Aftershocks

Aftershocks

Economic Crisis and Institutional Choice

Anton Hemerijck
Ben Knapen
Ellen van Doorne
(eds.)

Amsterdam University Press

Cover design: Maedium, Utrecht
Layout: Het Steen Typografie, Maarssen

ISBN 978 90 8964 192 2
e-ISBN 978 90 4851 185 3
NUR 754 / 781

Table of Contents

Establishing a New Macro-economic Policy Regime

Willem Buiter
PROFESSOR OF EUROPEAN POLITICAL ECONOMY,
LONDON SCHOOL OF ECONOMICS

"My first concerns about a potential crisis began in 2005, when the British government issued its first 50-year Index-linked Treasury Gilt, and the interest rates on it were 0.36%. This is extraordinary low – the long-term historical average is just below three percent. This gave me my first sense of foreboding that something was amiss. Not only were these long-term risk-free interest rates astonishingly low, but also the credit risk spread across the board were at rock-bottom levels. The only way to explain this was that the inventors of these new financial instruments had found new and improved ways of trading risks by engaging a huge new population of risk-holders. These people tried to convince us that the risk had not just been traded, but had effectively been traded away. I didn't buy it. I knew too many people in the industry to believe that this story was credible. So there clearly was something wrong with global asset markets: risk-free rates were too low, and risk itself was severely under-priced.

"My second indication that a crisis was looming was when Blackstone went public. At this point I realised that something serious was going to happen, and soon. This was an insane institutional transformation. Blackstone's entire pur-pose had been to take public companies and make them private, and then it turned around and enlisted the advantages of public companies to its own ben-efit."

PRELUDE TO THE CRISIS

Every crisis is in many ways the same: there is excessive growth and an asset market boom. A sense of euphoria emerges, and everybody becomes convinced that this time they have truly invented the elusive *perpetuum mobile*. The fact that society suffers from such periodic bouts of insanity must be taken as a given. They have happened before and will surely happen again. The important question is whether the given regulatory arrangements and macro-economic policy arrangements lean against or feed the inevitable credit and asset bubbles that accompany these bouts of insanity. In this case, policy arrangements undoubtedly fed the euphoria.

Prior to the crisis, most macro-economists operated in an academic language that had become completely disconnected from the world they were supposed to be modelling. This made it impossible for them to foresee the crisis before it hit. The discipline was based on a common paradigm, which was, at its core, a mix of neo-classical and neo-Keynesian economics. Unfortunately, while this model functioned well in good times, it was useless in times of crisis. Its logical structure did not recognise even the possibility of defaults, insolvencies, or illiquidity problems, instead relying faithfully on complete market structures. Therefore, the problem was not merely that their models could not answer questions on these subjects – they did not even allow the user to ask the right questions.

There were many imbalances in the pre-crisis economic system that could have triggered the crisis: the unsustainable growth of credit, the risky increases in leverage, unbridled financial innovation, and regulatory arbitrage both within and between countries. Any of these could have created conditions ripe for a 'Minsky moment' – the point in the business cycle when investors realise that they hold too much debt and sell off their assets, leading to declines in markets and a severe demand for cash.

Every crisis is in many ways the same: there is excessive growth and an asset market boom.

In actuality, it was the little-understood subprime mortgage market (primarily in the US, although parallel systems existed globally) that triggered the collapse. Sadly, this was, in large part, a social experiment that went disastrously wrong. American Republicans used government-sponsored programs to solidify their political base by turning tenants into homeowners. Eventually, this created a disastrous bubble that, upon bursting, exposed other underlying economic imbalances.

These imbalances had been simmering just below the surface of the past decade's apparent macro-economic stability: high and smooth GDP growth, low and stable inflation, and low and falling interest rates had blinded people to these underlying flaws. First among them was the often cited US-Chinese trade imbalance, reflecting too much US consumption and too much Chinese saving. However, even more important was a far less frequently referenced imbalance: a portfolio imbalance between the global demand for and supply of low-risk financial assets. Countries exporting oil and other commodities – specifically the Gulf Cooperation Council countries – had become a *nouveau riche* in the global community, yet like China and many other New Industrial Countries that had been hit hard by the 1997/98 crisis, they maintained an unfortunate preference for investing mainly in low-risk assets. When their conservative portfolio preferences were not matched by an expansion in the supply of such assets, the low-risk interest rates dropped to ludicrous levels.

In addition to these imbalances, Alan Greenspan (former head of the Federal Reserve) instituted monetary policies that exacerbated the already dangerous pace at which liquidity was being injected into the US economy. The problem was not that he cut rates drastically in 2003, but that he left them far too low for an extended period of time, inciting excessive investment and liquidity flows into the economy. Similar patterns occurred both in the eurozone as well as in Japan.

As a result of these multiple layers of underlying instability, the fallout from the crisis was severe with only slow rates of recovery. Luckily, policymakers learned the lessons of the 1930s and avoided pro-cyclical behaviour, high interest rates, allowing the money supply to collapse, or trade wars. Unfortunately, they also made new mistakes. Specifically, they failed to reform the current problems of moral hazard and insufficient or inadequate regulation. Both the Obama administration and Gordon Brown's government engaged in insufficient re-regulation programs; rather than truly correcting the existing regulatory deficiencies, they simply tried to turn back the clock to recreate the economies that they thought they had in 2005. They refused to tackle the Too Big To Fail problem, and they were insufficiently aggressive in tackling excessive leverage. The US, specifically, was worryingly unwilling to tackle schisms and balkanisation in the regulatory structures. By neglecting this issue, they set the stage for an infinitely worse financial sector boom and bust in the decades to come. Incentive structures remain corrupted, encouraging excessive risk-taking by institutions that are too big or too politically connected to fail.

The already excessive but still rising public debt burden must be reduced, and solutions such as allowing central banks to set negative interest rates should be explored in order to help economies emerge less damaged from the crisis. Yet the most necessary change in the post-crisis period will be the development of new macro-economic models that allow researchers to ask the right questions and explore issues that are central to modern economies. Backward looking analyses may be a good place to start in such a quest, but if they ignore modern developments, these analyses will necessarily be lacking. Keynes and Minsky were certainly important thinkers, but they only offer preludes to what is currently required. Although they asked many of the right questions, they failed to create fully articulated theories.

On the whole, given the magnitude of the financial collapse, it is actually surprising that the economic fallout has not been greater. Despite their oversights and shortcomings, the monetary and fiscal authorities did a remarkable job of mitigating the damage and preventing the crisis from spinning completely out of control. Aggressive intervention by central banks provided external credit to households and corporations when banks were hoarding capital and liquidity. If this is as bad as it gets, the global community got off lightly.

GLOBAL REBALANCING

All of the above-mentioned problems predominantly impacted the North Atlantic region. As a result, these countries are especially likely to undergo slow and painful recovery from the crisis. However, by now it has become plainly apparent that this crisis has spread beyond the developed world and has had especially severe effects on emerging economies. However, the character of these effects has been mixed, with some emerging economies actually having the potential to emerge from the crisis stronger than they went in. Specifically, those emerging economies that (1) did not suffer much damage to their financial sectors, (2) were not too dependent on exports to the West, and (3) were not too dependent on external finance will do better overall. Based on this analysis, India, which satisfies all three of these conditions, may fare quite well in the post-crisis period. Brazil and China, both of which meet two of the three conditions in this analysis, may similarly avoid significant damage if they are able to redirect domestic policy to make up for vulnerabilities in the remaining component.

> *Given the magnitude of the financial collapse, it is actually surprising that the economic fallout has not been greater.*

In addition to the crisis clearing more space for emerging economies to grow, it may also weaken existing powers. Many are speculating that the international system of reserve currencies is likely to shift. Specifically, it is highly likely that the world will move away from the dollar's current dominance, and towards a new multi-polar reserve system. The country issuing an international reserve currency must meet two criteria: it must be a hegemon politically, economically, and financially; and it must act responsibly in its monetary, fiscal, and financial policies. The US no longer satisfies either of these prerequisites, making the long-term prospects bleak for the dollar's standing as the favoured international reserve currency. However, such changes will occur only slowly; in the short-term, China, the Middle Eastern countries, and other newly wealthy nations will still invest overwhelmingly in dollars. Gradually, this preference is likely to be eroded, leaving space for new reserve currencies to emerge.

In the medium term, the euro is likely to be the primary beneficiary of this shift. This currency is an anomaly, seeing as the European Central Bank has no fiscal back-up. This is a negative factor from the perspective that in other countries the treasury guarantees the solvency of the central bank. However, the negative side of fiscal back-up is that if a treasury ever asks the central bank to monetise their deficits, they would be effectively obliged to do so. In this regard, the fact that the euro is a shared currency between many countries is actually an advantage because it is protected from national fiscal irresponsibility. Additionally, although less admirably, the ECB bankers have been extremely conservative throughout the crisis, and have maintained excessively high interest rates. Although this is unfortunate for real investment in the euro area, it is good news for outside investors in euros, increasing the likelihood that the euro will be adopted as a replacement international reserve currency in the medium-term. However, in the long-term, this niche is likely to be shared with emerging markets' currencies. The Chinese yuan and Indian rupee, for example, are likely to emerge as viable competitors to the dollar and the euro.

AVAILABLE POLITICAL TOOLS

The post-crisis response has been described as the coordinated efforts of a 'Keynesian fire brigade'. In fact, this is far from the truth. Keynes was not an advocate of monetary policy, favouring fiscal policy instead. Yet the greatest policy victories against the current crisis have overwhelmingly been won with monetary instruments.

It was the monetary authorities who cut interest rates almost to the floor, and when this was still insufficient, it was again the monetary authorities who began engaging in unconventional monetary policies such as quantitative easing, credit easing, and extending unlimited credit. One should not underestimate the degree to which such practices have heroically broken the mould of central bank dogma. Creativity in central banks is akin to swearing in church.

Fiscal policy, Keynes's weapon of choice, has been weak and insignificant in comparison. Some countries have managed to achieve a limited discretionary fiscal stimulus – the US and, to a lesser extent, France, Japan, and Germany. However, most of the fiscal stimulus that has occurred since the crisis has been purely the result of automatic stabilising mechanisms. Allowing these to function was certainly a preferable fiscal stance to blocking them and initiating procyclical policies, but it did not constitute a true fiscal reaction. This was largely the result of the fact that most countries – especially in the West – entered into the crisis with dismal underlying fiscal capacities.

However, the weak fiscal policy response may not be as much of a tragedy as it appears to be on the surface, as there is little evidence that discretionary fiscal policy actually works. In 2008, Spilimbergo and others published a report for the IMF, outlining their fiscal policy recommendations for the crisis period. Ironically, the appendices – which were supposed to contain the empirical support for increasing fiscal policy expenditures – were all at best inconclusive, and often showed a negative effect from fiscal stimuli.

This is not to say that fiscal policy should be avoided altogether. Clearly, pro-cyclical policies remain detrimental. However, further increasing government debt could prompt a panic about the all too real threat of sovereign debt default. Automatic stabilising measures alone created 10% of GDP deficit in the UK, with discretionary fiscal policies accounting for another 2%. The US maintains a similarly disheartening annual deficit. At the same time, government revenues have dried up. The British government had been heavily reliant on the housing sector for its revenues. Both the British and the US governments counted on the financial sector for income – in the US, this sector alone accounted for 40% of the country's total corporate profits in 2006. With the crisis severely impacting these two industries, governments currently face a structural deterioration of their revenues. As the tax buoyancy of GDP declines, governments have increasingly less fiscal elbow-room before they are confronted with concerns about fiscal sustainability. Suddenly, the once ludicrous idea of sovereign debt default appears worryingly plausible – even in some of the world's largest economies.

There is little evidence that discretionary fiscal policy actually works.

There are two additional reasons that this particular crisis was unfit for a predominantly fiscal response. First, to be effective, counter-cyclical policies in the downturn require that the markets believe counter-cyclical policy would be implemented in the next upturn as well. If not, they will spook the financial markets. This condition is unlikely to be satisfied, because counter-cyclical policy during the upswing would run exactly counter to the policies of the past eight years, especially in the US and the UK, where pro-cyclical policies during boom times had actually become the norm. Second, fiscal policy becomes emasculated by excessive private and public sector debt. Textbook macro-economics maintains that once monetary policies such as interest rate reduction and quantitative easing begin to create a liquidity trap, the time is ripe for Keynesian fiscal policies to save the day. However, when debt is as high as it is currently, even fiscal policy is unable to salvage these losses.

In such a context, tackling unemployment is difficult, if not impossible. Monetary policy is useless in such an endeavour, and fiscal policy is unhelpful in the current crisis for the reasons mentioned above. Wage moderation is also unconstructive if every country tries to achieve it simultaneously. It is largely a beggar-thy-neighbour policy of last resort, and only works if the country implementing it is facing a domestically isolated downturn while their neighbours are overheating. Finally, policies of work sharing must be avoided, as they only institutionalise inefficient and distortionary employment patterns that tend to linger long after their necessity has passed. In fact, short of creating a condition where negative interest rates can be implemented, there is little that can be done to combat unemployment. Like old age, it has become, quite simply, a fact of life. Despite the difficulty that the Western mind has in accepting such a reality, it is crucial that policymakers do not get ahead of themselves, making irresponsible interventions in the labour market. If anything, now is the time to increase labour market flexibility, not rigidity. If this cannot be achieved – for example because of unions or other vested interests – it may be better to do nothing, as poor institutional reform is infinitely worse than none at all.

Nevertheless, at the core of the problem of unemployment is a far more tangible problem: debt. Unemployment has been amplified because the crisis caused a demand problem, and this demand problem, in turn, was caused by excess debt and lack of credit. The neo-liberal period triumphantly claimed to have reduced the public debt, but in fact this was little more than a smoke screen for shifting contingent public debt on to the private sector. The average debt to GDP ratio in the eurozone is currently 70%. Leverage increased dramatically in the past decade, especially in households and in the financial sector. Naïve neo-liberal market optimism led policymakers to take their eyes off the ball; they assumed that as long as debt was private, it was innocent. Sadly, as the current crisis has made clear, unsustainable private deficits are just as much of a problem as unsustainable public deficits. This is particularly true in cases where there is an implicit option for policy authorities to socialise and take over or guarantee private sector debt, as has been done in Europe in Sweden, Latvia, Ireland, the UK, Germany and many other countries. In a way, all private debt of entities deemed systemically important is, at its core, contingent public debt.

Private debt also makes countries vulnerable to international capital markets and speculative attacks. New EU countries that have not yet joined the euro have suffered tremendously under pressures from international speculators. In order to attack financial institutions of, say, Romania or Lithuania, international speculators were able to buy Romanian lei or Lithuanian litas on liquid markets and sell them for other currencies, most notably, for euros. This has made joining the eurozone an urgent imperative for many of these countries, in order to protect their financial standing. However, it should be noted that acquiring the euro does not entail acquiring the fiscal credibility of the entire EU, let alone of its best members. As an illustration: recently the basis point credit spread between German and Irish or Greek bonds reached 300 points. Clearly, the markets do not believe that there is a de facto pooling of sovereign default risk in the eurozone. This proves, once and for all, that although joining the common currency brings financial benefits, it does not mean that countries become responsible for each other's debts.

The neo-liberal period triumphantly claimed to have reduced the public debt, but in fact this was little more than a smoke screen for shifting contingent public debt onto the private sector.

Unlike the problem of unemployment, if the international community could agree that debt (public and private) was the core issue delaying a recovery from the current crisis, there are a variety of ways in which they could tackle it. Many people argue that debt could best be reduced with inflationary policies. They suggest aggressive monetary policy and extensive quantitative easing that would essentially wipe out the real value of the current debt. However, a less-bad policy would be to agree to an international Jubilee: an agreement to force forgiveness of all debt. While this is certainly not a policy that could be repeated, it may be an appropriate measure for such extraordinary times. It essentially means cheating people out of their loans, but it would at least cheat people upfront and honestly rather than the more legal – but less moral – method of cheating them through unanticipated inflation.

HOW MUCH EUROPE?

In Europe, there is an ongoing battle between those who favour giving more power to the EU, and those who favour ridding them of the powers they already hold. Regardless of one's position on this spectrum, it seems pathetic that Europe has resigned itself to an uncompetitive international position for its banking and financial sectors because it cannot agree on a fiscal burden-sharing rule. All banks must be backed by a central bank, a regulated supervisor, and a treasury. Because these three institutions do not all exist at the EU level, banking must necessarily be done nationally. In order to use its unification to its competitive advantage, Europe must set up cross-border institutions of supervision and fiscal burden sharing, including a minimal European-level fiscal authority that could solidify these commitments.

When Europe established a customs union, it realised that it could not set separate tariff policies for each of its member states. To solve this problem, it made trade a supranationally determined policy component of the EU. Similarly, if Europe wants to truly establish a single market – for financial products and services as well as for the free mobility of capital and people – it will need to put regulation into the supranational domain of the EU. Sadly, there is insufficient leadership at the EU level to implement such drastic reforms.

Therefore, if EU level regulation proves impossible, legal space should be provided for countries to create sub-EU level international regulatory institutions. These sub-groups of countries would be able to broaden the reach of their financial services beyond their own borders, even if they were unable to expand their presence throughout the entire EU. Such agreements would avoid future repetition of shameful catastrophes like the Fortis debacle. For a week, the Benelux governments tried to reach an agreement on how to share the burden of capital to be injected into this international bank while maintaining its cross-border character. Eventually, Fortis was split into three parts – Dutch, Belgian and Luxembourgian – essentially recreating a Dutch territorial ‘rump’ of ABN and insulating it from foreign competition. Yet insulation of national banks has already caused decreased competitiveness in the Netherlands, where ABN AMRO, ING, and Rabobank essentially control the Dutch financial market as an oligarchy.

The crisis has highlighted the need to create a new role for the ECB in Europe.

In addition, the crisis has highlighted the need to create a new role for the ECB in Europe. In response to the current crisis, the ECB will be formally mandated to perform a variety of new functions, including liquidity and credit-enhancing measures, becoming a lender of last resort, and maintaining general financial stability. Whereas its previous functions (primarily limited to interest rate adjustments) allowed it to remain politically independent, such an expanded role requires political accountability. Realising such a change in the US or the UK is relatively uncomplicated; governments simply have to pass a law. But in the EU, the ECB is based on treaties that are extraordinarily difficult to amend with 27 member countries. While aspects of the ECB’s behaviour and governance can be changed without opening the treaties in their entirety, changing its mandate is not as simple.

However, this may have to be done, as the only alternative proposal on the table is downright unacceptable. EU leaders have proposed creating a European Systemic Risk Council that will be authorised to make binding decisions on the regulation of banking and financial institutions. While on the surface this appears to be exactly what is needed, the proposal puts the politically unaccountable ECB at the head of the organisation. It allows the ECB to continue working within the same politically insulated policy-space it had been operating in previously. However, the decisions that it is entitled to make in this new capacity are unquestionably political.

THE BOTTOM LINE

In the upcoming crisis recovery period, five reforms are to be recommended. First, the public debt burden must urgently be reduced. Otherwise, by the time the next major downturn occurs, countries will be completely incapacitated by public debt overhang and unable to respond with aggressive stabilisation policies. Second, policymakers should introduce innovative new institutions. Specifically, they should allow central banks to implement negative interest rates.

Third, Europe must create an EU level regulatory structure to manage cross-border banks and other systemically important financial institutions, such as insurance companies. Once these are established, they should be expanded to include agreements with other countries and regions on new globalised standards. This will prevent European financial institutions from being undercut by global regulatory arbitrage again.

Fourth, as the crisis changes the relative wealth and power of nations, these changes should be reflected in international institutions. The US's veto in the IMF must be abolished, and EU's combined weight should similarly be dramatically reduced.

Fifth, the "Too Big To Fail" problem must be addressed. Banks should not be allowed to grow so large that they no longer can be left susceptible to the vulnerabilities of their own risk-taking. Their size could be constrained, for example, by creating vertical splits in banks (re-inventing Glass-Steagall-type distinctions between commercial banks and investment banks, or other splits between 'narrow banking' and other, riskier banking activities) as well as by establishing capital requirements that are not merely counter-cyclical, but also higher for larger banks. In addition, rating agencies should be banned from engaging in activities that constitute conflicts of interests. No company should be both broker and dealer; no proprietary investor should also be entitled to act on behalf of clients. Aggressive anti-monopoly policies would also significantly check the size of companies. Finally, high-risk financial institutions should be prevented from having limited liability constructions – instead they should be required to operate as partnerships, as investment banks used to be.

Many factors aligned to contribute to the current economic downturn, and many policies and institutions will have to be revised in order for the international economic community to pick itself up again. In the search for new policies and institutions, policymakers must be realistic, recognising inadequate instruments for what they are (fiscal policy comes to mind) and attacking the roots of problems, rather than their symptoms (unemployment is an unavoidable side-effect of its policy-susceptible root cause: namely excessive debt, both public and private). In this endeavour, the EU faces the added policy challenges of insufficient coordination between the national and supranational policymaking levels.