11:00-12:00 Session I: Europe and the global economy - Challenges, options and policies

The financial crisis was triggered in the US financial system, but it revealed a strong exposure to systemic risk in financial systems around the world, including in the European Union. The crisis was preceded by relatively long period of rapid credit growth, low risk premiums, abundant availability of liquidity, strong leveraging, soaring asset prices and the development of bubbles in the real estate sector. Over-stretched leveraging positions rendered financial institutions very vulnerable to corrections in asset markets and a turn-around in a relatively small corner of the financial universe (the US subprime market) was sufficient to trigger a crisis that toppled the whole structure.

Such episodes have happened before and the examples are abundant (e.g. Japan and the Nordic countries in the early 1990s, the Asian crisis in the late-1990s). The difference with these earlier episodes, however, is that the current crisis is global. This has at least one major implication for economic policy: devaluation or other 'solutions' that seek to 'export' the economic effects of the crisis to neighbouring countries – which always risk backfiring – are now potentially extremely dangerous. This is why international coordination is a precondition for an orderly exit from the crisis.

But there are other reasons why international coordination is essential. As I have noted, the proximate cause of the crisis is the excessive leveraged position of financial institutions, including in the EU, and the associated excessive vulnerability to a reversal in their fortunes. However, this is the proximate cause, and the ultimate cause resides elsewhere, and is of a global nature.

A widely accepted, even if partial, explanation of the crisis is that persistent and large current account surpluses in the emerging Asian and oil producing economies have served to finance the US current account deficit at favourable terms, which led to easy financial conditions. The emerging economies in Asia – in particular China – and oil producers are naturally disposed to assume their role as US creditor owing to their large national saving surpluses – with the US' financial maturity, manifested in its open and deep financial markets, attracting large capital inflows to finance its current account deficit. This has led to easy financial conditions not only in the United States itself, but these also spilled over to parts of the world via arbitrage-driven capital flows.

Prior to the crisis the expectation was that global imbalances would abruptly unwind via a steep drop in the US dollar exchange rate. This has not happened (so far) and in stead the adjustment has taken the form of forced deleveraging (across the board, not only in the United States). However, while the crisis can be seen as a response to the

global imbalances, it is unlikely to resolve the global imbalances – as these are largely of a structural nature. Specifically, the huge Chinese national saving surplus, which is at the root of the problem, stems inter alia from: (i) a strategy of export-driven growth, with the exchange rate de facto pegged to the US dollar so as to secure stability of the value of the huge exchange reserves that were built up in the process, (ii) underdeveloped financial systems that force businesses to fund their investment primarily through retained earnings or by attracting foreign capital, and (ii) underdeveloped social insurance systems that force households to maintain high rates of precautionary saving. It is only if these issues are resolved that the global imbalances will ultimately disappear as a potential source of global instability.

But it would be unfair to put the blame of the crisis onto the emerging economies in Asia in general or China in particular. The economic policies and institutions in the developed industrial economies have clearly also contributed to the depth and severity of the crisis. They have added fuel to the economic boom conditions that prevailed in the run-up to the financial crisis and encouraged disproportionate leveraging. The problems are well-known:

- Regulation and supervision of financial markets has failed to prevent and detect the very risky leveraging strategies of financial institutions that occurred in many (sometimes very complex) guises hampering transparency about the nature and location of risks. This

is true for the United States, but also for the EU, where it in part reflects the lack of cross-border coordination of regulation and supervision. Moreover, financial regulation, compensation structures and accounting rules produced pro-cyclical behaviour and excessive risk-taking of financial institutions. A problem specific for the EU has been the lack of cross-border cooperation in financial regulation and supervision, in a time when cross-border activities of banks was rapidly growing, including in Central and Eastern Europe.

- Monetary policies across the globe were rather easy in the run up to the crisis – in part due to what may have been an over-reaction to the dotcom slump in the early 2000s, especially in the United States, and possibly a misguided belief in the 'Great Moderation'. Except for a short stint of soaring commodity prices in 2008, inflation remained generally low in the run-up to the crisis, and this may have made central bank unduly sanguine about the imbalances that built up. Low inflation itself was partly a globalisation phenomenon, i.e. due to disinflation impulses stemming from cheap imports of manufactured goods from emerging Asia, supported by their exchange rate policies. But since liquidity was very abundant as a result of the accommodative monetary policies around the world, asset prices were soaring. The question is legitimate if monetary policies primarily geared to price stability (as opposed to one which is geared to a broader set of indicators of

macroeconomic stability), is fully appropriate once a low-inflation environment has been established.

- While fiscal policies may not have been a major factor in fuelling the boom generally, they are found to have been unduly accommodative in many industrialised countries as well, notably where housing and construction booms occurred. The assessments of the structural fiscal positions were too favourable as large tax windfalls associated with the asset boom masked fiscal expansions that went unnoticed. The authorities in many countries (including in the EU to some extent, although the European Commission did issue warning signals) failed to detect this as a major potential problem. An associated problem is that in many countries (including in the EU) tax systems are biased toward debt financing through deductibility of interest payments, notably for mortgages.

So, we are left with lots of questions, like for example: How should financial market regulation and supervision be organised, both nationally, and even more importantly internationally? Can monetary authorities across the globe maintain a policy of 'benign neglect' vis-à-vis asset prices or are we at the advent of a review of the inflation targeting framework? Is a coordinated change in the exchange rate arrangements around the world a precondition for global macroeconomic stability? And of course many more.

With this in mind, let me now introduce the distinguished members of our panel:

1. **Jørgen Elmeskov, Director, Policy Studies Branch, Economics Department, OECD**, who is invited to shed further light on the underlying causes of the global crisis and to review the current economic conditions around the world. The OECD leading indicators released early this week suggest that the downturn has bottomed and I would be very curious to his current assessment.

2. **Reza Moghadam, Director, Strategy, Policy and Review Department, International Monetary Fund (IMF)**, who is invited to assess the internationally coordinated response to the crisis and their impact on the stabilisation of the financial systems around the world. Did we do better than in the 1930s? Can we still do better?

3. **Aladdin Rillo, Head of Finance and Integration Division, ASEAN**, who is invited to assess the respective roles of the industrial and the developing countries in stabilising the global real economy. Will this crisis prove a blessing in disguise in that it would help resolve the 'global imbalances'? How can developing countries contribute in this regard?

4. And last but not least, **André Sapir, Professor of Economics, Université Libre de Bruxelles, and Senior Fellow, Bruegel**,

who will assess the European policy response to the crisis. What further steps may be necessary to ensure a timely, credible and coordinated exit from the various strands of crisis resolution policy?

I now give the floor to ….