Stabilising the Financial Markets

Recommendation on International and National Fiscal Sustainability Policy Measures

Statement issued November 10, 2010

Outcome

Stable financial markets and sound public finances must find much greater focus in future-oriented policies than has been the case until now, as they are a vital prerequisite for sustainable economic management.

- The German Council for Sustainable Development supports the Federal Government's endeavours, both internationally and within the European Union, to press consistently for preventative measures to ensure financial market stability and for budget monitoring, and to go new ways in this connection.
- The German Council for Sustainable Development recommends measuring the sustainability of financial market development on the basis of suitable indicators. For the purpose of early warning a regular report on those indicators is recommended.

The financial markets should be encouraged to strengthen those business models which make a contribution to sustainable development:

- At international level, the German Council for Sustainable Development supports the Federal Government in its efforts to ensure that the measures to be taken in all major financial communities are introduced competitively neutrally and area-wide, and to make certain that such measures are not circumvented or become the source of renewed instability.
- With respect to Germany, the German Council for Sustainable Development advises policymakers at the federal and the *Laender* level to restructure and denationalise the regional banking sector.
- Bank regulation aside, accompanying measures are required which support the essential tasks of the financial markets in climate protection and the shaping of demographic change and for which concrete proposals are made.

Preamble

Ecological, economic and social aspects must be brought together in a well-balanced way if sustainable development is to be achieved. In terms of the global financial markets, this is not the case, however. It is the considered opinion of the German Council for Sustainable Development that the fiscal dimension of sustainability policy should be afforded greater attention.

This statement marks the first time that the German Council for Sustainable Development is commenting on the fiscal sustainability of financial markets. The forthcoming G20 Summit in Seoul in November 2010 lends credence to the topicality of the statement; nevertheless, it takes a long-term approach and relates to both international and national policies.

In the past, the German Council had commented, on various occasions, on individual aspects of financial policy – most notably on intergenerational justice – and called for fair burden-sharing between the generations. During the acute stage of the financial and economic crisis, the German Council advocated, in 2009, the introduction of a national debt brake, whilst also pointing out that, in general, the manner in which financial resources and natural livelihoods are handled must be rethought in order to find ways out of the crisis and to make them viable. In this context, the Council also supports the German government's effort to develop a charter for sustainable economic management during the G20 Summit with commonly shared principles and possible courses of action. The German Council for Sustainable Development equally believes that it is necessary to give fresh impetus at national level, and it supports the fiscal policy demands contained in the recent Sustainable City Initiative of 16 Lord Mayors of German cities.

The German Council for Sustainable Development will continue to take a stance on important aspects of sustainable economic management. The goal here must also be to improve the regulatory framework, to hone criteria for "sustainability" on all levels of government and to improve the self-monitoring of a sustainable industry on the financial market and to make key indicators more binding and more effective. Players on the financial markets and in commercial enterprises as well as within the political community should be encouraged to embark upon new ways in order to achieve future viability. With this in mind, the German Council for Sustainable Development will, in the near future, be submitting a proposal to the circles concerned.

The German Council for Sustainable Development adopted this statement on 10 November 2010 and submitted it to the Federal Government.

Preliminary remarks

Financial market stability is a precondition for the success and performance of the real economy. Phases of instability endanger the investments that need to be ploughed into future tasks such as the sustainable use of natural resources and global poverty alleviation. Prevailing uncertainty on the financial markets stands in the way of long-term investment and innovation. Added to this, public budgets are highly strapped as a result of financial crises and the measures needed to combat them. High payables resulting of not or not sufficiently covered social security systems are also to be taken into account.

A certain degree of instability is inherent in the financial system, however: free markets have been and always will be influenced by herd behaviour, and excesses, phases of collective exuberance and abrupt mood swings are bound to re-emerge in the future. The ongoing financial and economic crisis is not the first crisis by a long shot, and it will most probably not be the last. The key, however, is to prevent the entire system from being put in jeopardy in the first place and to avoid the then massive use of national budget funds. It is highly unlikely that the public can be counted on a second time around to support government bail-out packages on the scale of those provided in 2009/2010. Loud criticism that losses have been socialised can already be heard today.

In this respect, greater financial market stability and greater risk bearing ability are required in order to achieve sustainable development. Imbalances, such as those found in private and public sector over-indebtedness must be nipped in the bud from the outset, the risks throughout the system limited and existing imbalances reduced.

This gives rise to two points of emphasis for the political and business communities: a) strive to achieve financial market stability and balanced development, plus b) enforce sustainable business models in the financial sector. To this end, the German Council for Sustainable Development recommends the following measures.

Measures to stabilise financial markets

Sound public finances

The EU Stability and Growth Pact must be reformed if sustainable development is to be achieved. With this in mind, the German Council for Sustainable Development calls on the Federal Government to continue pressing for a fundamental reform of the Pact.

The acute crisis of confidence within the euro zone is a haunting reminder of how vital sound public finances are to financial market stability – even though the current high levels of debt are in part directly attributable to the previous financial crisis. Confidence can best be built through budget consolidation. This is true not just for Greece, the Republic of Ireland and other countries that are particularly the focus of capital markets but equally the remaining countries of Europe, not least of all Germany. Here, too, reducing the national deficit is a high priority.

Generally speaking, a sense of proportion needs to be applied when it comes to public budget consolidation. Overly drastic expenditure cuts or tax increases can jeopardise economic recovery. Germany has embarked on a viable solution in the shape of its so-called debt brake law *(Schuldenbremse).* This form of self-restraint does not rule out the possibility of cyclical deficit as a means of stabilising the economy but aims to hold deficits at an affordable long-term level. An affordable long-term level is one which satisfies the balance of interests between the present and future generations.

The example of Greece shows that reducing national debt is an arduous task if started to late. Not accounting for any changes in the current conditions, Greece will need to achieve a primary surplus[1] in excess of 5 percent over a period of many years in order to lower its debt-to GDP-ratio within ten years to its 2007 pre-crisis level.

Institutional reforms must be made within the monetary union at all costs in order to restore faith in the euro. The European Financial Constitution has proven to have only limited effect. The original aim of the Stability and Growth Pact was to curb the rise in extreme debt levels. In effect, however, it has not been able to exert the degree of discipline that would have been necessary. For example, the debt figures in the years prior to the crisis were not consistent with the intention of the treaty: even during the 2006 economic boom, ten of the sixteen member states recorded a budget deficit, four of which were above three percent of GDP. Such periods of economic growth were originally supposed to produce surpluses.

The proposals put forward by the European Commission – extension of fiscal precaution (of the "preventive arm"), consideration of the debt level, stricter sanctions as well as greater automatism in the deficit procedure – are a step in the right direction, and tighter monitoring of macro-economic imbalances is a welcome move. Even though compromises may need to be found for them to be approved at European level, the German Council for Sustainable Development would advise the German government to continue its pursuit of severe sanctions, including the suspension of voting rights, and also to hold fast to these demands as an institutional reform during the next round of talks on the European Union budget[2].

Since the imposition of tighter budget monitoring by the EU runs into conflict with the financial policy sovereignty of the member states, national disciplinary measures in the member states should also be strengthened as a complement to the Stability and Growth Pact. (New) EU legislation must go hand in hand with the national laws of the individual member states. Each member state should – along the lines of Germany's debt brake law – introduce a regulation suitably enshrined in its legal framework that provides for a mid-term balancing of the budget. Consequently, it would also need to be established as a precondition for joining the monetary union.

Measuring the sustainability of financial market development

In addition, policymakers should intensify their efforts to detect the potential causes of market excesses in good time and initiate appropriate counter-measures. This (new) task is currently the subject of widespread discussion in international fiscal policy circles under the banner of "macro-prudential regulation"[3].

Work is currently underway to establish a global early-warning system. Some years ago, the International Monetary Fund, IMF, developed 40 so-called Financial Soundness Indicators, which are regularly published for numerous countries (Germany included). At European level, the European Systemic Risk Board (ERSB)[4] will commence its work.

A reliable interaction between global, regional and national levels is indispensible. The Federal Government should extend the indicators used to measure sustainability to include details on the financial system. They should be reflected in the periodical "Sustainable Development in Germany" reports issued by the Federal Statistical Office. Until now, no sustainability indicators on the financial markets have been incorporated into such reports. According to both the well established IMF's and ESRB's indicators the following could serve as suitable indicators:

- Debt equity ratio of public budgets, social security systems, companies and financial service providers as well as private households
- Time pattern of debt (maturity)
- Equity ratios of banks and companies – where applicable, in relation to their size and relevance.

Taking this one step further, these indicators – taking into account the specific conditions in Germany – should be evaluated and combined to form an overall "Finance Market Stability Index". This would also be valuable input for the work of the ERSB. The Federal Government should also include the ERSB in the review and perpetuation of the European Sustainability Strategy.

Enforcing sustainable business models

Strengthening the resistance levels of financial market players

Current efforts within the G20, above all, are aimed at strengthening – through a new global regulatory framework – sound, long-term viable risk management on the financial markets. The focus of attention is new bank regulations governing minimum capital and liquidity management ("Basel III")[5]. Quite aside from the current crisis, the forthcoming Solvency II[6] Regulations are set to be applied to long-term investors (pension funds, insurers) in the future. These requirements will further reduce the risk tolerance of long-term investments, however, and might therefore thwart the original intention of hedging long-term investments. Should this prove to be the case, the typically present ability to robustly absorb risks would be diminished.

Now that agreement has been reached in principle on the new bank regulations, the focus of attention of the G20's international cooperation is shifting: from here on, implementation will take centre stage.

- Competitively neutral and area-wide implementation

  The German Council for Sustainable Development supports the Federal Government in its efforts internationally to ensure that the regulatory measures are introduced competitively neutrally and area-wide by all major G20 financial communities. The implementation of new rules must be done consistently and simultaneously so as to stave off looming incentives of regulatory arbitrage, which, instead of heightening market stability, might prove to be a source of renewed instability.

  In addition to appropriate regulation, competition is key to enforcing sustainable business models. Measures are also required at national level. In this context, the restructuring of the regional banking sector (*Landesbanken*) plays a vital role.

- Restructuring of the regional banking sector (*Landesbanken*)

The plethora of (necessary) relief measures for banks has resulted in considerable distortions. The German Council for Sustainable Development therefore calls upon the Federal Government to relinquish its shares in banks as soon as possible. Under no circumstances, must state shareholdings become a permanent fixture. The case of the regional banking sector has provided sufficient warning in this regard.

Only through direct and indirect state aid have the *Landesbanken* been able to stay afloat even without a viable business model. Favourable refinancing terms have enabled them to grant generous loans which, in some cases, were no longer covered by the original mandate.

The German Council for Sustainable Development suggests a restructuring of the regional banking sector. The aim here should not be to consolidate or reduce the number of *Landesbanken* but, above all, to reduce the influence of the state in the sense of a "denationalisation". The *Laender* should restrict their involvement in banks to the public task of promoting business. Regular banking business should be handed over to the private sector.

Active promotion of long-term business models in a sustainable economy

Measures to strengthen the resistance levels of financial market players follow the precautionary principle. As necessary as they may be, they also harbour the risk that the willingness and ability of market players to assume long-term risks generally fall. Examples include liquidity standards, which allow banks to acquire more government bonds, or accounting regulations, which hinder insurers from investing in shares. It therefore appears inevitable to consider "accompanying" measures more closely than before which influence the behaviour of market players.

The paramount task of the financial markets, that of making capital available long-term for government, corporate and private activities, must regain centre stage. This is essential not least of all in the light of demographic change (securing retirement provisions) and climate change (financing of innovation of renewable energies technologies). Appropriate tools for operationalising this concept are already available today for implementation and extensive application.

- Sustainability reporting

  In order to boost personal responsibility, the Council calls upon all market players not only to report the financial status but also non-financial risks in the manner commensurate with the capital market (separate sustainability report or one integrated within the annual report). Reporting is an appropriate self-monitoring tool and one that lends itself to dialogue with stakeholders.

- Long-term risks

  By creating the right framework conditions, the Federal Government should emphatically encourage the long-term assumption of risks and curb short-term deals ("speculation"). Several approaches are available to do this. The main objective at national level is to strengthen equity, which, under the present German fiscal system, is at a significant disadvantage compared with borrowed capital. Possible measures include, for example, reinstating tax exemptions for securities held longer than a specified minimum period (speculation tax); equally, private individuals who lock up capital long-term, most notably for the purpose of providing for their old-age pension, including staff profit-sharing schemes, should receive tax benefits.

At European and international level, it must especially be ensured that the risk tolerance of long-term investors is raised and not curtailed. Furthermore, adequate accounting regulations are essential which take account of economic realities and the risk tolerance of individual market players rather than intensifying market volatility.

- Rating agencies

In the financial crisis rating agencies, as we know them today, turned out inadequate. The German Council on Sustainable Development calls for a separation of the mandate to advice and the mandate to rate structured assets. Furthermore, the support of all efforts to establish a European Rating Agency is recommendable.

- Financial transaction tax

In addition to promoting long-term investments, the Council calls for internationally coordinated government measures to be taken to restrict short-term speculation. These include a financial transaction tax pursuing the clear object of correcting negative externalities.

Notes

[1] The primary surplus (total expenditure minus interest payments) describes the ratio of public expenditure for the benefit of the citizen in the shape of transfer payments and services to the taxes and levies in the year in question. The *Wissenschaftlicher Beirat*, an advisory board serving the Federal Ministry of Finance, deems a financial policy to be sustainable when the present value of all primary surpluses corresponds to the size of the current national debt, or when the present value of the net tax payments of all generations equals the present value of government spending plus government indebtedness. For further details, please see: *Wissenschaftlicher Beirat beim Bundesministerium der Finanzen: "Nachhaltigkeit in der Finanzpolitik – Konzepte für eine langfristige Orientierung öffentlicher Haushalte*", BMF-Schriftenreihe, Heft 71, Bonn 2001.

[2] In the European Union, the expression "financial perspective" denotes the seven-year framework programme for the European Commission's budget. The current programme will run until 2013. Negotiations on its continuation from 2013 to 2020 are currently underway.

[3] Macro-prudential regulation is the term given to the activity performed by regulatory bodies on the financial markets whose purpose is to ensure the stability of the financial system as a whole. http://www.finanz-lexikon.de/aufsicht,%20makroprudentielle_1943.html

[4] The ESRB is the European Systemic Risk Board. The Board will be located with the European Central Bank in Frankfurt. It is scheduled to commence its work as of 2011, which will involve identifying risks within the financial system, warning of crises and, in the worst-case scenario, coordinating crisis management measures and formulating corresponding policy recommendations. The aim of the national early-warning system is to provide

a data-protected assessment of the current state of the financial system. If certain threshold values for sustainability were exceeded, the Federal Government would be called upon to take suitable counter-measures.

[5] The term Basel III refers to the rules and regulations adopted by the Basel Committee at the Bank for International Settlements in Basle (Switzerland) as an extension of the existing equity capital regulations for financial institutions. These supplementary rules and regulations seek to strike a balance between a more stable financial system and avoiding a credit crunch, and also aim to improve liability issues.