Brussels Economic Forum

Introductory statement by Andres Sutt

This crisis is global, it affects all of us. It is not idiosyncratic crisis affecting emerging markets as Asian or Russian crisis in 1997-98 nor is it a regional crisis as the one in Nordic countries in early 1990s. While it affects all of us the impact varies significantly across countries that are often presented as homogeneous groupings, such as CEE, BRIC, Nordics, Eurozone etc.

I believe this context is important in understanding and assessing risks of specific countries, in designing a rulebook for tomorrow's financial industry and then looking back why it went so wrong so fast

*[Global context]*

For setting stage two points are relevant in the global context. First, it is now universally acknowledged that <u>financial sector in mature markets did not play its role as an efficient intermediary of funds</u>. Banks and others with easy access to vast pool of retail savings put these moneys into high-risk uses, without the corresponding increase in capital buffers. This is the so-called „easy part" of the current policy paradigm.

Second factor is <u>global payment imbalances</u>. Huge current account surpluses in a number of regions were important sources of funds that fuelled the unsustained demand. However, the „savings glut" is only one part of the story. Large surplus of domestic savings over domestic investments, and the accumulation of foreign assets, reflected in many cases fundamental economic weaknesses. <u>Reliance on overpriced natural resources or undervalued exchange rates, or infant social protection systems or, indeed, lack of functioning markets – these factors produced unbalanced growth patterns</u>. The resulting - at least partial - lack of healthy and sustained domestic demand is a severe drawback in todays's world and should be addressed to ensure balanced recovery.

*[European context]*

Against this global backdrop a question for Europe is – to what extent are the current difficulties in a number of Member States, including in some of the recently acceeded countries, the signs of fundamental weaknesses?

<u>In my view, the current global turmoil hasn't invalidated the relevance of the European model of integration and convergence.</u> Unlike in many other parts of the world, the growth in Europe has been driven by export of capital to regions with higher growth potential. Economic integration between Scandinavia and the Baltics is one example to validate the point. This fundamentally healthy pattern is in stark contrast to situations, whereby poorer countries finance domestic demand in much more advanced economies. It is the great achievement of the Single Market, and the European political framework.

That said, by many observers CEE, once darling of investors is now the worst spot on globe. What has changed in past [18 months] to explain such a fundamental U-turn in investor sentiment? In my view the medium-to-longer term outlook for the new member states is fundamentally positive, for there is still a significant convergence gap to be closed. In the short term, economies, including Estonia, have to go through the correction phase. But this is of course the challenge that nearly all Member States have to face. For sure, the current state of dysfunction in advanced financial systems and collapsing world trade have hurt some of the Member States more than would have been the case under normal economic and market conditions. Consequently, in some cases official borrowing is completely justified, not least because of the inability of private mature markets to provide any financing at this point in time. However, this does not invalidate the European model of growth and convergence.

*[Policy challenges]*

What are the right policies to restore financial stability and to support the recovery? I start with a premise that more market integration is in the interest of Europe and of the World. Therefore, policy actions should be based on further integration of the Single Market and stronger European policy frameworks. Each and every European country would be much worse off outside the Union.

One of the primary goals is to stabilize the financial markets and banking systems. I believe that the short term emphasis should rest on implementation of agreed principles of cooperation in financial stability and supervision

- Domestically, focus should be on strengthening cooperation and interaction between the financial stability function of a central bank and a supervisory authority. Integrating better macro-prudential and micro-prudential analysis helps to discover risks and mitigate them with coordinated macro and micro-prudential measures
- In cross border context involvement of all relevant parties in supervisory colleges, every-day supervisory cooperation and agreeing the principles of burden sharing are important. Likewise cooperation among home-host central banks is crucial in financial stability field. This approach supports efficient functioning of the EU's single banking market and provides firm basis for home/host cooperation, including the implementation of support schemes.
- For the industry: full transparency and loss recognition. The sooner recognized losses converge with estimated losses the faster a normal flow of credit will resume. However, lack of credit is both supply and demand side phenomenon and deleveraging is fundamentally a healthy process
- Better regulation doesn't mean more regulation.

The implementation of common framework is particularly important for most of the new member states where, market integration has gone much further than in other parts of the Union. This has been the key strength both over longer term, but also in the current environment. In the Nordic and Baltic region, banking groups have used centralized liquidity and capital management efficiently to ensure financial sector stability in current market conditions. Regulatory and supervisory cooperation has followed this market logic and been supportive for even closer integration.

I should add here that some of the vulnerability analyses do not take into account this market structure. Often cited „huge refinancing needs" in banking system should be interpreted with great caution. In case of fully integrated cross-border financial groups, all rollover ratios related to intra-group flows should be assumed to equal to 100 per cent from the financial stability point of view. Otherwise, the groups are expected to default on their intra-group liabilities. The EU framework should support stability of our integrated financial and banking markets, and large groups in particular.

The other critical issue is to ensure fiscal sustainability. One of the key lessons of the current crisis is that far too little was done on fiscal front in good times. While this applies almost universally to all Member States, the issue was of particular relevance to countries with higher growth rates, including the new member states. Here, the European fiscal framework and its implementation has been far too unambitious. The immediate near-term concern for the EU should be to put in place firm plans to restore medium and long term budget sustainability.

Let me finish with optimistic note - economic convergence in the Union is continuing and will resume after the crisis. This is indeed the crucial notion. We should continue to aim our policies at strengthening integrated financial market, budgetary systems and resilience of economies.