

Thomas Drozda

Federal Minister for Arts and Culture,  
Constitution and Media



## Opening address: The Financial System of the Future

Dear Governor,  
Ladies and gentlemen,

It is my pleasure to welcome you today, also on behalf of Chancellor Kern, who sends his greetings. I have started my personal career in the central bank, so this is kind of a homecoming for me. Today, I would like to talk about the financial system and its role in the allocation of capital. I will also briefly mention what the government and the regulators can do to make the financial system of the future more stable.

But first, let me thank the central bank for hosting this conference for the 44<sup>th</sup> time because when you bring together policy makers and economists, bankers and academics, you provide us with a good opportunity to exchange our views and learn from each other. Today, the production of knowledge very often is organized in strictly separated fields, sometimes even called “silos”, and even within one field, theory and practice often are not much in contact. I would like to thank my former colleagues for organizing this event where we can mingle and chat and see what views we have on the financial system of the future.

When I worked as an economist in the Oesterreichische Nationalbank (OeNB) – some 25 years ago – our present financial system of today was still very much the financial system of the future. I am quite sure that back then no one would have imagined the financial system of the future in the way it has developed since. In the words of Paul Krugman: “The old world of banking, in which institutions housed in big marble buildings accepted deposits and lent the money out to long-term clients, has largely vanished.”

Then like today, we were concerned about the efficient allocation of capital. This has always been one of the most important functions of the financial system. Our economics textbook offered a rather sketchy idea how this allocation would work: banks take deposits and lend to enterprises that use these credits to fund their investments; the investments in new machinery, or more general: in new technologies, would then enhance the productive capacity of the economy and thereby drive growth. If each credit expansion was used to finance productive investment, financial deepening indeed would always contribute to growth and employment.

But it wasn't, so it didn't.



More and more often we see that people take credits to buy already existing assets, for example houses. While building a new house creates value added and therefore contributes to growth and employment as it generates profits for the construction firm and wages for the masons and plumbers, buying an already existing home is merely a financial transaction. Sure, there might be some value added from the real estate agent, but in comparison, it is negligible.

Adair Turner analyzed this phenomenon very well and called it “too much of the wrong sort of debt”. He shows that 2/3 of bank lending in the UK went into residential mortgages and another 14% into commercial real estate. By using a large share of credit for real estate transactions, you can inflate house prices, thereby making the house owners richer. But this is not the most productive use of capital one can imagine. And it also raises the question of sustainability: credit-fueled asset inflation drives up house prices and higher house prices justify larger loans because the loan-to-value-ratio stays within reasonable limits. As long as credit supply is unconstrained the expectation of increasing future prices itself leads to higher house prices and eventually to a bubble that will burst.

This is exactly what we have seen in the U.S.A., in Ireland or Spain. To prevent these self-reinforcing boom-bust-cycles from happening, we have to equip our regulators and supervisors with macroprudential instruments. But as useful as these instruments may be in strengthening the resilience of the financial sector and the economy as a whole, they do not address the root cause of the unsustainable credit demand: the rising inequality in our societies.

Thomas Piketty, Tony Atkinson and others have well documented the increasing inequality in western societies over the past decades. Raghuram Rajan was one of the first to explain the rising financial instability of the 2000s by the simultaneously rising inequality of income and wealth. His reasoning is straight forward: when a rising share of income goes to the people at the very top of the distribution, the middle class and everyone else must take credits to keep their standard of living. This leads to growing indebtedness of more and

more private households and once an asset price bubble bursts, these households end up being over-indebted. This over-indebtedness makes the recession following the crisis especially painful and long, because households have to deleverage before they can spend a larger share of their income on consumption again.

Now for what we know, in Austria income inequality has not risen as strongly as in other countries, but we cannot be quite sure as we have no reliable data. We know that wage inequality has not risen strongly, but information on capital income is lacking. Besides, wealth inequality is rather high in Austria as we know from the studies conducted by the OeNB in cooperation with the Household Finance and Consumption Network, for example.

So what is our policy response? If we want to avoid financial turmoil and strengthen the resilience of our economies, we have to strengthen the middle class. As it happens, this is exactly what our chancellor aims to do. Already last year Chancellor Kern has presented his vision for more growth and broadly shared prosperity by strengthening investment and labor demand. His aim is to implement practical measures that improve the lives of the men and women in our country directly.

As we are here on invitation by the central bank, let me quote Mario Draghi:

*“In a society where [...] the welfare state generously supplies education, health and housing benefits, covers against the risk of unemployment and protects old-age income levels, [...] holdings of wealth are less important. When these conditions cease to hold, [...] wealth takes on a new significance for household prosperity.”*

The plan of the chancellor, the so called “Plan A”, also aims at the sustainability of the welfare state. It includes

many initiatives that can be implemented at the national level and we have already started to do so.

But I would like to come back to the allocation of capital, this time at the international level. We know from our textbooks that national savings minus national investment equals the current account balance. This is not a theoretical conjecture but a mere accounting identity, so we know it must hold. Countries that exhibit a current account surplus save more than they invest and lend their excess savings to other countries. This might be a perfectly sensible thing to do as many countries face demographic challenges in the form of ageing populations. The financial system should also facilitate the allocation of capital over time and enable people to manage their personal finances across their lifetimes, between generations and across borders. In theory, well-integrated financial markets allow for international risk sharing and should stabilize the economy.

There are several problems with this assumption. First, there is no empirical evidence that risk sharing has happened in Europe to a degree that would have had any stabilizing impact on final demand, even before the crisis, despite a significant amount of financial integration (e. g. Moser et al., 2004). And second, investing abroad does not really yield high returns, if any. When German and French savers invested in U.S. mortgage backed securities or Spanish residential property, they suffered quite painful losses.

At the same time, investment at home is lacking. This is in particular true for the public sector: public investments have been at low levels for many years but the ministers of finance are obsessed with the “black zero”. This is worrisome because if domestic infrastructure is deteriorating, incentives

for private investments are waning, too. And in the current low interest rate environment, public investment would be cheaper than ever. Martin Hellwig, one of the most eminent German economists of our time, published an opinion piece in the FAZ last week, in which he was asking his government exactly to do that: invest more in public infrastructure to improve German roads and rails and to reduce the exorbitant German current account surplus.



I would also like to comment briefly on the stability of the financial system of the future. That financial stability is dear to central bankers goes without saying. But also we in government have a very strong inherent interest in the stability of the financial system, mainly for two reasons:

1. The economic, social and political consequences of financial crises can be dreadful. The Great Depression that followed the financial crisis of 1929 brought poverty and despair, radicalization and war.
2. Even if a financial crisis does not lead to depression, the cost of fighting a financial crisis or of avoiding a meltdown of the financial system usually ends up on the government's balance sheet.

Unfortunately, according to the work of Hyman Minsky we seem to be trapped



in a cycle: financial stability bears complacency, complacency bears crisis, crisis bears better regulation, better regulated markets bear financial stability, and so on.

How can we break this cycle? If I may say so, there are some dialectic lessons from the past:

First, we were told to avoid a financial meltdown at all cost, which meant to save banks, sometimes even bankrupt banks in order to prevent panic. This was the big lesson from the 1930s.

Then we learned that banks that were almost bankrupt could delay or even impede the recovery when kept alive artificially; the warning example has been Japan since the 1990s. So, the conclusion was to avoid “zombie banks”, and let bankrupt banks go belly up. (e. g. Caballero et al., 2008)

So how do we square this circle? The synthesis seems to be to save the part of financial sector that serves a useful economic purpose, and unwind the rest. To do so, we had to create a workable and credible resolution framework. An appropriate EU framework has been enacted, now we have to live by the rules that we have agreed upon in order to establish the credibility that we need.

In this context, I would like to echo a warning by the IMF. In its recent Global Financial Stability Report, the

IMF states that in response to the financial crisis, major regulatory reforms have been started. However, while the financial system is still vulnerable in some respects, there are pressures to stall or even roll back the reform process. Clearly, we have to evaluate our reforms constantly and adjust shortcomings or overshooting when needed. But, for the very reasons I have just presented, we want the financial system of the future to be strong and stable and therefore we cannot allow ourselves to be complacent or our regulations to be weak.

Also the policy makers must be strong and sincere on this point. It is not sincere to agree on regulations in Brussels and then to complain at home about the onerous EU regulations. They did not appear from nowhere, member states’ ministers have a fair share of ownership for these regulations and they have to live up to that.

Before I end let me just briefly mention two more issues about the future of payment systems that you might discuss during the conference. With respect to Bitcoin and other alternative forms of money: personally, I am rather open to these approaches, but also skeptical about their chances. We know that Hayek had this idea about competing private currencies and good money driving out bad money. However, that was in the 1970s. Now, in the days of Google and Facebook, we are constantly reminded of the existence of network externalities that might also work in favor of our legal tender issued by the central bank.

And with respect to the future of coins and banknotes, let me paraphrase Mark Twain: reports on the death of cash are greatly exaggerated. We will use cash in everyday transactions for the foreseeable future and we in government have no intention to take away

cash from our citizens. Unfortunately, some politicians like to evoke a phantom menace that is threatening the public because they hope to gain some additional votes by fighting these made-up conspiracies. Unfortunately, some sensationalist media like to propagate these made-up threats. But I can assure you that there are enough serious politicians who are focused on the financial system of the future and the real problems and the real solutions.

Finally, as Governor Nowotny quoted Rumsfeld’s distinction of “known knowns”, “known unknowns” and “unknown unknowns” I would like to bring to your attention a response by the philosopher Slavoj Žižek who reminded Rumsfeld that next to these “knowns” and “unknowns” there is also the “unknown known”: things that we don’t know that

we know them. Žižek was referring to the Freudian unconscious. When it comes to the financial system and the question: how to avoid a financial crisis? I find it quite interesting how many things that we have known were unknown when we needed them. The insights and findings of Keynes, Minsky, Tobin or Galbraith – just to name a few – have been suppressed to establish a new orthodoxy in the spirit of the ever so efficient market. Generations of economists had to unlearn the things they had known from their university training and when the crisis hit us, many policy makers and their staffs were unprepared. I hope that this conference also gives us the chance to uncover some of these insights and help us to establish a more stable financial system of the future.

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