Federal Ministry
of Finance

Financial markets

Speech by the German Federal Minister of Finance Dr Wolfgang Schäuble 4th Lindau Meeting in Economics

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"From Financial to Debt Crisis - Financial Markets, Fiscal Policy and Public Debt in Europe's Monetary Union"

Ladies and Gentlemen,

Thank you very much for giving me the opportunity to talk with you today. I would like to share with you my thoughts on the recent financial crises from a policy maker's perspective.

There appears to be a consensus that the financial crisis which erupted in 2008 was caused by a combination of cheap money, deregulation and a race for profits among many executives and investment bankers who because of insufficient incentives did not show sufficient regard for potential risks.

I think there is broad consensus about these – direct – causes of the financial crisis. But the "causes of the causes" are just as important. These are quite controversial in academic and political circles alike, as demonstrated by the Report on the Causes of the Financial and Economic Crises from the National Commission of the United States Congress. Three of the Commission's ten members felt that the report should have given more weight to the impact of excess global liquidity as a key cause of the crisis. In the increasingly difficult search for lucrative investments, they felt that global capital flows caused the bubble in the United States securitisation business.

And I don't think this explanation is farfetched either. But I do believe we have to dig deeper. For me it is no coincidence that the global financial market crisis started in the United States and its real-estate sector. US policymakers attempted to support high levels of growth via monetary policy. They tried to promote home ownership of poorly skilled workers by having less stringent lending practices. And this is where I agree with the former IMF chief economist Raghuram Rajan.

Helping these people is praiseworthy. But lax monetary and lending policies are no replacement for good education and social policies. Sure, there are adverse incentives in the social market economy. But as a system partially designed to alleviate social inequity by a mix of income redistribution and providing for equality of opportunity, I think it is superior to the US model which uses monetary and lending policies to soften inequality.

The next thing we need to do is examine why the crisis was not restricted to the United States? It was able to spread all over the globe because of the growing integration of financial markets during the past 20 years, the intellectual roots of which lie in economic thought. For too long, the underlying idea was that unregulated markets around the world always served the common good. That unfettered markets were the only necessary foundation for economic prosperity.

Today we have learned that the dream of a self-regulating and permanently stable global economy has remained elusive, that financial markets, like all free systems, need rules and boundaries they cannot set or enforce effectively themselves. Academics have begun to question the efficiency of financial markets and policymakers have begun to strengthen the role of the state. The objective is to find a new balance between financial markets and the state. The market needs a

regulatory framework that only a strong state - better a strong community of states - can provide. And they are getting it. But, 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.

I have my intellectual roots in the Freiburg school of ordoliberalism. The intellectual godfather of the Freiburg School is Walter Eucken, whose German brand of institutional economics is perhaps not well known internationally but has been very influential in Germany. It served as the blueprint for Germany's social market economy.

Eucken was not a mathematical wizard, but his insights are nevertheless useful. One of Eucken's key insights - what he called "konstitutionelle Prinzipien", constituent principles, was that for a market economy to function properly one has to dismantle the limits on market participants' liability. In recent years exactly the opposite took place, developments in recent years typically saw capital market participants loosening the ties between risk and liability. That was bound to go wrong.

I am deeply convinced that for financial markets to contribute positively to society – and function efficiently – we must restore the link between risk and liability, reward and responsibility. This connection must be there for our social order and our economic system to be sustained. I am not an acolyte of Colin Crouch who argues that we already live in a postdemocratic world, where, I quote, "Politics and government are increasingly slipping back into the control of privileged elites in the manner characteristic of pre-democratic times", but I would argue that the risk is there.

Sadly, there are financial industry apologists who, citing the theory of rational markets, want to return to business as usual, behaving as if there had not been any crises or any damage. Apologists who say, although not entirely without justification, that this theory of rational markets provides the best explanation of market behavior in many cases. But, ladies and gentlemen, such a theory does not help us policymakers much: A theory unable to explain market behavior that may be rare, but threatens our economic welfare and tears our societies apart at the seams.

The truth is that markets, including financial markets, work well, but they do not always act rationally, since human beings do not always act rationally. Like human beings they need institutions, need rules and boundaries to act responsibly.

Ladies and gentlemen,

Strenghtening financial markets to make them less volatile and more resistant to crises is a laborious process, and momentum within in the G20 appears to be fading. That would be a shame, as we have made considerable progress and are clearly on the right track: All of the G20 countries have already ensured that supervisors have more powers. All large G20 nations have already introduced smarter compensation and liability rules. These will help rewarding long-term success, not short-term profit maximisation. And all of the G20 countries will improve the capital and liquidity regimes of their financial sectors within the framework of Basel III.

Not to loose momentum, I would argue it has become necessary for key countries to occasionally move ahead unilaterally and try to address virulent problems by providing - admittedly - imperfect solutions. That is why Germany put the controversial ban on some forms of naked short-selling in place, as a means to address the problem of the excessive use of leverage in today's financial systems. And I am convinced that the introduction of a Financial Transaction Tax, agreed upon by chancellor Merkel and president Sarkozy, is another case for such an "pacemaker-approach" by key countries.

We have started to correct fundamental shortcomings of modern financial markets. But I am not pretending that we have done enough. We need to limit "irrational exuberance" as well as "irrational gloom", i.e. we have to limit perilous volatility and excessive leverage in financial markets. For this to happen, we need to regulate the shadow banking system and tackle the moral hazard problems posed by systemically important financial institutions as well as confine the risks posed by the extensive leverage of some modern financial instruments.

This brings me to the crises within the Eurozone: Weakened national economic fundamentals were not the only reason for the dramatic worsening we saw in Portugal's refinancing conditions. The events of past years again demonstrate convincingly that modern financial markets can increase as well as limit volatility. In May last year as well as in recent

weeks we saw how the Euro zone threatened to tear apart because of 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 tell governments things that governments don't want to hear, and they force governments to do the right thing – although too often, too late and too suddenly.

Now, putting all the blame for what went wrong on financial markets would be convenient, but far too easy. Excessive government spending has led to levels of debt and deficits that are unsustainable and endanger economic welfare. More debt will stunt rather than stimulate growth in the long run. Eurozone 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.

There is no disagreement about the fact that Europe, and above all the Eurozone, must improve the links between its countries' national fiscal and economic policies. It is essential that European Monetary Union's institutional structures are indeed capable of obliging Euro members to adopt a fiscal and budgetary 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.

The question is - if I use your lingo correctly - how to arrive at efficient solutions in strategic and only partly cooperative games   exactly those "games" we political decision makers are faced with in Europe.

By supporting Greece and later on Ireland and Portugal, we prevented a further collapse of European and international financial markets. This was a great success, but only a partial success. The situation of some member states of the Eurozone, notably Greece, remains serious.

But this does not mean that our measures were wrong. They are part of the overall concept of the European Heads of State and Government to get the problems of some member states under control and to stabilize the Eurozone for good. The fundamental idea of this concept is as simple in theory as it is difficult to execute in practice: Member States faced with high levels of debt and deficits need to cut expenditures, increase revenues and remove the structural obstacles for sustainable growth. By this strategy, we allow for the economic recovery of the states concerned and lay the basis for sustainable growth in the Eurozone as a whole.

But for the reforms to take effect, these countries need some time – time that financial markets no longer provide, - perhaps because they have lost faith in the capacity of mature democracies to resolve long-term structural problems. I think it will be the task of western governments in the coming years to restore lost credibility by demonstrating their problem-solving-capacity. And I am not only thinking of fiscal policy problems here, but problems like swelling youth unemployment, leading to societies drifting apart. Given the rise of autocratic capitalist systems there is a growing debate that old-style western democracies are increasingly incapable of adressing pressing structural societal problems. The challenge for policymakers will be to blend democratic accountability with a rules based fiscal policy.

The key question is: Can we establish and adhere to a framework for the economic governance of the Eurozone that encourages long-term sustainable growth of our economies instead of short-term volatile growth bursts or long-term economic decline? I think we can. But for this to happen, immediate fiscal consolidation and structural reforms in Italy, Spain, Portugal and Greece are of the essence.

There are some who argue that fiscal consolidation, a smaller public sector and more flexible labor markets will lead to a decrease in consumption in these countries in the immediate future. I am not sure that's necessarily the case, but even if it were, there is a trade-off between short term pain and long term gain in these countries: 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.

I am not deluding myself, however: It will take years, before these efforts will bear fruit. I am usually careful with biblical images, but there might well be seven lean years ahead for the world economy.

But this time we will have to take the long view. For too long we have forsaken long-term gains for short-term gratification, the result being that our fiscal and financial policies are off-track and debt and deficit levels are unsustainable. Our economies are in need - and in the process of – deleveraging to put our economies on a path for sustainable growth. We won’t come to grips with economies deleveraging by having governments and central banks throwing – literally – even more money at the problem.

At the same time however, European countries have to provide conditional financial assistance to highly indebted and less competitive member countries. In essence buying those countries the time they need to put their public finances on a sustainable footing and improve their competitiveness.

I do not deny the possible risks of this strategy. Yet they are considerably lower than the risks of any alternative scenario. By this strategy we prevent the debt crisis of some countries from becoming a crisis threatening the Eurozone as a whole and with it the Euro.

Of course there are those who are not satisfied by the way European politicians are dealing with the crises, who are now calling for the supposed structural faults in European Monetary Union to be corrected once and for all by building up the political and fiscal union. But that is an approach that – in my view – does not reflect the genesis of European integration. Europe always moved forward one step at a time. And it will do so in future as well.

The direction is clear. We will strengthen the institutional links between the common european monetary policy and the still national responsibilities of member states for fiscal policies. By the way, that is in the very interest of the independent ECB and in my understanding that is exactly what the president of the Federal Republic said. Strengthening the institutions of the Eurozone may need some day treaty changes, and they will need time. But to be clear: the direction is not disputed, and the decisiveness of all member states to defend the common European currency is granted.

Going back to the the debate on post-democracy I alluded to at the beginning: I would argue that it will become increassingly necessary for European democracies to strengthen the bond between its citizens and Europe on each step of the way; by strengthening the democratic mandate of European institutions. However, that does not mean that the fiscal and monetary policy decisions taken by these democratically legitimated institutions need the public’s continual approval of their decisions. As I understand it that squares with an insight of constitutional economics: That you establish and legitimate your principal monetary - and fiscal - institutions with a strong democratic mandate but entrust them to conduct monetary and fiscal policy as independent from politics as possible.

Of course these institutions will still make mistakes, but at least mistakes based on errror-prone interpretations of the public mood should not be one of them. I am a great fan of Karl Popper and his concept of an open society which improves through a constant process of trial and error. If we want to draw the right lessons from the recent financial crises, then that is how we have to proceed.

To sum up, I strongly believe that we can only overcome the major challenges of economic and financial globalization by maintaining the superior system of a market economy. But I believe as well that financial markets are incapable of regulating themselves. They need the state to create and enforce a regulatory framework.

At a national, European and international level we have begun to create such a framework. A framework which encourages more responsible behaviour on the part of financial market participants and European governments. A framework that promotes the sustainable growth of the real economy. By fits and starts, by trial and error we will improve on this framework. That is how open societies work and that is how they should work.

Thank you very much!

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