"Policy Implications of the Current Crisis"
Conference in Honor of Pentti Kouri
Bank of Italy / Bank of Finland
Comments by Guillermo Ortiz

Like Bengt, I met Pentti at Stanford in 1976, as I was finishing my graduate work and he was beginning his career as an Assistant Professor. I was writing a dissertation on a subject close to Pentti's interest -capital accumulation in an open economy with imperfect markets- and thus began our friendship. I will not go into further detail of our relationship, except to say that he organized a conference here in Helsinki in 1986 on "Debt, Stabilization and Development"[1], in honour of Carlos Diaz Alejandro. Apart from the fact that it was a very good and well attended Conference with a number of well known economists interested in the subject of open economy macroeconomics, what I remember most is the fact that Pentti introduced me to the world of a whole new technology.

---

[1] See Guillermo A. Calvo, Ronald Findlay, Pentti Kouri and Jorge Braga de Macedo, "Debt, Stabilization and Development: Essays in Memory of Carlos Díaz Alejandro", 1989.

We were talking at a reception prior to the conference's inaugural dinner, and Pentti was carrying a contraption that looked like a small brick, only it was made out of plastic. I asked what that was and he responded that it was a telephone. I had my doubts since I did not see a wire connected to the small brick, so he asked me for the telephone number of my mother in Mexico City. To my disbelief, minutes later I was speaking to her.

Let me now say a few words about Pentti's work. His research is closely related to the problems we are facing today.

In his work, Kouri tried to combine the separate pieces of the international-adjustment literature into one unified framework. The short-run determination of exchange rates in asset markets is linked through interest rates and expectations to the commodity and factor markets, because interest rates and exchange rates influence income, expenditure, employment and prices. The link between the financial and the real economy is quite clear for us nowadays. In the current crisis, the financial shock was transmitted to the real sector almost in real time.

Also, an important part of Pentti's work addressed balance-of-payments problems; in particular the adjustments arising from some countries' surpluses and other countries' current-account imbalances. There are two issues I would like to point out concerning these global imbalances. First, they were one of the main causes of the current crisis; and, second, they are one of the policy challenges we are facing; in order to achieve a global recovery, global demand needs rebalancing.

What are the policy consequences of the current crisis?

One way of addressing this subject is to divide the needed policies between those that require immediate attention (short-term), and those that are needed to provide a lasting framework of sustainable growth. Of course both issues are interrelated.

The first thing to be done is to resolve the current tension in the global economy: the world economy is recovering, but there are strong forces threatening to derail it.

On the one hand, there are hefty and synchronized forces pushing up economic activity from its very depressed levels. On the other hand, this cyclical lift may not be enough to generate sufficient growth to support public finances and heal labor markets, which have been severely hit during the recession.

The world economy is actually doing better than was expected only a few months ago. Most regions in the world are bouncing strongly from the worst recession since World War II. For instance, Asia's economic performance continues to surprise on the upside, and Latin America and the Caribbean are recovering at a robust pace. Furthermore, data coming out of the US have been in general better than expected, despite the weak labor report of last week. Notwithstanding these positive signals, a number of uncertainties remain. In the case of the US, the big question is whether employment generation will be sufficient to self-sustain the economy once fiscal stimulus fades out, and whether the headwinds coming from the housing commercial real estate market and the need to repair damaged balance sheets will be sufficiently- helped by an accommodating monetary policy.

In addition, Europe is facing an uneven recovery and complex policy challenges that I will point out latter, and is coming out of recession at a slower pace than other regions.

Against this background, the financial market turmoil of recent weeks is complicating the sustainability of the recovery. If the turmoil persists, the consequences of the sharp drop in equity prices and the rise in risk aversion are likely to have an impact mostly in developed countries, both on consumer and businesses confidence.

The causes of the recent turmoil have to do mainly with:

- The spillovers from the sovereign fiscal crisis in Europe, which is a prelude for the massive general fiscal sustainability problem in developed economies;
- The regulatory uncertainty introduced by the actions of several national governments, ongoing legislation and largely pernicious rhetoric coming from politicians in different parts of the world.

Also random noise such as fears of China slowing down, tensions in Korea, etc...) have an unusually amplifying impact on markets that are nervous and fragile.

Let me elaborate a bit on these issues.

a. <u>European sovereign debt crisis</u>

The initial causes of financial turmoil were narrowly focused on the issue of funding pressures for Greece. Risk aversion has broadened considerably, despite strong (but belated) action taken by the authorities in the Eurozone to mitigate funding concerns of the most challenged countries: Greece, Spain, Ireland and Portugal.

The funding concerns of the Eurozone have morphed to more basic questions regarding the effectiveness of the Euro Area Policymaking and even the sustainability of the Euro Currency.

- <u>The effectiveness of Euro Area Policymaking</u>

European institutions are (with the exception of the ECB) not designed to take decisions, but to deal with processes. Thus, they are ill-equipped to face a financial crisis.

Only the ECB has the power and ability to take decisions, but the mandate and scope of the Bank is in the sphere of monetary policy and financial stability.

The question regarding the effectiveness of policymaking in the Euro Area has to do with the absence of political mechanisms (and perhaps political leadership), to tackle problems which in the view of market participants are essential to the viability of the Eurozone. At the core of the problem is the absence of a mechanism for the coordination of fiscal policies in a common currency area. It is apparent that arrangements embedded in the Stability and Growth Pact, based on mutual assessment and monitoring, peer pressure and sanctions are not working. Alternative and stronger arrangements for policy coordination must be devised. Several proposals have been put forth, but the common denominator is to bring a closer integration in Europe in this basic aspect. The obvious trade-off is that national sovereignty over this issue has to be partially or totally ceded. This process is in the hands of politicians and not of policymakers- which seems to be a big part of the problem.

- <u>Sustainability of the Euro Currency</u>

The concerns that policymaking is ineffective have morphed into the question of the sustainability of the euro currency. Something that was unthinkable only a few weeks ago is today an open question. This is the most difficult and worrying aspect of the euro crisis.

Key components for the solution of this crisis are:

- 1. The establishment of an effective political mechanism of coordination and decision making, particularly on the fiscal front. Also an ECB which acts (as has done lately) in a more pragmatic fashion. The public dissent inside the ECB has been damaging for the institution and has contributed to market uncertainty.
- 2. Clarity is needed on how the €750 m package will actually work, although some progress was made this week. Indeed, uncertainty about the mechanics of the package, as well as the bond-purchase program on the part of the ECB, is a major reason for markets nervousness today. In fact, debt spreads on the euro-periphery are higher today than when the package was announced.

- 3. Banking System: Interbank markets have frozen in Europe. This is an xxx reminder of the past-Lheman situation. Although spread indicators have not gotten as bad as in the past – Lheman situation, the dollar swap facility whit the Fed had to be reactivated and the ECB is providing unlimited liquidity. There is a growing sensation of fragility in the European banking system, aggravated by the holding of peripheral European sovereignty assets in the balance sheet of banks. The crisis seems to have come to a full circle. Governments and debs to resume banks.- debt crisis.- xxxx about the banking system.

  A second fund of credible xxx as European banks is probably necessary / but the solution has to be thought beforehand.

- 3. Greek restructuring (and more recently Hungary's). It is unhelpful to deal with this issue now. The primary deficit is so large that a very strong fiscal adjustment (with or without restructuring) is needed. It is true that at some point Europe has to deal with a more comprehensive mechanism of debt restructuring, but this should be done at a later stage when market jitters have mitigated and the larger questions have been settled. Trying to tackle the issue of Greek restructuring now is akin to putting the cart before the horse and reminds me of discussions on the SDRM that were hotly debated at the Fund a few years ago and that failed for the same reason.

- 4. Adjustment and Growth. Fiscal adjustment is a clear necessity but just as important is setting the stage for renewed economic growth. Deflation will certainly not cure Europe's fiscal problem. Reforms to alleviate uncertainties and to stimulate growth are of the essence.

The outlook for activity in Europe remains uncertain, and downside risks stemming from fiscal fragilities loom ahead, but this is true not only in Europe. In fact, other advanced economies have larger deficits and debt/GDP ratios than Europe. A key concern is that room for policy maneuver in most advanced economies has either been exhausted or become much more limited.

Fiscal policy provided major support in response to the deep downturn in the advanced economies. At the same time, the slump in activity and, to a much lesser extent, stimulus measures pushed fiscal deficits in advanced economies to about 9% of GDP.

Governments in the developed world are re-leveraging, in part to socialize private losses and to slow private sector deleveraging. Public debt is ultimately a private burden since taxes may have to be raised and/or expenditures cut sharply. This public debt cannot substitute indefinitely for excessive private deleverage. Governments will have to deleverage too, or else public debt will explode precipitating deeper public/private sector crisis.

The projections of the IMF regarding public debt levels in the developed markets –which on average exceed 100% of GDP in a few years-, underscore the core of the problem. Simply put, debt dynamics in the developed countries are unsustainable. This is already being recognized in Europe and the UK, and real measures are being taken. It is not happening yet in the US, where conceptually it is easier to solve the fiscal situation: a value-added tax plus a tax on gasoline/carbon emission would solve the problem. Of course, the issue as everywhere else is political and the prospects for action (at least in the short term) are not encouraging.

The predicament is that governments have overcommitted themselves and made too many promises. From bailing out banks and other non financial institutions to entitlement commitments (basically pension and health) which are totally unsustainable given the expected dynamics of population aging on current trends. Social contracts may have to be rewritten in many countries. This is already happening in some countries that are rising retiring age (e.g.: Mexico raised public sector retiring age from 60 to 65 at the beginning of this administration).

In my view, these fiscal issues are one of the most important challenges for world prosperity over the medium term.

b. <u>Regulatory uncertainty</u>

A second element behind recent market turmoil is related to regulatory uncertainty. Since the financial system was at the core of the global crisis, financial reform has been the focus of political attention throughout the developed world and within the G-20 process.

As a consequence of the crisis, international organizations and national governments got together under the aegis of the G20 to coordinate an ambitious financial reform to strengthen the resilience of the world financial system.

In this context, the FSB and the Basel Committee were able to put forward in a relatively short time period a far reaching reform agenda.

However, the need to attain ample international consensus (to prevent regulatory arbitrage) and the difficulty to grasp many technical aspects that are essential for financial reforms of this type, contributed to increase the level of public frustration regarding what was perceived as a very slow process.

The use of tax payers money and the underestimation by banks of public frustration (leading bankers to continue providing themselves with generous bonuses and trying to go back to business as usual) soon contaminated political agendas.

So, what started as an international effort to coordinate a comprehensive reform agenda has given way to a Financial Reform being discussed at two levels:

- Multilateral settings such as the Basel Committee (BC) and the Financial Stability Board (FSB); and,
- National Jurisdictions.

Perhaps the most damaging aspect of this whole subject- and one that is creating more market noise- is the perception of a lack of coordination and cooperation in these discussions. Some examples:

- On May 20th the US Senate passed a bill on financial regulation.
- Germany banned short sales of various assets, giving rise to protests basically everywhere else.
- A global levy on financial transactions is being suggested by several countries, with special taxes charged to financial institutions to create funds for future bailouts supported by others, and so on.

In theory, the work of multilateral governments and national initiatives was supposed to convey in a unified approach of the G-

20. This, of course, is not happening to date, and will be one of the most important issues at the next G-20 summit.

Regulation Conclusions:

Problem: We have a global financial system with a regulatory framework fragmented in national jurisdictions. Top some, the ultimate solution is a global regulator. This, however, is not a viable option.

Perhaps one of the most viable outcomes, making a substantial xxx of international cooperation would be:

- An agreed set of international standards coming out of the B:X: and the FSF, regarding the most important aspect of regulation: - capital adequacy
  - Liquidity
  - Leverage ratio

At present there is considerable disagreement (k-buffers- on my view unmistakable) not only among the financial industry of the B.C. proposals, but also within the BC itself. Some DC countries that have weaker banking systems (and not great perspectives for raising capital) are on the side of long implementation periods and generous grant to their clauses.

Lewys on the Financial Sector, limitations on the scope of activities (Voker xxx) are unlikely to be agreed internationally. So it would be left to national jurisdictions to design an implement legislation, including resolution regions. Crisis-border issues are so complicated that is will take a long time to make progress.

- Regulatory Arbitrage (challenge)

Permanent or structural challenges

The second category of issues and challenges for sustainable growth, some of which are intimately related to the first, has been around for some time, and I would include among them:

- The question of global imbalances; and,
- International cooperation.

a. Global imbalances

A word on global imbalances. The bad news is that they are in the process of winding again. Now stimulus from the OECD suggest that the combination of a falling euro and slusion growth in the eurozone will produce surplus of 300 bn plus in the next few years. Chinas surpluses are also in a trajectory to return to pre crisis levels.

The question is whether we will reproduce the same sunami that contributed to this crisis. Of course, the solutions are well known and have been discussed for a long time. I suspect that Olivier Blanchard will say something about this issue.

Economies that ran excessive current account surpluses will need to further increase domestic demand to sustain growth. As the currencies of economies with excessive deficits depreciate, then logically those of surplus economies must appreciate. Rebalancing needs to be supported with financial sector reform and structural policies in both surplus and deficit economies.

In economies with large external deficits before the crisis, most notably the United States, private demand is likely to remain below the pre crisis trend and a strong recovery will require an increase in net exports.

Indeed, in the United States, household debt remains at historic highs, while financial and housing wealth have suffered steep losses alongside rising unemployment. In this context, consumption growth will have to decrease and the recent upturn in US household saving rates sustained or even extended.

For surplus economies facing weaker demand from deficit economies, the challenge is to rebalance growth from external to domestic sources and to run smaller surpluses in the future. In this respect, emerging Asia, notably China, should step up structural efforts to foster domestic demand and lower precautionary savings. Germany should also aim at reducing its surplus to facilitate the adjustment within Europe. Exchange rate appreciation in key surplus countries is also required. Indeed, this would encourage a shift in productive resources from tradeable to non-tradeable sectors in these economies, thus fostering lower reliance on external demand and supporting global growth. Together, these two adjustments could promote a strong and balanced global recovery.

b. International cooperation

The attainment of global, efficient and reasonable reforms is crucial. Otherwise, there is a real risk of us becoming witnesses to the next global crisis. International financial reforms are particularly difficult to design and even more difficult to implement. On the one hand, their success depends crucially on the perception of legitimacy on the part of many countries. This implies the need to attain ample and solid consensus. On the other hand, implementation often involves the participation of national legislatures. These democratic bodies pay close attention to the public's mood and so have their own agendas and time schedules for implementation.

As mentioned before, some recent initiatives put forward by national governments are casting doubts on global coordination. These initiatives make it apparent that national priorities differ across countries and that political agendas are starting to dominate.

After the global crisis of 2008–2009, the G20 coalesced. In October of 2008 after the Lehman Brothers episode, Governments acted in a coordinated fashion to restore market confidence and economic activity with financial sector backstops and reflationary policies. But in 2010 national imperatives took precedence, relegating international coordination.

Beyond the challenges still faced in the financial sector, concern has grown substantially on how best to unwind the extraordinary levels of public intervention set in motion to deal with the crisis. There is consensus on the need to keep fiscal stimulus in place until global economic recovery is assured. But since expansionary fiscal policies have had a detrimental effect on public-sector balance sheets, confidence in fiscal solvency will erode if the deficits are not reversed in an orderly and timely way.

If previous financial crisis have provided any lessons at all, one of them is that restoring market confidence is of the essence. This means that swift and forceful action has to be taken to achieve an adequate combination of adjustment and financing. This is not happening.

- A few words on E Markets:

  No EM that had a financial crisis in 90's and 2000's suffered a domestic financial crisis as a consequence of the global crisis.

- National banking system did not engage in the trade of purchase of exotic products.

- Banks in EM are well capitalized, etc...

- A model that works best is subsidiaries. In the absence of a global regulator or a global tax payer, it is up to the host country to make sure that banks – both domestic and foreign owned, are well capitalized, etc.

  Example: Banamex – Citibank.

- Many of the rules and legislation being discussed, are not taking adequately into account the situation of EM. Example: Volker rule.- limits are prexxx trading. In may EM banks the most important cut.

  Limitations on home coaching banks.- xxx in liquidity, etc.. of EM.

It is evident from the previous comments that removing the macroeconomic stimulus in advanced economies without triggering adverse spillover effects as well as rebalancing global demand will require a high degree of international cooperation. The framework for international policy cooperation should be strengthened, not only as a vehicle to address the current period of financial stress forcefully, but also to improve the framework for its use in "normal times".

2. Conclusions

The global economy is facing acute tensions which must be addressed promptly, since otherwise the current recovery may be derailed. To this end, bold actions to solve the problems observed in a number of European countries are required, as well as an authentic international effort to set in motion a process aimed at dealing with the period of regulatory uncertainty that we are currently facing.

In addition, the world economy requires rebalancing through a far reaching structural reform within the framework of international cooperation.

The deficit countries must rebalance towards saving and investment; the surplus countries must move to stimulate domestic demand.

The quid-pro-quo for fiscal adjustment and financial sector reform in the deficit countries must be deregulation of product and service markets, labor market flexibilization and corporate reform in the surplus countries.

Without a comprehensive solution we will condemn ourselves to slower growth, macro volatility and a heavier burden for future generations. We may still be able to avoid a financial collapse, but we will still perform well below potential globally and face the risk of further serious crises.