Session 1.1: Exit strategy, financial regulatory reform from a global perspective

European perspectives

Hans-Helmut Kotz
Member of the Executive Board
Deutsche Bundesbank

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Outline

No matter how refined and how elaborate the analysis, if it rests only on the short view it will still be…a structure build on shifting sands
Jacob Viner (1958)

1. **Unprecedented shocks and forced entry**
2. **Crisis containment**
3. **Exit from extraordinary policies**
4. **Crisis prevention: medium-run policy objectives**
5. **Concluding observations**

1 Unprecedented shocks and forced entry

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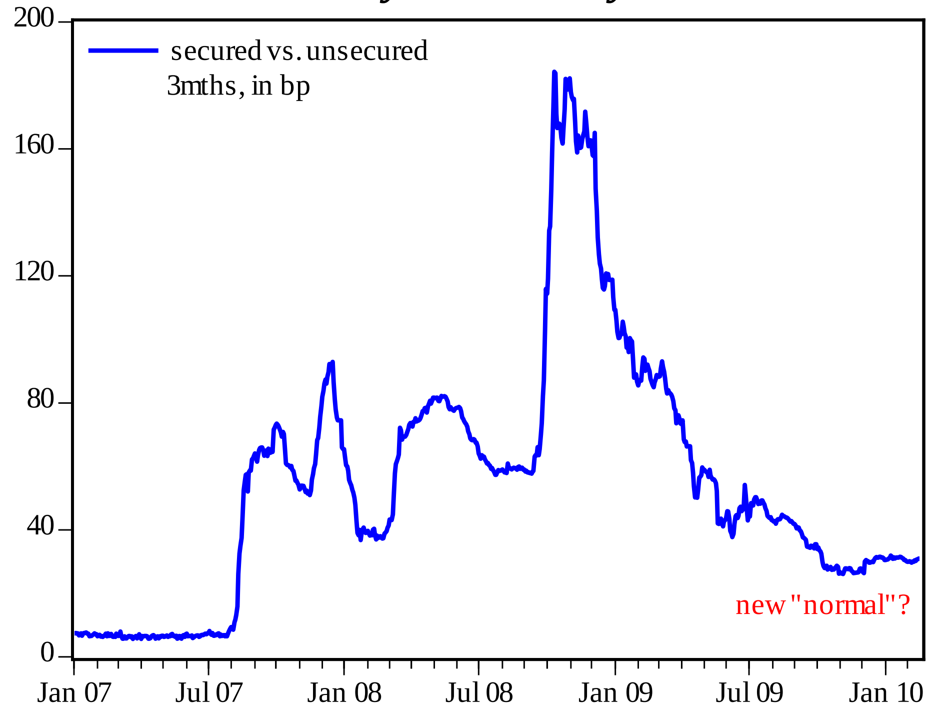
Dysfunctional money markets

- Pervasive market disruptions: sudden change in risk perceptions, strong decline in asset prices, substantial reduction in (market and funding) liquidity, strong increase in correlations
- Symptoms: widening spreads, high price impact of transactions, persistent imbalances, seizing up of markets
- …underlying **real** (e.g. house prices) **and financial** problems (e.g. structured products)
- …ultimately: systemic over-exposure to risk: **It's never different!**

Interbank money markets: systemic stress



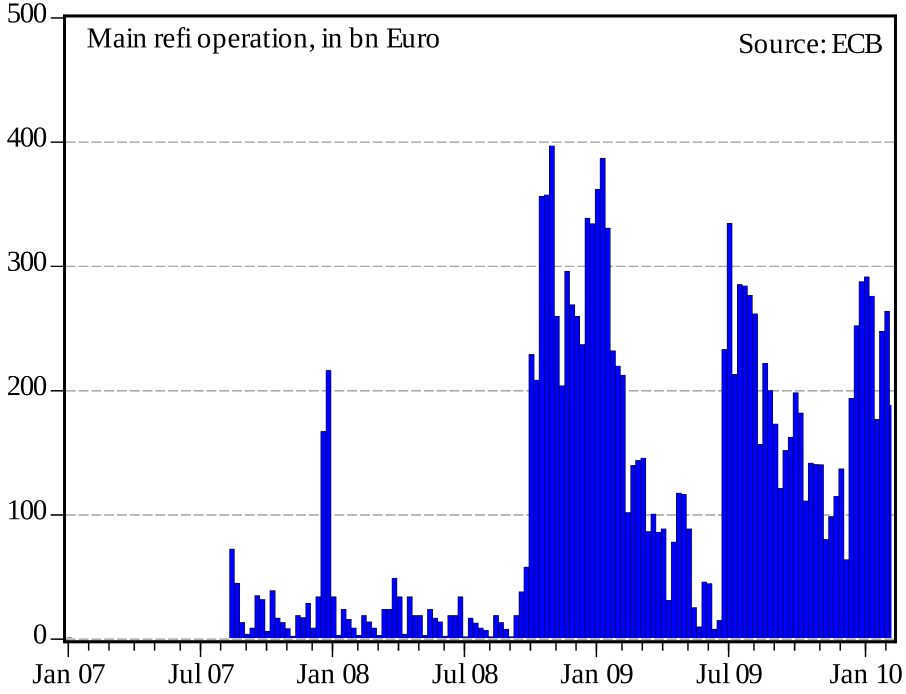
Central bank policy responses

- Diagnosis problem (Aug 2007): asymmetric information vs. run on banks – by themselves, however
- Liquidity support – stemming the run
- Allotment significantly above benchmark

Second phase: Fall 2008

- Liquidity management – full allotment
- Monetary policy: policy rate down 325 bp since Oct 2008
- Separation principle

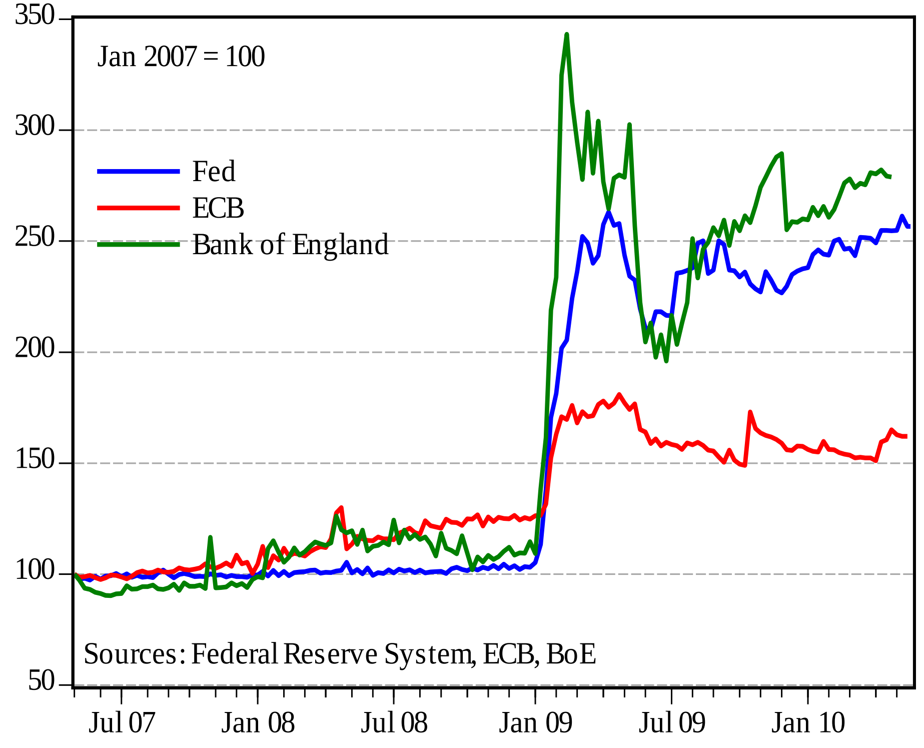
Allotment above benchmark



2 Crisis containment
Non-standard operations (1)

- Non-standard liquidity measures – European case
  - full allotment at fixed rates
  - temporary expansion of list of assets eligible for use as collateral
  - lengthening maturity of market operations
  - swap lines: Liquidity provision in foreign exchange (mainly US-$)

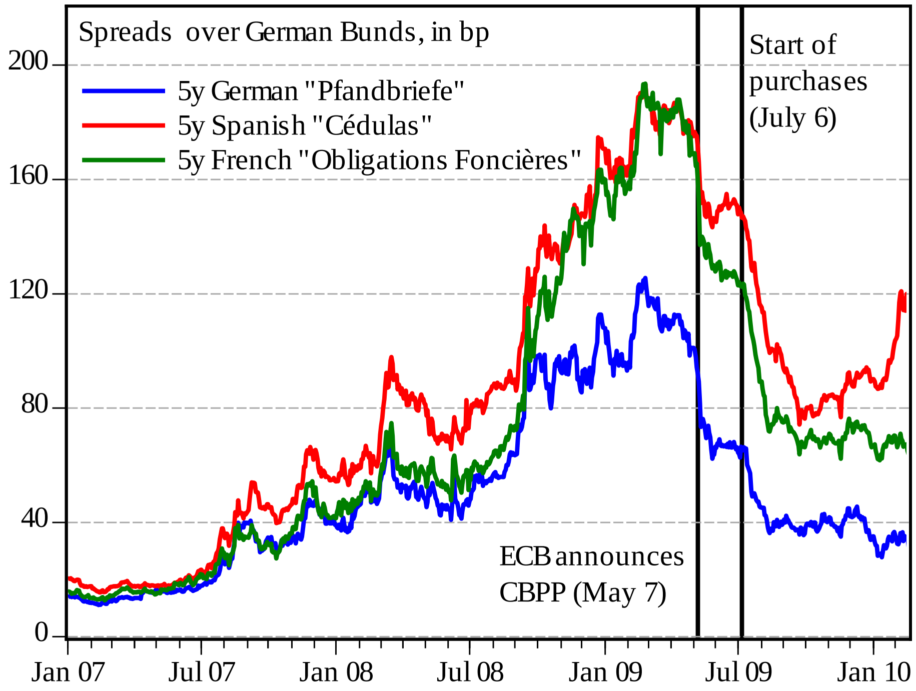
Central banks' balance sheets



2 Crisis containment
Non-standard operations (2)

- Programme of purchasing covered bonds – particularly important in Europe
- max. volume €60 bn, €30 bn purchased so far
- Functionally similar to repo transactions
- Purpose: support primary market activity
- Contributed to new issuance activity and spread narrowing

Covered Bonds



2 Crisis containment

Fiscal policy measures

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Fiscal stimuli supported economic activity

- In the German case, two discretionary fiscal "packages" of €32 bn (1.5% of GDP in Nov 2008) and €50 bn (2% of GDP in March 2009)
- ...taking account of automatic stabilisers (social safety net, progressive income tax system) effective countercyclical impulse substantially higher

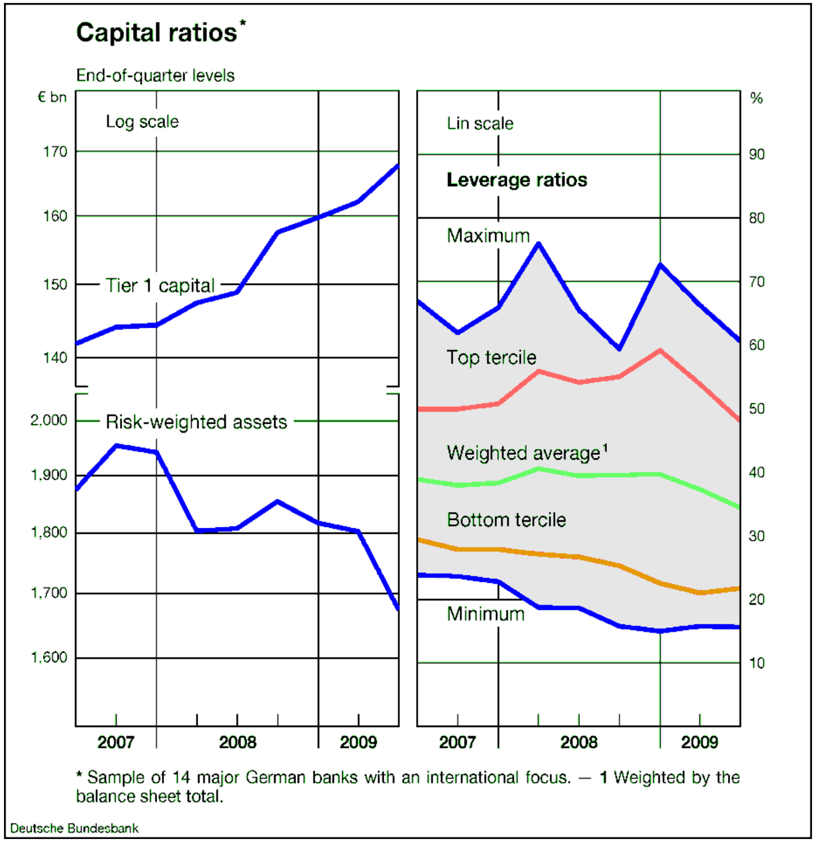
Economic recovery underway in Germany

- Contraction of 5% of GDP in 2009 (higher than in any other advanced economy, export orientation)
- Start of mild recovery in summer 2009
- Growth forecast for 2010 1.6% of GDP – but noticeable statistical effects (carry over, working day adjustments)

2 Crisis containment
Financial system stabilization

Rescue measures in Germany

- *Financial Market Stabilisation Act* (Oct 2008) → *Financial Market Stabilisation Fund (SoFFin)*
  - Guarantees (Jan 2010: €150 bn)
  - Recapitalisation (€28 bn)
  - Assumption of risk positions
- Progress in adjustment process in the German banking system
  - Balance sheet consolidation
  - Capital adequacy improved
  - Leverage palpably lower
- …but signficant challenges remain (e.g. further write-downs; see Bundesbank's *Financial Stability Report* November 2009)



Where do we stand?

Table 1.1. **A modest recovery from widespread recession**

OECD area, unless noted otherwise

	Average 1997-2006	2007	2008	2009	2010	2011	2009 q4	2010 q4	2011 q4
	Per cent								
Real GDP growth[1]	2.8	2.7	0.6	-3.5	1.9	2.5	-1.0	2.1	2.8
United States	3.2	2.1	0.4	-2.5	2.5	2.8	-0.3	2.5	3.0
Euro area	2.3	2.7	0.5	-4.0	0.9	1.7	-2.1	1.2	2.0
Japan	1.1	2.3	-0.7	-5.3	1.8	2.0	-1.1	1.4	2.2
Output gap[2]	0.1	1.8	0.3	-4.6	-4.1	-3.2			
Unemployment rate[3]	6.5	5.6	5.9	8.2	9.0	8.8	8.8	9.1	8.6
Inflation[4]	3.0	2.3	3.2	0.5	1.3	1.2	0.7	1.2	1.2
Fiscal balance[5]	-2.0	-1.3	-3.5	-8.2	-8.3	-7.6			
Memorandum Items									
World real trade growth	7.1	7.3	3.0	-12.5	6.0	7.7			
World real GDP growth[6]	3.8	4.6	2.2	-1.7	3.4	3.7			

1. Year-on-year increase; last three columns show the increase over a year earlier.
2. Per cent of potential GDP.
3. Per cent of labour force.
4. Private consumption deflator. Year-on-year increase; last 3 columns show the increase over a year earlier.
5. Per cent of GDP.
6. OECD countries plus Brazil, Russia, India and China only, representing 81% of world GDP at 2005 purchasing power parities. Fixed weights based on 2005 GDP and purchasing power parities.

Source: OECD Economic Outlook 86 database.

- Spillover into real economy – sharp contraction of activity
- Uncertainty about (a) potential output (partly reflecting credit bubble) as well as (b) growth potential

3 Exit from extraordinary policies
Challenging balancing act

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- **Extraordinary circumstances called for unconventional responses – policy measures, however, clearly unsustainable, logical corollary: exit**
- **Difficult balancing act, but high costs of unwinding too late – much more art/judgment than science**
  - Historically, governments have largely erred on the side of being too late – especially with regard to fiscal policies
  - Current policies are clearly unsustainable (inter-temporal budget constraint) and prone to create inflationary pressures in the medium term
  - But still too soon for reversing course (financial sector still under strain, fragile recovery, highly dependent on exceptional policy stimuli)
  - Need for credible commitment to future monetary tightening and fiscal consolidation to guide markets' expectations
- **Not coordinated but transparent and co-operative exit strategy required**
  - Economic background conditions heterogeneous, hence timing of exit to be determined by country-specific factors (e.g. resilience of recovery, financial sector soundness, strength of public finances)
  - Clear communication of exit strategy of the essence to allow markets to adjust to change in policy stance
  - International coordination of exit from expansionary policies entails the costly risk of being too late for some countries

3 Exit from extraordinary policies
Monetary policy (1)

- **Start of gradual phasing out of non-standard liquidity support**
- **Improvement of market conditions allowed ECB to take first steps in gradually phasing out extraordinary liquidity support**
  - Reduced frequency of longer-term refinancing operations
  - Change of design of last 12-month tender

- **Despite high excess reserves, currently no need for additional absorption operations**
  - Monetary conditions are very subdued
  - Automatic reduction of excess reserves when additional long-term operations expire
- **Further stabilisation of financial market conditions would allow a return to control overnight rate effectively with policy rate**

3 Exit from extraordinary policies

Monetary policy (2)

- **Overriding goal: Keep inflation expectations anchored**
- **Gradual phasing out of extraordinary liquidity support not intended to signal change in policy stance (not changing the extent of LTRFs would have resulted in more accommodative stance)**
- **Monetary policies need to be tightened as soon as inflation outlook deteriorates or inflation expectations would become less firmly anchored**
- **Interdependencies between fiscal policy and monetary stance**
  - Lack of fiscal consolidation might require earlier and stronger monetary tightening
  - Sustainable public finances important to ensure price stability at low interest rates
- **Institutional framework of EMU with independent central banks is cornerstone for continuation of sound monetary policies**

3 Exit from extraordinary policies
Fiscal policy

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- **Public finances under pressure**
  - Debt levels (over GDP) will rise as an upshot of the crisis by 40 percent in the OECD
  - Debt – as a consequence of ageing (pensions, health care) has been on an unsustainable path before

- **Credible consolidation of key importance to consumer and investor confidence**

- **EU Stability and Growth Pact provides clear guidance on timing of fiscal exit**
  - Well-specified fiscal consolidation programmes starting in 2011 at the latest
  - Choice of concrete measures left to national governments
  - Additional international coordination of exit from expansionary fiscal policies not necessary (probably too ambitious, prone to disappointments)

3 Exit from extraordinary policies
Financial policy

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- **Unwinding financial sector support measures should be gradual and will require flexibility and judgment (again: art, but principled)**
- **Several support programmes (eg debt guarantees) have a pre-determined expiration date (automatic) or incentives endogenously lead to the exit**
- **Recapitalisation and impaired asset relief have an inherently longer-term character**
  - Measures aim at contributing to a permanent improvement of banks' health by reinforcing their balance sheets' resilience to risk (injection of capital and asset support)
  - Finding right exit point remains difficult (especially with regard to payback of public capital injections)

3 Crisis prevention: medium-run policies
Macro-prudential perspective

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- **Traditional micro-prudential perspective to be supplemented**
  - Focus of traditional solvency supervision (i.e. safeguarding stability of individual institutions) not sufficient to ensure stability of the overall system
  - To be supplemented by macro-prudential approach that takes a holistic, system-wide view
- **Macro-prudential supervision**
  - Fallacies of composition – unintended consequences of individually purportedly prudent behaviour – public good dimension/policy issues
  - Focus on risks arising from dynamic interactions both within the financial system and between the financial system and the real economy
  - Overall goal: ensuring smooth functioning of the financial system (i.e. efficient allocation of aggregate capital and risks)

3 Crisis prevention: medium-run policies
Complex problems

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- **Major challenges for central banks and supervisory authorities**
  - Risk – systemic stress – is to a significant degree generated endogenously, two dimensions (Claudio Borio)
    - Cross-sectional – common exposure
    - Time dimension – self-reinforcing mechanisms
  - Pro-cyclicality – inherent in risk-based capital requirements (pro-cyclicality of default probabilities) or in fair-value accounting, via margin requirements, not smoothly, but in a rapid process
  - “Too big to fail” – collapse of large institutions can pose major threat to financial system as a whole → authorities forced to intervene
  - Interconnectedness – contagion effects both across and within financial sectors

3 Crisis prevention: medium-run policies
International cooperation

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- Structural interdependence (Cooper 1985): substantial externalities – and the resulting need for international coordination – G20 and FSB
  - "Coordination – significant modification of national policies in recognition of international economic interdependence" (Henry Wallich 1984)
- G20 has charged FSB to define the new "rules of the game"
  - "Institutions are the rules of the game in a society…humanly devised constraints that shape interaction" (North 1990)

3 Crisis prevention: medium-run policies
Commonly shared diagnosis

- More capital, of higher quality (also: risk weightings)
- Reduce pro-cyclicality
- Leverage ratio – as a complementary restriction
- Liquidity risk has to be appropriately acknowledged
  - funding vs. market liquidity (Brunnermeier/Adrian/Shin)
    - becomes particularly important in a non-bank intermediation environment
    - possible detrimental interaction

Crisis prevention: medium-run policies

Implementation: Basel Committee

- **Proposals made by Basel Committee on Banking Supervision 2009**
  - Raising quality, consistency and transparency of capital base
  - Enhancing risk coverage
  - Introducing a leverage ratio
  - Reducing pro-cyclicality / promoting countercyclical buffers

- **Important that …**
  - … new requirements not considered in isolation, but in terms of their cumulative effect
  - … attention is paid to specific features of national financial systems

- **Commitment in Pittsburgh by all G20 countries to adopt Basel II capital framework by 2011**

3 Crisis prevention: medium-run policies
Co-operation within EU

- **Institutionalizing the macro-prudential dimension**
- **European Systemic Risk Board**
  - To strengthen macro-prudential analysis / oversight
  - Secretariat to be located with ECB
- **Three new European supervisory authorities**
  - European Banking Authority, European Insurance and Occupational Pensions Authority, European Securities and Markets Authorities
  - Coordination with national level via principle of subsidiarity → incentive-compatible alignment of financing and decision responsibilities (capacity to process information, form judgment on the basis of common rules and regulations; democratic and budgetary legitimacy)

4 Concluding observations

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- **Financial system could only be stabilised by non-standard monetary and fiscal policy measures**
- **Systemic risks have continued to subside as economic fundamentals have improved – but too early to relax**
  - Financial system still dysfunctional, dependent on intensive government and central bank support
  - 2nd phase of the crisis: traditional loan books, commercial banking activities affected (reflecting large output gaps) rather than trading book exposures; possible to credit losses are a particular concern of smaller and medium-sized banks
  - Signs of renewed “search for yield” need to be watched very carefully
- **Given enormous social costs of crisis, window of opportunity for regulatory reform has to be used forcefully**
- **G20-FSB reform agenda → right track towards a more resilient global financial system**