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The Financial Market Crisis- Consequences and Counter Measures

Bavarian Representation

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Ladies and Gentlemen,

It is my great pleasure to be here and I thank Minister Muller and the Munich Financial Centre Initiative for inviting me to join you today. Bavaria is one of Europe's economic powerhouses and I welcome this opportunity to meet with the key players of this dynamic region. I also know that, as a burgeoning financial centre, you have a strong stake in how events in the financial sector play out.

So let me go straight into discussing the ongoing financial turmoil and the EU's policy response, before I detail the consequences for the European economy.

Financial-market developments and policy responses

I will not dwell on the factors underlying the turmoil. These have been widely discussed on other occasions. Suffice to say that we are now experiencing the consequences of an aggressive use of leverage.

After a long period of unconstrained borrowing by financial intermediaries, the international financial system is firmly in the grip of a de-leveraging process. And, just as the process of leveraging brought bumper profits, the process of de-leveraging is bringing sharp losses. And strong uncertainties.

Since the beginning of 2007, reported write-downs and credit losses in the global banking sector have risen to about USD 375 billion. German banks have not escaped, reporting about USD 50 billion in write downs. These are not insurmountable sums in the context of modern financial systems. But, they have indeed had damaging effects.

Key credit markets have been severely disrupted and the banking sector has come under great strain. We have seen banks refusing to lend on interbank markets and engage in frantic efforts to recapitalise. Clear evidence of such strain can be seen in both the US and Europe, including in Germany, where three banks (IKB Deutsche Industriebank, Sachsen LB and West LB) have required significant capital injections to maintain their solvency.

Throughout this period, the European Union has taken swift action to limit the fallout from the financial turmoil. The European Central Bank has injected billions of euros into European markets to provide vital liquidity, without changing its monetary policy stance.

Meanwhile, the Commission along with EU Finance Ministers and the G7 have made strong calls for the prompt and full disclosure of losses by financial institutions. This is vital if we are to increase investor confidence to a level where markets can begin to function normally again.

In recent weeks, the disclosure of losses has in fact been increasing and there are indications that confidence between financial players has gained ground.

However, we are still far from declaring an end to the turmoil in the international financial system. Signals indicate that some segments of financial markets, and in particular interbank and structured product markets, are not working at their full potential.

But this is not all we can and should do. In the medium term, we are working hard at EU level to address the weaknesses in the financial system that allowed such uncertainty to emerge in the first place.

The difficulty in removing uncertainty is that it is an almost inevitable consequence of how the modern financial system operates. Today, our financial system is characterised by the transfer of risk via anonymous trading of highly sophisticated instruments. The so-called "originate and distribute" model. On the one hand, this process has brought major benefits to the global economy. It has fostered a more efficient allocation of resources and boosted economic growth potential.

But on the other hand, we now know that very serious problems can arise, if investor confidence in the sophisticated processes of risk transfer is lost. So, we must find a way to improve transparency and accountability in financial markets. And, in so doing, we must also safeguard the capacity of these markets to deliver their full economic benefits.

It is this balance between transparency, accountability and efficiency in financial markets that underlies the EU's policy response to the financial turmoil. A roadmap of actions was adopted by EU Finance Ministers in October 2007. This roadmap identifies four objectives:

- First, improving financial transparency in the market, notably with respect to banks' exposures to securitisation and off-balance sheet items; in addition, comprehensive and up-to-date statistical data on credit market developments should be provided by the private sector to supervisors and, where appropriate, to the public;
- Second, the roadmap foresees an upgrading of valuation standards, particularly in respect of illiquid assets; in this context, the main focus is on consistent application of international accounting standards in respect of all financial intermediaries;
- The third objective is strengthening the EU's prudential framework for the banking sector, notably in relation to managing liquidity risk, concentration risk, and off-balance sheet exposures; and
- Finally, we will investigate structural market issues, such as the role played by credit rating agencies, and the incentives created by the "originate and distribute" model of credit-risk management.

The roadmap puts considerable importance on industry-led initiatives. This aspect has been criticised by some. But it reflects our belief that the primary responsibility for managing risk in the financial system lies with the private sector. On the other hand - and we should be clear about this - regulatory action is certainly not excluded if the financial industry fails to deliver substantive responses.

EU Finance Ministers and Central Bank Governors received updates on the implementation of the roadmap in April and May. I am pleased to report that work is progressing well and the roadmap should be fully implemented by the end of 2008. Let me give you some examples of where we are making headway:

- The Commission is preparing formal proposals to strengthen the prudential framework for banks via changes in the Capital Requirements in September 2008. These proposals are being discussed with relevant parties and will be tabled formally in September. The aim is to obtain a political agreement with the Council and Parliament to have the proposals adopted before April 2009.
- Work on enhancing transparency is well underway. The financial industry has been in active co-operation with the Commission and will make a first proposal on data provision in the early summer; and
- The role of credit rating agencies in the turmoil has been scrutinised. The Commission will soon come forward with concrete proposals to address the identified shortcomings, based on advice from the EU Committee of Securities Market Regulators.

In a context of globalised financial markets, it is of course essential that the EU response to the turmoil is consistent with similar actions at the international level.

In this respect, we can be reassured. There is a close correspondence between the ECOFIN roadmap and the report of the Financial Stability Forum (FSF) published in April under the auspices of the G7 Finance Ministers. Both the analysis and main policy recommendations of the FSF report are consistent with the EU roadmap.

I also welcome the fact that the recommendations of the US President's Working Group on capital markets also published in April are strikingly similar to the EU roadmap. This is encouraging. Today, global capital markets and economies are inextricably linked so we need to work together with key international partners.

Some observers and market participants are of the opinion that we may now be closer to the end of the financial turmoil than to the beginning. They may well be right. But, wherever we are in the course of this crisis, there is a major amount of work to be done to repair the international financial system.

Consequences and outlook for the EU economy

Let me now turn to the implications of the financial turmoil for the EU economy.

While the mood in financial markets may have improved slightly in recent months, further convulsions in financial markets and further distress for financial intermediaries can certainly not be excluded. In this respect, much will depend on how developments in the real economy feed back into the financial system.

As the Commission's spring forecast shows, the EU economy is already feeling the impact of the turmoil through a tightening in credit conditions. Combined with global headwinds such as the slowdown in the United States and soaring commodity prices this is resulting in lower external demand and higher inflation.

Consequently, we expect economic growth to slow to 2% of GDP this year in the European Union and 1.7% in the euro area. This is half a percentage point lower than we predicted in our autumn 2007 forecast. Growth is expected to remain at similar rates in 2009, maybe somewhat lower. Recent data shows a decline in economic confidence, which may point to a weaker outlook for the second half of this year, but it is also true that the outcome for the first quarter GDP growth was better than expected.

I should say that our growth forecasts would be considerably weaker if it were not for the remarkable resilience of the German economy. Our spring forecast indicates that the German economy will grow by 1.8 % this year and this view could be considered on the cautious side given an exceptionally strong performance in the first quarter.

All in all, in spite of these difficulties the European economy as a whole is weathering these global economic storms rather well.

Several factors in particular are supporting the EU economy at present.

Labour market conditions have strengthened considerably bringing unemployment to its lowest levels in 15 years. The balance sheets of companies and households are much sounder now than in the past. Moreover, the fiscal consolidation carried out in recent years has left many EU countries with a greater margin of manoeuvre to use automatic fiscal stabilisers than in past downturns.

Of course, looking ahead, we do face major downside risks. A severe US recession, further increases in oil and commodity prices or a renewed intensification of the financial turmoil would all impact negatively on European growth.

Meanwhile, euro-area inflation is a major concern against a background of rising commodity prices. The euro-area inflation rate remains well above the ECB's target level. We are therefore extremely wary to avoid second round effects and call for a considered economic response to contain inflationary pressures.

Conclusion

To conclude,

The European and global economy face challenging times ahead. High energy and food prices are a reality of the 21st century that we must learn to adapt to. So too are highly connected global financial markets that despite bringing major economic benefits, carry a certain level of risk.

With this in mind, we are drawing important lessons from this episode of financial turbulence and are working hard to prevent a recurrence of today's turmoil from happening in the future.

The coming months will be crucial but we are encouraged by the remarkable international consensus on the policy response needed. We will now build on this consensus to ensure that policymakers around the world work together to upgrade the functioning of the global financial system.

Thank you for your attention.