

**Weathering the Storm – The Impact of the Financial Market Turmoil on
European and Global Economies**

**Speech by Commissioner Almunia
at the Paul H. Nitze School of Advanced International Studies (SAIS),
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Ladies and gentlemen,

It is a great pleasure to join you today here in Washington and an honour to address such a distinguished audience at the SAIS Center for Transatlantic Relations. Given this institution's valuable mission to strengthen EU-US relations and promote a collaborative approach to global challenges, few places could be more appropriate to discuss the latest developments in financial markets.

We gather at a time when the outlook for the global economy is more uncertain than it has been for some time. So far, the impact of the turbulence that has reverberated through capital markets since the summer has been largely confined to the financial sector.

But, it would be unrealistic to believe that the broader global economy can come through this episode entirely unscathed. The first question I will address this afternoon is how much of a bearing financial market events are likely to have on the real economy.

The second issue I will examine is how policymakers have reacted to the financial turbulence and how we should act in the months ahead to manage the impact. Indeed, while the episode of financial turbulence is still unfolding, we

can already identify lessons for the future and pinpoint those areas where a policy response must be considered.

I will focus the third and final part of my remarks on the need for an internationally co-ordinated approach in response to the financial turmoil. That the turbulence first emerged here in the United States and has since spread around the globe – and, notably, to Europe - highlights the links and inter-dependencies between our financial markets and our two economies. It also carries a strong message for closer international policy co-ordination.

A storm in international financial markets

First though, let's briefly re-cap events.

For several years, financial market activity has been characterised by an aggressive search for yield among investors – a phenomenon which has occurred against a background of low interest rates, low volatility, steady economic growth and stable prices.

As the investor search for yield resulted in ever narrowing credit-risk premia, there was widespread concern about a possible mis-pricing of risk. Indeed, over the past year by the IMF, the European Commission and the European Central Bank among others, have warned about the risks of holding illiquid assets linked to a market that was showing clear signs of deterioration.

These concerns proved well founded when the collapse in the US market for sub-prime mortgages sparked financial turmoil.

Here in the US, the functioning of financial markets has to a degree been improving over the last two months, helped by the Federal Reserve's efforts to provide liquidity, but conditions in mortgage markets remain difficult.

However, the fallout was not limited to the US but has impacted heavily on the international financial system as a whole. This is due to the fact that mortgage loans were passed on to banks, repackaged and then sold on again to international investors – including investors in Europe – through 'securitisation'.

We in Europe do not share the problems of a sub-prime mortgage market with the US – our mortgage markets are structured very differently and rules on lending are stricter. But the revelation that certain European financial institutions were suffering losses linked to the US sub-prime market knocked investor confidence in Europe as usual and triggered liquidity problems in the money markets.

Two relatively small German banks suffered heavy losses due to exposure to the US sub-prime mortgage market as did Northern Rock, a larger bank in the UK. However, these isolated incidents fortunately have not developed into widespread, cross border disruptions.

I believe that this is partly thanks to the swift and assured strategy of the European Central Bank that took the initiative to inject billions of extra liquidity into markets - a move which certainly helped stabilise the situation in Europe, but also to maintain a relatively smooth functioning of financial markets.

The supervisory system in Europe has also functioned well during this period of turmoil, although Finance Ministers and the Commission have recognised in the aftermath of the turmoil that further improvements are needed in cross-border cooperation and information exchange.

Normality has however not yet been restored because the risk has been spread throughout the financial system in such a way that it is difficult to understand how much of it different institutions really hold. This makes it very difficult to rebuild investor confidence quickly.

Today we have entered a period of uneasy calm. But it would be premature to rule out further problems emerging in the weeks or even months ahead.

Strong headwinds facing the European economy

In light of this, let me turn to the ramifications for the financial sector and for the broader economy.

The implications of the recent turbulence for the financial sector are relatively clear, even if they are difficult to quantify at this stage. The essence of the turbulence is the re-pricing of credit risk, which implies an increase in risk premia and a reduced capacity or willingness to lend.

Many financial institutions will suffer damage to their balance sheets either through direct exposure to sub-prime mortgages or indirectly through a diminished ability to securitise loans and a reduction in non-interest income. After several profitable years, the financial sector might face some lean times ahead.

A greater concern is the broader economic impact.

In the US, recent data confirms a further weakening in the housing market, a development that will probably hold down growth in the real economy during the fourth quarter of this year and early in 2008. But this takes place against the

backdrop of sound economic fundamentals should help this country weather the current housing slump, despite it remaining an important risk.

Fortunately the episode of financial turbulence has occurred at a time when the global economy is also relatively robust, following on from four consecutive years of global growth around an impressive 5% of GDP.

Even if there are concerns about a slowdown in the US economy, such concerns are offset by strong economic growth elsewhere, notably in Asia. Both China and India will grow at above or close to double digit rates this year and together these two countries will contribute more than 20% of world GDP in 2007.

Europe too is making a positive contribution to global economic growth. Our latest interim forecast from September projects a growth rate of 2.8% in Europe and 2.5% in the euro area for 2007. This is only 0.1% lower than our spring forecast.

But the available data suggest that the current cycle has peaked. After a strong performance in 2006 - when a growth rate of about 3% was recorded in the EU - the pace of economic activity has slowed in the first two quarters of 2007. Survey indicators confirm the overall softening of economic activity, although most of these indicators remain very strong from an historical perspective.

We will publish our autumn forecast for 2008 and 2009 in November, but already it is clear that the economic outlook for the next two years appears less favourable than before the financial turbulence.

Headwinds are building from several sources, including the recent dollar depreciation, continuing increases in oil prices, deterioration in the US

economy, and the prospect of tighter credit conditions. These headwinds are likely to impact on the European economy via several channels.

- First, there is the trade channel, where the combination of lower US domestic demand and a lower dollar exchange rate could reduce the role of external trade in European growth.
- Second, tighter credit conditions could potentially weaken domestic demand in the European economy by limiting activity in both corporate and household sectors. We are already seeing a tightening of lending standards via higher risk premia and increased collateral requirements as a result of the financial instability.
- Finally, a third source of economic headwinds could be the impact of the turbulence on business and consumer confidence. This is harder to gauge but already business confidence has been weakened while consumer confidence was rather fragile even before the financial turmoil.

Learning the lessons of the financial turbulence

It is apparent that the financial turbulence will impact negatively on our economic outlook. Therefore the next question is how we should deal with financial instability in the future.

There are four sets of issues at stake when we think about a policy response to the financial turbulence. Some of these issues were already under review in Europe and other major economies before the events of the summer. However, the financial turbulence has now added urgency to this work.

The first set of issues relates to transparency. Financial innovation has contributed to the efficiency of financial markets by facilitating the spreading of risk. However, it has made it difficult for market participants and public authorities alike to identify risk exposures across the financial system. This has been a major issue in the recent turbulence.

Second, we will have to take a closer look at valuation and the accounting treatment of assets. The main responsibility in this area certainly lies with the institutions holding the assets. However, more work is needed on standards to ensure reliable valuation of assets, particularly of those where markets are potentially illiquid in times of stress.

A third set of issues relates to strengthening the prudential framework, risk management and supervision in the financial sector. It is essential that arrangements for safeguarding financial stability are kept up to date.

With this in mind, Finance Ministers in Europe very recently agreed common principles that will allow for a more coordinated response to financial disturbance in the future. Moreover, the forthcoming review of the Lamfalussy process will provide an opportunity to address outstanding issues in the framework of our financial sector regulatory and supervision process.

Finally, more analysis is needed on improving financial-market functioning. The objective here is to obtain a better insight into the incentive structures, including possible conflicts of interest and disincentives to perform proper due diligence. In this context, the role of credit rating agencies in the area of structured finance will come under particular scrutiny.

Work on these various areas is to be completed by the end of 2008 at the very latest. This rather extended timeline is necessary to allow appropriate analysis to

be undertaken and does not reflect a lack of urgency on the part of EU Member States.

But work at the EU level alone is not enough, no matter how important the nearly 500-million-citizen-strong Europe has become. In our globalised and increasingly complex financial markets, the EU and US need to work hand in hand with their G7 partners as well as in the broader constituencies of the IMF this weekend, and in all other relevant for a, to avoid a repeat of the ongoing turmoil in credit markets.

This international dimension is entirely appropriate. After all, perhaps the most striking feature of the current turbulence was how problems in a very specific segment of the US mortgage market quickly mushroomed into a severe disruption of international credit markets. The highly inter-linked nature of today's financial system means that only a global answer to these issues will suffice.

Just imagine if the United States, Europe and other parties were to seek their own solutions without due regard for each other: the result would be a regulatory mess. We should pursue broader international co-ordination in financial-market regulation and not only as a response to crises, but to boost the efficiency and competitiveness of our respective financial systems and economies.

Global Imbalances

So far I have spoken about the risks and our response to the financial turbulence. But the recent instability in financial markets alerts us to deeper underlying vulnerabilities in the global economy.

I am talking about the global imbalances which are projected to be large and persistent for the foreseeable future. The two issues are not unrelated. It is the same financial liberalisation, innovation and liquidity behind the mis-pricing of risk that has also helped to fund a larger US current account deficit than was previously possible. Indeed, the US deficit has risen considerably over the space of a decade - from 1.6% of GDP in 1996 to a record 6.1% in 2006.

This increase has been matched by the rising trade surplus in China, which today exceeds 10% of GDP. Oil exporting countries have contributed to growing imbalances, as the revenues from higher oil prices have meant higher savings, and Japan's current account surplus is also on the rise, reaching 3.9% of GDP last year. We cannot remain indifferent to the fact that, between 2000 and 2006, the euro area's trade deficit with China has tripled to 90 billion euro.

Six months ago, the US, the euro area, China, Saudi Arabia and Japan had constructive discussions on a range of policies to rebalance global growth and reduce imbalances as part of the IMF-brokered multilateral consultations process.

Throughout this process, China announced that it would boost domestic demand, deepen financial sector reform and increase exchange rate flexibility. The US agreed to encourage private and public saving in order to shift the composition of growth away from private consumption and credit, which have had their counterpart in historically low levels of saving.

In our turn, the euro area pledged to raise growth and enhance resilience to economic shocks through structural reforms and better public finances. Japan announced it would strengthen competition and consolidate public finances, and

Saudi Arabia that it would increase investments in its oil sector and in social services and infrastructure.

The euro area's current account is now broadly balanced. But although we do not directly contribute to imbalances today, it is true that low growth in our economies in the first part of this decade affected our capacity to contribute to their solution. In the last couple of years Europe had some of its homework in terms of raising growth, and has therefore reinforced its role as the anchor of stability in the global economy.

However, we are not impervious to the problems and the marked appreciation of the euro against the dollar, the Japanese yen and the Chinese yuan, raises questions.

The euro area economy would suffer alongside the rest of world should a disorderly adjustment of global imbalances occur. Although the likelihood of such a scenario is low, it carries high risks.

Conclusion

While global imbalances are projected to decline somewhat from their recent peak, we should not be lulled into a false sense of security. They remain at elevated levels and represent a vulnerability for the global economy, especially in an environment like the present one, where investor sentiment could change suddenly.

Today more than ever, governments need to act to reduce vulnerabilities by implementing sound policies. After all, the sub-prime mortgage crisis and the

financial market turmoil teach us that unsustainable situations cannot continue forever. Sooner or later, corrections do take place.

And if the current financial disruption generates some headwinds to the economic outlook, just remember that a disorderly unwinding of global imbalances would be the equivalent of a force five storm. While I still believe this is an unlikely scenario, I want to emphasise that only a concerted and co-operative effort on the part of all governments involved will reduce the risks and safeguard the stability and prosperity of our global economy.

No single region should bear the burden of the adjustment alone.

Thank you for your attention.