

Mastering Global Financial Crises: A German Perspective

The world economy has experienced a downturn of historical dimensions since the onset of 2009. Almost everywhere, production has declined rapidly, world trade has virtually collapsed, and the recession has spread to all major economic regions. The global financial crisis is the culmination of an exceptional boom in credit growth and leverage in the financial system. Low interest rates, abundant liquidity, and low volatility prompted investors to search for higher yields without an adequate appreciation of related risks. Financial institutions developed new structures and innovative risky instruments to meet investors' demand for higher yields. Investors in turn, overly optimistic about continued rises in asset prices, did not look closely enough into the nature of the assets they bought. They mostly relied on the analysis of credit rating agencies which were, in some cases, also selling advice on how to develop the rated products. This failure of market discipline played a considerable role in the crisis.

Misplaced incentives, such as compensation systems based on short-term sale targets, helped boost excessive risk taking and profit expectations of investment banks. In addition, loose monetary conditions and global imbalances, which contributed to the large capital inflows to Europe and the United States, also fueled the crisis. Cheap money encouraged leverage that boosted asset prices, which in turn encouraged further leverage. At the same time, the financial turmoil revealed shortcomings in firms' risk management practices and deficiencies in regulatory frameworks.

The financial system, being knocked by turbulent shocks, reacted by restricting economic activity through several channels, most notably by

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limiting the availability of credit. The strains in financial markets have also led to a sharp drop in equity prices. Capital losses on corporate equities, combined with further losses in real estate due to continued falling home prices, have considerably reduced household net worth, consequently restraining consumer spending. At the same time, the world economy entered a cooler cyclical phase at the end of last year, after a long and robust period of expansion. The global economic slump has deepened since then and spread to every region of the world.

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As an open economy with strong foreign trade links, Germany is being hit particularly hard, with threats to a large number of jobs, and is facing one of the most difficult economic times experienced in many decades. Looking

forward, the challenges are twofold. The first challenge is crisis management, which should focus on the resolution of bank-specific problems regarding liquidity and solvency, financial system rescue packages and their implementation, as well as measures necessary to stabilise the real economy. The second challenge is to enhance the resilience of the global financial system by reshaping global financial architecture. This concerns structural changes regarding regulation,

strengthening transparency and accountability of financial markets, promoting market integrity, reinforcing international cooperation, and reforming international institutions.

There have already been some actions taken internationally. The Group of 20 (G-20) leaders adopted the “G-20 Action Plan” during the Washington summit in November 2008. The plan sets out an agenda of 47 concrete measures designed to reform the financial system based on five principles: strengthening transparency and accountability; enhancing sound regulation; promoting integrity in financial markets; reinforcing international cooperation; and reforming international financial institutions. All immediate measures were already implemented before the second world financial summit in London on April 2, 2009.¹ An important concrete outcome of the London summit is the declaration on strengthening the financial system. It clearly states that regulation and oversight will be extended to all systemically important financial institutions, instruments and markets including, for the first time, systemically important hedge funds.

In order to meet the objectives elaborated in Washington and London, individual states have to take actions domestically. Overcoming this global recession will require a great political effort. Does Germany possess the political

will to deal with the challenges of the financial crisis? And which measures have already been taken in Germany to stabilize banks and the economy at large?

German Crisis Management

The exceptional situation of extreme financial stress and a deep economic downturn calls for exceptional measures. Prompt and massive policy action to restore confidence and provide liquidity have successfully limited the period of panic in the markets. There was no alternative to the coordinated, comprehensive, and in part unorthodox measures that were taken by both the central banks (e.g., cutting interest rates sharply) and governments (e.g., guaranteeing private bank accounts, implementing rescue measures for individual banks to prevent them from failing). Policymakers have proven they can act quickly and under extreme time constraints if necessary, as demonstrated during their efforts to stabilize the financial sector.

This systemic crisis, however, needed a more systemic response. As a result, the German federal government adopted a rescue program for the German financial system in October 2008. The Financial Market Stabilisation Fund was established and endowed with a range of financial support measures totalling up to 480 billion euro to safeguard the stability of banks, insurance companies, pension funds, and other financial institutions that are domiciled in Germany, including German subsidiaries of foreign banks. The objective was to ensure that the financial system would be able to maintain its central function as an intermediary between savers and investors, thus contributing to stable macroeconomic development. It is the banks' key relevance for the prosperity and stability of the real economy that justifies the massive mobilization of taxpayers' money in such a rescue program. Furthermore, the German government came up with a proposal concerning impaired assets that are clogging banks balance sheets and affect bank lending.

Besides the stabilisation of financial markets, clear stimuli were undertaken in Germany, as in many other countries, to strengthen internal growth and domestic demand. The federal government made a vital contribution to steadying the economy with packages of measures providing a total boost of almost 90 billion euro for 2009 and 2010. This adds up to approximately 1 and $\frac{3}{4}$ percent of the yearly GDP, which is a considerable amount. The focus is on safeguarding both jobs and businesses' capacity to invest. With these measures, Germany is making an above average contribution to implementing the agreement reached by the European Council in December 2008 to allocate 1.5 percent of GDP for measures to stimulate the economy.

The first challenge is crisis management . . .

In times of considerable national stimulus packages, it is a legitimate concern that this should not lead to protectionist measures to the detriment of other countries. Otherwise, this would only reinforce the downward spiral. Germany has to prove its capacity to

act on the national as well as on the global level, and has to coordinate its efforts to restore economic confidence and avoid any form of protectionism. All countries benefit from open trade and an open international investment climate, which are crucial for economic growth and employment. Against this background, it is regrettable that there was no agreement last year concerning the Doha round. This is why Germany has to now step up its efforts to come to an ambitious, balanced, and comprehensive conclusion of the Doha Development Agenda. It is the best signal against protectionism that can be sent. This is only possible if all the members of the World Trade Organization (WTO) show their readiness for compromise. Germany will, therefore, use its contacts to WTO members to convince them of the necessity to rapidly conclude the Doha Round as stimulus for world trade. Actively engaging India and the United States, two of the most important players in the current trade negotiations, is certainly of special importance. The German government strongly supports the idea to use the Group of 8 (G-8) and other international fora to accelerate the Doha negotiations.

Moreover, while there is no doubt that the joint efforts of many countries to tackle the crisis by implementing considerable stabilizing measures were necessary, it is paramount to refocus as soon as possible on the virtues of fiscal discipline and structural reforms. Effective exit strategies, such as the new budgetary rule in Germany, need to be put in place as economies start growing again. Given the exceptionally large uncertainties concerning the further path of economic development, policymakers should aim at securing a growth-oriented policy aligned with short-term cyclical needs.

In this context, there are concerns about the increasing budget deficit in Germany. With a highly expansionary fiscal stance, budgets are stretched to the limit. Policymakers should be aware that, in the coming years, they will have to be as determined to reduce deficits as they are now in implementing expansionary measures. This should be the cornerstone of future macroeconomic orientation in Europe, together with a monetary policy which takes into account the inflationary pressure of rising liquidity.

In this regard, Germany will establish a new budgetary rule limiting the structural deficit. The objective is to avoid pro-cyclical policies by enhancing budgetary discipline in periods of economic recovery while creating the necessary room to accommodate economic downturns and reduce government debt at a

satisfactory pace. This will contribute to the long-term sustainability of public finance.

Global Financial Architecture

While short-term policy responses primarily focus on crisis management to stabilize markets, it is also important to remain focused on enhancing the resilience of the global financial system over the medium term and restoring confidence in financial markets. But confidence can be undermined by underregulated jurisdictions that contribute to regulatory arbitrage (the practice of taking advantage of a regulatory difference between two or more markets), and by non-transparent jurisdictions that contribute to an environment of secrecy. A global effort is therefore needed to identify supervisory and regulatory gaps and arbitrage opportunities, especially for cross-border active market participants, and to agree on necessary national regulatory measures to adequately address these gaps. The G-20 leaders already agreed that measures need to be taken against uncooperative jurisdictions in the areas of prudential supervision, antimoney laundering, and the fight against terrorist financing, as well as tax matters.

Transparency and accountability on the part of all financial market participants are indispensable for global financial market stability. Accounting standard setters should accelerate efforts to reduce the complexity of accounting standards for financial instruments and to harmonize the standards, especially with regard to impairment of financial instruments and in some cases the reporting of derivatives. Compensation practices and bonus payments that contributed to excessive risk taking fueled the crises and undermined the accountability of financial markets. G-20 leaders support the sound practices for compensation,² suggested by the Financial Stability Forum (FSF) now called the Financial Stability Board (FSB).³ What is needed are compensation systems that provide incentives consistent with the firm's long-term goals and its overall risk tolerance. Going forward, prudent supervisors should further enhance their oversight of compensation schemes when assessing risk management practices.

The current crisis results also in part from regulators' failure to recognize some of the underlying weaknesses of the financial sector and effectively addressing them. For example, similar activities conducted by various types of institutions were often regulated differently at the national level, though a uniform system should have been in place. As a result, regulation at a global scale faces two challenges. First, all systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation and

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oversight to encourage transparency and improve risk management practices, consistently applied and proportionate to their local and global systemic importance. No “blind spots” should be allowed to remain. This is especially true of those private pools of capital, in particular hedge funds, that may present a systemic risk. Second, the regulatory capital framework should be improved to address weaknesses revealed by the crisis. Capital should serve as an effective buffer which would build up during growth periods of rapid earnings and be drawn down in a downturn, so as to protect both the solvency of financial institutions in the event of losses and their ability to lend. Prudent supervisors should also promote stronger liquidity buffers at financial institutions to ensure that they can withstand prolonged periods of market and funding liquidity stress.

Reducing deficits should be the cornerstone of future macroeconomic orientation in Europe.

The framework for regulating the financial sector has traditionally been built on a micro-prudential foundation, limiting the risk of financial distress of individual financial institutions. As a result, policymakers and regulators underestimated the systemic risk that macroeconomic trends in credit growth, leverage, and house prices may pose. A challenge for policymakers, therefore, is to achieve the appropriate balance between the micro-prudential and macro-prudential approaches to financial sector oversight.

Introducing an effective macro-prudential component to the regulatory framework involves better cooperation and coordination, both at the domestic and international level.

Considerable progress has already been made in the G-20 process on multilateral coordination and cooperation. First, the International Monetary Fund (IMF) and the FSB will work closely together in providing joint risk assessments, in particular with regard to early warning exercises. In the future, while the IMF will generally focus on macro-financial risk and surveillance, the FSF will focus on standard setting and financial system vulnerabilities. The main reason for expanding the FSF and renaming it the FSB was to include the emerging market members. Expanding membership has been successful and has increased legitimacy and ownership. Financial stability has to be based on broad legitimacy and ownership, and it requires an institutional capacity that allows for effective and efficient policy design and implementation. This new FSB along with a reformed IMF, and particularly the strengthened cooperation between these two institutions, will play a decisive role in further developing the global financial system.

Germany, through its membership in both institutions, stays committed to actively contributing to this process. Germany has always been a constituting member of the FSF. In fact, the FSF was established in 1999 based on a proposal by Hans Tietmeyer, former president of the Deutsche Bundesbank, and at the request of the Group of 7 (G-7). In the past, for example, it was due to German initiative that offshore centers remained on the FSF agenda. More recently, not least due to German persistence, the FSB was tasked by the G-20 leaders to develop measures to implement the principles for appropriate supervision and regulation of hedge funds. In the IMF, Germany is the third biggest shareholder behind Japan and the United States. Germany is also ready to contribute accordingly to an increase of IMF resources, as agreed at the G-20 summit in London.

The Financial Future

The future financial system has to continue to be global, interconnected, and reliant on open global trade and free capital flows across jurisdictions. Large complex financial institutions will continue to operate in multiple jurisdictions in order to meet the needs of their large global clients. Linkages and interrelated risks across institutions and markets, therefore, will persist. The complexity of contemporary finance will continue to pose a challenge for both financial market participants and regulators.

To this end, there is a continuous need for coordinated action on the international level. Robust regulation, based on effective global standards, is vital to financial stability. The future financial system will require greater consistency in regulating similar financial instruments and institutions performing similar activities, both within and across borders. All systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation and oversight, consistently applied and proportionate to their local and global systemic importance. Once the financial crisis is over and the economies start growing again, the focus should then shift to implementing effective exit strategies and on ensuring sustainable public finances for future generations.

Notes

1. "Declaration Summit on Financial Markets and the World Economy," G20.org, November 15, 2008, http://www.g20.org/Documents/g20_summit_declaration.pdf; "Leaders Welcome G20 Action Plan," BBC News, November 16, 2008, <http://news.bbc.co.uk/1/hi/business/7732056.stm>.
2. The FSF principles for sound compensation practices aim to ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective

supervisory oversight and stakeholder engagement in compensation. See “FSF Principles for Sound Compensation Practices” (Basel, Switzerland: Financial Stability Forum, April 2, 2009), http://www.fsforum.org/publications/r_0904b.pdf.

3. On April 2, 2009, the G-20 leaders agreed to broaden the mandate and strengthen the institutional basis of the Financial Stability Forum, and so reestablish it by renaming it the Financial Stability Board. See Financial Stability Forum, “Financial Stability Forum re-established as the Financial Stability Board,” press release, April 2, 2009, http://www.fsforum.org/press/pr_090402b.pdf.