VERANSTALTUNGSBERICHT

Konrad-Adenauer-Stiftung e.V.

AUSLANDSBÜRO
GROßBRITANNIEN

17. OKTOBER 2011

www.kas.de/london

Achieving Sustainable Growth: Fiscal Consolidation and Financial Market Regulation

Rede des Bundesfinanzministers, Dr. Wolfgang Schäuble:

Ladies and gentlemen,

Let me get straight to the point: As a result of recent crises we have learned that the dream of self-regulating and stable international financial markets is elusive, that financial markets, like all free systems, need rules and boundaries they cannot set or enforce themselves effectively.

As academics as well as practitioners have begun to question the efficiency of financial markets, policymakers have begun to strengthen the role of the state. The understanding is growing that financial markets work well in general, but they do not always act rationally, since human beings do not always act rationally. Like human beings financial markets need institutions, need rules and boundaries to act responsibly.

The objective is to find a new balance between financial markets and the state. Financial markets need a regulatory framework that above all increases transparency, reduces extreme leverage, and limits excessive volatility. Only the state can provide such a framework. In times of global markets only the community of states.

But strengthening financial markets to make them more transparent and less volatile is a laborious process. The G20 have embarked on this process. Indeed the G20 have already decided on a number of crucial reforms to strengthen financial markets: Above all, they have endorsed a new capital and liquidity regime for banks – Basel III.

They are also set to endorse a new regime for systemically important financial institutions that will comprise additional capital requirements and measures to improve the resolvability of SIFIs, including global active ones. Most G20 nations have also introduced smarter compensation and liability rules that will help reward long-term success, not short-term profit maximisation, thus reducing volatility.

Despite these achievements, I see an increasing danger – not so much of 'regulatory fatigue' – but of 'regulatory parochialism'. Not only within the G20 but in Europe as well: One example is the Financial Transaction Tax. It is short-sighted parochialism which is currently keeping us from implementing a European Financial Transaction Tax. If an FTT were introduced in all of Europe – which of course includes UK - it could help reduce volatility further, not least because it could make leveraged trading less profitable.

I am also in favour of an FTT because financial market participants need to convincingly demonstrate to taxpayers and their fellow citizens that they are willing to contribute to clean up the mess they helped to create. One way of doing that is through the FTT. With a reference to President Obama, the FTT might be the only thing standing between banks and the pitchforks.

Above all, the current demonstrations against financial market participants show that the FTT can play an essential in peacemaking between different parts of the society.

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To stabilize the international financial system we need to overcome such parochial behaviour, increase transparency and reduce volatility: We need to make dark pools and over-the-counter-trades more transparent; regulate the shadow banking system - including hedge funds - and confine the risks posed by the extensive leverage of some modern financial instruments, including Credit Default Swaps. We also need to make the assumptions of rating agencies more transparent and wean markets away from their influence. States empowered rating agencies so that they could point to policy errors earlier than financial markets and thereby smoothen market reactions. But the opposite has happened.

Don't get me wrong here: This does not mean that an obsession with the market should be replaced by an obsession with 'statism'. One extreme is just as bad as the other. But I am deeply convinced that for financial markets to contribute positively to society – and function efficiently – international financial market policy must refocus financial markets on their primary role, which is to serve the real economy. Clearly, not all of the products offered by the financial industry are necessary to fulfil this role.

We need to limit 'irrational exuberance' as well as 'irrational gloom' of financial market participants more effectively, i.e. we have to limit excessive leverage and perilous volatility more effectively. To do this, regulation must restore the link between risk and liability, reward and responsibility of financial market participants and institutions.

The core lesson from the past crises is that highly cyclical, credit-fuelled growth, which is driven by the financial market, does more harm than good. Instead, we need to create the conditions for lasting and sustainable growth: Sustainable growth defined as steady, environmentally-friendly and socially-compatible growth propelled by the industry and productivity of the real economy and not by an overleveraged financial sector which can cause erratic volatility and massive distortions.

A growth model focused on the real economy has more advantages than a financial sector driven growth model, which generates high growth rates when the economy is running well, but fails in downturns without government support to prop it up.

This takes me straight to the crises within the Euro area: Weakened national economic fundamentals were not the only reason for the dramatic worsening in Portugal's, Spain's or Italy's refinancing conditions. Indeed, events in Europe demonstrated again that modern financial markets can increase volatility. We saw how the Euro area was at a risk of being torn apart by the tremendous speed at which the situation of the European bond market was deteriorating. Seen in that light, our task, policymakers' task, is to reduce financial markets' potential for making crises worse.

This does not mean that we must abandon interest rates as a disciplinary mechanism. On the contrary, governments need the markets: Markets can force governments to do the right thing – although too often too late and too suddenly. No, putting all the blame for what went wrong on financial markets would be convenient, but far too easy. In the Euro area, excessive government spending has led to levels of deficits and debts that are unsustainable and endanger economic welfare. Euro area governments need to demonstrate convincingly their commitment to fiscal consolidation but also to increasing competitiveness to restore confidence of markets as well as their citizens.

And there is no disagreement about the fact that Europe, and above all the Euro area, must improve the link between its countries' national fiscal and economic policies. It is essential that the European Monetary Union's institutional structures are indeed capable of obliging Euro members to adopt a budgetary and economic policy that reflects their responsibility for the common currency. European Monetary Union won't succeed if a number of countries persistently run deficits and weaken their competitiveness at the expense of the Euro's stability.

But what we are faced with is more than a sovereign debt crisis of a few spendthrift countries in the Euro area. We are faced with a fundamental shift in financial markets' attitude towards public debts: Debt and deficit levels which might have been tolerated only a few years ago are now considered to be too high and unsustainable. That is perhaps because markets – as well as citizens – have come to realize that for more than two decades, economic policy in industrialized countries has tried to avoid recessions by sacrificing fiscal prudence and monetary rectitude in the process. When financial markets crashed, central banks, particularly in Anglo-Saxon countries, cut interest rates. And when growth declined, governments plundered the public's purse to make up for the private sector's reluctance to spend freely.

Monetary and fiscal lavishness led to a series of debt-financed asset bubbles. As these financial bubbles burst in the last three decades, it became even more difficult and expensive to contain the fallout on the real economy. When the last of those debt-financed bubbles burst three years ago, governments had to up the ante and use massive fiscal stimuli and central banks had to take resort to unprecedented measures of easing monetary policy to avoid the breakdown of financial markets and an ensuing depression. For example in Germany we suffered a loss of 5.1 percent of GDP in 2009, we had never thought that would be possible in the times after World War II.

To be fair, those measures have been necessary to avoid a depression. But too often governments have promised they would consolidate when times were good. They rarely did: Debt and deficit levels kept creeping up. As a result governments' credibility with financial market participants is at an all time low. Markets and citizens have become increasingly suspicious that governments would not honor their debts. As a consequence markets demand higher risk premiums, i.e. interest rates. And they withdraw their confidence at a whim today, already when governments only appear not to take credible immediate action to place their debts and deficits on a sustainable footing.

But governments are faced with a predicament. There is little political or market appetite for more fiscal and monetary stimuli. On the other hand markets and citizens do not crave tighter fiscal and monetary policies either, for fear of their economies heading back into recession.

So, what do we do? There is a feeling that politics is at wit's end. There are those who argue that fiscal consolidation, a smaller public sector and more flexible labour markets will lead to a decrease in consumption in these countries in the immediate future. But there is a trade-off between short-term pain and long-term gain: I would argue that an increase in consumer and investor confidence and a shortening of unemployment lines will in the medium term cancel out any short-term dip of consumption.

Governments and central banks have used up much of their fiscal and monetary firepower. We will not spend our way out of the current predicament, nor will it work to lower the debt burden by inflating the problem away. I think it is no accident that unemployment in the US has remained stubborn despite all the efforts by the Federal Reserve and the United States government to promote growth. Loosening monetary and fiscal policies in the short-term while promising monetary and fiscal tightening in the medium-term might have worked in the past. Today however, as market reactions demonstrate, it lacks credibility with investors as well as with our citizens.

Governments' public debts and deficits are too high because their public sectors spend too much, get too little and their economies lack competitiveness. That is why immediate fiscal consolidation and structural reforms in highly indebted countries are of the essence. Not – as *The Economist* recently implied – because of a German penchant for Lutheran self-righteous rectitude, but because it is best for indebted countries and their long-term growth prospects.

Only material and immediate measures will regain lost credibility of highly indebted countries and demonstrate to markets and citizens alike that their governments mean what they said. Only when highly indebted governments stop living beyond their financial means and start lowering deficit and debt levels today investors and citizens can be convinced of the sustainability of debt and deficit levels tomorrow.

I am not deluding myself, however and neither should you: It will take not months but years, before these efforts will bear fruit. As regards the Euro area, given the time necessary to bring public deficits and debts down to sustainable levels, we will have to provide strictly conditional financial assistance to highly indebted and less competitive member countries. In essence we are buying those countries the time they need and shield them against the excessive volatility of financial markets so that they can put their public finances on a sustainable footing and improve their competitiveness. But such solidarity has its limits, it can only accompany a country's reform efforts, not replace them: A member state has to be willing to deal with the root causes of its problems itself.

I am convinced that, if we stick with our policy of fiscal and structural reforms, we will restore confidence and put the economies of the Euro area on a sustainable footing. We will prevent the debt crisis of some countries from becoming a crisis threatening the Euro area as a whole and in turn the world economy. And while – in the case of Greece – a further restructuring of debt might be necessary it is not a panacea. Without fiscal and structural reforms Greece's deficits and debts would reach unsustainable levels again.

Now, there are some, who are not satisfied by the way European politicians are dealing with the crises; who are now calling for the supposed structural faults in the European Monetary Union to be corrected once and for all by building up the fiscal and political union. That is an approach that does not reflect the genesis of European integration.

Europe moves forward one step at a time. And it will do so in future as well.

But there is time for small steps and there is a time for bold steps. And the time for bold steps is now. Governments in the Euro area need not just to commit to fiscal consolidation and improved competitiveness and governance, they have to deliver. And they will. We will strengthen economic and fiscal governance in the Eurozone by means of an enhanced Stability and Growth pact. Where this proves to be insufficient we will find ways and means to reconcile a member's fiscal and economic policies with his responsibility for the Eurozone's stability.

Ladies and gentlemen, to sum things up: To regain credibility with markets and citizens, immediate fiscal consolidation and structural reforms in highly indebted and noncompetitive countries are of the essence, even as the returns on that investment are one, perhaps two election cycles away. But markets too often react too late, too suddenly and too violently, and when they do so, they do not aid but hurt the real economy and our citizens. To curb these aberrations, financial market policies have to increase the transparency and reduce the excessive short-term volatility and inordinate leverage in financial markets in turn leading to sustainable growth of the real economy and contributing to European prosperity and global stability in the process.

Thank you very much.

Impressum

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