Dinner Speech

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Public Finances and Financial Stability

Dear Governor,
Ladies and Gentlemen,

Thank you very much for the invitation. I am very pleased to have the opportunity to discuss with you how to restore and maintain sound public finances and financial stability in Austria and in the EU.

The financial and sovereign debt crisis has put the previous strategies of EU economic and financial policies and its institutional decision-making settings to a hard test.

The Lisbon Treaty did not provide for an effective framework to deal with the major challenges linked up with the banking and debt crisis in the EU. Partly because we did not apply our own rules and partly because our rules did not cover the relevant policy areas.

Thus, the first question was, whether we would be able to deal with the financial stress in a cooperative manner. And secondly, whether we would be able to reform the architecture of the euro area so that we effectively prevent future crises.

As to the first point, let me stress that there has been a willingness within the euro area (and the EU) to come together and to help. We established financial solidarity instruments, first bilaterally in the case of Greece and then multilaterally with the European Financial Stability Facility, the European Financial Stabilisation Mechanism and the European Stability Mechanism. The ECB played a particularly positive role within the limits of its mandate. Let me note that also non-euro area countries contributed bilaterally, and thus solidarity went beyond the euro area.

Solidarity can mitigate the effects of a desaster but it cannot and should not prevent the need of each country to return to sustainable policies and business models based on productivity and not based on credit and excessive leverage.

This brings me to a second point. The strong correlation between sound public finances and financial stability has become evident over the past years. This holds true not only in a national context, but especially for the stability of EMU. Budgetary deficits and debt ratios rose significantly due to the crisis and turned the financial crisis into a sovereign one. Ultimately, it was not only the stability of certain Member States that was at stake, but the stability of the common project *euro* and even the whole European Union.

We learned from the crisis that dealing with the fiscal issues alone would not solve the problem and thus also new rules for the financial sector became necessary.

1 Fiscal Issues

At the European level, we have brought forward a comprehensive European fiscal and macrogovernance package of new rules. This package focuses on ensuring the stability and sustainability of public finances, avoiding macroeconomic imbalances and strengthening competitiveness.

The *Sixpack*, in force since December 2011, lays down both preventive and corrective fiscal rules. It reinforces the old Stability and Growth Pact. Now, the Stability and Growth Pact has much more bite in order to detect and tackle excessive deficits much earlier.

These fiscal rules have been complemented by the Fiscal Compact, in force since the beginning of this year, and the so called *Twopack*, which entered into force on 30th May 2013.

The Fiscal Compact contains the requirement for Member States to broadly balance their general government budgets in structural terms by implementing a national debt brake with automatic correction mechanisms.

The Twopack implements a new and harmonized framework for the preventive coordination of national budgetary processes and puts the procedures in case of financial assistance on a legal basis.

At the national level, the Austrian Federal Government together with the federal states "Länder" and municipalities have done their job by embarking on an ambitious budgetary reform path.

On the one hand, we transformed very comprehensively the EU fiscal rules into national law; in particular with our national debt brake. On the other hand, we adopted the Stability Package 2012–2016.

Moreover, fiscal discipline from all levels of government has been enshrined by the Austrian Stability Pact, which entered into force on 1 January 2012. This Pact transposes the provisions of the Stability and Growth Pact into binding national rules. This guarantees that the transition to the national medium-term objective of –0.45% of GDP in structural terms by the general government will be achieved by 2017 at the latest.

The Austrian economic and fiscal strategy can be characterised by four key objectives:

- fiscal discipline by the swift consolidation of public finances
- implementation of structural reforms
- future investments into education, innovation and infrastructure
- ensuring a sound financial sector

Our fiscal consolidation commitment has been further underlined by the adoption of the Stability Package 2012–2016. All measures have been consistently implemented so far. The total volume of the package sums up to nearly EUR 28 billion over the full period, with around two-thirds of the consolidation stemming from the expenditure side.

It is to be noted that the budgetary outcome of a deficit of –2.5% of GDP for 2012 (despite the costs of banks) was significantly better than expected, and the second in a row below 3% of GDP. Projections for this year confirm the durable success of the Austrian consolidation path.

Restoring budgetary sustainability, hoewever, is just one side of the coin. A sound economic policy strategy extends consolidation with efficient investments and structural reforms. Education, innovation, energy efficiency and infrastructure are key future growth drivers.

Based on these facts, the Austrian Federal Government already decided in 2012 to allocate more financial resources to the areas of education, universities, R&D (research and development) and infrastructure. Overall, in the period 2013 to 2016 almost EUR 4.5 billion are going to be spent additionally on these matters.

Other preconditions for an efficient growth model in times of tight budgets and persistent challenges as ageing societies or migration are ambitious structural reforms.

Austria is consistently addressing pensions, health and long-term care, public administration, subsidies and labour markets. The objective is to maintain the already high quality at more reasonable costs.

2 Financial Sector

We are all aware that a lot of taxpayers' money was spent in order to stabilise the financial system in the crisis. Alongside many other countries, the Austrian Government released a package of measures to stabilise the Austrian financial system in October 2008.

With the "Vienna initiative" we also assumed responsibility for the stability of the banking sector in the CESEE-region (Central, Eastern and Southeastern Europe), where Austrian banks are very active.

- From an ex-post perspective, the measures taken in 2008 were effective and helped to avoid significant damage to the Austrian economy. Thus, most of these measures have already ended or could be significantly reduced.
- The measures providing liquidity for the interbank market (via the Intermarket Support Act (ISA)) were particulary successful. The envelope of EUR 75 billion in 2008 could be reduced step by step and the ISA expired by 2011.
- Instruments allowing the contribution of equity – for example by the provision of participation capital or shareholder contributions – and instruments granting governmental liabilities were used intensively. In total, eight Austrian financial institutes requested and received governmental support based on the Financial Market Stability Act.
- In three cases, the only way of avoiding significant impacts on the Austrian economy was to take over ownership of the financial institutes by the Republic of Austria (Kommunalkredit AG: November 2008, Hypo Alpe Adria: December 2009, Österreichische Volksbanken-AG: April 2012).
- The current challenges are to find sustainable and value-conserving solutions for the state-owned banks, which will reduce the costs for the taxpayer.

3 EU-Legislation

Here, I believe that we have our lessons learned: We are currently shaping the EU legislation in a way which will lead us to a more stable banking sector.

3.1 CRD (Basle III)

One important part is already finished at EU level, and we are now transposing the Capital Requirements Directive (CRD IV) into Austrian law.

The main objectives of these legal acts are:

- to enhance financial stability and the capability of institutions to bear losses. Credit institutions will have to hold a capital buffer to raise the institutions' loss-absorbing capacity.
- to ensure that Austrian companies and individuals are supplied with credit.

- to strengthen and harmonise the supervision of credit institutions, investment firms, insurance companies and financial conglomerates.
- to improve the *corporate governance* of banks.

To make it short: In the future it should not happen as easily as in the past that banks are getting in financial troubles.

3.2 BRRD/ BIRG

Another directive is on the brink of finalisation, the Bank Recovery and Resolution Directive (BRRD) will lay down union-wide rules for the recovery and resolution of banks. In the future, important banks in troubles, which were considered to be too big to fail in former times, should be resolved. The new framework will allow for in-depth restructuring of banks but keeping its vital functions for the real economy in order to protect financial stability.

The losses and costs of failure will be born by shareholders and creditors, thereby putting an end to the need to finance the process with public resources. This is what we call the "bail-in". The taxpayer funded "bail out" should be a thing of the past.

Another equally important aspect of this directive is prevention and early intervention.

We decided to bring forward the main elements of prevention and early intervention by the "Bankeninterventions- und -restrukturierungsgesetz" (BIRG) on national level and not to wait for the finalisation of the (European) negotiations. According to this new law, the Austrian credit institutions will be obliged to draft recovery and resolutions plans. The Financial Market Authority (FMA) will also be equipped with early intervention tools.

3.3 Banking Union

In the medium to long-term, the EU will be going towards a Banking Union. The goal is to break the vicious circle between the banking sector and the sovereign.

We have already agreed on one important pillar, the Single Supervisory Mechanism, giving the ECB the competence to directly supervise significant banks of the euro area. Unfortunately, only the Member States of the euro area are to participate, but I hope that the various incentives for closer cooperation for the other Member States will be sufficiently attractive for them to join the Mechanism so that the benefits of the system can be fully gained.

For the second pillar, the Single Resolution Mechanism, the Commission put forward its proposal on 20 July. Here, it is absolutely crucial, that we must avoid a system that creates moral hazard and gives incentives for free riding due to a single fund.

There is no doubt that a Single Resolution Fund must be financed by the banking sector. Otherwise it would be again the taxpayer that will finance the resolution – and I will not agree on that.

3.4 ESM

Last but not least, I would like to mention that the European Stability Mechanism (ESM) is now better linked up to restoring soundness in the banking sector, in particular with the now negotiated instrument of direct recapitalisation of banks. However, we still need to solve some problems in the design, for example how to avoid moral hazard.

To sum up, we have made substantial progress – both at EU and at national level.

In Austria, we have done our homework. I am sure that this is why the Austrian economy has consistently performed better than the euro area in terms of GDP-growth, it has the lowest unemployment rate in the EU and a very good record in terms of "well-being" indicators and an excellent rating of its credith-worthiness.

Still, a lot of work needs to be done to make the European Union more resistant. But I am quite confident that we have defined the new building blocks so that it can withstand future storms or floods.