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SPEAKING NOTES

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FINANCIAL MARKET REGULATION: HOW TO ENSURE FINANCIAL MARKETS WORKING IN SUPPORT OF THE SOCIAL MARKET ECONOMY?

Financial market reforms are urgent and represent a vital component of a global strategy to restore confidence in the economy. But I would like to start with an even more urgent issue: it is the stabilisation of the financial crisis which could be entering its third phase now that the global economy has entered into recession.

Some financial market tensions were alleviated in recent weeks thanks to the massive interventions of governments and central banks, but they have not disappeared. And recent reports of massive bank losses raise the risk of a new spiral of asset price depreciation, credit restrictions, rising cost of financing and growing risks of default.

Companies have already seen a dramatic deterioration in financing conditions since the demise of Lehman Brothers in September:

1. Share issuances have become highly unattractive means of financing at present valuation levels, and the massive decline in stock market capitalisation has also worsened corporate balance sheets and increased leverage problems.

2. Corporate bond markets illustrate how bad the situation is, as companies with BBB ratings currently need to pay 8% in interest rates to issue bonds at 5 to 7 years' maturity, while the German government can issue debt at 2% over the same period. These spreads reflect less the risk of default of the companies than the agonising need of companies to refinance their debt with whatever meagre financing is available from dysfunctional wholesale markets and overly cautious banks.

3. Banks are also becoming more restrictive in their lending behaviour and are reducing their exposure to less creditworthy companies, which are obviously growing in numbers as a result of the rising cost of financing and the worsening economy.

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All this is leading to a massive retrenchment of capital spending, trade and business activity worldwide.

The Commission is now forecasting a contraction in EU GDP this year by 1.8% and a loss of 3.5 million jobs, but even that could prove optimistic if the access to and cost of financing cannot be improved rapidly.

What should be done?

1. The first line of defence is to pursue interest rate cuts when and where possible.

2. Restore the functioning of the interbank market, which is really at the core of the financial system. This can only be achieved if trust between banks is rebuilt, but the ECB could greatly help if it would take up the role of clearing house for the interbank market. This would have the additional advantage of limiting the risk of market fragmentation due to uncoordinated national guarantees.

3. The ECB could also further expand its balance sheet by accepting less liquid and long-term assets as collateral, while also considering other temporary options like the direct purchase of government and corporate debt on secondary markets. (There is room for manoeuvre: while the US Federal Reserve has tripled the size of its balance sheet since August 2008, the ECB's balance sheet increased by 55% in 2008.)

4. Reinforce bank balance sheets, by pursuing the recapitalisation process and improving the effectiveness of public guarantees to support banks' refinancing operations. What is particularly crucial here is to establish a fair price for these guarantees so that they create real incentives while not distorting the internal market.

5. Finally, and this is obviously crucial for us, the state should help the flow of credit to companies through specially designed guarantees and risk-sharing schemes, through which governments endorse part of the default risk.

Obviously, all this implies a significant transfer of risk from the private to the public sector, with probable consequences for government bond yields and public debt at the time when markets are becoming much more vigilant about fiscal sustainability issues. But this could prove at the end of the day to be the most cost-effective way to address the crisis (as the alternative would be an abrupt and massive deleveraging of the private sector, leading to prolonged recession, collapsing tax revenue and ballooning public deficits).

While keeping the patient alive and preventing a systemic collapse, policy-makers need to accelerate the reforms of the international and European financial systems.

Reforms should be approached without taboos and with a clear view on the proximate causes of the present turmoil, which is poor risk management, bad incentive structures, pro-cyclical rules, poor market oversight and lack of transparency.

If I can address two issues in particular:

1. cross-border supervision will need to be reinforced considerably at both European and international level in order to better assess systemic risk, cover all relevant products, instruments and markets, increase transparency and limit the risk overregulation constraining sound financial innovation. In the EU context, closer coordination by a supervisory college might be a pragmatic solution in the short term, while the option of a European or euro area supervisory authority must be given due consideration. In this respect, We eagerly await the De Larosière report for concrete proposals.

2. Second issue is related to pro-cyclicality, which has played a large role in spreading and amplifying the present financial crisis. Whilst ensuring a level playing field, capital adequacy regulations for banks must be further modified in a globally consistent manner to reflect the increased risks. Accounting standard-setters, bank regulators, central banks and other financial regulators must also study the interconnection between accounting rules and capital adequacy requirements. We have welcome the recent changes to mark-to-market accounting rules but further and more comprehensive work will be needed in the future, bearing in mind the need to find global solutions.

Let me conclude by saying that the crisis will justifiably lead to a significant transformation of regulatory, supervisory and crisis management systems to put global and European financial markets on a sounder footing. However, these changes should not bring into question the benefit of efficient markets and financial innovation, which remain a vital component of a thriving economy.