



ECFIN Economic Brief

Beyond the crisis: a changing economic landscape Keynote speeches at the Brussels Economic Forum 2009

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The shock waves from the U.S. subprime crisis have intensified throughout the last two years and have by now reached almost all economies. Our forecasts clearly indicated that in Europe the recession would be the deepest since the foundation of the EU. Hence the decision to put crisis-related issues on the programme of this year's Brussels Economic Forum. While it might be fascinating to analyse how the crisis emerged and how the shock waves moved across the globe, our main interest is forward-looking: how will the crisis change the economic landscape? What strategies are needed to steer us out of the crisis and to pave the way for a recovery?

A group of distinguished speakers addressed these questions at the BEF. **Joaquín Almunia** reviewed the crisis response and exit strategies. **Mario Monti** discussed how the crisis affects market integration and how it could help to bring economies with different market models together. **Jacques de Larosière** looked at structural imbalances and wrong incentives stemming from the regulatory framework and the development of proposals for averting future crises. **José Viñals** investigated which changes in the regulatory framework would be the most important. **Sir Anthony Atkinson** pointed to shortcomings in economics, the

distributional impact of the crisis and the need for the stress testing of social policy institutions. These presentations identified the challenges ahead and offered a set of fascinating new ideas and ambitious plans.

Joaquín Almunia's presentation, titled *Beyond the crisis: what strategies for a sustainable economy?* drew a line between the immediate crisis response and the need to pave the way for Europe's future. The recession made crisis response the first priority and recent developments are already indicating some progress. But developing exit strategies for unwinding recovery plans and withdrawing financial sector support could help to underpin confidence in the future.

- Balancing fiscal sustainability and sustainable long-term growth will require the eventual withdrawal of budgetary support – with the optimal timing and pace depending on country-specific factors – and a plan for budgetary consolidation, not least to address the challenges of ageing.
- Withdrawing support from crisis-hit sectors will also be necessary to avoid distortions and to remove impediments to adjustment. Structural reforms can then help create dynamism. The strategy should include strengthening R&D and innovation, prioritising education and increasing employability, and tackling climate change.

Exit strategies would thereby include core recommendations of the EU's Lisbon Strategy, the implementation of which has now become more imperative than ever as a result of the crisis. He found that enhanced policy cooperation and more effective surveillance were crucial for the success of exit strategies. The former should encompass a commitment to a fair and open multilateral trading system, the anchoring of stability in the global system by setting up a new framework for macro-financial surveillance, and governance that brings all relevant players together. Proposals for better surveillance could build on a review of existing instruments and the role of the Commission and the Eurogroup, and aim to create a new body that would act as an early warning system for the build up of macro-financial risk.

Mario Monti focussed on the future of market integration and the prospects of Europe's market models. He thought that the crisis had raised questions about the 'Anglo-Saxon' model and its reliance on market mechanisms, when the social market economy model often seems to have performed better. Dealing with growing inequalities, including within countries, might be the key challenge for market economies. As the crisis had changed views about models, there is an unexpected political opportunity to find new answers that would allow the EU to meet its increasing social challenges, while safeguarding integration. Social market economies find it hard to meet social objectives in the absence of any form of tax harmonisation, which the 'Anglo-Saxon' model economies and new Member States had opposed, weakening their commitment to existing single market rules, e.g. on state aid and competition. To avoid the risk of resentment against Europe, especially against the single market, he suggested a strategic pact combining a renewed commitment to the single market and to some form of limited tax coordination. While social market economies could gain more margins for pursuing social objectives without having to tear apart market rules, 'Anglo-Saxon' model economies and new Member States would reduce the risk of a collapse of the single market; the pact could perhaps bring new vigour to the European project.

Jacques de Larosière spoke about the need for regulatory reform. He identified two key factors that contributed to the crisis: structural imbalances and wrong incentives. These incentives, set by the regulatory framework, resulted in too much reliance on faulty risk-assessment models and myopia in behaviour, which were particularly dangerous because of the existence of loopholes in regulation. But he also saw a lack of proper multilateral macroeconomic, particularly regarding structural current account deficits in the U.S. and reserve accumulation in emerging economies. A lax monetary policy and financial innovation resulted in a massive credit bubble that burst when the sub-prime crisis erupted. Blaming only regulatory failures would be a mistake and would lead to wrong policies in the future. To avert future crisis, regulatory reform should aim to: (1) reduce the systemic pro-cyclicality in financial and accounting regulations; (2) close loopholes in regulations, such as the treatment of hedge funds; (3) improve the supervision of financial institutions with cross-border activities; and (4) give more power to supervisors and bring the IMF on board. He reiterated the De Larosière Report's proposal to create a European Systemic Risk Council under the aegis of the ECB that would analyse systemic risks and propose recommendations.

In his speech on *Financial stability and the design of a new rule book*, **José Viñals** asked whether it will be sufficient to just modify the rulebook for financial sector regulation and supervision by changing pages and adding new chapters, or if more was needed. The first signs of recovery might still be vulnerable as the global financial system remains under stress, with uncertainty about the health of banks persisting, with capital outflows from emerging markets possibly continuing, and with doubts about medium-term sustainability of public finances remaining. He welcomed crisis responses such as continued support to bank intermediation through the provision of liquidity and funding guarantees, but warned about country-specific measures that could endanger cross-border competition and bring about financial protectionism. Improvements in the regulatory framework should focus on (1) expanding the regulatory perimeter,

(2) addressing excess pro-cyclicality, (3) closing information gaps, and (4) improving cross-border cooperation. All these changes in the rule book should be accompanied by a strengthening of supervisory enforcement. He also emphasised the need for consistency between short-term crisis measures and medium term changes in the regulatory and supervisory framework. The IMF would support the design of the new rule book as well as its implementation, which he emphasised as deserving equal attention. Finally, he warned that appetite for reform might wane as the world economy emerges from the crisis, calling for these issues stay on the policy agenda.

Sir Anthony Atkinson's speech on *Three questions about the global economic crisis and three conclusions for EU and Member State policy-makers* dealt with the role of economists and the impact of the crisis on income distribution and on the appropriateness of redistributive policies.

The crisis has challenged the economics profession and showed that economists have become too much specialised in narrow areas, such as DSGE modelling. This limited their ability to address new challenges and left economic and social policy dimensions too often separated institutionally.

While there is little doubt about the loss in world GDP, he found less awareness about how this loss is distributed. Evidence from the Great Depression and more recent recessions is mixed, pointing to the need for careful monitoring of the distributional impact of the crisis. The latter would also help to improve forecasting and the assessment of the impact of fiscal stimulus measures.

He suggested stress testing social protection institutions to examine the impact of recession on employment, income, and the living standards of people. Identifying the most vulnerable regions and people could help in the designing of better policies.

I hope you will find these keynote speeches as interesting and inspiring as the participants of the Brussels Economic Forum 2009 did. While arguments may have differed, all these speakers argued for rapid action to seize the opportunities the current crisis created. However, this will only ever be possible if we join forces in Europe and work together.



Beyond the crisis: a changing economic landscape



Joaquín Almunia

European Commissioner
for Economic and Monetary Affairs

Ladies and Gentlemen,

It gives me great pleasure to welcome you to the tenth edition of the Brussels Economic Forum.

Since the BEF was first set up in 2000, it has been a key platform for debating and shaping policy on the pressing challenges facing the EU economy.

This year will be no different.

Since I last stood here one year ago, the context for the European and global economy has been utterly transformed and is still changing day by day.

Our economies and financial systems have come under unprecedented pressure from the most severe financial crisis in the post war era. The global economy has experienced its first contraction in 50 years. We have witnessed the steepest fall in world trade on record. And this year Europe is set to live through the deepest recession since the foundation of the Union.

At this juncture, immediate crisis response is our first priority.

And yet, in our efforts to manage current challenges, we must take a longer term perspective.

Deep crises leave a lasting trace on economic activity. They bring powerful lessons for economic governance. It is likely that we will emerge from this crisis in a new economic and financial context with new challenges to tackle, even as we grapple with the old.

The upshot is that even when growth is restored, we cannot expect a return to business as usual.

Already now, when we look beyond the immediate crisis, there are a number of key questions that we need to ask ourselves.

- How do we plan for the unwinding of the economic recovery plans and withdrawal of the massive support to the banking sector when growth and stability return?

- How can we ensure that we have learned the lessons of this crisis, and taken appropriate action to ensure history will not be repeated?
- How do we position Europe in a post-crisis world, so that we are equipped to manage the challenges of globalisation, ageing and climate change?
- And as Member States turn increasingly to Europe for answers, how can we deliver the best results for the European economy at a time of global economic and societal transformation?

This year at the BEF we want to explore these pressing questions, propose potential solutions and debate a possible policy framework that will allow us to exit this crisis on a path of stability and sustainable growth.

Perhaps this is a lot for two days of discussions? I don't think so. Like many of you, I am convinced that we need to tackle these issues right away.

We cannot wait until the end of the crisis.

Medium term economic performance depends a great deal on action taken during a crisis. If we can develop post-crisis strategies now, we will help underpin confidence in our economic future. And we can sow the seeds for future growth and prosperity.

But before I address these issues, let me take stock of where we are today in terms of our crisis response.

Crisis response: progress and priorities

The crisis has tested the resilience and rapid reaction of governments worldwide and many of them have responded with speed and intensity. The EU is no exception.

Those who say that the EU, or the Commission, didn't react to the crisis are not taking into account what we did, and what we are doing. Let me remind them of some of our decisions and initiatives.

By creating coordinated deposit insurance schemes we have avoided large scale bank runs. Other important financial regulations have been adopted or are currently being discussed.

Thanks to efforts to re-capitalise banks and guarantee credits, no Lehman Brothers has happened in Europe. Following a proposal from the Commission, several countries are now tackling the impaired assets on bank balance sheets. We encourage member states to go further down this road, and to complement these efforts with stress test exercises.

Monetary policy has been eased aggressively and the ECB has embarked on unconventional policies to ensure liquidity is available for businesses and financial markets.

Moreover, the EU has launched a massive, coordinated fiscal stimulus, in a bid to sustain demand and provide the hardest hit with temporary support or job protection. National measures amount to 1.8% of GDP for 2009 to 2010 and this figure rises to around 5% if we include the impact of the automatic stabilisers and other additional budgetary measures, including some at EU level.

Looking at all these measures, who can say that we were inactive?

The real question now, however, is the following: Where does this massive financial, fiscal and monetary policy effort leave us today?

We are seeing some progress. Financial markets have stabilised and recent indicators give grounds for optimism: Short term interest rates have come down from 5% in the autumn to 1% in the euro area today. There are signs that stock markets may be stabilising and financing conditions for companies appear to be improving if we consider the large wave in corporate bond issuances in the last months.

In the real economy too we have seen some positive signals in terms of business confidence and export data. The results of the massive stimulus underway here in Europe and around the world should begin to feed through in the coming months.

But let's be honest. Although there are signs that the recession is easing, a return to growth is not yet there. The economic forecasts I presented last week foresee a 4% contraction in the economy this year and only a modest and gradual recovery in 2010. And there are risks to this scenario linked to the still fragile financial

sector and feedback loops between financial markets and the economy.

To bring about recovery sooner we need to focus on three immediate tasks:

We need to continue implementing fiscal stimulus measures as swiftly as possible. The Commission will monitor the economic situation carefully and be prepared to take further action if necessary.

We need to cushion the impact of the recession on labour markets. We anticipated that the impact of the crisis on employment would be severe. This impact is now materialising and jobs are being lost at a rapid pace. However, governments are not powerless to act.

Temporary working arrangements and flexible hours, active labour market policies to prevent people exiting the labour market and investment in training and skills, to empower workers to take advantage of new opportunities when the economy recovers – all these measures can cushion the impact of the crisis on labour markets. If efforts are coordinated between Member States, the positive effects will be multiplied.

Last but not least, we need to mobilise a concerted effort to address the crisis at source: to restore trust to the banking sector through a drive for transparency; and restore confidence through treating impaired assets.

For this, we need a full disclosure of losses so government support can be provided in the most efficient manner. And we need to push the process of bank restructuring forward. The crisis will never be resolved by simply pouring vast amounts of public money into an ailing banking sector. This was the Japanese approach of the early 1990s and it led to a decade of zombie banks, low growth and deflation.

Restructuring is essential for securing financial stability, and restoring financial institutions to normal functioning – a key requirement for recovery.

Exit strategies: from crisis to sustainable and equitable growth

This brings me to the issue at the heart of this year's Brussels Economic Forum – the need to devise strategies that will help us emerge from the crisis and lay the foundations for sustainable and equitable future growth.

As we come out of this crisis, we will be faced with the task of having to unwind the huge amounts of support channelled to the financial sector and the real economy. Not only that, but the crisis may leave us with a potentially subdued growth potential, high unemployment and public finances under severe strain.

Policies must take account of this new context and at the same time factor in the wider forces that are reshaping the economic and financial landscape in the longer term – especially ageing, globalisation and climate change.

Effective exit strategies should steer our economies out of the crisis phase, equipping us to cope with a post-crisis world by bolstering growth potential and resilience.

Regarding this approach, I will highlight some key considerations which will need to be addressed as a matter of priority.

The first concerns fiscal policy. Here we need to devote serious attention to devising an exit strategy that balances fiscal sustainability with sustaining long-term growth.

At some stage the budgetary support to the economy will have to be withdrawn. There is no question this will be a complex task, particularly to assess the right timing and pace of withdrawal specific to the situation of each Member State.

Winding up the fiscal stimulus should be followed with credible and well designed strategies for budgetary consolidation. Government deficits and debts have soared due to the crisis. And this deterioration occurs just when the impact of our ageing populations is gradually starting to set in. As our recent report on ageing confirms, age related spending is set to rise just as our shrinking labour force will negatively impact growth if current policies do not change.

So we must find, as a matter of urgency, strategies to put public finances back on a sustainable path once the recovery begins. Such strategies might include stronger fiscal frameworks to counter pro-cyclical fiscal policies. They may require pension reforms for certain Member States, or a renewed assessment of the role of automatic stabilisers.

Turning to structural policies. Structural reforms have a crucial role to play in helping our economies adjust to the multiple shocks associated with the crisis and to foster a sustained recovery.

One of the first challenges in this domain will be to withdraw the temporary support to crisis hit sectors.

This support has been necessary in the short term; but if left in place, such measures would only hinder the adjustment of our economies.

Take, for example, the use of targeted aid to industry. This aid must be reversed if we want to avoid a situation where the state is propping up companies, creating competitive distortions in the market and a drain on scarce public resources. However, we have to consider that some industries may have to undergo a restructuring if they want to maintain a competitive business model and guarantee their long-term survival.

Taking a longer term perspective, structural policies will be critical when it comes to boosting growth potential and competitiveness.

We need to be realistic. The recovery in growth that follows the crisis may be gradual. Moreover, it is unlikely that the financial sector will be the engine of growth that it has been over the last decade. Financial institutions will be less leveraged, more risk averse and will have to adapt to new capital constraints. So the dynamism that previously came from the financial markets will have to be found elsewhere.

This is where structural reforms come into play. An acceleration of structural measures should start as soon as possible and should be focused on several areas:

We will need to continue efforts to make product and labour markets more efficient. This will be essential to reinforce economic resilience and yield competitiveness gains in the longer term.

With reduced resources coming from financial markets, governments will need to step up investment in productivity enhancing R&D and innovation. We must aim to consolidate our strengths in high value technologies and position ourselves to grasp new opportunities that will appear as the world economy recovers.

We will need to prioritise education and skills to develop our economic strengths and increase employability. The crisis will unquestionably lead to social hardship. To counter this, we need to equip people with the tools they need to make the most of new opportunities.

Finally, our exit strategy in terms of structural policy must put green growth at the heart of the agenda. The world's shift to low carbon offers huge possibilities for business and industry. Only by investing in renewable energies, low carbon technologies and green infrastructure will Europe maintain its place at the

frontier of this revolution and tackle climate change that risks being so costly for our societies and economies.

Most of these initiatives are not new. They have formed the core recommendations of the EU's Lisbon Strategy for some time. And yet the crisis makes an ambitious and coordinated implementation of this agenda more necessary than ever.

Against this background, stronger economic policy coordination will be crucial.

Indeed, in general enhanced coordination coupled with more effective surveillance will be key to putting these exit strategies in place and ensuring their success.

Especially because the crisis has exposed shortcomings in both areas. The existing surveillance mechanisms proved unable to anticipate the nature and severity of the crisis. And if we are honest, the initial crisis response in Europe lacked the necessary coordination.

The Commission is already working on broadening economic surveillance to cover key challenges to stability such as internal imbalances and competitiveness developments. Moreover, building on the very useful recommendations of the de Larosière report, we will come forward at the end of May with proposals to renew our system of financial supervision, including the creation of a new body that will act as an early warning system for the build up of macro-financial risk.

Moving forward swiftly on both fronts will help develop a more holistic approach to surveillance of Europe's economy and financial systems. However, we may have to go further. For example, we could take a fresh look at the potential of existing instruments, and the role Commission and the Eurogroup to enhance economic policy coordination and reinforce governance of the EU economy.

Stronger coordination and governance will also help Europe to project its interests at the global level.

The crisis has brought the linkages between our economies and financial systems into sharp focus. Even the best policy framework at EU level will fail without a coordinated international effort to anchor growth and stability in the world economy.

Above all, this should encompass three elements:

First, the commitment to a fair and open multilateral trading system must be respected if we are to see a lasting recovery. Global leaders must make good on their pledge to counter protectionism to avoid doing lasting economic damage. And they must pursue the Doha negotiations

as the only means to generate more equitable growth and development in the years to come.

Second, to anchor stability in the global system, we need to set up a new framework for macro-financial surveillance at the international level. Agreements to reinforce the role of the IMF should be implemented as soon as possible. We also need to tackle the global imbalances that grew to such large and damaging proportions during the last decade and which are partly responsible for the current crisis.

Finally, there can be no effective governance of the world economy without bringing all the relevant players to the table. International policymaking no longer concerns a cosy transatlantic club. If new global powers are to take their share of the responsibility for global governance, then multilateral institutions need to undergo a fundamental reform. These reforms have been a long time coming, and yet the crisis provides a real window of opportunity to move this agenda forward.

Without question, the EU must be an active partner in this new global order. We need to strengthen our voice and consolidate our external representation. If not, we will be powerless to influence the processes that are set to fundamentally transform the landscape of our world economy over the next decades.

Conclusion

Ladies and gentlemen, let me conclude.

We are currently experiencing some of the toughest conditions and biggest changes in a generation. Despite positive signals, we still need to fire on all cylinders to bring about a recovery.

At the same time, we must look beyond current challenges and turn our attentions to developing a policy framework that will deal with the crisis in a longer term perspective. The stakes are high because the choices we make today will determine how we manage the challenges of tomorrow.

Over the next two days, I look forward to vigorous debates on these issues. Your discussions and contributions during this conference can help shape a wider vision for Europe in the decade to come and answer some of the looming questions about how we organise our economies and reform our social models to ensure a fair and prosperous world for the generations to follow.

I wish you a fruitful and constructive conference. ■

Keynote address



Mario Monti

President, Bocconi University

I wish to thank Joaquín Almunia and Marco Buti for inviting me to this important event.

The crisis has exposed the insufficiencies of the present structure of governance of the EU. In view of the new European Parliament and the new European Commission, the reflection on the updating and strengthening the framework of governance should be stepped up. And I believe that in the presentation by Commissioner Almunia we find all the key elements not only to explain the crisis and to explain the reaction to the crisis that has been put in place by the European institutions, but also to identify how to move forward.

But I believe that within the limits of the current structures of governance, in my view the European Commission has coped distinctly well with this unprecedentedly difficult situation. I would like here to pay tribute to Joaquín Almunia in particular and also to his colleagues, who have been under much pressure but have not given up their fundamental task of enforcing the single market and particularly competition and State aid policy. Therefore Neelie Kroes, I think, should also be recognised as doing a remarkable job, as well as of course President Barroso who is the leader of the team.

Incidentally, on a personal note, I saw a few days ago that one of the European political parties put forward my name as one of their two candidates for President of the European Commission. I thank them for their expression of appreciation, but I would like to underline that I do not belong to any political party or group and that I am not a candidate for the Commission or any other position.

I do serve on the Reflection Group on the future of Europe in 2020-2030, chaired by Felipe González, who will deliver his address in the afternoon. My remarks to you this morning, though they fit in the

reflections I am also conducting in that context, represent of course only my personal opinions.

As we look to Europe in 10 or 20 years from now, I think that we cannot avoid some tough questions, very basic and very structural. I have in mind two questions in particular.

First, Europe is an integration process that since the very beginning was based on market integration; until not too many years ago we were known as the 'Common Market'. Will this integration project survive and how, after the current crisis of the market economy, of the concept of the market, of the acceptance of the market?

Secondly, Europe is to a large extent, and of course to different degrees across countries, a social market economy. That was started in Germany, by Ludwig Erhard and others, and was transposed onto the European level in two steps. First, with the Treaty of Rome, with the notion of the market and competition and integration; and subsequently with the Treaty of Maastricht with the notion of the single currency, monetary stability and the independent Central Bank.

Now, where are we in terms of allowing a social market economy to function at an integrated level? I believe there are huge asymmetries, because there has been the construction of the market and of the currency at the integrated level, but what about the budget and tax policy? So, let me deal with these two questions.

My starting point is the following: if the world economy is in crisis, the market economy is even more in crisis.

It is seen as unfair, having generated unacceptable inequalities, and inefficient, having attracted massive resources into financial activities whose contribution to the economy is questioned. Yet the world needs an integrated market economy which is a necessary,

though by no means sufficient condition for growth and welfare. The key test for market economies, perhaps even for democracies, in my view, will be whether they master the growing inequalities, including within countries, caused by ungoverned globalisation and aggravated by the crisis.

I think that the European Union in its own DNA has the feature of coping with inter-temporal inequalities. I have always seen the European Union as being the ally of future generations of Europeans, safeguarding their interests, protecting them to some extent from the excesses of the national political arenas, which have more of a short-term perspective. But is the European Union equipped to deal with inequalities at the current time – at each current moment? Much less so, I fear.

I think that paradoxically, one aspect of the crisis has been to unsettle, to defrost the hierarchical order among economic and social models across countries. This is visually very well represented in this week's cover story in *The Economist*, which I am sure you have noted. Built around 'le modèle français', 'model Deutschland' and a sinking entity called the 'Anglo-Saxon model'.

Without being so glamorously pictorial, I believe that there is something to that. The crisis is leading countries embracing the 'Anglo-Saxon' model, such as the US, the UK and Ireland, to reconsider some of its features. Perhaps they relied too much on market mechanisms and too little on regulation, overextended their financial industry while neglecting manufacturing, and did not care enough about inequalities and welfare systems. They now look with greater respect, as does China, at countries in Europe such as Germany and France, which have long followed social market economy models.

The Anglo-Saxons in my view should not feel embarrassed by their partial conversion. Nor should the social market countries be too emboldened by this vindication. After all, during the previous decade, the social market countries had to move quite speedily in the Anglo-Saxon direction, introducing economic reforms to gain competitiveness. And in my view they definitely should continue to do so. But the convergence on the middle in domestic models gives the international community, in my view, an unexpected political opportunity that is not really being discussed. It is an opportunity that

could allow the European Union to meet the increasing social challenges, while safeguarding integration.

In the EU, each group of countries has a major concern and I saw that at work, in my ten years as European Commissioner.

The Anglo-Saxons and new Member States are rightly angry with the social market countries, France in particular, but also Germany and others, because they are increasingly intolerant of the existing rules of the single market, including competition and State aid rules, let alone of further developing it. Let us not forget that the reluctance to go ahead with the single market, witnessed on the occasion of the discussions leading to the adoption of rather weak directives on takeovers and on services, pre-dates the economic crisis. They are the signal that countries that used to be the engine of the construction of the single market, such as Germany and France, have been back-tracking.

The social market countries on the other hand, complain, also rightly in my view, that the longstanding opposition by the Anglo-Saxon countries and the new Member States to any form of tax coordination makes it hard for them to meet social objectives through their budgets. Tax receipts curtailed by tax competition often do not allow the funding of social programmes. In addition, mobile tax bases – capital, corporations, skilled professionals – tend to move to countries with favourable tax regimes, thus driving a race to the bottom as regards tax rates. Labour, being less mobile, carries an increasing burden.

To avoid frustration in both groups of countries, resulting in resentment against Europe generally, and the single market specifically, the EU should in my view grab this chance, which was not there one or five years ago, for a compromise. The European Commission should first prompt the Council, the European Parliament and public opinion with a realistic – which in my view means a rather worrying – assessment of the outlook for European integration, as economic nationalism gains ground. It should then propose a strategic pact comprising two simple elements.

The first would be a renewed binding commitment to the single market, including strengthened enforcement mechanisms and initiatives, with

deadlines, to implement the single market in areas where it is still lacking.

The second element of this compromise would have to be some limited measures of tax coordination. The aim should not be full tax harmonisation, which is neither feasible nor necessary, but to enable Member States to retain tax sovereignty by acting together on part of it. If Member States, jealous as they are of what they believe to be their fiscal sovereignty, prefer to defend individually the principle of tax sovereignty, they will see the continuing *de facto* evaporation of their nominal sovereignty through unrestrained tax competition. In a sense, we are bound to a destination that could be called 'no taxation without coordination'.

Did we see something very different in the monetary area? I do not believe so. There, it was just the realisation that the beloved monetary sovereignty to which treasury ministers and central bank governors were so attached, only existed in Germany, which gradually brought the others to an acceptance of the notion of a single currency and a European central bank. Now it is my impression that if markets go on integrating – of course, the problem would go away if, as it is not impossible, we were to see a disruption of the European single market – Member States will increasingly see their tax sovereignty evaporate as they try to defend it individually.

This poses, I believe, a problem which is of conceptual and political importance, about how to have, at the integrated level, that classical function of the state which is redistribution through the budget.

We have seen in many national cases over time that, if social objectives cannot be pursued through the budget, i.e. the classical instrument of redistribution, they tend to be pursued by taking violence to the market, be it with political prices, be it with state aids, be it with discrimination *de facto* against foreign acquisitions of domestic assets. All these are ways in which governments hope to postpone the processes of restructuring. The temptation to use these instruments is all the greater, the less governments, due to tax competition, can effectively make use of their budgets for social and distributional purposes.

So in my view we have an alternative confronting the most integrated part of the world, the EU in the first place, in the next few years. Social objectives

will not be abandoned, quite to the contrary they are likely to be more and more cultivated after the crisis. Thus, either Member States regain the possibility of coping with those objectives through the classical instrument of the budget, or else they will have to blatantly or silently interfere more and more with the single market.

Then we would arrive at the paradoxical situation that those countries which for years had most forcefully advocated the single market as the core of the European construction, like the UK and Ireland and now the new Member States, would end up being partly responsible for the collapse of the single market – they would have resisted the creation of one of the accompanying conditions for a single market, which is a minimum of tax coordination.

If the compromise that I have described could be entertained, the Anglo-Saxons and new Member States would make an opening on tax coordination – which they may need anyhow as they intend to care more about welfare – but they would also secure the future of the single market.

The social market countries would feel the heat of an effective single market but would gain more margin to pursue social objectives, without having to tear apart the markets' rules. (Incidentally, the appetite shown by large Member States in seeking portfolios in the area of competition policy and of the internal market for 'their' Commissioners, must be noted with some worry. This was not the case many years ago. When I came in 1995, the internal market portfolio was more or less thrown at me, it was not one of the crown jewels of the European Commission, even though at the time it included financial services and taxation. Of course, being a believer in the single market, I am happy to see that this has become one of the 'hottest hits in town', but one has to reflect why being in charge of these enforcement activities suddenly becomes so interesting for Member States, the large ones in particular).

Both groups, the Anglos-Saxons and the social market economies, if there was such a compromise, would end up closer to the Nordic countries, which combine the market and the social dimensions quite effectively. Last but not least, a pact of this sort would perhaps bring new vigour to the faltering European project.

Now, one could say, isn't the G20 doing this already through their fight to the tax havens? Yes and No. Because a crack-down on a few tax havens, as decided in April by the G20 and being implemented, is important. But that only addresses tax evasion, not legal tax avoidance which goes on massively, as most states engage in unlimited tax competition with each other. So the Member States of the European Union themselves have to realise that under some angles each of them is a paradise relative to the citizens of the others.

I know that two objections come easily to one's mind.

First, if successful, would this not be a negative development, because it would set up a 'cartel' of states against citizens and companies. Not in my view, because as I said the objective should not be to move to full tax harmonisation, which is at any rate impossible, but rather to put an end to this continuing trend whereby certain factors of production get a declining effective tax rate while those factors, like labour and lower skilled labour in particular, which economic policies would like to encourage in terms of their use in the production processes, are penalised by a growing relative tax burden.

Secondly, one could say: nice, perhaps, but clearly impossible, due to the unanimity requirement. I am aware that this is a very heavy burden, but one that does not necessarily make any progress is impossible. Again, a concrete experience when I first 'hit the ground' on tax issues. Then again it was said, in 1995-96, that it was clearly impossible. But in December 1997, the ECOFIN Council unanimously approved a tax package, a modest one, but a tax package comprising the Savings Directive, the code of conduct on business taxation and another measure.

That did not come from heaven, and ECOFIN was then chaired by Luxembourg, and Prime Minister Juncker presided over this agreement. The European Commission was chaired by a gentleman from Luxembourg as well, Jacques Santer. Also around the table of the Council was a young, very belligerant, newly appointed Chancellor of the Exchequer, Gordon Brown, who was in the 'fervour of love' with the City of London, and therefore adamantly against measures of tax harmonisation. Yet the pact was

achieved. Of course it takes patient and determined pedagogical efforts with Member States and I believe that no progress can be made in this area unless the real threats, that are looming large concerning the single market, are in a merciless way exposed to the Member States.

My very final note. In this very room, and here I link to what Commissioner Almunia mentioned, i.e. that we must continue to make product markets more efficient, there were heated debates years ago between the US and European anti-trust authorities. The business community in Europe was nervous because they believed Brussels was departing from the American practice vis-à-vis dominant companies. Europe did not change its course and Commissioner Kroes did not, and stayed adamantly on course.

You may have seen a couple of days ago that the newly appointed Head of anti-trust in the US, Christine Varney, is revoking a Bush doctrine on anti-trust – clearly pointing to the need for greater cooperation with the European Union which has gained the leadership in this area – and says that, and I quote, 'the financial crisis is a reason to step up anti-trust activity and not to pull back'. So I believe that in the context of those structural reforms, the need of which was underlined very much by Commissioner Almunia, Europe should not give up this rather forceful enforcement tool, which is competition policy. Precisely at the time when from the other side of the Atlantic, there is a recognition that perhaps Europe and not the US was on the right course.



Keynote address



Jacques de Larosière

President of the High-Level Expert Group on EU Financial Supervision. Chairman of the Strategic Committee of the French Treasury. Adviser to the President, BNP Paribas

You have asked me to speak about the global economic situation and about regulatory issues. I will deal with those questions in succession.

Global economic situation

In spite of the severity of the global recession and the rapid deterioration in unemployment, there have been some objective signs of improvement over the last weeks: consumption appears more resilient than had been expected, real estate data in the U.S. seem somewhat better oriented, banks' access to liquidity has eased, interest rates are lower, the Chinese economy is picking up...

There is thus some moderation in the pace of the recession, but this not to say that the recovery is at the corner. It is hoped that things will start turning around in 2010 but the recovery may well be weak and below potential for some time. I would like to add some observations on the speed and the intensity of the deleveraging process.

I believe that the most indebted parts of the private sector will suffer most. If you look for instance at the US's total private sector debt ratio to GDP, you see that in 1976, which was a year of relative historic stability, total private debt to GDP was 112%. In 2008 it peaked at 295%, so it is a quasi-tripling. And if you look into what happened to the financial sector, it went from 16% in 1976 to 121% of GDP in 2008. So one has to understand that the financial sector in the United States has become enormously indebted and dependent on the markets.

And if one observes for instance the mortgage debt of households in the United Kingdom related to disposable income, one sees that in 1991 it was 80% and in 2008 it was 140%. Whilst in France and Germany the figures were around 50%, and are now in the order of 70%. So I think that, in this world of

uncertainty, it is safe to say that this crisis, being an over-indebtedness crisis, will affect probably more those countries and sectors who are very highly indebted and leveraged and will to some extent spare the parts of the private sector which have kept more reasonable ratios.

One can say this in another way, which is that much will depend on the speed of the rebuilding of savings in the United States. One knows that household savings related to disposable income were zero for quite a while. Today, because of the crisis, they have come back to 4%. The historical figures are around 10% or a little more. Thus the strength of the recovery in the United States will very much depend on how savers under the present conditions are going to see their wealth evolve and are going to regain a more reasonable level of savings. Will it be 10%, 11% or 8%? I don't know. But that is a substantial factor in what is going to happen.

Concerning the banking system, I think that the situation is very diverse and that institutions have been very differently affected by the crisis. There are some European banks that have been more inclined to follow the American investment bank model and got heavily involved in proprietary trading and transacting in what became toxic assets. But others, especially on the continent, but not always – sometimes on the continent they did engage in very dangerous business – have kept a model that is more balanced with a large retail sector in domestic markets, corporate banking, asset management, investment banking but tied very much to the needs of clients. And those banks, I happen to think, have a good future because of their business model. They are already making substantial profits in part because of the very low short term interest rates that central banks are providing and they are building-up reserves in the right way, i.e. because of their

profitability. One might not see that in those parts of the financial sector that are more engaged in toxic assets and therefore in cleaning-up operations.

Finally, a few words on the issue of exit strategies. It is clear that substituting – as is the case – huge public indebtedness to the shrinking of – unsustainably high – private debt is not going to cure in the medium term the problem of overleveraging. This policy has indeed its shortcomings and limitations.

If governments were reluctant – as soon as the global economy starts picking up – to return to balanced budgets, and if central banks were hesitant to cut back their easing, the risk would be a rise in inflationary expectations. This turning point in present policies will be crucial. Too prolonged fiscal and monetary expansion could feed a return to stagflation which is the worst of all combinations. The ability of governments to continue to run large deficits will, in any case, be limited by the cost of financing them. Those countries with large debt/GDP ratios will be the most vulnerable. If markets lack appetite for treasury instruments, the resultant rise in long-term interest rates could harm the recovery. Therefore, the way the conduct of exit strategies will be handled will have a decisive role on expectations and on future economic and financial developments.

Regulatory and supervisory reform

I am not going to sum up the report of the panel I chaired. It is on the website and it has been discussed. I would only like to underline two issues.

The first one is that the report focuses on the misleading incentives that had contributed to the crisis and that characterised financial regulation, monetary policies in the preceding years. We have to have in mind that the lack of multilateral surveillance on structural current account imbalances was one of the most salient features of the very roots of this crisis. The structural deficits of the United States which went on and on and on and reached some 5% to 6% of their GDP, combined with a huge accumulation of reserves – which meant exchange rate intervention – in emerging economies, have led to very high liquidity creation, leverage and low interest rates. And those liquidity conditions were

not counteracted by an active monetary policy in advanced countries. On the contrary, monetary policy was lax and led to very low interest rates, actually sometimes negative or zero in real terms, which of course encouraged financial actors and investors to lend and to borrow. And if one combines that with some aspects of financial innovation, and what can be called the ‘abuse of securitisation’, that explains the massive bubble of credit. The reliance on the idea that markets would always provide liquidity to the vehicles that contained those types of innovative complex and often opaque assets became a terrible illusion when the sub-prime crisis erupted, when liquidity vanished and the whole superstructure of these immense heaps of leveraged instruments fell apart.

Now, what the report says, and this is a rather obvious observation but it is worth repeating, is that the crisis is not the result of a regulatory failure only. If we believed it, then we would no doubt make big mistakes in the way we handle the future. The root causes of the crisis are to be found in large imbalances, loose monetary policies and in the lack of multilateral surveillance.

The second issue highlighted by the report is the fact that the system of financial regulation combined with the accounting rules that had been imported from the U.S. into Europe some ten years ago, led to very dangerous incentives. Too much reliance on faulty risk-assessment models, too much immediate full recognition of mark to market asset prices, without discounting for future losses ‘through the cycle’, etc. All this led to very short-term behaviour and was also accompanied by a number of loopholes in regulation, like the absence of monitoring off balance sheet operations. Of course these shortcomings encouraged all sorts of off balance vehicles that proved very dangerous.

One could also note strange limitations of capital requirements on proprietary trading assets while it should have been the reverse. No regulation of any substance on a number of dark pools of assets or hedge funds. Too much reliance on risk assessment models that were based on erroneous assumptions... I could go on and on, the list is in the report.

So these are sobering thoughts. Our idea is not to just propose to add more regulation on layers of past regulation. If the layers of past regulation have

been misleading, which they have in many cases, then one has to overhaul those misleading incentives and change them. So it's not more regulation, it's better regulation in cases where the facts show that the regulations have not been effective.

Some may say 'Yes, all this is good for the future, that's for after the crisis; what is important now is to clean up the banking system and get things going'. But that was not our mandate, which was to focus on the post-crisis reform. These reforms are essential and urgent. We need to be prepared for the new slippages and the new systemic risks of tomorrow. We already see bubbles and a return to questionable practices emerging in some parts of the world that give rise to concern. We have not already achieved a regulatory environment and a supervisory efficiency that can provide stability to the system. So it is very urgent to act. It reminds me of an observation by Maréchal Lyautey. He wanted to plant an oak tree in his park in Morocco, and his gardener said (Lyautey was already an elderly man): 'An oak tree will take 40 years'. Lyautey replied 'Is that so, then it's urgent, you have to do it now'. That is exactly the situation that we are in.

What are the most important aspects, and I will close on this, of the regulatory reforms that we are proposing in our report? I will put them on a global level because we live in a global world and I don't think it would make much sense to limit our effort to Europe alone. So I am just going to cite a few headlines.

We should try to eliminate as much as we can systemic pro-cyclicality in financial and accounting regulations. I think that there is an emerging agreement on this. It will be very important for the Financial Stability Board to address that issue.

We have to close some loopholes that are unacceptable: unregulated off-balance-sheet operations and some aspects of hedge funds activities. The Commission is working on that and has already started. We have to have a set of rules that are consistent, not necessarily identical but consistent, in order to avoid regulatory arbitrage, to avoid the temptation to 'choose your regulator'. And here also the Financial Stability Board should play, like the G20 has recommended – and we had in our report – a very important leading role.

I believe that we should also supervise in a consistent way cross-border groups. This is one of the main recommendations for our European work. There are cross-border groups in Europe, in Eastern Europe in particular. It is very important to get host – and home – regulators together, and to build colleges that are really working colleges. On the global plane we must generalise these colleges for cross-border groups and introduce more coherence in the way they are supervised.

We have to give some more powers to supervisors. And here the combined role and collaboration of the FSB and the International Monetary Fund is of the essence. The International Monetary Fund has embarked over the years on 'financial sector programmes'. They are extremely important but I don't think they are sufficiently exploited. They should become part-and-parcel of the strategic policies of the IMF. They should be compulsory of course for all member states and should be an integrated part of the Article 4 reviews of countries. That is something very important, because if one sees that in a particular case the, the 'coherent rule setting system' is not being applied, then the IMF has some substantial powers to make it public, and to react.

I would end my list with setting-up a macro-oversight approach to avoid the repetition of these awful events.

Some might say that there were macro-oversight mechanisms. Yes! In a certain sense there were, but they lacked precision, they lacked specific recommendations and they lacked accountability. What we have proposed in our report for Europe, and I think that is transposable into the general system, is to build under the aegis of the ECB a group of central bankers, plus supervisors and the Commission, who would not only analyse looming systemic risks but also propose early warnings and recommendations that would be applicable by a number of entities concerned, be they central banks, governments or supervisors. This did not exist in the present setting and that lack was a major deficiency in the functioning of the international financial system.

To conclude, I think that the European Union should act very quickly on the report. I am very happy to see that the Commission is very seriously engaged

in that exercise. It has made precise proposals based on our report at the end of May and those proposals will be discussed in June by the Council. It is important to act swiftly.

It is also important to avoid postponing the difficult parts of this compromise – I liked Mario Monti's allusion this morning to a sort of historical compromise between market economies on the one side and social policies on the other side. I think we also have a historic window of opportunity. This report is a very moderate report. It does not recommend for instance the creation of a supranational body to supervise the financial system in Europe. It considers that national authorities can do the job pretty well. But it does propose a modest enhancing of the authority of what we call 'Level Three Committees'. And one of the things we propose, and which I would really like to be safeguarded in the decisions to be taken, is the possibility, when you have a conflict between a host – and a home – country within a college, to give to the revamped level 3 committees CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors), CEBS (Committee of European Bank Supervisors) and CESR (Committee of European Securities Regulators), who would become 'authorities' as we suggest in our report, to give them the power to act and propose binding mediations, in case of divergences of views.

Now this is a modest incursion of a supranational nature. Very modest, it has indeed been delineated in the most prudent way. But if in 2009 in the middle of all this mess, Europe is not able to surmount some of its slight differences – because others would have liked a much more ambitious scheme – if we are not able to get together on a reasonable compromise, then we should forget about it! In that case, after four months spent on that report, it will end on a shelf and dust will fall on it, and we will have been losing, vis-à-vis the G20, the international community, one opportunity which is absolutely unique for Europe: to be heard and have some influence.

We can propose at the global level a system which we have decided to apply ourselves and which can be a sort of a blueprint for the international system at large. I think that the Americans are counting on our ability to pull our act together. Up until now, when you speak to an American or an Asian official

or businessman, he says 'Yes! Europe, you have a lot of ideas but you are always disunited and fragmented, you never agree on anything' – that is too often the image of Europe. If we can, through this very reasonable report, if we can pull our act together, then Europe will have much more credibility in the system.

This is true also for the macro oversight proposal we made. I see positive reactions from the United States; they say that this is exactly what they want to do at home, and if they do it and if we do it, then we can start discussing bilaterally, plus with Japan, plus with Asia. Then the system becomes a true system that will be crowned by the Financial Stability Board and the IMF. One has to have it as a bottom-up approach. Because if it is only a top-down approach, if it is the IMF that says things, that is fine but it is not sufficient. You have to have central bankers and supervisors in the world looking at the horizon and detecting what may be going wrong. That is the bottom up approach that must become the multilateral one.

Basically, that is what I wanted to say. I would like to thank the Commission for the way it has received the report, which has been very positive. The Parliament has been also extremely cooperative. And I hope now, at the level of the Council of Ministers, we are able to surmount what I would call traditional little differences. So thank you very much, and let's hope!

Financial stability and the design of a new rule book



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Introduction

Good morning, let me start by thanking the European Commission and, in particular, Marco Buti for his kind invitation to participate in the Brussels Economic Forum.

The global economy and financial system continue to face very important challenges, and this provokes the natural question of whether we need to throw out the old rule books for financial sector regulation and supervision, or whether it is sufficient simply to change a few pages and add new chapters. In other words, do we need a revolution or reform of our regulatory model?

Last month, in the course of the Spring meetings of the IMF and the World Bank in Washington DC, I discussed these very topics with representatives from the Fund's diverse and global membership, and I am glad to be able to share my thoughts with you on these subjects here today.

In trying to tackle this issue, I will first lay out my view of how the crisis is unfolding, since this helps frame the more medium term debate, then I will turn to the issue of regulatory reform.

An assessment of the current situation

I will begin with an assessment of global financial conditions. The global financial system remains under stress, although there are some recent tentative signs of improvement in financial markets. The acute interbank stress following the Lehman bankruptcy has subsided. Counterparty and liquidity risks have declined, although they remain at elevated levels. Asset prices have rebounded from their recent lows. Emerging market equities and spreads have improved, and there are welcome increases in bank equity prices and a narrowing

of credit default swap spreads, which had reached extraordinary levels in recent months. We are also seeing tentative signs that equity markets have reopened for banks, which is providing helpful scope for strengthening their capital position.

Like everyone else, I am heartened to see these signs of improvement. But like many, I do worry that the green shoots that have emerged may still be vulnerable to a spring frost. This vulnerability underscores the critical need to avoid complacency and underpin these tentative signs of recovery with sustained policy commitment to healing in the financial sector. This is indispensable to regain and maintain confidence so as to have a sustained recovery.

What do I see as the main risks to these emerging green shoots of recovery? I would point to three in particular:

- first, that uncertainty about the health of mature market banks may continue to undermine their funding prospects, and more generally, confidence by markets and the public,
- second, is the risk that private capital outflows from emerging markets continue or accelerate and deprive the world of a much-needed engine of growth,
- and third is the risk that the medium-term sustainability of public finances is compromised, including as a result fiscal support to financial sectors.

Looking at the first risk, the vulnerability of banks' balance sheets, the concern is that worsening credit quality will continue to weigh on banks' capital positions. Potential writedowns are likely to continue to accrue alongside deteriorating economic activity, and so banks that are already reeling from losses may not have sufficient amounts and quality of capital to perform their intermediation role adequately.

We already expect that the overleveraging that occurred over the last several years needs to be unwound. In the

IMF's baseline forecast, we estimate that U.S. and European private sector credit could contract through 2009 and will recover only gradually thereafter. However, we cannot exclude the possibility of a more abrupt cut in credit, and our experience in earlier crises is that the speed with which credit gets flowing again depends critically on the policy response. A policy response that is rapid, forceful, and effective means that we can leave the crisis behind us sooner. By contrast, a slow response tends to make the process longer and more costly.

Turning now to the second risk, from emerging market capital outflows, what is truly different about this episode is how broad and all-encompassing it has been. The epicentre was the United States, but it quickly spread to Europe and now to emerging markets. Cross-border capital inflows to emerging markets are expected to be negative in 2009, with only the possibility of recovery in 2010. Moreover, significant risks remain. A particular concern is the threat of a 'sudden stop' of international capital flows to emerging markets, affecting predominantly private rather than sovereign borrowers.

Turning to the third key risk, of impairing public finances, we can see that the amount of net sovereign debt that will need to be issued in the short term in mature markets is very large. It is projected to rise from an annual average of about 1.6 trillion dollars over the last eight years to an annual average of about 4 trillion dollars over 2009 and 2010; that is, by a factor of two and a half. Market concerns regarding medium-term fiscal sustainability have notably affected the sovereign CDS spreads of mature market countries. The very narrow spreads before the crisis have given way to much wider spreads, though, very recently, CDS spreads have declined somewhat, perhaps reflecting some fall in uncertainty in markets generally.

The immediate policy response

To deal with these important risks, the Fund has emphasised the need for immediate, forceful, and effective policy responses, which focus on restoring confidence in the financial system, and, particularly, in the banking system. We have advocated a three-pronged approach for achieving this important goal:

- first, continue to support bank intermediation through the provision of liquidity and funding guarantees, and take measures to restart securitisation markets;

- second, assess the soundness of banks' balance sheets, based on a careful analysis of the quality of each bank's assets; and,
- third, viable banks must be recapitalised and restructured where necessary, while nonviable banks must be promptly resolved. When bank recapitalisation is needed, funds should be raised preferably in the market, and, only when this is not possible, should public funds be used.

Certainly, experience clearly teaches us that there is not a single approach for all countries. Indeed, countries are taking different approaches to implement these principles, and here I would cite the welcome steps recently taken by the U.S. and European countries to stress test banks and address their asset quality problems and capital shortfalls.

While these steps are welcome, it is important that all affected countries continue to make progress along these lines. However, I would offer two cautionary notes. While there is no one-size-fits-all solution, care must be taken to avoid endangering cross-border competition and falling into financial protectionism. Second, meeting these principles over the short term should be consistent with the improvements required in the regulatory and supervisory framework over the medium-term.

Against this background, let me take up again the question I posed at the beginning of whether we need to throw out the old rule book, or rather re-write a few pages or add some new chapters.

Improving the regulatory framework

As we look to reform the regulatory framework for global finance, there are four issues that stand out:

- First: do we need to expand the perimeter of financial sector regulation and oversight, given the role played in the present crisis by the less regulated parts of the financial system?
- Second, how should regulation deal with the excessive procyclicality in the financial system, given that current market practices have exacerbated the earlier lending boom and subsequent crisis?
- Third, do we need more and better disclosure, given that a hallmark of the present crisis has been uncertainty over the quality of bank balance sheets?

- Fourth, how do we ensure more effective cross-border regulation, supervision, and resolution of internationally active financial institutions, something that is critical, as highlighted by the problems created by the failure of several such institutions in this crisis?

Let me look at each in turn.

Regarding the first question, the expansion of the perimeter of financial sector regulation and oversight, there were clearly instances in which nonbanks created problems in addition to banks. Reliance on market discipline proved to be ineffective in constraining risk taking outside the banking sector, and the failure of several nonbank financial institutions, which disrupted key financial markets, had systemic repercussions. So here I would suggest we need to add a chapter to the rulebook, with the aim of increasing the likelihood that the systemic risks posed by unregulated or less-regulated financial sector segments are identified and addressed alongside risks in the regulated sector.

Now, how should we do this? I have to admit that thinking along these lines is still at an early stage. But the key objective would be that financial activities that pose systemic risks are appropriately overseen, regardless of their legal form. Institutions that fall into such an expanded perimeter would be subject to increased disclosure obligations, so that authorities can monitor activities and exposures to determine potential systemic risk. Institutions deemed to be of systemic importance would then be subject to higher levels of prudential oversight. Of course, I would expect that prudential requirements themselves should differ based on the type of institution or activity. It is important that such regulations include authority for supervisors to take rapid corrective action in order to contain an unacceptable build-up in systemic risk, and appropriate resolution tools to resolve failing institutions.

We should also acknowledge that there were clearly many instances in which the supervision of regulated financial institutions like banks was inadequate. Therefore, as we expand the perimeter of regulation, this must be accompanied by more effective implementation of rules.

The second area for reform is addressing elements of excess procyclicality in the financial system. Such procyclicality has aggravated the current crisis by both promoting rapid credit growth when the economies are booming and then restricting credit when economies

turn down. Reducing this procyclicality is an important element of the new rule book.

In addressing procyclicality in the norms governing capital, provisions, liquidity, and incentives in general, regulators will need to balance carefully the trade-offs between rules and discretion. For instance, in the area of capital and provisions, coming up with the appropriate approach will be difficult and controversial, but I would lean towards introducing a more ‘rules-based’ approach. There is work underway in the standard-setting bodies to develop appropriate countercyclical standards, such as capital requirements and through-the-cycle provisioning, and we hope to continue to work with them in reflecting on appropriate standards and measures to determine prudential buffers.

Promoting more effective disclosure is a third area for reform. Disclosure is important for market discipline, but we also need to ensure that disclosed information is both accurate and informative. Requiring financial institutions to provide massive amounts of information can be just as ineffective as too little. Therefore, a concerted and consistent approach to disclosure on a global basis would be a substantial benefit to strengthening market discipline, as would be the development of a common database of comparable financial statistics for all globally active banks. An important example of this gap in information is the wide difference between the frequency and availability of basic bank data across countries.

This crisis has been unique in modern times in terms of its cross-border dimension, and so this is the fourth area of the rule book needing reform, or perhaps a new (and thick!) chapter. The need for consistent cross-border resolution and deposit insurance frameworks has been recognized for many years, well before the current events unfolded. The reason is that differences in approaches can make supervision of a cross-border institution more complex and resolution more costly. So with this crisis, the time has come for concrete action.

I recognise that such frameworks are integral parts of national regulatory and legal traditions, so advancing in this area will require strong political will. We should commend the recent progress that has been made to develop colleges of supervisors involving the authorities of the countries responsible for the supervision of each of the globally active banks, but more is needed. Let me say in connection to this that Europe has the

opportunity to be a model for the rest of the world, given its shared institutions and commitment to a regional approach. If anyone can make progress on this issue, surely it can be in Europe. So I look forward to the steps that will be taken as a result of the discussions triggered by the De Larosière Report.

All of these suggestions I have made are clearly in the nature of reforms to the existing rule book, some of them significant, rather than re-writing it in its entirety. Encouragingly, the G20, the Financial Stability Board, and standard setters have already begun work on these improvements. In some cases, new regulations will have to be introduced. In other cases, existing regulations will be enhanced, as is being done by the Basel Committee on Banking Supervision in the case of the Basel II framework.

But while we reform the rule book, we must also consider its implementation. One of the key lessons of the crisis is that supervisors and regulators were not as effective as they should have been in identifying risks and acting on them: that is, the implementation of existing standards was as much of a problem as what was not captured by the rule book.

Let me offer a few examples of implementation issues that we should be mindful of.

The crisis has illustrated the importance that supervision and regulation adapt in response to financial market developments and innovation, as experience shows that regulation typically lags behind market developments. This is not surprising. Innovations take place and then develop into market-wide practices. But regulators must keep a watchful eye on market developments to understand emerging risks, and as these evolve into market-wide practices, regulators need to respond.

Another issue relates to the Basel II framework. This approach aims to adapt regulatory and supervisory practices to market developments. The Fund supports the implementation of Basel II, given its significant focus on strengthening bank risk management. At the same time, we must take into account national specifics when determining the speed of Basel II introduction, particularly in emerging markets. Their banks and supervisory systems must have first adequately implemented the Basel I capital rule before the countries advance to the more sophisticated Basel II guidelines. This is consistent with the fact that the G20 has called

for the framework to be adopted over time across its membership.

Effective application of rules also requires a strengthening of the ability and accountability of regulatory and supervisory agencies to undertake timely and credible action. As mentioned already, all of the effort that is going into updating the prudential rule book will be unsuccessful if equal attention is not paid to enforcing the rule book. The supervisory response to the vulnerabilities that emerged ahead of the present crisis varied widely. In some countries – and I know we did this in Spain – supervisors used existing regulations to require banks to hold capital against a range of risks (like off-balance-sheet structures such as SIVs or conduits), effectively reining in the build-up of risky exposures. But in many jurisdictions, supervisors may have faced impediments to enforcing fully all supervisory regulations. So, an issue that requires more examination is whether we can identify factors that inhibited supervisors from taking more timely action. In this respect, the Fund's work on assessing the effectiveness of supervisory regimes suggests that operational independence, the ability to hire and retain skilled supervisors, and the capacity to take corrective actions are most important.

Finally, a basis for assessing and acting upon macro-prudential risks is also essential for effective implementation of the rule book. Regulators and supervisors, as well as central bankers, must develop frameworks for working better together, sharing critical information and analysis. Of particular importance is that central banks take adequately and fully into account financial considerations when taking monetary policy decisions in the pursuit of their ultimate policy goals (such as, in the European Central Bank case, price stability). Likewise, regulators and supervisors need to adequately and fully take into account the systemic repercussions for the financial sector resulting from monetary policy and other macroeconomic developments. In short, they should also incorporate a macro-prudential dimension in the regulatory and supervisory framework.

The Fund's role in the reform agenda

Let me say a few words about the role of the IMF. The Fund has been asked to play a role in helping to design the new rule book, and ensuring its implementation. While we are not directly involved in setting standards, we participate in standards discussions to provide feedback on gaps in the design and implementation of standards based on our work with member countries. We are also contributing to international efforts to develop better surveillance and crisis management tools, and supporting member countries in enhancing their central bank operational frameworks. In November, the Fund entered into an agreement with the FSB (now FSB) aimed at improving cooperation and collaboration.

The Fund has also been an active participant in the G20 process, which took on sharper focus following the November meeting of the leaders. In their April London declaration, the G20 leadership assigned several tasks to the Fund in keeping with its mandate of financial stability. Briefly, the Fund has begun work toward:

- expanding our program of assessing the quality and effectiveness of a country's financial sector infrastructure to encompass: macroprudential oversight, the scope of regulation, and supervisory approach to overseeing the influence of the structure of compensation schemes at financial institutions on risk taking,
 - producing guidelines (with the FSB) for national authorities to assess whether a financial institution, market, or an instrument is systemically important, with a focus on what institutions do rather than their legal form; and to review and adapt the boundaries of the regulatory framework to keep pace with developments in the financial system and promote good practices and consistent approaches at the international level,
 - developing an international framework for cross-border bank resolution arrangements with the FSB, World Bank, and the Basel Committee on Banking Supervision and continuing its work on exit strategies,
 - providing an assessment, with the FSB and standard setters, of implementation of prudential regulations by relevant jurisdictions, and building on existing Financial Sector Assessment Program (FSAPs) where they exist,
 - assessing the progress with international convergence in the provision of deposit insurance to identify gaps and highlight best practices in terms of regulatory cooperation.
- We have also started work with the FSB on another key agenda item – to provide early warning on macroeconomic and financial risks and the possible actions that would need to be taken to reduce these risks. This work is being further developed at present.

Conclusion

To conclude, revising the rule book and making progress in regulatory reform are critical to preventing future financial crises and minimising their severity. In examining the lessons from the crisis, expanding the regulatory perimeter, effectively addressing excess procyclicality, closing information gaps, and improving cross border cooperation should be high priorities. At the same time, the effectiveness of new rules requires a strengthening of supervisory enforcement.

Let me end with a note of caution. While implementation of many of the suggested reforms will be a medium-term exercise, the appetite for reform may wane as we emerge from the crisis, and this would be detrimental for future financial stability. It is now or never. Consequently, keeping these topics on the policy agenda will be an important task, and discussions such as the one taking place today at the Brussels Economic Forum, have a major role to play in this regard. ●

Three questions about the global economic crisis and three conclusions for EU and Member State policy-makers



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I very much appreciate the invitation to give this Closing Keynote Address to this impressive Forum. What I am going to do is to ask three questions about the current economic crisis, to give three answers that – despite the amount already written and spoken about the crisis – you may not fully expect, and to draw three conclusions for EU and Member State policy-makers.

Question 1: In what respects are economists to blame?

The first question is – in what respects are economists to blame? Today, when people at dinner parties ask me what I do for a profession, I am a little reluctant to admit that I am an economist. While bankers get most of the blame, economists are not far behind in the list of those held by the general public to be responsible for the current economic crisis. Even the Queen of England, when visiting the London School of Economics, is reported to have asked the assembled professors of economics – why did you not see it coming?

Now, forecasting is not, of course, the only purpose of economics, and we are not all forecasters. Nevertheless, there can be little doubt that recent economic events present a challenge, not just to policy-makers, but also to the economics profession. Indeed, we have already seen a rapid reaction in terms of the revival of Keynesian ideas in macro-economics. Economists have been re-discovering some of the things that I was taught as a student in the early 1960s, such as the role of automatic stabilisers.

The point that I want to make today is however a different one. I believe that economists can be rightly criticised for having become over-specialised. It is quite reasonable for the subject to be divided into micro-economics and macro-economics, but we have seen it become increasingly sub-divided and fragmented. People only study a particular form of macro-economics;

they specialise in a particular approach, such as DSGE modelling. In these fields they attain high levels of technical expertise, but they are not able to react flexibly as circumstances require. Academic economists have come to resemble highly-bred race horses, trained to race on the flat over a certain distance, but not able to jump over fences and still less to pull a plough. Economists are good in their niche, but unable to cope with a changing environment.

What the current economic crisis has, I believe, demonstrated is the need for economists to have a broad understanding of the subject. They cannot simply extrapolate from their sub-field; they have to appreciate how different parts of the problem fit together. This clearly applies at a global level, where we need to consider the whole range of interlocking problems with which the world is confronted:

- the financial crisis,
- the recession,
- the challenge of climate change,
- meeting the Millennium Development Goals and ending world poverty.

This is very important for policy-makers. I saw recently that US commentators have been criticising President Obama for trying to make progress on too many fronts at the same time. However, what he may see, and what they may not, is that progress may only be possible if all the issues are on the table.

To be more concrete, I would like to give an example of one particular policy interaction that affects EU and Member State policy: that between the financial crisis and policy towards pensions. There can be little doubt that the growth of the financial services sector, notably in the UK but also elsewhere, has been strongly influenced by the move towards private funded pensions and the scaling back of state pensions. Households did not choose to take risks, but were forced

to do so to replace the reduced benefits from state schemes. Equally, they moved towards buying property as a security for their old age, the ‘buy-to-let’ phenomenon, in part fuelling the house price boom.

We have therefore to see problems as inter-related. Now, even more than in the past, we need ‘joined-up’ policy-making. Policy cannot be made solely in ministry ‘silos’ or even in Directorates General. In the specific case that I have just identified, we need to integrate economic and social policy. There are a number of reasons why consumers have been slow to respond to stimulus measures, but one important group of consumers are pensioners, and unlocking the structural problems of pensions will help the macro-economy. It was no accident that the 1930s saw President Roosevelt introduce the US social security system. It was no accident that Keynes in constructing the post-war economic institutions worked closely with William Beveridge, the architect of Britain’s post-war welfare state. At that time, economic and social policy were seen as working together; they were seen as complementary. They should be so seen today.

This brings however me to my second question.

Question 2: Whose recession?

The economic statistics show that world GDP is falling and the IMF World Economic Outlook is predicting the ‘deepest post-World War II recession’ (IMF, April 2009). But how is this loss being distributed? We are not all losing equally. Some countries and some people are bearing much more of the burden. So whose recession is it?

In seeking to answer this question, it is natural to look back to the lessons of history. I have already referred to the revival of interest in Keynesian economics, and many commentators are pointing to the parallels with the Crash of 1929 and the Great Depression of the 1930s. What do we see if we go back 80 years? The historical estimates of GDP per capita produced by Angus Maddison suggest that in the 1930s the output fall was concentrated particularly on the developed countries. The maximum fall was nearly 30 percent in the US, around 12 per cent in Western Europe, but less than 7.5 per cent in China and India. The divergence between countries – or global inequality – was noticeably reduced over the 1930s. The coefficient of variation of country

GDP per capita fell significantly between 1929 and 1935.

What was happening within countries? Here we know little about the distribution as a whole. There were at that time no statistics from household surveys that could be used to track what was happening to the ordinary population. What we can track is what happened to the top incomes: the share of the top 1 per cent. Thomas Piketty from Paris and I, together with a team of researchers, have assembled data on the shares of top income groups covering 22 countries for most of the last 100 years. The top 1 per cent are, of course, a special group, but they are of particular interest at the moment with all the focus on executive remuneration and bonuses. What our data for the 1930s show, and this is a preview of a forthcoming book, is that the top income shares did fall after 1929 in quite a number of countries affected by the then crisis. They fell in the US, in the UK, in France, in Japan, and in the Netherlands.

However, I do not believe that the distributional effects of today’s recession, 80 years on, are likely to be the same as in the 1930s. I believe that this recession is more likely to be a cause of rising economic inequality. There are several reasons for this. The first reason is that the world economy is more globally connected and the poorer countries will not escape. As is noted by the IMF, ‘the countries of the world are more integrated today through trade and financial flows ... creating greater potential for spillover and contagion effects’. As the IMF puts it, ‘the hard-won economic gains in Africa are being threatened’. The forecast falls in GDP are rather similar across all major regions. I do not expect therefore that we will see the convergence of country per capita incomes that was observed in the 1930s. The poorest countries today are much more exposed.

The second reason why 2009 is different from 1929 is that the within-country distribution is quite different. The 1929 stock market crash did, it was true, hit small savers, but the bulk of shares were owned by wealthy individuals. Today the bulk of shares are owned by institutions. The consequent losers are not the richest top 1 per cent but pensioners and other small savers. There were big headlines when Forbes Magazine announced a fall in the number of billionaires in the world, but the number recorded in February 2009, while down on 2008 and 2007, is exactly the same as in 2006.

In this respect, it is interesting to examine the distributional effect of more recent recessions. The OECD has identified 6 major recessions that followed banking crises, including those in the Nordic countries around 1990 and the Savings and Loan crisis in the US. Of course, these recessions were not global, and in this sense are not comparable with the current position, but they all led to lengthy downturns in economic activity. What is striking is that in every single case the share of the top 1 per cent rose significantly. In the US, the share rose by a quarter; in some of the Nordic countries the share of the top 1 per cent nearly doubled. It is true that top shares were trending upwards, but there was an acceleration. And looking at other crises, we find that in Singapore, the share of the top 1 per cent, which had been stable for many years at 10 per cent, rose after the Asian financial crisis to 15 per cent. It has since fallen a little, but it remains a third higher than before the financial crisis.

Moreover, looking at the distribution among the population as a whole, we find that each of the banking-crisis induced recessions was associated with a rise in income inequality. The Gini coefficient of overall income inequality rose in the US by some 2 percentage points; the coefficient in the Nordic countries rose by more like 4 or 5 percentage points.

So, I am seriously worried that the burden of the recession is going to be borne disproportionately by those least able to bear it. This highlights the need to monitor the distributional impact of the crisis just as closely as we monitor the changes in macro-economic aggregates. This leads me to my recommendation to policy-makers, which is that they need to press their statistical offices to produce key distributional indicators more quickly, possibly via 'flash' estimates based on a rapid initial processing. At the moment on the Eurostat website we have provisional estimates for 2007, but these relate to incomes in 2006. The speed of current events means that this is already old news. To put the matter more sharply, 2010, next year, has been designated the European Year for Combating Poverty and Social Exclusion. It seems to me imperative that the Commission be able to say something early next year about the impact of the economic crisis on poverty in Europe.

Next year must however seem a long way off to many of those suffering from poverty and social exclusion. This brings me to my third question.

Question 3: Are our redistributive policies up to the challenge?

I said earlier that the 1930s are not a good guide to what is likely to happen today. One reason for this is that we have set in place redistributive institutions. We now have in OECD countries extensive welfare states, providing social protection to a degree that was not present in 1930.

But is this protection adequate? How effective are today's welfare states? How far has the European welfare state been eroded as a result of the labour market 'reforms' undertaken during the 1980s and 1990s? Will those who lose their jobs in 2009 in fact be cushioned against catastrophic loss of income? Will income-tested benefits stabilise family incomes in the face of a downturn? How far will pensioners find that public income support makes up for the loss of savings income?

I cannot give an answer to this question, but I believe that we need urgently to seek one. This leads me to a concrete proposal for policy-makers, both national and at the EU level. In my view we must carry out a 'stress testing' of the welfare state. There has been much discussion of the stress testing of financial institutions, and last week saw the presentation of the results for US banks. But surely the same applies to our mechanisms of social protection? We need to know how they are likely to withstand the pressures to which they are increasingly being subjected.

So, last November at an EU conference organised under the French Presidency, I proposed that we should begin a process of stress-testing the European welfare state, and I gather that DG Employment has already taken steps in that direction. What do I mean by stress testing Europe's welfare states? In concrete terms, it means examining the impact of the loss of employment and loss of income on the living standards of people and their families, taking account of the sources of assistance from which they are likely to benefit. This is important both on account of the consequences for individual families, but also on account of the fiscal burden associated with transfer payments and reduced taxes. We need to know how much public spending could rise and tax revenues fall.

The impact of the crisis depends on an interaction between the circumstances of individual families and the policy instruments in operation in their respective countries. For this reason, we cannot evaluate the impact in abstract. We cannot posit a set of 'model' families and calculate how they would be affected by losing their jobs. We have to consider the situation of a representative sample of real people. We have to make use of household survey and administrative statistics. In this respect, it is fortunate that the European Union has invested in the establishment of the EU Statistics on Income and Living Conditions.

Information on the circumstances of a representative sample of households is the first ingredient necessary to carry out a stress test. The second element involves modelling the response of the welfare state and fiscal regimes. We know that the interest income of the elderly from savings has been greatly reduced as a result of the fall of interest rates. Pensioners as a result will pay less income tax, which will help relieve the pain. They may also find that they are now entitled to income-tested housing assistance, so that this provides a further cushion. The combined effect may still leave the pensioners worse off, but an effective welfare state will ensure that they avoid the risk of falling into poverty. Interest rate reductions affect savers in general; increased unemployment is much more specific in its impact. Even in a severe depression, most people are going to remain in employment. How then do we identify those who will become unemployed? The forecasts show unemployment as rising by perhaps as much as 7½ million this year in the EU. It will surely be important which 7½ million people become unemployed, not just in which countries but in which households.

I should emphasise that this is not a forecasting exercise. The aim of a stress test is not to predict what will happen, but to test the resilience of the welfare state. When stress testing a financial portfolio, the aim is not to predict the expected return but to see what would happen in extreme events. What is the worst case scenario? How large a rise might we see in the proportion of people at risk of poverty? Could there be a large rise in child poverty? This would indeed be a matter for concern, since even temporary income reductions may

have permanent effects on the next generation if they come at a critical time in the development of children.

The most important reason for carrying out this exercise is that if we stress test Europe's welfare states early enough, then we can take measures to increase their effectiveness and minimise the rise in poverty. If we can identify the Member States and regions where there is most risk, then dialogue can be put in place with national and sub-national governments. If we can identify the groups of the population who are most vulnerable, then priorities can be established.

Conclusion

I have asked three questions and given three answers, if only partially, and drawn three lessons for policy-makers:

- first, yes, economists are partly to blame for becoming too specialised. They, and policy-makers, need to reconsider their approach to policy formation, adopting a broader approach that sees the interconnections between different issues and different policies, economic and social. More than ever, we need joined-up policymaking; President Obama is right to move on all fronts,
- secondly, yes, there are real grounds to fear that the burden of the recession will be unequally shared. To monitor whether this is the case, we need to produce key distributional indicators more quickly. We cannot enter the European Year for Combating Poverty and Social Exclusion unable to say anything about the impact of the economic crisis on poverty in Europe,
- thirdly, there is a real question whether our redistributive institutions can stand up to a major and prolonged recession. We need to stress test the welfare state.

