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Real Implications of the Financial Turmoil: Strategies for Growth and Stability

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Es gilt das gesprochene Wort.

Financial Turmoil and its Impact on the Austrian Banking Sector

- As you all know, global financial markets have been shaped by financial turmoil since the summer of 2007. In **September 2008, the crisis intensified** as uncertainty in international markets was raised considerably when Fannie Mae and Freddie Mac were placed under conservatorship, and when Lehman Brothers – which had been a major counterparty in the credit derivatives and swap market – went bankrupt.The uncertainty was further heightened by massive write-downs and liquidity problems of large international banks and insurance companies. Stock prices plunged, credit risk premia rose substantially, and conditions on the interbank market tightened even further.
- In this situation, central banks and governments responded with numerous **measures to restore confidence and stability** in the financial market. In the EU, the heads of state or government endorsed a joint action plan to fight the financial crisis by raising the savings guarantee for depositors, recapitalizing financial institutions and guaranteeing certain bank obligations.Austrian policymakers also adopted comprehensive measures to fight the financial crisis.
- Although the direct effects of the financial crisis on Austrian banks have been limited so far due to their relatively small exposures to the U.S. subprime market, Austrian banks have been **indirectly affected** to a significant extent as refinancing costs rose, income declined, loan loss provisions had to be raised and risk aversion increased among investors especially towards exposures in Central, Eastern and Southeastern Europe (CESEE). However, Austrian banks expect net income to have been still clearly positive in 2008 – as of the 3rd quarter 2008 they expected a net income of EUR 3.6 billion for 2008, which is 25% down compared to year-end 2007; additional write-downs expected in the 4th quarter will, however, have depressed income even further.
- Regarding **foreign currency loans**, which are very popular in Austria, the share of foreign currency lending to customers decreased over the last years, although it is still high on an international comparison (18% of total loans to domestic customers in Q3 2008). In 2008, the developments on foreign currency markets (e.g. appreciation of the Swiss franc and the Japanese yen against the euro) had a negative impact on outstanding FX volumes. Due to this increase in FX risk, most banks announced more restrictive allocation policies for the future, and the Austrian authorities increased their monitoring activities of these loans.
- Austrian banks were **first movers in the CESEE banking markets** in the late 1980s.Since then they have continuously expanded their presence and are now significant players with highly diversified exposures across the whole CESEE region.[1])According to business segment reports, the largest Austrian banks generated consolidated profits of EUR 3.3 billion in the first half of 2008 in CESEE, compared to EUR 1 billion in the domestic segment and –EUR 0.3 billion in the rest of the world. In recent months, the global economic slowdown has also led to increasing vulnerabilities in CESEE, especially in Hungary, the Ukraine and Latvia; and the risk aversion of global investors towards this region has increased. In addition, local banking systems are quite exposed to foreign exchange risks given the high share of foreign currency loans.

Austrian Measures to Combat the Financial Crisis

- The measures adopted by Austrian policymakers to fight the financial crisis were endorsed by the Austrian Parliament in **October 2008** and encompass primarily two new laws, the Interbank Market Support Act (InterbankmarktstärkungsG), and the Financial Market Stability Act (FinanzmarktstabilitätsG).

- The Austrian measures were designed in accordance with the common principles highlighted in the **Ecofin meeting** on October 7, 2008, and the **Declaration on a concerted European action plan** that the heads of state or government of the euro area made on October 12, 2008.This declaration, which defines specific cornerstones regarding national measures for supporting the financial markets, shows that the European Union is in the position to act quickly and coordinated in the case of a financial crisis.

- With the Interbank Market Support Act, an **“Austrian Clearingbank”** (Oesterreichische Clearingbank AG) was established as a special purpose entity for strengthening the inter-bank market. The Austrian Clearingbank serves as an intermediary on the interbank market by borrowing funds and lending such funds to credit institutions and insurance undertakings.The Republic of Austria assumes limited-term liability for receivables and a guarantee for debt instruments issued by the Clearingbank.Measures under this law may **not exceed EUR 75 billion** and they are temporary – the law expires on December 31, 2009.

- Under the Financial Market Stability Act, the Minister of Finance may **take measures to recapitalize** credit institutions and insurance undertakings by way of assumption of liabilities, guarantees for loans and provision of own capital, acquisition of company shares or convertible bonds, takeover of company assets, and – as last resort – takeover of property rights (i.e. nationalization).Fees and interest for the instruments must be set at market rates.Measures under this law may **not exceed EUR 15 billion**. The law also provides for (re)privatization after the purpose has been achieved.

- Another measure taken by the Austrian authorities concerns the **safeguarding of bank deposits:**

    - For bank deposits of retail customers, a 100% state guarantee was put in place retroactively from October 1, 2008, limited until the end of 2009.

    - As of January 1, 2010, protection for retail customers will be raised to EUR 100.000 (previously EUR 20.000 per account holder/per bank).

    - The deposit protection for small and medium-sized enterprises will be raised to EUR 50.000.

    - A maximum of EUR 10 billion is allotted to this measure.

- In addition, the Austrian Financial Market Authority (FMA) passed a decree prohibiting the **short-selling** of the stocks of insurance companies and banks listed on the Austrian Stock Exchange, for a period of 3 months until the end of January 2009 (which can be prolonged if deemed necessary).

- All these measures, adopted in a swift and comprehensive way, will contribute to **re-establishing confidenc**e in the Austrian financial market and securing financial stability.

Development of the European Supervisory Framework

- The current financial crisis has revealed certain **weaknesses in the EU's supervisory framework**, which is still fragmented nationally despite increasing financial integration and cross-border activities of financial institutions.Until now the supervisory development in the EU has followed an evolutionary approach, and the Level 3 Committees of the Lamfalussy Framework – CEBS, CESR and CEIOPS[2]– have achieved considerable convergence regarding supervisory practices and procedures. However, the weaknesses revealed in the course of the financial crisis have prompted supervisors and regulators on international as well as EU levels to rethink the supervisory framework and come up with proposals for strengthening the current architecture.

- From my point of view, **strengthening the role of the consolidating supervisor** as originally proposed in the amendments of the Capital Requirements Directive (CRD) is **not the right way forward** in developing EU supervisory regimes. The strengthened consolidating supervisor, or "lead supervisor," would hinder the development of an EU-wide supervisory approach, and lead to group-specific and fragmented supervisory regimes. Credit institutions would be faced with an unlevel playing field, since they would conduct business on the same local markets but be subject to different supervisory regimes.Moreover, the lead supervisor approach would not take into account the interests of local supervisors and governments. The local entities would be supervised by a foreign authority with very limited incentives to provide information, while responsibility for financial market stability would remain with the local authorities.These are not favorable preconditions for effective crisis management and resolution.

- Thus, I would suggest to **further optimize the current supervisory framework** in the short term, building on the improved supervisory colleges, and further promote regulatory convergence. However, in the longer term, the only feasible concept, from my point of view, is the establishment of a **federally organized European System of Banking Supervisors**.This seems to be the only way to ensure real supervisory convergence as well as efficient and effective supervision of cross-border institutions. In such a system, a European Banking Supervisory Authority should act as regulator and take all supervisory decisions on cross-border banking groups.At the same time, and coordinated by the European Supervisor, the fact-finding in terms of on-site inspections and off-site analyses should remain at the national level.This would ensure that supervisors have local market knowledge.For banks that are predominantly active at the national level, the national authorities would keep their current responsibilities.This would not only prevent an overburdening of the European Supervisor, but also be consistent with the principle of subsidiarity.

- However, the move to such a system requires a **strong political commitment** and probably also stronger political integration; moreover, a number of preconditions especially with respect to burden sharing arrangements would have to be fulfilled. I would therefore suggest establishing some kind of **"Masterplan"**a roadmap towards a European System of Banking Supervisors with defined milestones and timelines.

Necessity of Coordinated Stimulus Packages

- The financial crisis has become an economic crisis.Consumer confidence is rapidly decreasing, and growth forecasts for industrialized countries have been revised downwards several times during the last weeks. We expect Austrian GDP to shrink by slightly less than -1% in 2009, which means a downward revision of about 2.5 percentage points since the official June 2008 forecast of the OeNB.[3]) Forecasts for Germany are between -2% and -3%. Italy continues to struggle in growth terms; about -2% are expected for 2009.[4]) Even world growth is going to be below +1% (recent projection by World Bank of +0.9% for 2009).

- In “normal” times, fiscal policy supports monetary policy in smoothing the business cycle via automatic stabilizers. This concept has worked quite well over the last 25 years. However, we do not live in normal times at present: Due to the financial crisis and due to very low expectations on returns of possible investments for the near future, the ability of monetary policy to boost investment and consumption is very limited right now.We seem to be already in an investment trap and might fall into a liquidity trap as well. So there is a need for fiscal policy measures.

- Automatic stabilizers still work but are not large enough to prevent a severe economic downturn.The leeway of automatic stabilizers has been diminished through structural reforms like reductions in the progressivity of tax systems and a decrease in the relative size of governments.

- So coordinated discretionary measures as proposed in the European Economic Recovery Plan are necessary.Coordination among EU Member States is important due to their high openness, as a result of which multipliers are relatively low.Most EU countries (including Austria) are already implementing such programs.In Germany, the coalition just agreed on a EUR 50 billion package last week.[5])

- The importance of discretionary fiscal policy in the current environment has also been recognized by the IMF, as pointed out in a recent staff position note.[6]) They also call for timely and collective measures. The measures should be “lasting” because the downturn might be lasting, and “contingent” because it might get worse. So there has to be commitment to keep the measures until the recession is over, and to do more if the recession gets worse indeed.

- “Sustainability” of the measures is very important as well. They should not conflict with long-term goals of growth policy, such as the objectives of the Lisbon Strategy; this point has been heavily emphasized in the European Economic Recovery Plan.Furthermore, in accordance with the Stability and Growth Pact, there has to be a commitment that consolidation will be carried out in better times.Trust of investors in the sustainability of public finances is crucial to keep financing costs low, and trust of the general public is important to prevent compensatory private savings in a Ricardian-like reaction to stimulus programs. The latter point has been emphasized in a paper in the IMF World Economic Outlook on the effects of discretionary fiscal policy.[7])

- Both the IMF and the EC call for diversified packages combining revenue and expenditure measures.Spending measures generally take longer to implement but have also a higher multiplier (which is, incidentally, also the assumption on which the new chair of the Council of Economic Advisors in the US[8]) has based its assessment).

- Tax cuts and transfers should be targeted to households with a large marginal propensity to consumption. One possible measure in this context would be to increase the size of unemployment benefits and the corresponding period of entitlement. This would also increase the degree of automatic stabilization. Relatively recent papers by Solow and Blinder[9]) made some interesting proposals how to raise the degree of automatic stabilization without increasing the (structural) size of the government sector (e.g. tax rates responding automatically to the business cycle).

- Furthermore, it is important that enterprises belonging to the real economy have access to credit. The increase of the EIB’s credit supply is a step in that direction.Banks which get capital injections from the Austrian government will be required by law to use at least parts of the injection to grant credit to SMEs and households.

[1]) According to figures from the BIS, the overall exposure of Austrian banks to CESEE amounted to about EUR 191 billion at the end of Q2 2008 or 66.5% in terms of AT’s GDP forecast for 2008. Their share in the entire CESEE banking market was 15.2% in mid-2008 (if Russia is excluded: 21.8%). At end-2008 twelve Austrian banks operated 73 fully consolidated subsidiaries in CESEE.

[2]) CEBS: Committee of European Banking Supervisors, CESR: Committee of European Securities Regulators, CEIOPS: Committee of European Insurance and Occupational Pension Supervisors.

[3]) Until now (OeNB forecasts since 1998), the highest downward revision has been 1.2 pp (December 2001 in forecast for 2002).

[4]) Euro Area 2009: -0.9% (Consensus Forecast Dec. 08); -0.5% (BMPE Dec. 08).

[5]) Agreement on 12 January 2009.

[6]) IMF Staff Position Note: Fiscal Policy for the Crisis. 29 December 2008.
http://www.imf.org/external/np/pp/eng/2008/122308.pdf

[7]) IMF World Economic Outlook, October 2008 – Chapter 5: Fiscal Policy as a Countercyclical Tool.
http://www.imf.org/external/pubs/ft/weo/2008/02/pdf/c5.pdf

[8]) http://otrans.3cdn.net/45593e8ecbd339d074_l3m6bt1te.pdf, page 13.

[9]) Alan S. Blinder, 2004. "The Case Against the Case Against Discretionary Fiscal Policy," Working Papers 100, Princeton University, Department of Economics, Center for Economic Policy Studies. Robert M. Solow, 2005. "Rethinking Fiscal Policy," Oxford Review of Economic Policy, Oxford University Press, vol. 21(4), pages 509-514.