to be drawn to avoiding similar adventures in the future.

Why Greece?

Greece is not the only European country whose sovereign debt has come into doubt since the turn of 2009/10. However, Greece was the first and hopefully only country that was confronted with the hard choice between declaring bankruptcy and asking its partners for substantial rescue measures.

A few observations may be sufficient to characterize the Greek economy.[1] Greece is one of the poorer eurozone member countries; the per capita income is below 90 percent of eurozone average. Also, the country is rather small; its share in euro-GDP is no more than 2.6 percent. The Greek export structure is dominated by services, notably transportation services and tourism. While the balance of services is in surplus year after year, the trade balance is in serious deficit and dominates the current account. The trade deficit has moved from 19 and 27 billion euros during the past decade. As a result, the current account has remained in deficit since 2000. In 2008 it reached a record high of 34.8 billion euros or almost 15 percent of GDP. The permanence of current account deficit reflects a basic weakness of the Greek economy: its development is consumption driven. Private consumption amounts to 73 percent of GDP in Greece to be compared to only 57 percent in the eurozone. Adding public consumption provides a total consumption ratio of 89 percent for Greece but no more than 77 percent for the eurozone. The excessive private propensity to consume is also reflected in an extremely low savings ratio; it amounted to no more than 0.5 percent of disposable personal income on average over the period 2000–2009.

In principle, it would have been possible for the Greek governments to consolidate budgets by enforcing higher taxation, thus curbing private spending some-

[1] Data sources used are Eurostat and the Bank of Greece.

what. But in fact, borrowing was preferred by the socialist as well as the conservative governments. To be sure, the cheap availability of credit in international capital markets after Greece's accession to the eurozone in 2001 was tempting, hence promoted the governments' lenience to easy finance. As a result, the Greek deficit exceeded the 3-percent threshold of the Stability Pact year after year with the exception of 2006 and Greece' sovereign debt level doubled in no more than ten years, reaching 273 billion euros by the end of 2009.

From hindsight, it is not too surprising that it was Greece which suddenly came under critical scrutiny by international investors as well as the rating agencies. In contrast to Portugal, Italy or Spain, Greece had become insolvent already in 2009, if not earlier, because its internal economic policies were unsustainable for long and had resulted in a current account deficit that was widening continuously. In 2009 it reached 27 billion euros or 11 percent of GDP. The real surprise is how long it took the international financial markets to detect that Greece was unable – and still is – to service and repay its external debt.

The rescue package

The risk premium on Greek debt started rising in November 2009 after a newly elected government had revised upward the reported 2009-deficit figure from 3.5 to 12.7 percent of GDP. This was a dramatic revision that was badly received on the background of widespread mistrust in the reliability of Greek statistics.[2] In a series of political negotiations that followed during the first quarter of 2010 Greece promised its partners to adopt structural and fiscal reforms. The Hellenic Stability and Growth Programme stages a three-year reform supported by the euro area member states (Euro Group) and the IMF. As regards fiscal consolidation, various types of spending cuts and measures of raising taxation shall be combined to achieve a programmed consolidation from both sides of the budget. Among the measures to be taken the following are worth noting: a reform of income taxation such that different sources of income are treated equally and all exemptions are repealed; a further increase of value-added taxation; a serious cut into the wages and bonuses paid to the civil servants; and a revision of pension law to raise the entrance age. The Euro Group responded to the Greek agenda by announcing its readiness to take measures for 'supporting financial stability and the euro'. The end of the story was that the EU put up a rescue package for Greece of 110 billion euros, to be financed jointly by the eurozone members (80 billion euros) and by the IMF (30 billion euros).

The package is supposed to guarantee financial support for three years and is conditional on Greece carrying out the domestic measures specified in accordance with the calendar set out. Table 1 differentiates the main uses of the support. The table shows that the maximal deficits accepted by the EU in March were slightly raised in May.[3] The bulk of finance, totalling 79 billion euros, will serve to permit Greece the redemption of maturing international loans, i.e. the replacement of private investors by member governments of the eurozone. Another 50 billion euros will serve as fresh money to facilitate the finance of Greece's budget deficits 2010–12. Note that the total support required may rise to even 130 billion euros instead of 110, except Greece will be able to refinance a larger part of its maturing debt. A basic assumption of the calculation presented is that the consolidation programme promised by Greece will permit cutting the deficit – that had reached 13.6 percent of GDP in 2009 – in 2010 by 5.6 percent of GDP down to 8.0 percent, to 7.6 percent in 2011, to 6.5 percent in 2012 and to 4.9 percent in 2013.

While the consolidation programme is impressive and the idea of a stronger frontloading convincing given that the sharpest cuts must always be made at the start to make an austerity programme politically viable, it is open to serious doubt that the Greek government will be able to deliver the measures as planned. The required size of the budget cuts, notably in 2010, is impressively large and potentially dangerous. The Greek Ministry of Finance expects that the Greek GDP will fall this year by 4 percent and next year by 2.6 percent but will return to growth in 2012.[4] It should be no surprise, however, if the Greek economy ends up in a more severe and longer lasting recession. If so, it will damage tax receipts and possibly require additional social expenditures. Thus there is some danger of social unrest that could slow down if not terminate the execution of the consolidation pro-

[2] In its 'Stability and Growth Programme 2000–04' the Greek government reported a deficit of 1.8 percent of GDP for the year 1999, the test year as regards admission to the euro union. The true number is conjectured to have been much higher but is unknown. Accordingly, Eurostat's data series on the deficits of member states provides a blank for the Greek deficit of 1999.

[3] See Council of the European Union, Ecofin Doc. 250, UEM 171, 7 May 2010.

[4] See Hellenic Stability and Growth Programme Newsletter, 17 May 2010.

Table 1
Checking on the size of the rescue package for Greece (in million euros)

	Total support as of		Classification of total support		
			Debt redemption	Fresh deficit as of	
	March	May		March	May
2010	37.1	34.2	15.8	21.3	18.4
2011	45.5	48.4	31.3	14.2	17.1
2012	39.1	46.6	31.7	7.4	14.9
2010–2012	121.7	129.2	78.8	42.9	50.4

Sources: Bloomberg; European Commission; own calculations.

gramme. In that case the rescue package will turn out to be too small and it is not clear at all that any euro government will be ready to contribute to another programme for Greece.

Is the package a breach of the Maastricht Treaty?

Until only recently the citizens of the EU member countries had reason to believe the long held claim of governments that they had provisioned for a strong no-bail-out clause in the Maastricht Treaty. Meanwhile, the governments have made it clear that from their point of view that was a faulty perception. Two articles of the Lisbon treaty need to be examined – Article 122 and 125.

Article 125 (1) contains indeed the famous no-bail-out principle: the EU as well as any member state "shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State". Not being liable for existing commitments of any member state is an important guarantee. In fact, it is a constitutive condition for any union because it serves as a protection against the exploitation by overly indebted countries. But the no-bail-out guarantee must not be interpreted to mean that member states are not allowed to grant financial aid or loans to any member state if they so desire.

Moreover, joint financial aid by the EU may be granted in cases of emergency. The relevant Article 122 (2) states: "where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the European Council may grant the financial assistance to the Member State concerned." To be sure, financial aid by the EU, not by the member states, is conditioned. It requires that the member state asking for help is troubled by 'exceptional occurrences beyond its control'.

The stipulation 'beyond its control' is open to legal interpretation. It is appropriate to differentiate the short from the long run. The sudden outbreak of a solvency crisis with risk premia jumping creates a situation that is difficult to control. At the same time, such a crisis does not happen at random but is the result of misguided policies of long standing that in principal could have been corrected if not avoided from the beginning.

No alternative to the rescue package?

Contrary to the official view held in politics there was an alternative to the plain bail-out of Greece. From a purely economic point of view, Greece could have considered to declare default and to exit from the eurozone for a couple of years. From a political point of view, however, that solution was not attractive, neither to the Greek government nor to the other European governments. The common belief was that the exit of any country from the eurozone would be taken worldwide as a signal that the euro was not a viable currency.

The declaration of default would have permitted Greece to ask for a restructuring of its sovereign debt; its level that had risen to 273.4 billion euros by the end of 2009. It seems that setting a demanding target for debt relief, a cutting by 40 percent, say, would have been a defendable aim. Such a cut would have brought the necessary relief to Greece; it would have reduced the government's annual interest burden by almost 5 billion euros or 2 percent of GDP. To be sure, the cut would have implied asset losses amounting to 20 billion euros for French, 11 billion euros for German, and 8 billion euros for Italian investors, hence a Greek default would hardly been attractive to them. The rescue package, in contrast, serves to bail out the private investors at the expense of European governments, and, should things eventually go badly, at the expense of the tax payers. In any case, the current package does not provide debt relief to Greece.

Apart from default, a pending issue is how to achieve an effective devaluation. Greece has seriously lost competitiveness during the last decade, not just with respect to tradeables but also as regards services, notably transport and tourism. Hence the Greek economy needs a significant devaluation. The planned redressing of government spending by cutting the wages paid in the public sector by 15 percent and more may somewhat contribute to reducing the general wage and price level in Greece but the degree of adjustment will hardly be a strong one. It goes without saying that the Greek government cannot order similar cuts to the wages paid in the private sector. Thus, Greece would have been better off if it still would be in command of a currency of its own; in that case it would have been possible to engineer the necessary real devaluation by means of a monetary devaluation. In principle, it would have been preferable to letting Greece exit from the eurozone for a couple of years. But in practice and to politicians the idea is a far cry from academia that must not be listened to. Whether this attitude will remain, should the rescue package fail, remains to be seen.

A new playing field for the European Central Bank ?

The debt crisis has inspired the ECB to start intervening in selected sovereign bond markets. Those bonds are used by banks as collateral to their borrowing from the ECB and a uniform quality standard was the rule. Recently, however, the ECB has started discrimination when it first decided to reduce the minimum standard for Greek government bonds, next abolished the minimum standard, and finally decided to even buy Greek bonds outright.

From a purely technical point of view this new intervention policy amounts to subsidizing Greece at the expense of the other eurozone member states. It is not obvious that the ECB is entitled to discriminatory subsidization. More importantly, the decision to buy government bonds outright is most unfortunate as it may seriously hurt the ECB's reputation as inflation fighter, at least in Germany. There it is almost common knowledge that all large inflations resulted from the monetisation of government debt by compliant central banks, notably the German hyperinflation of 1921–23. In view of this, the Deutsche Bundesbank used to emphasize the fact that it stayed away from buying government debt and so did the ECB during the early years. It seems the ECB would be well advised to return to that tradition.

Some lessons

One lesson for the EU is that it is potentially very dangerous tolerating the not playing by the rules that some member countries have become used to. Greece is the most prominent example. In only one out of the nine years since Greece became member of the eurozone the country has honoured the 3-percent deficit limit of the Stability and Growth Pact. True, Greece repeatedly deceived the European Commission, and it took a long time to find it out. Even so, the time it takes from the first observance of a too high deficit until the decision of applying a sanction is taken is generally much too long.

In fact, sanctions have never been applied because the European Council has simply avoided taking the decision. The lesson from this bad practice is that sanctions must not be politically negotiable but need to be automatic. When the deficit limit is exceeded, the sanction should be set to force without any further consideration. Only after the sanction has been initiated the Council might consider a revision provided the country in question has a valid point. Also, sanctions must be biting in the sense that a priori politicians will wish to avoid them. Financial fines make little sense because they do not hurt governments and, moreover, make the financial situation of an overly indebted country worse. A much more effective sanction might be the temporary loss of voting power in the Council. It hurts the politicians concerned directly because they lose influence and public reputation. It is conceivable that the danger of losing personal reputation will induce them to avoid violating the Stability and Growth Pact.

The most important reform to consider is negotiating a declaration on sovereign insolvency proceedings for eurozone members. The advantage of an orderly insolvency is that the country in question in one stroke gets rid of a larger part of its debt burden. This goes – as it in principle should – at the expense of investors, among them possibly larger banks of other euro union member countries. One or the other of these banks might not be able to bear the loss. If there is reason to expect that a break down of that bank endangers the stability of the payment system the respective government will have to consider stepping in by providing capital. While this is a cost to consider, in all likelihood it will become the higher, the longer an overly indebted government has the means to postpone declaring insolvency. Under conditions where this government can trust that it will

be bailed out by the euro union, it will prefer the instrument of rescue package and flatly reject the instrument of orderly debt restructuring. Consequently, to reach an agreement among the eurozone members on a declaration on sovereign insolvency proceedings the German government will have to consider taking the harsh position of indicating that it will not participate in any future rescue package if the partners reject provisions for sovereign insolvency. Should the German government not succeed, the danger is that the euro union will drift further into indebtedness and instability.

Panel

Panel 2 was chaired by **Brian M. Carney,** Editorial Page Editor of the *Wall Street Journal,* London.

A further academic introduction was given by **Giancarlo Corsetti,** Economics Professor at the European University Institute, Florence, who stressed that fiscal consolidation is now the key policy strategy for managing the crisis. As we now exit the crisis, we are left with large debt, public and private, and with low growth prospects for most of the globe. Macroeconomic stability and low interest rates must be regarded as a public good that we must pursue with our policies. Low interest rates give governments a breathing space to commit to debt consolidation, which it turn is needed for macroeconomic stability. There is a 'virtuous circle between consolidation and low interest rates'. Consolidation is the essence of the recovery. The recession we are witnessing is strange because it started from global uncertainty. Before 2007, a collapse of the financial system was completely unimaginable. With the uncertainty during the crisis, everything simply came to a halt. In this situation, fiscal stimulus worked because governments came in to reassure the private sector. Risk was the essence of the crisis, and it was shifted from the private-sector to the public-sector balance sheet. The essence of the recovery is to shift risk back to the private-sector balance sheet – it needs to invest and plan. There is of course a concern that debt restructuring could stall the recovery since it implies a drag on aggregate demand. In Corsetti's view it is a help to recovery if it is done well, as it grants macroeconomic stability. "A gradual implementation of fiscal correction can moderate the pressure on monetary policy. And the expectation of macroeconomic stability will have an enormous impact on today's stimulus, as it will translate into lower long-term rates and conditions for macroeconomic stability in the financial markets".

The first panel speaker was **Konstantinos Simitis,** former Greek Prime Minister, who spoke in favour of the issuing of Eurobonds that would serve the realisation of investments but also the financing of activities that are conducive for growth and employment. Simitis greeted the eurozone governments' declaration calling for a closer coordination of economic policies in Europe. The way out of the crisis entails moving forward towards an economic governance and political integration in Europe. Specifically with regard to the Greek crisis, Simitis observed that Greece itself is largely responsible for the present difficult situation, but simply requiring Greece to follow the rules is not the answer. "There is a north/south gap in the European Union that must be addressed". He referred to **Martin Wolf** who observed that it would not be possible for all EU states to follow Germany's example, promoting exports and discouraging domestic consumption. Simitis explained that the north/south gap in the EU is not due to character or unwillingness to work in the south but is at its core a structural problem. "I don't know the solution, but I am pointing this out because it is necessary that this be discussed". The Greek crisis itself is a symptom and we need to look at the cause. Finally, a central mechanism is necessary in the monetary union to address the problem of fiscal imbalances.

The next panel speaker, Bavarian Finance Minister, **Georg Fahrenschon,** stressed that the economic situation is not stable but that it is wrong to put all the blame on the speculators; they have the important function of identifying the problems. From the vantage point of a finance minister, it is clear that budget cuts alone are not enough. "We need policies that contribute to sustainable economic growth and the right cuts in the right places". Worldwide, there is one common financial market "and we need a regulation system, accounting standards, supervisory systems" that take this into consideration.

Jochen Sanio, President of the German Federal Financial Supervisory Authority, BaFin observed that governments have pushed themselves to the limit to rescue the financial system, "and yet we are in deep trouble again as financial institutions try to exploit this situation. Public debt has risen to such high levels that the crisis is now at a stage where speculators use the old nuclear financial weapons against individual countries. I take the liberty here to call this

shameless behaviour". This is an indication that we regulators have not done our job, and now there is no more time to lose. The much discussed regulatory tools must be adopted now and "decision-makers should not be too squeamish". The current financial system, according to Sanio, is still a playground for speculators, and one of the main problems is the credit derivatives market. Should credit derivative transactions be prohibited? The idea is appealing but it is not the panacea many believe. It would not make the financial world a safer place, as the new rules would be quickly circumvented. Sanio identified two sensible approaches. (1) The financial incentive structures must be reformed. "Checking unbridled profiteering is a key prerequisite for stabilising the financial markets in the long term". This was the real cause of the financial crisis and will spawn futures crises if nothing is done. (2) Greater transparency on the derivative markets is needed. These markets must be open and all its actors placed under strict financial supervision, including high capital requirements. It is extremely important to create stable regulatory requirements for the derivative clearing houses. We are at the cross-roads today: "people will not tolerate any longer a financial sector that generates vast profits for determined manipulators and inflicts lasting damage on millions of innocent victims".

The last panel speaker was **Theodor Weimer,** Board Spokesman at UniCredit Bank. The financial crisis has lasted much longer than initially expected and people ask themselves when the next bomb will explode. "We are living in a very serious bubble economy" with strong markets that can endanger states and even confederations. In retrospect, the financial market crisis was solidly managed. The question now is who will be the re-insurer of the states. "The problem of leverage and liquidity was fixed with even more leverage and more liquidity". Fiscal deficits have grown ten-fold on a global basis in only three years. Now, either we accept a bubble economy or we proceed down the slow and winding road of deleveraging. "If deleveraging is feasible for the banks, it should be feasible for states too".

In the discussion Hans-Werner Sinn asked why Latvia did not choose to devaluate its currency. Valdis Dombrovskis replied that the competitiveness gained from devaluation would have been short lived as there would be higher costs for imported energy and because 85 percent of Latvia's loans are in euros. It would also have led to a significant redistribution of wealth to the benefit of only a few in the society. With an internal devaluation, Latvia has been forced to make necessary structural changes. Konstantinos Simitis was also asked whether he was proposing a fiscal equalisation scheme for the euro countries. He replied that this is a problem that has not been addressed but needs to be, especially in connection with the burden sharing that already takes place in the EU. **Thomas Moutos,** professor at Athens University of Economics and Business, pointed out that the steady decline in Greece's net savings rate, which had reached minus five percent shortly before the crisis, should have been seen as an indicator of trouble ahead. There may be hope for Greece if the country can solve the problem of massive tax evasion.

Panel 3

Banking Regulation

Keynote Address by

Axel Weber
President of the Deutsche Bundesbank

The financial crisis, though in its third year now, still presents us with a great many challenges. Nevertheless, while the number of challenges has not decreased, their nature has changed. With the stabilisation of markets and the onset of recovery, the focus has shifted from managing the current crisis to preventing future crises. And a cornerstone of this attempt to create a more stable financial system is the reform of banking regulation. As the field of banking regulation is highly complex and involves a host of technical details, I will limit myself to a brief overview of the current state of the reform process, highlighting some critical points. However, I am sure that the ensuing panel discussion will provide us with an opportunity to elaborate on some of the more technical details.

Micro- and macroprudential aspects of regulation

Any attempt to create a more stable financial system 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 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, major elements of these proposals include a new liquidity standard as well as a revised definition of capital. In the course of the current year, the relevant measures will be calibrated on the basis of a comprehensive impact study and be finalised by the end of 2010.

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.

International cooperation and harmonisation

Another factor that increases the complexity of the reform process is the need for international cooperation in order to move to a regulatory level playing-field. Due to the ongoing process of globalisation and the emergence of internationally active banks, international harmonisation of regulation has

become essential in safeguarding the stability of the financial system. The general case for a stronger harmonisation of regulation could be made by imagining a globalised and interconnected world where national rules prevail. In such an environment, internationally organised banks could easily avoid national regulations by shifting business activities across borders. Via this process of regulatory arbitrage they would be able to comply only with the lowest standards and thus endanger the stability of the financial system. At the same time, this behaviour would put those banks at a disadvantage which are not internationally organised. A level playing-field as the basis for fair competition would not exist. Furthermore, nationally fragmented regulatory frameworks would hamper cooperation between home and host supervisors of international banks and thus lower the effectiveness of regulation. Hence, attempts to put the reform of regulatory frameworks on an international footing are fully warranted, even though this adds an additional layer of complexity to the process.

Conclusion

The financial crisis has taught us three very broad lessons. We have to strengthen regulation on the microprudential level, complement it with macroprudential supervision and ensure international harmonisation and cooperation. Although we have already come a good distance, we have to sustain the political will to stay the course. As we are now hopefully entering better times, there is a certain danger that some major issues on the reform agenda might fall prey to dwindling commitment and political interests. However, this must not be allowed to happen, as only a coordinated and harmonised effort will enable us to ensure financial stability and thus pave the way for steady and sustainable global development.

Panel

Anatole Kaletsky, Editor-at-Large of *The Times* and panel chairman, reflecting on the Greek debacle and its then unpredictable consequences for the euro, quipped that the conference title now could well have been 'The Financial Precipice: The Step Forward'. Or the step back, on second thought. He then pointed out that we have gone from a financial crisis in which the banks threatened the solvency of governments to one in which governments threaten the solvency of banks. And, while confident that Greece would be rescued, he wondered whether that would turn out to be the last possible rescue that was fiscally feasible. In that case, "Greece could be the Bear-Stearns of this particular crisis, so the question is what is going to be the next Lehman Brothers?"

With this he gave the floor to **Markus Brunnermeier,** a professor of economics at Princeton, who provided the academic introduction to the regulation issue. Echoing Bundesbank Axel Weber (see previous pages), he pointed out that current regulation is characterised by a micro-prudential approach, in which the risks of financial institutions are considered in isolation, but that future regulation should complement this and be macro-prudential in focus, centring on spillover effects between institutions. These spillover effects can arise both directly (through contractual channels) as well as indirectly (through price channels). For example, in times of crisis, fire-sales depress prices, leading to higher margins and haircuts; higher margins and haircuts, in turn, depress prices further, eroding the wealth of the whole financial sector. Thus, he added, there are three considerations to keep in mind for constructing a macro-prudential regulatory framework. First, existing risk measures, such as Value-at-Risk (VaR), should be replaced with new systemic risk measures like CoVaR, i.e. the VaR of the financial system conditional on institutions that are under distress. These systemic measures should also form the basis for calculating the tax base of any new bank tax. Second, regulation should be countercyclical to reflect the fact that, during the expansionary phase of a credit bubble, risk generally builds up in the background even while volatility is low. And, finally, to adequately regulate the shadow banking system, regulation should include not only financial institutions but also financial instruments.

The first panel speaker was **Robert Kimmitt** of the Deloitte Center for Cross-Border Investment. He called attention to the growing involvement of governments in the business of business, not only as a market participant, but even as owner, pointing out that decisions that matter are increasingly being

made at the intersection where business, finance and government meet. Acknowledging the efforts of the US Congress and the G20 to devise legislation and regulations for the financial system, he harboured the hope that "the key will be a continued effort to strike a balance between prudential regulation and market discipline". If regulation is tilted too far away from the markets, he warned, it could stifle the innovation and entrepreneurship needed for economic growth. He also drew attention to a frequently overlooked aspect: an enforcement agenda. In his opinion, it is going to be very difficult politically to come to agreement in the United States, Europe and elsewhere on this. Still, Kimmitt said, "my personal view is that the new financial services regulatory regime that will emerge in the United States and Europe will be more burdensome, costlier, but ultimately manageable for institutions". Finally, he stressed that it is important to continue this dialogue among business, finance and government on a regular basis, not just in times of crisis.

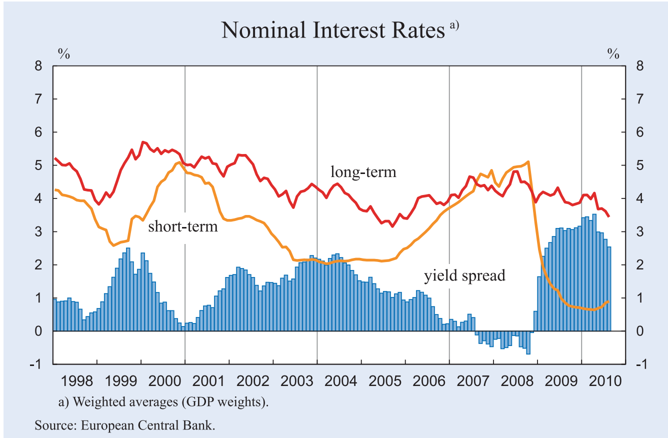
He was followed by **Takamasa Hisada** of the Bank of Japan, who expressed his worries that arguments on the regulatory reforms are focusing too much on capital and liquidity, and less on risks or risk measurements. Capital sufficiency, he said, cannot be appropriately judged unless risks are accurately captured by banks. He also remarked that the capital buffer and the liquidity buffer are not independent in terms of reducing a bank's probability of default. For that reason, he hopes that the Basel Committee and financial authorities in each country will carefully assess the impact of the regulatory reforms and propose a well balanced set of regulations. Timing for the introduction of new regulations is also paramount: a hasty introduction could impair the current economic recovery and may risk a double dip. Finally, Hisada emphasised the importance of country-specific regulatory frameworks that take into account each country's particular financial structure and economic conditions. He believes banking regulation alone cannot secure financial stability or avoid the recurrence of a crisis. Supervision is also important, as is a so-called macro-prudential policy.

The next speaker was **Leszek Balcerowicz** of the Warsaw School of Economics. He focused on how to reduce the incidence of serious financial crises, in particular on how to constrain the growth of booms which, when burst, inflict serious losses in the financial sector, and how to limit the 'transposition' of these losses into negative shocks to the real economy. He compared the former task to the introduction of car speed limits, and the latter to the introduction of safety belts and other safety equipment in the cars. The crucial thing is that this must be achieved in a cost-effective way. This rules out measures that would reduce the risk of such crises but at the cost of stifling the capacity of the financial sector to finance growth-enhancing projects. Most important, however, is to eliminate those policies that have contributed to the financial crisis, such as state-directed credit allocation, persistently expansionary fiscal policies, tax regulations that favour debt financing relative to equity finance, subsidies to mortgage borrowing, financial regulations that encourage excessive securitization, and generous deposit insurance, since it eliminates an important source of market discipline, to name but a few. In other words, care must be exercised to identify those components which enhance risk-taking in the financial sector by crowding-out market discipline or by subsidizing risk-taking, as well as those that enhance the credit and asset booms.

The last speaker was **Karolina Ekholm** of Sweden's Central Bank. From the Swedish perspective, today's financial crisis feels like "we've been there". The silver lining that comes with a crisis is that it does create momentum for reform. Now Sweden is considered as a good example when it comes to public finances, and that is a consequence of the reforms that Sweden was compelled to put in place in the mid-1990s. But the momentum that you get in a crisis does not last very long: "now we have a window of opportunity to enact the reforms to make the financial sector more resilient, but I worry that we have to move relatively fast". The Swedish experience is that once the crisis of the 1990s waned, some of the draft proposals written up were just put away, not being dusted off until the early stages of this crisis. There are lots of proposals now on the table. "I want to focus onto something that has not been talked so much about yet: the issue of how to deal with distressed banks. A problem bank must be handled extremely quickly, otherwise confidence will be lost. For this reason, it is necessary to be clear *ex ante* how we are going to act". In this respect, cross-border banks in distress are a particu-

larly difficult case, and the question of how to deal with them causes specific problems. But, she warned, it would be a pity if as a consequence of such difficulties in dealing with cross-border banks international financial integration were to be rolled back. "Therefore, we need legally binding international agreements that will regulate the principles for burden-sharing of crisis resolution costs between countries", she concluded.

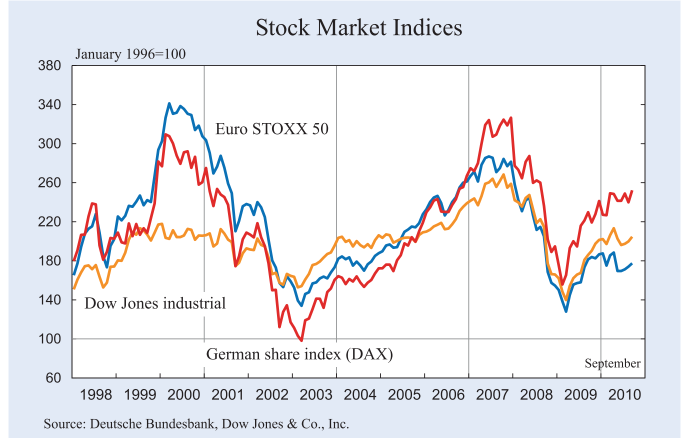
Financial conditions in the euro area



a) Weighted averages (GDP weights).

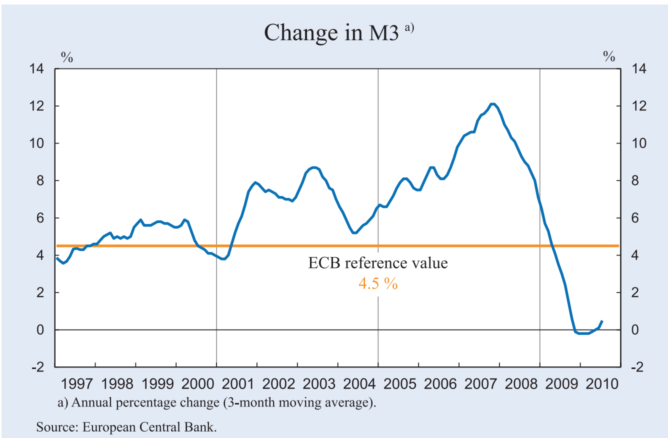
Source: European Central Bank.

In the three-month period from June to August 2010 short-term interest rates increased. The three-month EURIBOR rate grew from an average 0.73% in June to 0.90% in August. Yet the ten-year bond yields declined from 3.70% in June to 3.44% in August. In the same period of time the yield spread decreased from 2.97% (June) to 2.54% (August).



Source: Deutsche Bundesbank, Dow Jones & Co., Inc.

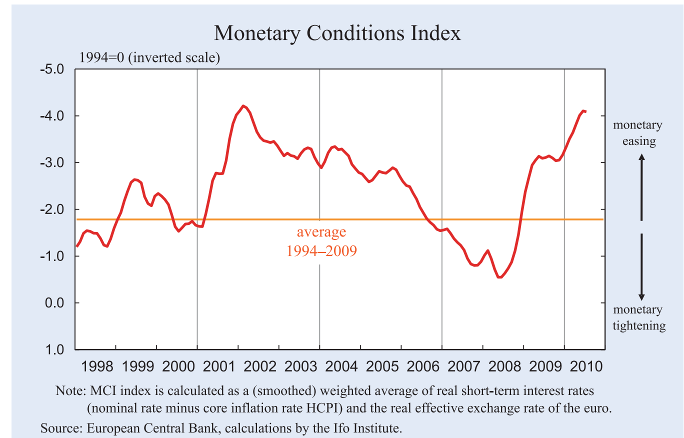
The German stock index DAX grew in September 2010, averaging 6,229 points compared to 6,142 points in July. The Euro STOXX also increased from 2,669 in July to 2,766 in September. The Dow Jones International grew as well, averaging 10,598 points in September compared to 10,222 points in July.



a) Annual percentage change (3-month moving average).

Source: European Central Bank.

The annual growth rate of M3 increased to 1.1% in August 2010, from 0.2% in July 2010. The three-month average of the annual growth rate of M3 over the period from June to August 2010 rose to 0.5%, from 0.1% in the period from May to July 2010

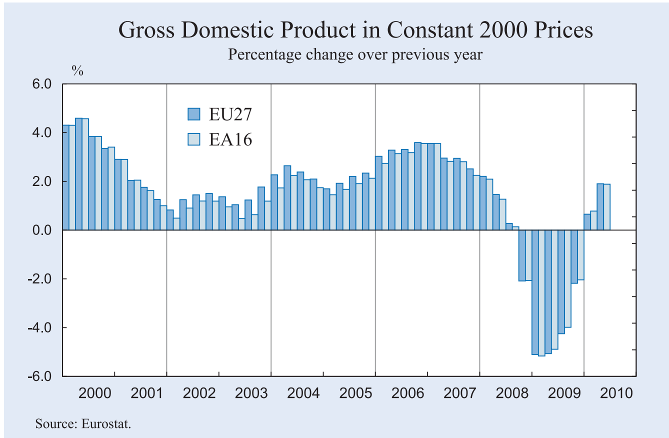


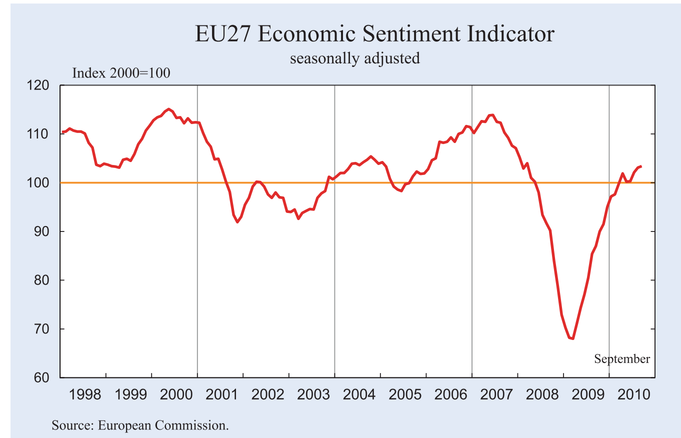
Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.

Source: European Central Bank, calculations by the Ifo Institute.

Between April and November 2009 the monetary conditions index remained rather stable after its rapid growth that had started in mid-2008. Yet the index started to grow again since December 2009, signalling greater monetary easing. In particular, this is the result of decreasing real short-term interest rates.

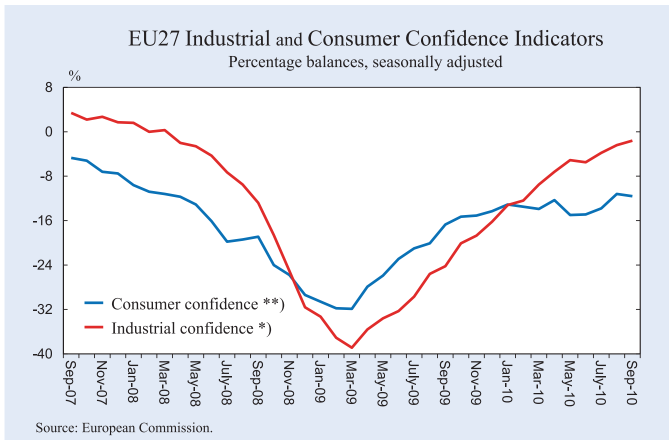
EU SURVEY RESULTS

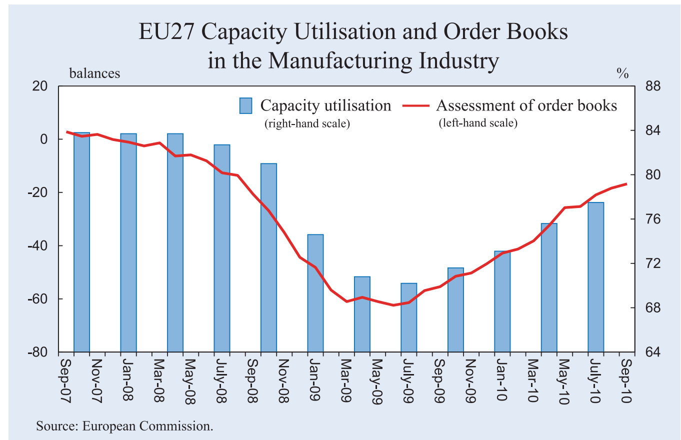




According to the first Eurostat estimates, GDP increased by 1.0% in both the euro area (EU16) and the EU27 during the second quarter of 2010, compared to the previous quarter. In the first quarter of 2010 the growth rate had amounted to 0.3% for both zones. Compared to the second quarter of 2009, i.e. year over year, seasonally adjusted GDP increased by 1.9% in both the euro area and the EU27.

In September 2010, the Economic Sentiment Indicator (ESI) continued to improve in both the EU27 and the euro area (EU16). The indicator increased only marginally, by 0.3 of a point in the EU27 and, more significantly, by 0.9 of a point in the euro area, to 103.4 and 103.2 respectively. In both the EU27 and the euro area the ESI stands above its long-term average.



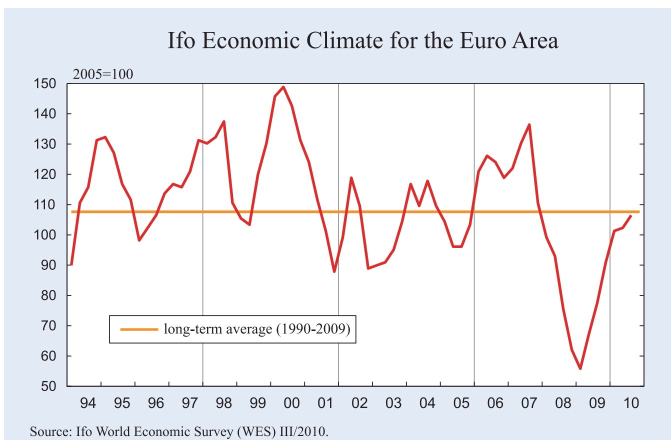


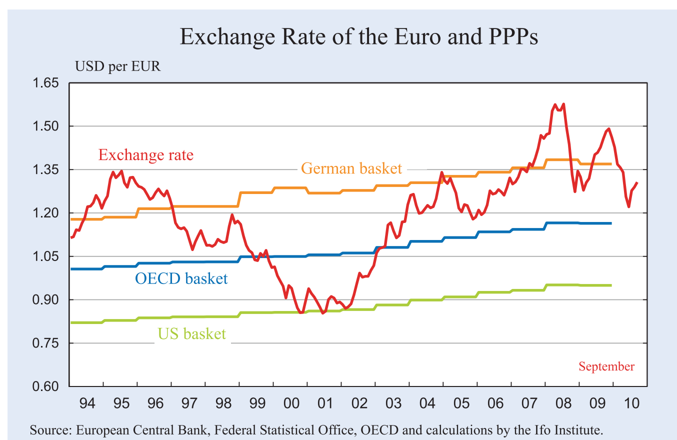
* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

In September 2010, the *industrial confidence indicator* remained broadly in the EU27 and improved by 1% in the euro area (EU16). On the other hand, the *consumer confidence indicator* remained unchanged in the euro area but decreased by 1 point in the EU27. However, these indicators stood still below the long-term average in both areas in September 2010.

Managers' assessment of *order books* improved from – 20.9 in July to – 16.8 in September 2010. In June the indicator had reached – 25.3. *Capacity utilisation* increased to 77.5 in the third quarter of 2010 from 75.6 in the previous quarter.

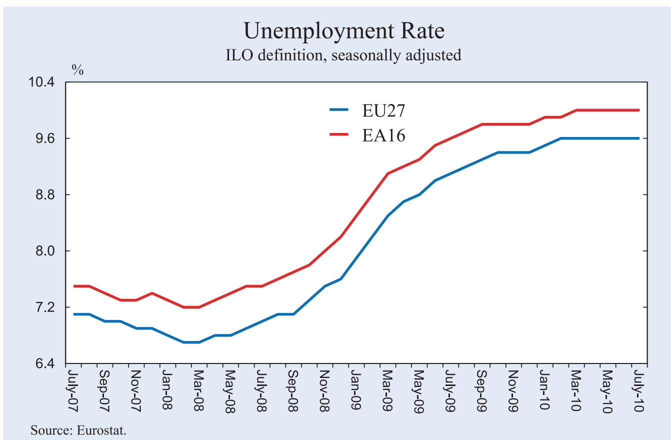
EURO AREA INDICATORS

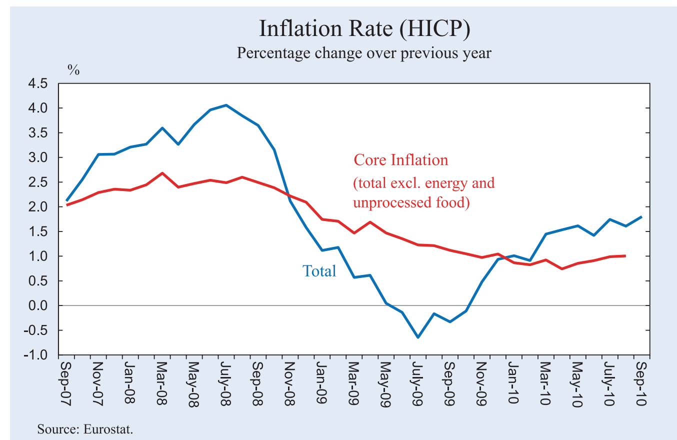




The Ifo indicator of the economic climate in the euro area (EU16) has risen again slightly in the third quarter of 2010 but has not yet reached its long-term average. The assessments of the current economic situation have improved clearly over the second quarter of 2010. The expectations for the coming six months, however, have weakened again but remain positive on the whole. These survey results indicate that the economic recovery will continue in the second half of the year but at a slower pace.

The exchange rate of the euro against the US dollar averaged 1.31 $/€ in September 2010, an increase from 1.27 $/€ in July. (In June the rate had amounted to 1.22 $/€.)





Euro area (EU16) unemployment (seasonally adjusted) amounted to 10.1% in August 2010, unchanged compared to July. It was 9.7% in August 2009. EU27 unemployment stood at 9.6% in August 2010, also unchanged compared to July. The rate was 9.2% in August 2009. In August 2010 the lowest rate was registered in Austria (4.3%) and the Netherlands (4.5%), while the unemployment rate was highest in Spain (20.5%) and Latvia (19.5% in the second quarter of 2010).

Euro area annual inflation (HICP) was 1.6% in August 2010, compared to 1.7% in July. A year earlier the rate had amounted to – 0.2%. The EU27 annual inflation rate reached 2.0% in August 2010, down from 2.1% in July. A year earlier the rate had been 0.6%. An EU-wide HICP comparison shows that in August 2010 the lowest annual rates were observed in Ireland (– 1.2%), Latvia (– 0.4%) and Germany (1.0%), and the highest rates in Romania (7.6%), Greece (5.6%) and Hungary (3.6%). Year-on-year EU16 core inflation (excluding energy and unprocessed foods) rose to 1.00% in August 2010 from 0.91% in June.

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