

The global crisis: Have we learned the right lessons?

György Surányi

The global crisis, which was the worst economic and financial downturn since the Great Depression, revealed the fundamental deficiencies in the global financial system and drastically changed the way we view the world and the global financial system. The crisis challenged long-standing views and ideas, and in response, after the most acute phase of the crisis, joint global efforts were launched to put the system on firm footing again and prevent the next crisis. These efforts can only be successful if we fully understand the root causes of the crisis and learn the right lessons from it. This brief focuses on four topics: regulation, external position, monetary policy and the European debt crisis.

Regulation and Growth

In the pre-crisis world, there was a broad consensus that markets are efficient and self-regulating, hence (too much) regulation would only impede innovation. It was an era of extensive deregulation. However, the crisis shattered these illusions. The world has become disillusioned with the laissez faire approach and serious efforts are being made to re-regulate the financial system.

The Basel III rules were designed to address the market failures that led to the crisis and will serve as global standards. On the one hand the rules are aimed at strengthening microprudential regulation, but at the same time they also have a macroprudential focus.

“The reforms raise both the quality and quantity of the regulatory capital base and enhance the risk coverage of the capital framework. They are underpinned by a leverage ratio that serves as a backstop to the risk-based capital measures, is intended to constrain excess leverage in the banking system and provide an extra layer of protection against model risk and measurement error. Finally, the Committee is introducing a number of macroprudential elements into the capital framework to help contain systemic risks arising from procyclicality and from the

interconnectedness of financial institutions.”¹

The fundamental role of the financial system in the economy is to promote stability and foster growth, but the crisis proved that the system can fail. Thus, a rethinking of the regulatory framework is more than welcome, but the following questions must be raised:

What would be the macroeconomic implications if

1. many countries simultaneously carry out huge fiscal and external adjustments?
2. the fiscal adjustment is accompanied by the massive deleveraging of the private sector?
3. and at the same time the banking system must comply with stricter capital and liquidity requirements?

Due to the massive fiscal packages and banking sector bail-outs (accompanied by falling revenues and higher expenditures resulting from the economic recession), budget deficits and consequently, public debt levels, rose substantially across the developed world. In countries where public debt is unsustainable even in the short run (or the market perceives it as unsustainable), governments are forced to carry out front-loaded fiscal adjustment programs. Where the situation is less acute, governments have more room for maneuver and are able to adopt a more gradual approach towards deficit and debt reduction.

In any case, the literature shows that with few exceptions, fiscal adjustments have a negative implication on growth in the short run. Thus, in the developed world, fiscal policies are not, and will not be in the position to provide support to economic activity; it is quite the opposite: restrictive fiscal policies have a negative impact on growth. Moreover, monetary policy has also reached its limits and the situation is further

¹ Basel III: A global regulatory framework for more resilient banks and banking systems, June, 2011

complicated by the fact that the private sector is also undergoing a drastic balance sheet adjustment.

Put it all together and the result is a prolonged period of slow growth. The growth outlook is further worsened by the new regulatory environment. Complying with the new regulatory standards implies higher capital requirements, increasing funding costs, lower profitability, and consequently, deteriorating lending capacity and tighter credit conditions.

Re-regulating the financial system is necessary, but timing does matter. Moreover, it would be very important to find a level of regulation that promotes stability but does not dampen growth. In this respect it is of utmost importance to take a wider perspective when designing the new regulatory framework by taking into account the entire macroeconomic environment of a given country as well as the global implications.

Economic policies – including fiscal policy, monetary policy, and regulatory policies - should be coordinated. In the absence of a proper level of coordination and cooperation, the steps taken in one field could easily become counterproductive and the negative feedback loop between the financial sector and the real economy could result in a deep and prolonged recession.

External position matters

Now it is widely accepted that regulatory failures were one of the main causes of the crisis. It is also important to emphasize, however, that other factors (excess global liquidity, lax fiscal and monetary policies, pervasive income distribution, global imbalances etc.) played their role as well. This suggests that re-regulating the financial markets is a necessary but not a sufficient condition to fix the system.

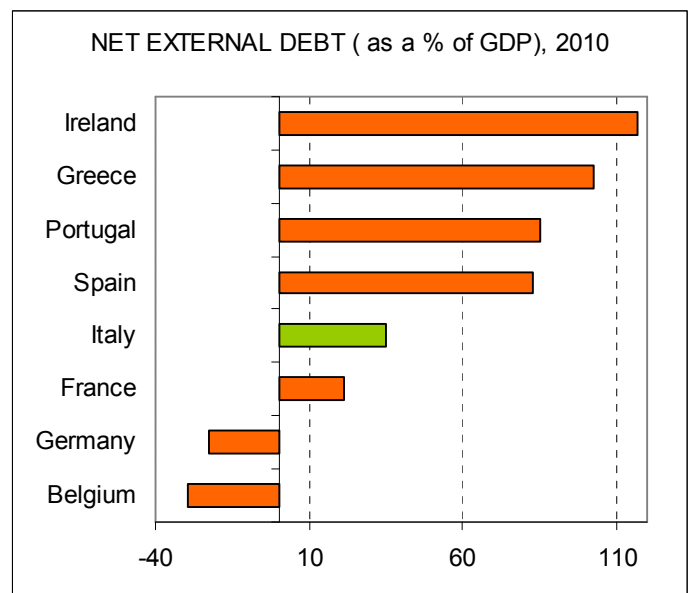
The pre-crisis world was characterized by ample global liquidity and irrationally tight risk spreads. In a world of excess liquidity, external positions were hardly considered when a given economy's vulnerability was assessed. (One of the most problematic aspects of Maastricht and the SGP is that the framework that governs the EU and the euro zone completely ignores the external position). It was widely accepted that an external deficit is sustainable if the market is willing to finance it; and as a result, countries could live happily with current account deficits well in double-digit territories.

The crisis painfully proved that this logic was wrong. A consensus has emerged that the external position does matter; in fact, the external position is the most important factor in determining a country's vulnerability. When assessing macroeconomic stability, it is important

to keep in mind that financial stability does not equal fiscal stability. What really matters is the S-I position of the economy as a whole, and the level of external debt (both public and private). When capital inflows to a country suddenly stop, it is irrelevant whether the external debt was accumulated in the public or in the private sector.

It is no surprise that there are economists who strongly believe that the root cause of the euro crisis is external debt.

On the one hand, the external position of the peripheral euro zone countries determined how seriously and through what channels the global crisis had affected the given economy. On the other hand, it determines how fast and at what prices the given economy will be able to emerge from the crisis.



source: IMF, own calculations

At a first glance there are huge differences in the situations of the PIGS countries (Portugal, Italy, Greece and Spain). In Greece, irresponsible fiscal policies, deep structural problems, the lack of competitiveness, and a credit bubble are to blame for the collapse. In Spain, a strong fiscal position was accompanied by a property and credit bubble, while in Ireland, the bursting of the property bubble was the main culprit.

Besides these differences, there are also similarities: the PIGS economies are less developed compared to the core euro zone economies, and thus are characterized by a higher potential growth rate and higher optimal inflation, and they all introduced the euro. Entering the euro club means giving up monetary policy independence: after the accession, the ECB determines

the monetary conditions for the whole euro zone (while fiscal policy and all other elements of economic policy remain under national control).

The same monetary conditions, however, are not adequate simultaneously for Germany and the less developed peripheral countries. An interest rate that is appropriate for the German economy implies loose monetary conditions in Spain or in Ireland. Lax monetary policy boosts credit growth, supports consumption, and results in housing bubbles –as we witnessed in the European periphery.

Certainly there were signs that these economies were on an unsustainable path: current account deficits were in double-digit territory and credit was expanding rapidly. The growth rate of monetary aggregates should have worried markets and authorities.

In the pre-crisis world, however, no one cared. European authorities ignored the growing imbalances as the rules that governed the EU and the euro zone exclusively focused on fiscal stability, and –except for Greece – the fiscal position of these countries was quite solid. Both the Spanish and Irish budget recorded surpluses, while in Portugal and Greece, deficits hovered around the 3% limit in 2007. The public debt/GDP ratio were well below the 60% Maastricht ceiling in Spain and Ireland, and Portugal's public debt was a touch above this limit. The market did not force out the necessary adjustments either, and shrugged off the building up of external and internal imbalances since it was a rule of thumb that a euro zone country could not default per definition.

The global crisis provided a painful lesson for everyone: the real barrier is always the external position.

At a first glance, Italy does not fit into this pattern, and it might seem strange that after Greece, Ireland, and Portugal had been bailed-out, the next country to be attacked by the markets was Italy and not Spain.

Although Spain had a strong fiscal position before the crisis, the country ran a double-digit current account deficit and its gross external debt surpassed 100% of its GDP. The worsening external position was the result of the growing indebtedness of the private sector.

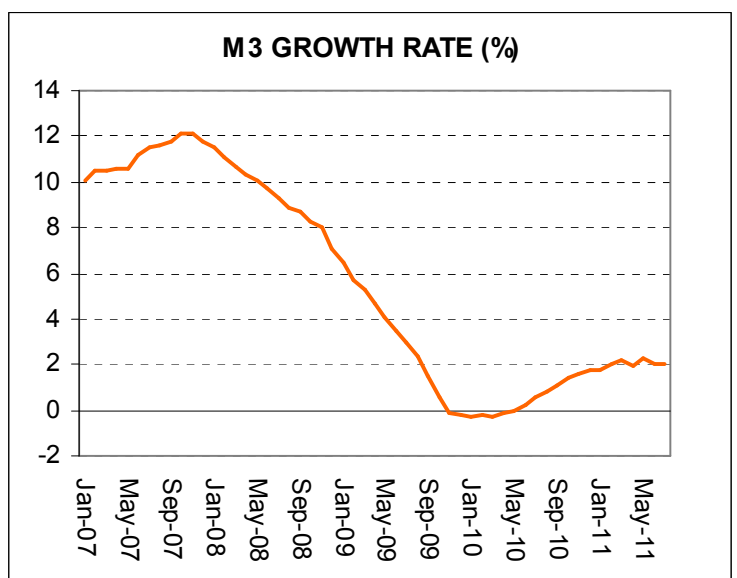
In the case of Italy, the gross and net external debt was well below the Spanish level, and the current account deficit hovered in the 2-3% range. The underlying problem in Italy was the high level of public debt and the low potential growth rate. During the boom years preceding the crisis, Italy notoriously grew less than the euro zone average; this trend reflected deep structural

problems in the economy and an unstable domestic political environment. In this respect, we have recently been witnessing positive developments: the new government is committed to structural reforms, and this determination is reflected in strengthening confidence. This suggests that if the government succeeds in carrying out the sorely needed structural reforms, the potential growth rate will improve, which in turn could help to bring the public debt down to a more sustainable level.

Although from a fiscal position point of view the initial conditions were better in Spain, the country is in a much more difficult situation now. Fiscal stability remains in the past (the budget deficit hit 8.5% last year and this year's budget shortfall is likely to exceed the targeted 4.4% with a wide margin), while external indebtedness is still high. Spain is now facing a classic twin deficit problem, which makes it more painful and complicated to carry out the necessary macroeconomic adjustments and return to a sustainable growth pattern.

Monetary policy during the crisis, the role of the ECB

The global crisis triggered a wide-scale rethinking of central bank theory and practice as well. From the early days of modern central banking, financial stability was among the responsibilities of central banks. In the pre-crisis world, however, this objective became secondary. The predominant view was that markets are efficient and self-correcting: central banks must focus on inflation, keep inflation in check by setting the short term interest rate, and should not interfere with the markets.

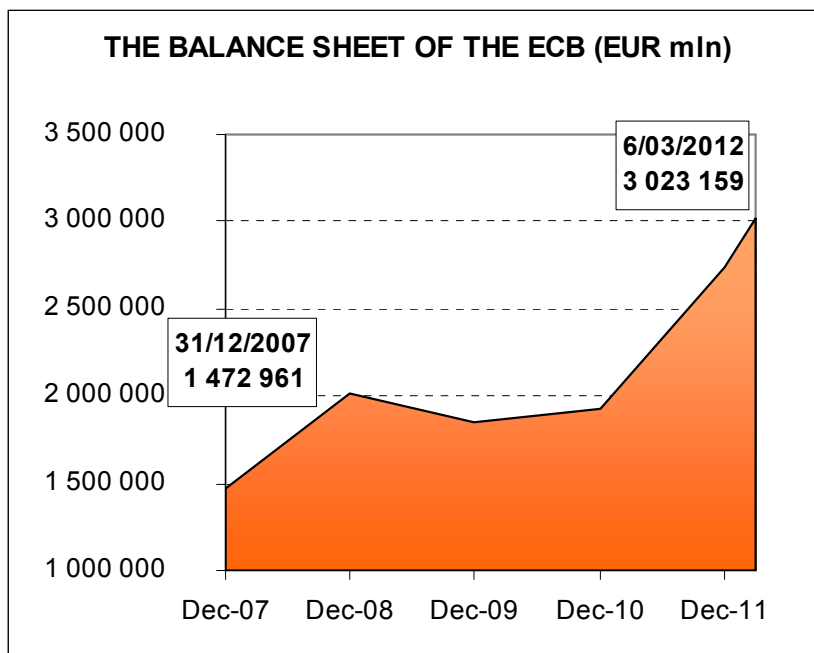


source: ECB

The crisis forcefully reminded us that protecting financial stability is at least as important as promoting inflation stability. Financial stability should not be considered a second-line goal any more. In acute stress situations, financial stability considerations must have a priority.

In the interbank markets, central banks traditionally function as lenders of last resort: they provide liquidity to illiquid but solvent market players against eligible collateral. During the crisis, central banks enhanced this function by lengthening the maturities of the refinancing operations and broadening the range of securities accepted as collateral and the range of financial institutions that have direct access to central bank facilities.

When all traditional tools had already been deployed (key policy rates reached the zero lower bound, and serving as a lender of last resort in the interbank market was insufficient to resolve the crisis), developed central banks engaged in unconventional policy measures and started to use their balance sheets much more actively.



source: ECB

Back in 2007, the ECB was the first major central bank to step into the market and accommodate the banks' liquidity needs via an unlimited provision of liquidity at fixed rates. Later on, the ECB expanded its toolkit, but then stepped back, and has refused to engage in more unconventional measures until very recently.

Although the ECB announced a covered bond purchase program and started to buy peripheral government bonds on the secondary market, this set of measures could not be defined as classic quantitative easing. Firstly, the ECB

sterilized the interventions. Secondly, the scale of the interventions was also much lower compared to the practice of the Federal Reserve, the Bank of England or the Bank of Japan. Until the end of 2011, the Fed and the BoE have spent more than 15% of the GDP for quantitative easing, while the amount the ECB had bought hardly surpassed 1% of the euro zone GDP.

The underlying problem is that euro zone countries issue debt that is denominated in a currency that they do not fully control. The BoE is a lender of last resort in GBP, which is an implicit guarantee for creditors, but in the euro zone, which lacks a lender of last resort, creditors can never be sure that they will be fully repaid, which is the very recipe for a full-blown confidence crisis.

We have recently been witnessing positive changes in the ECB's crisis management practices. The Bank adopted a more pragmatic approach towards crisis management: it still does not buy government bonds directly, but it has flooded the market with more than

EUR 1000 bln extra-cheap liquidity through two LTRO tenders and at the same time further loosened the collateral rules. The latter is quite important, since banks lend to each other without collateral in the interbank market, and in some cases, the insufficient level of eligible collateral meant banks were not eligible to access the ECB facilities.

The liquidity injections substantially eased pressures in the interbank market, prevented a major credit crunch, and at the same time, played an important role in stabilizing higher yielding euro zone bond markets.

It would be a mistake, however, to think that markets are flooded with liquidity and everything is fine now. Ample liquidity is illusionary: a big part of the excess liquidity has been deposited with the ECB rather than

flowing into the real economy. Notwithstanding the fact that there is certainly a lag between granting liquidity to banks and the time when this money will actually show up in lending, the most recent figures on monetary aggregates show that private sector credit growth remains sluggish. Taking into account the balance sheet adjustment needs of the banking sector, it is questionable whether the capacity and the willingness to lend will improve in the foreseeable future.

The crisis of the euro zone

The role of the ECB is only one aspect of the European crisis, the events of the past few years have highlighted the deep structural problems in the European architecture as well: a monetary union is not viable unless it is accompanied by a fiscal and political union and unless the OCA conditions are fulfilled. The idea of a “blessed trinity” - that a sovereign borrower can not go bust, that central banks are forbidden from monetary financing, and that the “no bail-out” clause prohibits one country from assuming the debts of another- has collapsed. The crisis had been encoded in the system since the birth of the euro, and now there is consensus that in its current form, the institutional framework is not viable. The current institutions and mechanisms contributed the development of imbalances within the euro zone and at the same time are barriers to efficient crisis management.

Summary

The purpose of this paper is not to examine the many challenges the global system is facing, but hopefully it sheds light on some important aspects of the crisis and helps to draw important lessons that we should not forget in the effort to build a new global system that is stronger, more stable, and more resilient to future shocks.

Four important lessons are:

1. Re-regulating the financial system is necessary and welcome. Timing does matter and it is of utmost importance to find the balance between stability and growth and target a level of regulation that promotes financial stability but does not constitute a barrier to growth.
2. When assessing a country's vulnerability, the external position does matter. The era of ample and cheap global liquidity is over; Growth strategies based on external deficits are not viable any more.
3. The European institutional framework needs fundamental changes. Steps should be taken to create a fiscal union. The role of the ECB should be reconsidered as well.
4. The rules that govern the European Union and the euro zone must be changed; A higher importance should be given to the external positions (external balance, external debt).

This E-brief is based on Dr György Surányi's presentation at the CASE 2011 International Conference on "Europe 2000: Exploring the Future of European Integration" held on November 18-19, 2011.

Since May 2001, Dr György Surányi has been Regional Head of Central & Eastern Europe at Intesa Sanpaolo and Chairman of the BoD of CIB Bank Ltd., Budapest, and PBZ, Zagreb, VUB, Bratislava and BIB, Beograd.

In 1995-2001, Dr Surányi was President of the National Bank of Hungary, a return to the positions he held for the first time in 1990-91. For three years from 1992, Dr Surányi was Co-CEO at Central-European International Bank

Ltd. In 1989-90 he served as State Secretary at the National Planning Office. In 1986-87 Dr. Surányi was consultant at the World Bank in Washington D.C. after spending nine years as an academic at the Financial Research Institute, Budapest.

Dr Surányi was awarded a Ph.D. in 1986 from the Hungarian Academy of Sciences, Budapest, and a Dr Habil. in 1996 from the University of Economics, Budapest. He is a Professor of Finance at Corvinus University of Economics and Central European University, Budapest.

