Report on Wilton Park Conference 964

RESPONSES TO THE GLOBAL ECONOMIC CRISIS: HOW CAN GROWTH IN THE EUROPEAN UNION BE RESTORED?

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The Global Economic Crisis

1. If the financial crisis continues for some time, and/or worsens, serious problems may develop affecting some of the larger European Union (EU) Member States. This could mean countries like Italy and Spain needing substantial support. If any (EU) Member State appears to be in serious danger of defaulting on their sovereign debts, pressure will rise for EU action to support them. It is too early to try to guess what form this might take.

2. Since the 1980s, many of the largest economies in the EU have developed unenviable reputations for protracted economic downturns followed by sluggish recoveries. The current downturn is set to repeat this pattern – in exaggerated form. There are two reasons. One is that Europeans have consistently underestimated the impact of the crisis on their economies. The other is that their willingness to push through supply-side reforms may be weakening. Many EU member-states could therefore end up suffering a steeper and more prolonged downturn than the US, and experience a more sluggish recovery.

3. When the financial crisis erupted in 2007, many Europeans were quick to treat the event as a morality tale. The US and UK (they believed) were paying for their profligacy and for their Anglo Saxon free market model of capitalism. They believed that the crisis would not significantly affect most EU countries. But the rapid deterioration in economic data has exposed the fallacy of this belief. Countries across the EU are now in recession.

4. EU countries have adopted fiscal stimulus programmes. Some of these have been larger than is generally recognised: if welfare payments to the unemployed are included, Germany's fiscal stimulus is one of the largest in the OECD. But the scale of the overall macroeconomic stimulus across the EU remains far smaller than in the US. It is furthermore too modest to offset the likely 3 per cent or more decline in GDP in 2009. Europe's economic prospects over the next two years will be determined by what happens on the demand side. Over the longer term, however, supply-side factors will be paramount.

5. In considering the causes of the financial crisis, deficiencies in regulation were clearly one factor. Other important factors were ample liquidity and low interest rates. This was a period of benign macro-economic conditions, low rates of inflation and low interest rates. These conditions led to a series of asset price bubbles, such as the dotcom stocks and sub-prime housing, fuelled by the low interest rate policy of leading central banks. Massive capital inflows to the US from major emerging countries with external surpluses, notably China, further fuelled the asset price bubble.

International Regulation

6. The deficiencies in regulation have been widely recognised, and a variety of official sector and quasi-official sector reports have put forward recommendations for reform.

7. The de Larosière Report outlines specific recommendations for strengthening international cooperation. For example, de Larosière proposes the creation of a new body called the European Systemic Risk Council (ESRC) which would have the function of pooling and analyzing all information relevant to financial stability and ensuring a proper flow of information between the ESRC and micro-prudential supervisors. The ESRC would also be responsible for putting in place an early warning system. In addition, de Larosière proposes the creation of a European System of Financial Supervisors (ESFS) which would be the coordinating body for a supervisory system that would remain primarily decentralised with national supervisors continuing to carry out day-to-day supervision.

8. Some argue there is a need for a reintroduction of some form of structural regulation, often referred to as a new ‘Glass-Steagall’. This is not quite the same as the ‘narrow banking’ proposal, although it is has some similarities. It would involve the creation of a new category of ‘public utility’ banks which would provide payment system services and undertake plain vanilla deposit-taking and lending activities.

Stability and Growth Pact

9. In refusing to plunge national budgets deeper into deficit, Eurozone governments have sent a clear signal that protecting Europe's monetary union is no less important to them than ending the world recession. Underlying their stance is a nervousness, especially in Germany, that the global financial crisis is putting the Eurozone economy to such a severe test that it is more essential than ever not to let public finances spin out of control.

10. The German government felt it necessary to indicate recently that it would not stand idly by, if a weaker Eurozone country were in such serious trouble that it risked being unable to refinance its debt. Amid these pressures Germany, and other relatively fiscally virtuous Eurozone countries such as Finland and the Netherlands, believe the EU must convince financial markets the deficit spending programmes are emergency measures to be replaced as soon as possible by a return to balanced budgets. If one EU country takes a different tack, it is the UK, which some economists forecast may run a budget deficit of 10-12 per cent in the 2009-10 fiscal year and not return to balance until 2015-16.

11. By drawing on the flexibility that was introduced in the Stability and Growth Pact (SGP) when it was reformed in 2005, the European Commission believed it can combine the fiscal stimulus in the short term with a sustainable position of public finances in the long term. The SGP remains the cornerstone of EU fiscal framework. The SGP is not about sanctions, but peer pressure and support for sound policies. It is about anchoring credibility for member states public finances, a factor which is particularly pertinent when considering widening spreads and the pressure that some countries are being placed under by the markets.

12. The Treaty's provisions on excessive deficits limit a Member State to a government deficit of three per cent of GDP, and specifies a procedure by which a Member State which exceeds this limit can be the subject of enforcement proceedings (albeit limited to large fines which would be politically difficult). So far, the Council of Ministers has been reluctant to enforce the three per cent limit, to the disquiet of several Member States. The European Council in March 2009 reaffirmed the commitment to "sound public finances and to the Stability and Growth framework". The reality is that during the critical phase of the financial crisis many Members will exceed the 3 per cent limit, and so the Council called for Member States to return to "their medium-term budgetary objectives as soon as possible, keeping pace with economic recovery".

Credit Rating Agencies

13. Credit Rating Agencies (CRAs) contributed significantly to the recent market turmoil, by underestimating the credit risk of structured credit products. The crisis revealed many weaknesses in the assumptions, methodologies, and models used by CRAs, thereby clearly compromising the quality of their ratings. It also revealed some acute conflicts of interest between the issuers and ratings agencies and loopholes in their transparency framework.

14. The European Commission's 12 November 2008 proposal for a regulation on credit rating agencies will take the form of a regulation at Community level. An impact assessment accompanied the proposal. The regulation has four objectives. First, to ensure that CRAs avoid conflicts of interest in the rating process, or at least manage them adequately. Second, to improve the quality of the methodologies used by CRAs and the quality of ratings. Third, to increase transparency by setting disclosure obligations for CRAs, and finally to ensure an efficient registration and surveillance framework to avoid regulatory arbitrage.

15. Regulating CRAs would implicitly assume that ratings are a public good. The transparency of CRA ratings and processes needs to be complemented by more disclosure and standardised reporting of underlying assets on the part of originators, placing a different symbol on structured products ratings would represent a stigma which could cause market disruption, and called instead for greater disclosure of

assumptions and risks inherent in structured products. There is a contradiction between reducing reliance on ratings and regulating the CRAs. Yet there is no real alternative to the ratings process.

The Central and Eastern European Economies

16. The shock that the credit crunch has caused some of the newer EU Member States in Central and Eastern Europe (CEE), both economically and politically, has been considerable. CEEs embraced the free market, albeit with varying degrees of enthusiasm, and experienced considerable growth in the run up to joining the EU and in the years since. High rates of growth and booming property prices all seemed initially to be signs of the success.

17. The swift collapse in rates of growth in the third and fourth quarters of 2008 and the weakening of CEE currencies were a severe shock. To many Eastern and Central Europeans, the free market approach they adopted after 1989, based around increased exports, openness to foreign investment and flexible models of employment, seemed to be failing. The fact that the EU advocated this free market model and that some of the older Members of the EU seemed reluctant to support them at this difficult time damaged the credibility of the EU.

18. Growth rates of six or seven per cent, year on year, were common amongst the EU ‘accession’ states in the period 2004-2007. However, economic performance was uneven with several countries becoming particularly dependent on external credit. Only Slovenia and Slovakia have so far qualified for, and since joined, the Eurozone.

19. The global financial crisis has caused particularly severe problems for some of the former Communist bloc countries that joined the EU. The scale of the credit problems became clear when first Hungary and then Latvia had to seek International Monetary Fund (IMF) support in the autumn of 2008. In both cases, consumers had borrowed heavily in other currencies than their own, as Eurozone interest rates, for example, were lower than those at home. This importing of foreign capital led to the build up of large current account deficits, in Hungary’s case of over six per cent of

GDP by the end of 2007 but as high as 23 per cent in Bulgaria (economists often regard a current account deficit of 5 per cent or more as having the potential to cause a balance of payments crisis). The falling value of national currencies and the decline in foreign direct investment left these countries and their citizens severely exposed. Many central and eastern European citizens have mortgages or other loans that are now more expensive as a result of the dramatic fall in value of their national currency against the currency in which their loan is denominated.

20. Although Central and Eastern European economies had been financed successfully for some time by foreign direct investment, by 2008 they had become more dependent on short-term loans. It was the withdrawal of this type of lending in the autumn of 2008 which was the proximate cause of the crisis for Hungary and Latvia. Hungary had to borrow €20 billion to stabilise its financial markets (60 per cent of loans to private companies in the country were denominated in foreign currencies). Romania was the third country to apply to the International Monetary Fund (IMF) for help in March 2009 given its large private sector debt and high public deficit of 5.4 per cent. Further support may be needed by other EU Member States in eastern and central Europe having similarly exposed financial positions.

21. There are many advocates of fiscal stimulus as the way to reinvigorate CEE economies. Even the IMF recommends applying diversified instruments boosting spending rather than tax reductions. There are, however, economists who have doubts relating not to the idea of frontloading itself, but in general to the effectiveness of fiscal stimulation. They point to the pessimism of consumers and entrepreneurs as the source of reduced private spending. The current financial crisis leads to the scaling down of credits being granted by banks. They say that a large fiscal stimulus would considerably increase public indebtedness, imposing a burden on future growth.

22. These doubts are shared by some CEE governments. The skepticism about a need to have expansionary fiscal policy is based on a fear of the growing cost of debt servicing. In CEE, the country risk is perceived as much higher than in the eurozone. Risk aversion and the flight to quality of many investors have already produced considerable depreciation of exchange rates in those Central European economies

with floating exchange regimes. The depreciation alone has already substantially raised the cost of external debt service; therefore those governments do not want to add fuel to the flames by borrowing more. Admittedly, even the most skeptical governments believe that frontloading is the cheapest means to stay afloat.

The EU's Capacity to Intervene

23. The EU does not (as opposed to its Member States) have the capacity to provide direct support to banks, nor is it empowered to manage the kind of economic and financial restructuring programmes traditionally provided by the IMF.

24. The capital movement provisions were designed to ensure that free movement of capital was realised within the Single Market. But they also were intended to enable such movements to be halted in times of emergency. Article 73f of the Maastricht Treaty permits the Council, acting by qualified majority on a proposal from the Commission, to take 'safeguard measures' for up to six months if movements of capital to or from third countries "cause, or threaten to cause, serious difficulties for the operation of economic and monetary union".

25. Economic and Monetary Union provisions contain several elements intended to deal with unforeseen difficulties. They include the right of the EU to provide Community financial assistance to a Member State when that state is "in difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control". Unanimous agreement is required except in the case of natural disasters (Article 103a).

26. The EU has provided support in two ways to Member States adversely affected by the financial crisis. It has partnered the IMF in offering loans to Member States. As part of the October 2008 package of support for Hungary, the EU lent €6.3 billion. This was not taken out of the EU's agreed budget but will be paid for through the issue of EU bonds by the European Investment Bank (EIB) which provides a potential vehicle for supporting CEE states.

Is the Lisbon Agenda Enough?

27. Since 2000, supply-side reforms across the EU have been guided by the Lisbon Agenda – a wide-ranging programme to raise productivity and employment (the two key determinants of long-term growth). The Centre for European Reform (CER)'s latest Lisbon scorecard, which tracks progress on the agenda, concludes that while there are still wide variations in reform efforts across EU countries, there does seem to have been convergence in the direction of reform.

28. One risk is that the intellectual case for supply-side reforms may be more difficult to make following the financial crisis. The Lisbon agenda was, after all, a conscious attempt to inject US dynamism into European economies. Now, critics argue, the freewheeling model of US capitalism has been entirely discredited. The American model of lightly regulated finance caused the deepest global economic crisis since the 1930s. To many US economic performance had been exposed as a mirage. One possible conclusion is that Europeans have nothing to learn from the US and the Lisbon Agenda should be abandoned. It is not hard to see why such logic might be compelling to Europeans who have long feared that market liberalisation would weaken their cherished social welfare systems. But at a time when many people are reading American capitalism's last rites, some argue Europeans might be more judicious. The US was mistaken to have allowed parts of its financial sector to thrive with little or no regulatory oversight. However, it does not follow that there is nothing in the US worth emulating; it is still one of the most productive economies in the world. Europeans do not need more regulated labour markets than many Member States already have.

29. It is not yet clear whether the financial crisis has weakened governments' commitment to supply-side reforms. Most continue to pay lip service to the Lisbon Agenda. Many have even been submitting proposals to the Commission for renewing the agenda after 2010. But it is becoming harder to square some politicians' denunciations of American capitalism with their continued support for a programme of market liberalisation.

30. Even if governments remain fully signed up to the Lisbon Agenda in principle, the financial crisis is generating domestic pressures that many are finding hard to resist. To date, the most visible effects have been on the EU single market. The Commission has the challenging task of ensuring that state rescues of ailing banks and car companies do not distort the single market. Banks are being leant upon by politicians to lend at home rather than abroad. British workers have held strikes to protest against the use of foreign contract workers. Strains on the single market are likely to increase as economic activity contracts.

31. So EU governments risk making two mistakes. They are not doing enough to offset the current contraction in private sector spending. At the same time, some of their interventions on the supply side will do little to lift growth over the longer term – and could even lower it. If EU countries fail to adopt a better mix of macro and micro-economic policies, they will suffer a worse recession than the US, take longer to recover, and will have a lower rate of long-term growth. Five years hence, talk of the crisis of US capitalism may sound distinctly dated.

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