



From the *Great Moderation (Misperception)* to
dealing with *fragility, inter-connectedness* and
lower growth prospects in the EU

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Sequence of presentation



1. Roots of the Crisis in the EU and policy implications
2. Lessons of the Crisis
3. The 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 in the EU: the financial system (I)



- Rediscovering the *Financial Stability* concern in mature economies;
- The role of *Structure* (institutional and policy arrangements) 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;

1.1 Roots of the Crisis in the EU: 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
- The industry is fighting back fiercely

1.2 Roots: sub-optimality of EMU and n-best institutional arrangements



- *Structure*: even countries with prudent policies suffer
- The EMU is not an “optimal currency area”
- Lack of convergence (Mezzogiornification of the EMU, Krugman);
- National prerogatives are still powerful (fiscal policy, R&S, etc.)
- One size fits all monetary policy has encouraged boom and bust cycles (resource allocation);
- Massive cross-border operations; systemic risks
- Contagion
- “Too big to fail” vs. “too big to save”
- Precarious arrangements for burden-sharing
- Weak analogy with the US (aggregate budget balance and current account deficit)

1.3 Roots: 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 policies too
- The role of EU economic governance

2. Lessons of the Crisis (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...) when 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 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 will make the EMU more prone to crises since it will introduce 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, especially in the EMU;
- Deep financial integration collides with the reality of national prerogatives;

2. Lessons of the Crisis (III)



- Bail out operations increase moral hazard
- A flawed EU economic governance system;
- Poor coordination tools;
- The role of externalities (as in the global economy/US; quantitative easing...);
- The importance of *trustworthiness*;
- National policies do matter (Scandinavian economies, Germany);
- The need to deal with reform of the R&S globally.

3. The Policy response



- *Crisis management* demarche: avoiding a financial meltdown + limiting the fall of economic activity;
- A resilient crisis: it is not a simple recession (Reinhart & Rogoff: a sovereign debt crisis in the making);
- *The reform of EU economic governance*, the Euro pact+ (proposals of the Council, the Commission, the Monti report, the de Larosiere report): 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 Controlling imbalances: fiscal discipline (I)



- Fiscal sustainability when shocks proliferate (the need for *fiscal 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.

3.1 Fiscal discipline (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 (NMSs);
- 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;
- EU funds absorption gets a macroeconomic dimension (as a Bruegel study says: one should not add public deleveraging to private deleveraging....the threat of low equilibria).

3.2 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?

3.3 *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...

3.3 The Economic Semester: a EU finance Ministry? (Trichet's proposal)



- 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

3.4 R&S of financial markets



- Its 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)
- The ESRB and the three Agencies should turn into a truly European system
- Go global with reform (FSB, G20, etc)

3.5. The ESM (I)



- *Liquidity vs. solvency* crisis;
- The ECB's role as lender of last resort to both banks and governments);
- The European Financial Stability Facility (until 2013);
- Bailing in the private sectorakes sense
- The contagion issue (a Lehman's moment);
- The ESM could heighten speculative dynamics (de Grauwe). It could turn the impossible combination “no bail out, no default, no exit” into another one: “default, persistent imbalances, lack of fiscal union” (Munchau).
- EU bonds (Juncker, Tremonti, Monti)? Purchases on secondary markets; soft (profiling) vs. hard restructuring;

3.5 The ESM and adjustment (II)



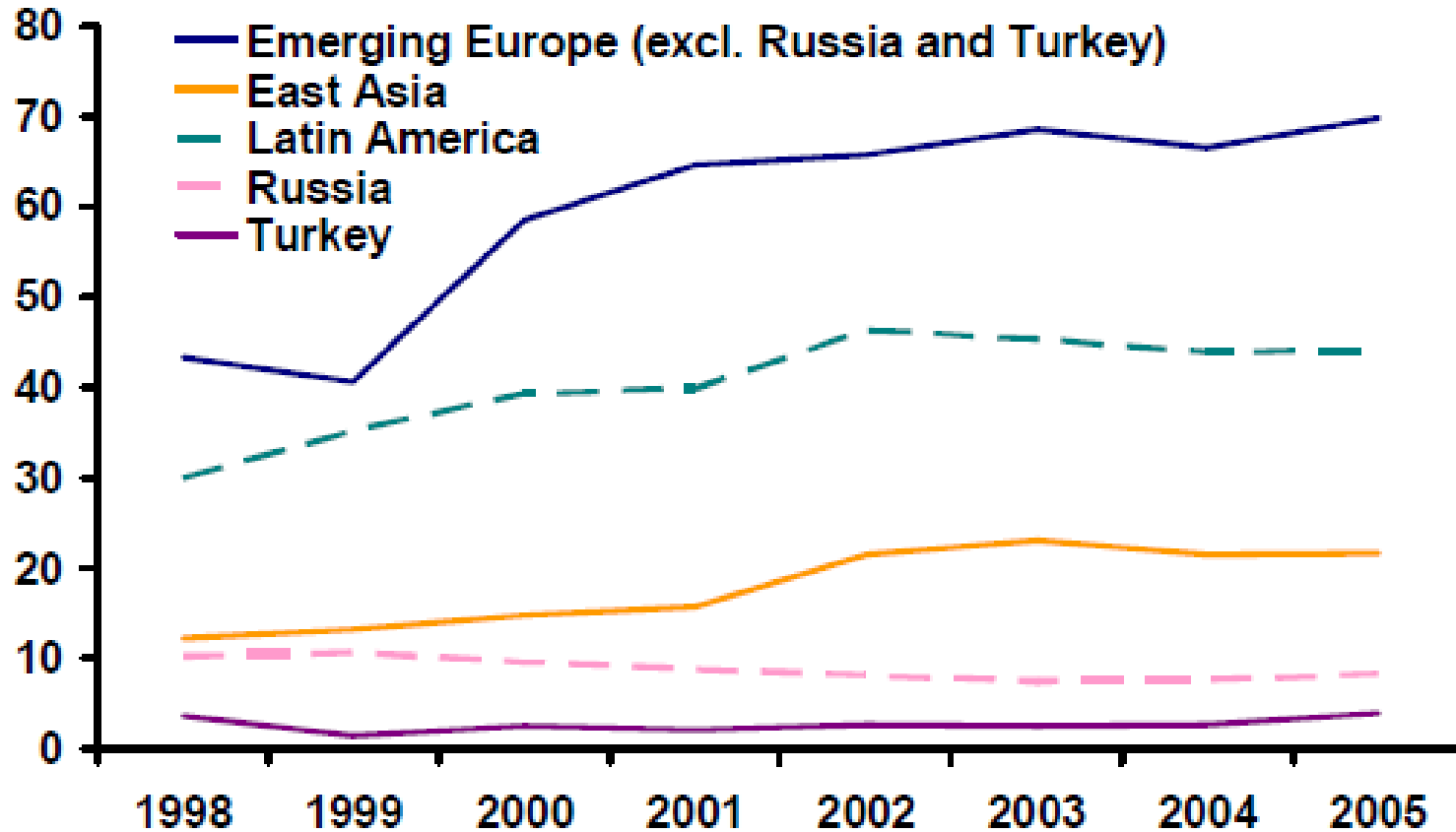
- How realistic are adjustment programs in the Southern flank EMU countries? They can create vicious circles...self-fulfilling prophecies
- Can debt restructuring be avoided?
- The ESM can hardly tackle the systemic risks created by major financial groups;
- What do we do with the “too big to fail”? Anti-trust and Glass-Steagal type legislation (Volcker rules, Mervin King and Lord Turner’s proposals in the UK)

3.6 A missing link: EU level policies



- None of the proposals deals directly with the issue of resource allocation in a sub-optimal EMU and fostering convergence (Pisani Ferry, 3 Dec/FT, 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

Fig.1: Foreign bank ownership, 1998-2005
(Assets owned by foreign banks as a percent of banking system assets)



Source: Chart 6b from Bergl of et al. (2009)

Table I.1.1: Budget balances in EU Member States (% of GDP)

	Budget balance					Structural balance					Structural primary balance				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
BE	-0.2	-1.2	-6.0	-5.0	-5.0	-1.3	-2.1	-3.9	-3.8	-4.0	2.5	1.7	-0.3	0.0	-0.2
DE	0.2	0.0	-3.3	-5.0	-4.7	-1.2	-1.1	-1.7	-3.6	-3.5	1.6	1.6	0.9	-1.0	-0.8
IE	0.1	-7.3	-14.3	-11.7	-12.1	-1.6	-7.0	-9.4	-9.3	-10.2	-0.6	-5.7	-7.3	-6.5	-6.7
EL	-5.1	-7.7	-13.6	-9.3	-9.9	-6.8	-8.7	-13.0	-8.5	-8.2	-2.7	-4.2	-8.0	-3.2	-2.4
ES	1.9	-4.1	-11.2	-9.8	-8.8	1.2	-4.1	-8.9	-7.8	-7.0	2.8	-2.5	-7.1	-5.7	-4.4
FR	-2.7	-3.3	-7.5	-8.0	-7.4	-3.8	-3.8	-6.2	-6.2	-6.2	-1.1	-0.9	-3.9	-3.6	-3.3
IT	-1.5	-2.7	-5.3	-5.3	-5.0	-3.2	-3.5	-4.0	-3.7	-3.6	1.8	1.6	0.7	0.9	1.2
LU	3.6	2.9	-0.7	-3.5	-3.9	1.1	2.0	1.2	-1.4	-1.9	1.3	2.3	1.7	-1.0	-1.3
NL	0.2	0.7	-5.3	-6.3	-5.1	-1.0	-0.5	-3.6	-4.9	-4.0	1.2	1.6	-1.4	-2.6	-1.7
AT	-0.4	-0.4	-3.4	-4.7	-4.6	-1.6	-1.7	-2.4	-3.6	-3.6	1.1	0.8	0.3	-0.8	-0.7
PT	-2.6	-2.8	-9.4	-8.5	-7.9	-3.1	-3.8	-8.1	-7.7	-7.0	-0.3	-0.8	-5.2	-4.6	-3.4
SI	0.0	-1.7	-5.5	-6.1	-5.2	-2.9	-4.8	-3.7	-4.4	-3.8	-1.6	-3.7	-2.3	-2.5	-1.8
FI	5.2	4.2	-2.2	-3.8	-2.9	2.6	2.1	0.4	-1.3	-1.0	4.1	3.5	1.6	-0.2	0.2
MT	-2.2	-4.5	-3.8	-4.3	-3.6	-3.1	-5.2	-3.8	-4.0	-3.4	0.2	-1.9	-0.5	-0.7	-0.2
CY	3.4	0.9	-6.1	-7.1	-7.7	2.5	-0.4	-5.8	-6.3	-7.1	5.5	2.4	-3.3	-3.6	-4.2
SK	-1.9	-2.3	-6.8	-6.0	-5.4	-3.7	-4.7	-6.6	-5.4	-4.7	-2.3	-3.5	-5.1	-3.9	-3.2
EA-16	-0.6	-2.0	-6.3	-6.6	-6.1	-1.9	-2.8	-4.7	-5.0	-4.8	1.0	0.2	-1.8	-2.1	-1.6
BG	0.1	1.8	-3.9	-2.8	-2.2	-1.5	0.0	-2.8	-1.1	-0.8	-0.5	0.9	-2.0	-0.3	0.1
CZ	-0.7	-2.7	-5.9	-5.7	-5.7	-2.9	-4.5	-5.4	-4.9	-4.9	-1.7	-3.4	-4.1	-3.2	-2.8
DK	4.8	3.4	-2.7	-5.5	-4.9	3.1	3.3	0.6	-2.7	-3.1	4.7	4.7	2.6	-0.6	-1.0
EE	2.6	-2.7	-1.7	-2.4	-2.4	-1.1	-4.3	-0.6	-2.1	-1.8	-0.9	-4.1	-0.2	-1.6	-1.4
LV	-0.3	-4.1	-9.0	-8.6	-9.9	-4.5	-6.4	-6.9	-6.7	-9.0	-4.2	-5.8	-5.3	-4.3	-6.1
LT	-1.0	-3.3	-8.9	-8.4	-8.5	-3.1	-5.6	-7.1	-6.8	-6.8	-2.4	-5.0	-6.1	-5.2	-4.9
HU	-5.0	-3.8	-4.0	-4.1	-4.0	-5.5	-4.7	-2.2	-2.3	-3.0	-1.4	-0.5	2.6	2.3	1.1
PL	-1.9	-3.7	-7.1	-7.3	-7.0	-2.8	-4.6	-7.2	-6.3	-5.7	-0.5	-2.3	-4.6	-3.5	-2.6
RO	-2.5	-5.4	-8.3	-8.0	-7.4	-4.7	-7.7	-8.3	-7.1	-6.4	-3.9	-7.0	-6.8	-5.2	-4.4
SE	3.8	2.5	-0.5	-2.1	-1.6	1.6	1.1	1.9	-0.2	-0.5	3.3	2.8	2.8	0.7	0.3
UK	-2.8	-4.9	-11.5	-12.0	-10.0	-3.9	-5.2	-9.5	-10.4	-8.7	-1.7	-2.9	-7.5	-7.6	-5.6
EU-27	-0.8	-2.3	-6.8	-7.2	-6.5	-2.1	-3.1	-5.2	-5.6	-5.2	0.6	-0.3	-2.5	-2.8	-2.2

Source: EC 2010d

AMECO RESULTS

General government consolidated gross debt :- Excessive deficit procedure (based on ESA 1995) (UDGG)

Country	Unit	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000
European Union (27 c)	(Percentage of GDP)	83,3	82,3	80,2	74,4	62,3	59,0	61,5	62,8	62,2	61,8	60,4	61,0	61,8
Belgium	(Percentage of GDP)	97,5	97,0	96,8	96,2	89,6	84,2	88,1	92,1	94,2	98,5	103,5	106,6	107,9
Bulgaria	(Percentage of GDP)	18,6	18,0	16,2	14,6	13,7	17,2	21,6	27,5	37,0	44,4	52,4	66,0	72,5
Czech Republic	(Percentage of GDP)	42,9	41,3	38,5	35,3	30,0	29,0	29,4	29,7	30,1	29,8	28,2	24,9	18,5
Denmark	(Percentage of GDP)	47,1	45,3	43,6	41,8	34,5	27,5	32,1	37,8	45,1	47,2	49,5	49,6	52,4
Germany	(Percentage of GDP)	81,1	82,4	83,2	73,5	66,3	64,9	67,6	68,0	65,8	63,9	60,4	58,8	59,7
Estonia	(Percentage of GDP)	6,9	6,1	6,6	7,2	4,6	3,7	4,4	4,6	5,0	5,6	5,7	4,8	5,1
Ireland	(Percentage of GDP)	117,9	112,0	96,2	65,6	44,4	25,0	24,8	27,4	29,6	30,9	32,1	35,5	37,8
Greece	(Percentage of GDP)	166,1	157,7	142,8	127,1	110,7	105,4	106,1	100,3	98,9	97,4	101,7	103,7	103,4
Spain	(Percentage of GDP)	71,0	68,1	60,1	53,3	39,8	36,1	39,6	43,0	46,2	48,7	52,5	55,5	59,3
France	(Percentage of GDP)	86,8	84,7	81,7	78,3	67,7	63,9	63,7	66,4	64,9	62,9	58,8	56,9	57,3
Italy	(Percentage of GDP)	119,8	120,3	119,0	116,1	106,3	103,6	106,6	105,9	103,9	104,4	105,7	108,8	109,2
Cyprus	(Percentage of GDP)	64,3	62,3	60,8	58,0	48,3	58,3	64,6	69,1	70,2	68,9	64,6	52,1	48,7
Latvia	(Percentage of GDP)	49,4	48,2	44,7	36,7	19,7	9,0	10,7	12,4	14,9	14,6	13,5	14,0	12,3
Lithuania	(Percentage of GDP)	43,6	40,7	38,2	29,5	15,6	16,9	18,0	18,4	19,4	21,1	22,3	23,1	23,7
Luxembourg	(Percentage of GDP)	19,0	17,2	18,4	14,6	13,6	6,7	6,7	6,1	6,3	6,1	6,3	6,3	6,2
Hungary	(Percentage of GDP)	72,7	75,2	80,2	78,4	72,3	66,1	65,7	61,8	59,1	58,3	55,6	52,0	54,9
Malta	(Percentage of GDP)	67,9	68,0	68,0	67,6	61,5	62,0	64,2	69,6	72,4	69,3	60,1	62,1	55,9
Netherlands	(Percentage of GDP)	64,0	63,9	62,7	60,8	58,2	45,3	47,4	51,8	52,4	52,0	50,5	50,7	53,8
Austria	(Percentage of GDP)	75,4	73,8	72,3	69,6	63,8	60,7	62,1	63,9	64,8	65,5	66,5	67,1	66,5
Poland	(Percentage of GDP)	55,1	55,4	55,0	50,9	47,1	45,0	47,7	47,1	45,7	47,1	42,2	37,6	36,8
Portugal	(Percentage of GDP)	107,4	101,7	93,0	83,0	71,6	68,3	63,9	62,8	57,6	55,9	53,8	51,2	48,5
Romania	(Percentage of GDP)	34,8	33,7	30,8	23,6	13,4	12,6	12,4	15,8	18,7	21,5	24,9	25,7	22,5
Slovenia	(Percentage of GDP)	46,0	42,8	38,0	35,2	21,9	23,1	26,4	26,7	27,4	27,3	27,9	26,7	26,4
Slovakia	(Percentage of GDP)	46,8	44,8	41,0	35,4	27,8	29,6	30,5	34,2	41,5	42,4	43,4	48,9	50,3
Finland	(Percentage of GDP)	52,2	50,6	48,4	43,8	34,1	35,2	39,7	41,7	44,4	44,5	41,5	42,5	43,8
Sweden	(Percentage of GDP)	33,4	36,5	39,8	42,8	38,8	40,2	45,0	50,4	50,3	51,7	52,5	54,7	53,9
United Kingdom	(Percentage of GDP)	87,9	84,2	80,0	69,6	54,4	44,5	43,4	42,5	40,9	39,0	37,5	37,7	41,0

4.1 Financial Stability in NMSs (I)



- Markets dominated by foreign groups; R&S of financial groups (cooperation between host and home country authorities)
- Enhance access to liquidity and mitigate solvency threats; the contagion issue
- Adequate macroeconomic policy
- Rules on convergence of deposit guarantees
- EU and IFIs supported assistance programs
- Swap lines with the ECB
- A broader range of collaterals accepted by the ECB

4.2 Preventing boom and bust cycles in NMSs



- Countercyclical capital and reserve requirements (including surcharges); dynamic provisioning against expected losses
- Limits on leverage and rates of credit expansion
- Similar capital requirements for foreign and local banks
- Measures to improve loan/deposit ratio
- Dealing with credit outsourcing: a/ national level (tax policy; encouraging domestic saving); b/ EU level (use Colleges; consolidated balance sheets; ESRB and EFC; monitoring of systemically important banks)
- Capital controls: not permitted in the EU, but...
- The denomination of lending (balance-sheet problems; funding problem)

4.3 Euro adoption



- A change of perception in NMSs (more caution)
- Real convergence vs. nominal convergence criteria
- Fulfilling the OCA criteria ex ante (the thesis that financial integration would foster convergence in the EMU was 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

4.4 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):
- Capital controls; discouraging short-term (speculative) flows
- 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 for the financial industry: who serves whom?

6. Issues to ponder on (I)



- Disentangling private from public debt (an acute issue in the EU);
- What are relevant economic indicators?
- New risk models
- Accounting rules: is “mark to market” appropriate when markets are highly dysfunctional?
- A deflationary bias in the conduct of monetary policy (pricking bubbles)? But would’ n’ t less instability support long-term growth?
- Implementing Basel III: too fast would stifle recovery; too slow would create prerequisites for a new crisis; should EU banks be an exception?
- Does size matter? (big vs. small economy)

6. Issues to ponder on (II)



- Unwinding global imbalances when zero-sum games are frequent;
- 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;
- Will societies turn more inward-looking? What will implications be for an open global system?

Final remarks



- The content of the reform of R&S of financial markets is fundamental: there is intellectual empathy between reforms in continental EU, US and UK; but vested interests resist
- Coordination in the G20 for consistent reforms worldwide (and avoiding regulatory arbitrage) is key
- Is there an optimal size of *openness* (trade and finance-wise): think globally and relocate operations as a means for mitigating risks;
- A three blocs-based global financial system?