

Foreword

The financial crisis that emerged in a small segment of the U.S. financial market has since developed into a severe global economic crisis. Both economic policy makers and central banks have to find effective and innovative answers to this difficult situation.

The current problems have multiple causes. First and foremost, the probability of a crisis (an inherent phenomenon of any economy) was undoubtedly underestimated, resulting in both excessive optimism and too little caution. Inappropriate incentive structures were another key factor contributing to the depth of this crisis. Owing to their short-term focus on maximizing stock prices, market participants were excessively ready to take risks. Furthermore, awareness about the risks entailed in complex financial instruments was inadequate. Misperceptions existed, in particular, regarding the implications of these incentive structures for the risks underlying such instruments. The role of some supervisory bodies and central banks in the run-up to the crisis has also come under scrutiny, and for good reason: Far too little consideration had been given to the correlation between global macroeconomic developments and the risks of individual institutions. Overall, we can now say without a doubt that the build-up of risk buffers in the global financial system had been inadequate in the run-up to the crisis.

Regarding the interaction between the real economy and the financial economy, too little attention has been paid to the procyclicality of the financial system, which is a topical problem in the current situation. In particular, accounting practices – including e.g. fair value accounting or loan loss provisions – underwent a series of developments that should be revisited in the

light of the crisis (with the aim of reducing this procyclicality).

In view of the dramatic growth slowdown and major external imbalances in the region, Austria's financial sector made the headlines primarily because of its leading role in the financial sector of Eastern Europe. In fact, Austrian banks hold approximately 20% of Eastern European countries' foreign liabilities vis-à-vis EU-15 banks, which is the largest share both in absolute and GDP percentage terms. The situation in Eastern Europe has eased significantly thanks to intervention by the EU and the IMF. In addition, Austrian politics has shown through its flexible intervention that it can take action on this issue. Strict vigilance is nonetheless warranted, a fact of which both banking supervisors and the banks concerned are well aware. At the same time, it should also be remembered that about 85% of loans issued by Austrian bank subsidiaries in Eastern Europe are covered by local deposits and that around three-quarters of Austria's exposures in the region are to countries which are already EU Member States.

What is to be done to resolve the situation? The following strategic elements are essential: We need to adopt a more systemic approach to financial regulation and supervision and strengthen the focus on the macroprudential dimension. In particular, micro- and macroprudential supervision must be integrated more closely at a national, European and global level.

In the future, effective financial stability analysis will have to be about more than identifying key weaknesses in the financial system – we have to ensure that risk mitigation measures are taken with immediate effect. The results of financial stability analysis must be integrated to a greater extent into

ongoing banking supervision and the regulation of financial players' behavior. This also implies that we need to make changes in the regulatory environment. We therefore support the de Larosière report on Europe's new supervisory architecture and related EU initiatives. After all, these matters can only be resolved at the European level. Institutional cooperation between supervisors, central banks and international organizations such as the IMF or the Financial Stability Forum is another equally important success factor.

The key debate on the financial crisis is focused on achieving the most effective regulation possible based on the lessons learned from the current crisis. At an international level, this discussion includes considerations about the degree of supervision to which major systemically important financial institutions (that are considered to be too big to fail) are subjected. Moreover, there are already specific proposals for more effective supervisory structures, such as the European Systemic Risk Board (ESRB), which has already been

approved by the European Council and assigns a greater supervisory role to the European System of Central Banks. There is an undisputed consensus that concealing risks in off balance sheet conduits must be impossible for market participants who are already subject to regulation. The same consensus exists regarding the well-founded call for greater transparency and increased disclosure duties for the financial sector as a whole.

The economic downturn in Austria has been severe and the fastest the country has experienced in a long time. The Austrian government reacted with a comprehensive flexible-use bank support package. Overall, Austria is well on track thanks to the fact that the country's supervisory architecture was restructured as early as 2007. Financial stability analysis plays an even more important role than ever before in this architecture. Central banks make a highly valuable contribution to the stability of the financial system and, for this reason, must safeguard their own independence.

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