Euro-zone crisis and EU governance: tackling a flawed design and inadequate policy arrangements

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Sequence of Presentation

1. Roots of the Crisis
2. Lessons of the Crisis
3. EU Policy Response
4. Non Euro Zone NMSs
5. EU Governance Reform Is Only Part of the Problem; the Global Reform
6. Issues to Ponder On

1.1 Roots of the Crisis: The Financial System (I)

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•Rediscovering **Financial Stability** concerns in mature economies;

•The role of **Structure** (institutional and policy arrangements in the EU) vs. national policy weaknesses;

•Rediscovering *systemic risks*: *complexity* and *inter-connectedness* (*black swans*/tail risks) …networks;

•Haldane: “**Deregulation swept aside banking segregation and, with it, decomposability of the financial network. The upshot was a predictable lack of network robustness**”;

•Abuse of securitization and **shadow banking sector**: *fragility* of financial systems (Lamfalussy);

•**Not all financial innovation is good** (CDOs);

•Inadequate risk models;

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1.1 Roots of the Crisis: The Financial System (II)

- An **oversized financial sector** (*rent-seeking* and *policy capture*, Simon Johnson)
- Banking performs an essential public utility function; they can do much good, but can also do much harm…
- Excessive trading (much of big banks' profits come from trading, which is an incentive to speculate)
- A **crisis of deep financial integration**; we no longer distinguish what is sovereign vs. private debt (financial industry)…huge moral hazard

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1.2 Sub-optimality of EMU and N-best Institutional Arrangements (flawed design)

• *A flawed design* : **the lack of a lender of last resort** and inadequate dealing with asymmetric shocks

•The EMU is **not an "optimal currency area"**

•**Lack of convergence** (*Mezzogiornification* in the EMU);

•**One size fits all monetary policy** has encouraged boom and bust cycles (resource allocation);

•Massive cross-border operations: interconnectedness

•Precarious arrangements for **burden-sharing**

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1.2.1 Deceptive aggregates: analogy with US deficits

- Poor analogy with the US: budget deficit was above 8% of GDP in in the US in 2010, whereas it was around 6% in the euro zone; the public debt is higher in the US than in the euro zone
- And yet, nobody is questioning the survival of the USD, or of the US as a monetary union; this is different when it comes to the EMU
  - **Inadequate institutional and policy arrangements in the EMU**: no lender of last resort; no common R&S of financial markets; market rigidities, no fiscal transfers, etc.…
  - External borrowing does matter when the power to tax is limited nationally

1.3 Inadequate policy response

- **Crisis management** vs. dealing with the **structural flaws** of the EMU
- Timing: incrementalism does not work (**too little, too late**)
- Political constraints

1.4 Economic Power Redistribution and Global Imbalances

- A EU competitiveness issue?
- **Zero sum games** in the world economy?
- From a failed *Lisbon Agenda*…toward *Europe 2020*
- National policies do matter, but so do EU institutional arrangements and policies

2. Lessons of the Crisis and debunking *cliches* (I)

- **Low inflation is not sufficient** for financial stability
- **Not all sovereign debt crises have a fiscal origin** (Ireland, Spain, etc)
- Financial/economic stability is linked with dynamics of private sector debt (the Asian crisis was a harbinger of this crisis…); systemic risks entail rescue operations that burden public debt
- The critical role of the financial sector for overall economic stability (Ireland, UK: overexpansion of banks; Spain and banks' poor lending (Cajas)
- **Inter-connectedness** has diminished the "robustness" of our systems (Andrew Haldane, Lamfalussy)….look how difficult it is to *ring fence*, whether a financial entity or a country (in the EMU in particular)…;
- The **intensity of contagion effects** in the EMU (the fear of a disorderly sovereign debt restructuring…a Lehman Brothers syndrome*;*

2. Lessons of the Crisis (II)

- When *black swans* proliferate and uncertainty is on the rise it is less clear what makes up a sound (prudent) budget policy (Pisani Ferry: **deterministic governance does not work in a stochastic world**); can a country run big primary surpluses in "normal" times as a buffer against "extraordinary" times?
- The "**Great Moderation" (Great Misperception) was highly misleading**: markets discriminate now among EMU member states via bond spreads (P. de Grauwe: the sovereign debt default mechanism makes the EMU more prone to crises since it introduces speculative dynamics into it…an analogy with the ERM);
- **The role of external debt** (vs. internal public debt): governments cannot tax non-resident holders of their bonds;
- Size, competitiveness, size of public debt, range of tools (in and out of the euro zone), market rigidities, industrial relations, exposure, etc (resilience)
- Poor regulation and supervision of financial markets entails major systemic risks
- Deep financial integration collides with the reality of national prerogatives;

2. Lessons of the Crisis (III)

- **Captivity of governments** (too big to fail syndrome)
- Rediscovering sovereign debt risk in mature economies
- Poor coordination tools;
- The role of **externalities** in the EU (as in the global economy/US; quantitative easing…);
- The importance of *trust*
- The need to deal with reform of the R&S globally
- The financial sector as an **in built destablizer**
- An untenable situation**: losses are socialized while banks are rescued due to systemic risks**
- The importance of **fairness (burden-sharing)**

3. The Policy Response: crisis management and addressing the flaws of the EMU

- **Defining the flaws of the EMU**: a belated and partial official acknowledgment
- The rising cost of inaction: **we are running out of time**…
- **Crisis management demarche:** avoiding a financial meltdown + limiting the fall of economic activity;
- **The reform of EU economic governance**, the Euro pact+ the fiscal issue; internal imbalances; R&S of financial markets; policy coordination (*the Economic Semester*); strengthened institutions; a crisis management mechanism;
- *A missing link*: addressing insufficient convergence in the EU and **EU level policies** (“shock-absorbers”; resolution schemes, etc)
- **Inter-governmental vs. community method**;
- Global reform (G20, the FSB): reform of the R&S of financial markets.

3.1 Defining the flaws of the EMU

- Fiscal rules are not sufficient
- The role of a **lender of last resort**
- **Eurobonds as a final stage of fiscal integration vs. being an instrument for addressing the crisis now (***The European Redemption Fund proposal***)**
    - The bottom line: there is a huge **confidence crisis** caused by: a/ indecision-making; b/ conceptual dilemmas; c/ opposing views
    - The damage caused by **vicious circle dynamics** (linkages between sovereign debt fortune and bank fortune)

3.2 Crisis management (I)

- *Liquidity* vs. *solvency* crisis;
- The inescapable **ECB’ s role** as lender of last resort; from monetary to fiscal dominance in its conduct…
- The EFSF is weak, ineffective;
- Bailing in the private sector makes sense, but it foments contagion…
  - The EFSF/ESM does not stop speculative dynamics (de Grauwe). It turns the impossible combination “no bail out, no default, no exit” into another one: “default, persistent imbalances, lack of fiscal union”

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3.2 Crisis management (II)

- How realistic are **adjustments programs** in southern member states?
- Can debt restructuring be avoided?
- The ESM can hardly tackle the systemic risks posed by major financial groups (are higher capital and liquidity requirements the answer?)
- **The deleveraging issue** in a period of slow growth (“the new normalcy”)
- What to do about the “too big to fail”? Anti-trust and Glass-Steagall type legislation (Volcker rules…)
- The **technocratic moment** as a response to the confidence crisis
- **Can crisis management be dissociated from repairing the EMU?**
    - **Are we running out of time?**

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3.3 Controlling Imbalances: Fiscal Discipline (I)

- Fiscal sustainability when shocks proliferate (the need for *fiscal space/***policy space)**;
- The data question (Eurostat; independent bodies);
- **Sanctions**; how automatic will they be?
- *Responsibility* and *accountability* for an adjustment program….the more EU institutions are involved the more vague this could become…(a **legitimacy issue**);
- For **countries with poor institutions**, however, the involvement of EU institutions could be a bonus. In addition, it can help policy coordination.

3.3 Fiscal Discipline; NMSs (II)

- The case of hidden deficits;
- When structural fiscal deficits are quite high fiscal consolidation can hardly be put off;
- The **role of EU funds in averting pro-cyclicality**
- Except Hungary (80% of GDP) NMSs have low public debts owing to a decade of high economic growth and higher inflation;
- But for some of NMSs, resource allocation geared toward non-tradables has revealed **a flawed growth model**, that needs repair: double digit current account deficits in the pre-crisis years turned into high budget deficits in the wake of this crisis and fiscal consolidation can not be put off;

3.4 Internal Imbalances in the EMU

- Not all tensions are rooted in fiscal profligacy;
- Competitiveness gaps (CA deficits: "Excessive Imbalance Procedure" (EIP)…analogous with the EDP;
- Which indicators?
- How will corrections be applied? **Will surplus countries be also involved in undertaking corrections**?
- What about NMSs that need capital imports for catching up?
- Which **tools for making corrections**? Is wage control sufficient? (could we have a race to the bottom here….a sort of competitive wage control…)
- **How realistic is internal devaluation over a longer period of time?**
- Correcting external (CA) deficits wouldn't it imply a restriction on capital flows?

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3.5 *The Economic Semester (ES)* (Policy Coordination) (I)

- Macroeconomic and financial stability (ESRB) concerns will be internalized;
- National budgetary framework: multi-annual programming; transparency and predictability; compatibility with the new rules of the SGP;
- **Internalizing policy recommendations** of the EU institutions would be an issue (in order to avoid a new fact of a democratic deficit); an **ownership problem**… (apart from intellectual mastery)
- Where local institutions are weak ES can be an advantage…

3.5 *Economic Semester*: a EMU/EU Finance Ministry?

- Defining its mandate; would it be a EU fiscal watchdog and nothing else?
- If it deals with the R&S of financial markets how would it relate to the ESRB and the three authorities?
- **What about overall EU economic governance**? How would it relate to the Commission (Olie Rehn)?
- Would it have a say in defining the EU budget (structure and size)?
- Its dialogue with national ministries

3.6 R&S of Financial Markets

- Content: **no financial entity be left out** (HFs and PEFs); limit leverage; higher capital and liquidity requirements; derivatives; remuneration; accounting standards (fair value vs. book value); rating agencies; regulatory arbitrage; restrict naked short selling ; protection of consumers, etc.
- Taxing the industry (feed a stabilization fund);
- "Too big to fail": apply **anti-trust legislation** (Volcker rules)
- **Ring-fencing** retail banking (Vickers commission)
- Go global with reform (FSB, G20, etc)

3.7 A missing Link: EU level Policies

- The proposals hardly deal with the issue of resource allocation in a sub-optimal EMU and fostering convergence (Pisani Ferry, speaks about “**revitalization programs**”, based on EU funds and so does a CEPS study. But is the EU budget appropriate to this end?

- There is need for **shock-absorbers** at the EU level (such as unemployment insurance schemes)…the EMU (EU)’ fiscal underpinnings

- Resolution schemes for banks

4. Financial stability in the NMSs

- **Markets dominated by foreign groups**; R&S of financial groups (cooperation between host and home country authorities)
- Euro zone crisis is a terrible negative externality to NMSs; a new **Vienna Agreement**?
- Enhance access to liquidity and mitigate solvency threats; the contagion issue
  - EU and IFIs supported assistance programs
  - Swap lines with the ECB
  - A broader range of collaterals be accepted by the ECB

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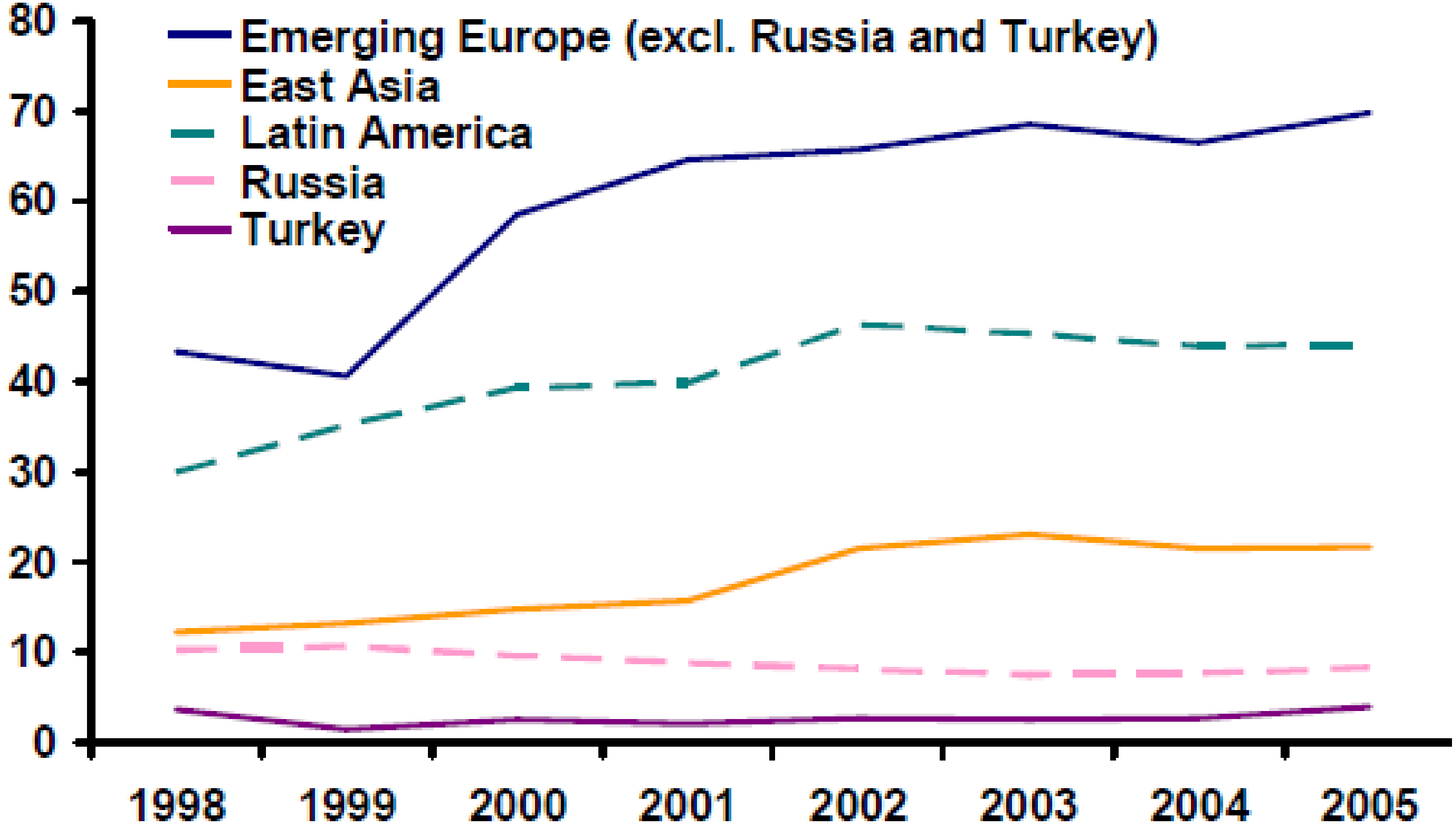
Fig.1: Foreign Bank Ownership, 1998-2005 (Assets Owned by Foreign Banks as a Percent of Banking System Assets)



Source: Chart 6b from Berglöf et al. (2009)

4.1 Euro Adoption

- **A change of perception** in NMSs (caution)
- Real convergence vs. nominal convergence criteria
- Fulfilling the OCA criteria ex ante (the thesis that financial integration would foster convergence in the EMU is not validated…)
- Competitiveness is a key concept
- Some non euro zone NMSs fit better the demands of the OCA than some current EMU member states
- The need for **policy space**

4.2 The Threat of Low Equilibria and Pitfalls of One Size Fits All Economic Policy

- The **crisis of a growth model** in several NMSs (heavy reliance on foreign borrowing; investment in non-tradable sectors);
- A **new international environment** (cost of borrowing; trade competition; capital flows, etc);
- Perils engendered by a one size fits all monetary policy;
- Restrictions on the CA deficit may clash with the need to attract FDI;
- Tax harmonization would reduce competitive advantages;
- Very low inflation rates may also be hard to achieve.

5. Taming Global Financial Markets Is a Must (I)

- Dealing with **too big to fail** (anti-trust law; capital requirements);
- Cap on leverage; capital and liquidity requirements (including HFs and PEFs);
- **Discouraging speculative capital flows**: the Volcker's rules…a version of Glass-Steagall;
- Transaction taxes (size of financial sector and nature of flows –contradicting Mirlees and Diamond (1971));
- **No loopholes for trading of derivatives**;
- Global coordination (preventing regulatory arbitrage).

5. Taming Global Financial Markets (II)

- A return to the initial logic of Bretton Woods (the financial policy trilemma)
- Limiting volatility in exchange rates and commodity markets (buffer stocks, curbing naked short-selling -- Michel Barnier and Dacian Ciolos in the EU, Gary Gensler in the US).
- A fundamental moral and policy issue facing the financial industry: **who serves whom?**

6. Issues to Ponder On (I)

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- **Disentangling private from public debt** (an acute issue in the EMU);
- The Crisis has brought about a **fiscal dominance** on monetary policy
- What are relevant economic indicators?
- **New risk models**
- Accounting rules: is “mark to market” appropriate when markets are highly dysfunctional?
- **Implementing Basel III**: too fast would stifle recovery; too slow would create prerequisites for a new crisis

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6. Issues to Ponder On (II)

- **EU burden-sharing arrangements** and resolution schemes (the political constraints in the EU);
- The geo-political constraints in G-20: bank competition, etc;
- **Technology used for circumventing rules** (ex: high-frequency trading);
- Demographics; natural disasters;
- **Social strain** and economic (financial) instability;
- **An increasingly uncertain environment (**complexity on the rise**);**
- **Resilience** (ability to withstand external and internal shocks) is a principal policy aim; **policy space**
- Will societies turn more **inward-looking**? What will implications be for an open global system?

Thank you!