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Article

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SEVEN QUESTIONS TO DOROTHEA SCHÄFER

»A Financial System Should Be Able to Restore Stability Autonomously«

1. Professor Schäfer, how sustainable is our financial system? The financial crisis showed us that our financial system is not particularly sustainable. Currently, a lot is being done to improve this situation. However, exactly what is required to make the system more sustainable remains a highly controversial issue.
2. What are the characteristics of a sustainable financial system? Sustainability can be defined as the long-term management of a system with the aim of maintaining it over a sustained period. The word itself is difficult to define but certain principles of sustainability can be identified. One very important precept is a long-term outlook. A second important prerequisite is that players within the system internalize the costs they cause. A third principle relates to the imperative that a financial system instills confidence in the population. If the public has no confidence in a system then it can never be sustainable as it is fundamentally very susceptible to collapsing. If people do not trust the institutions of the financial system, they tend to withdraw funds from their bank accounts, which is something that will condemn almost any financial system to failure. In these circumstances, only the government is able to avert a crisis.
3. Is a sustainable financial system more stable? Sustainability and stability are two terms that are often used synonymously. However, the two concepts are not the same. Sustainability can even be accompanied by short-term instability if the financial system is capable of independently restoring stability in the longer term. This is because sustainability is incompatible with taxpayers being forced to step in to save the financial institutions at regular intervals.
4. Are government guarantees therefore incompatible with sustainability? Permanent government guarantees certainly are incompatible with sustainability because they promote extremely high-risk behavior which makes a system very vulnerable to crisis.
5. How about government intervention or regulation? Regulation is the cornerstone of sustainability. A financial system without regulation is inconceivable. Regulation uses certain boundaries and incentives to point players in the right direction.
6. So what would the most important measures be to ensure a sustainable financial system? It is essential that the financial institutions using the public good of financial stability have enough of a capital buffer to be able to restore stability independently following a financial shock. This means, for example, that banks need much higher capital reserves than they have had to date. The major German banks, in particular, have such a low capital base that there is basically no scope for any negative financial market developments. If this is not done, the government will be obliged to shore up the major banks, at the very least with implicit guarantees. A low capital base is also a very small step away from insolvency, and the capacity to self-regenerate is non-existent. Capital reserves must, therefore, be increased as a matter of urgency.
7. Can a financial transaction tax also contribute to increased sustainability? I would certainly see it that way. A financial transaction tax would promote cost internalization and also contribute to financing the public good of financial stability. It will certainly lead to more transparency in the reporting of tax burdens because you will be able to see companies' actual activities on the financial markets much more easily than at present. Furthermore, it will also reward long-term orientation and penalize short-term trading with very short holding periods.

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