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# Stress-Testing the Regulators

## Market Risks and the EU Economy

Max Watson, Chatham House and Oxford University

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### Summary points

- Today's market turbulence and global imbalances prompt the question whether economic and regulatory policies are poorly designed or just badly implemented. The question is urgent for Europe, which has its own asset booms and imbalances to worry about as well as the backwash of US problems.
- The imbalances in Europe's economies in large part reflect favourable shocks, such as falling interest rates and growing financial integration. But the 'growth crisis' in Portugal underscores the fact that there can be hard landings, even without a financial crisis, if fiscal policy is unwise and if productivity fails to take off.
- The current global imbalances and turbulence also have a common backdrop in the long period of unusually easy liquidity and low risk premia during which today's problems built up. This suggests that central banks should be prepared more often to 'lean against the wind' in times of asset price exuberance, and that politicians should not cut taxes or boost spending permanently on the back of revenue gains that result from transient financial booms.
- Banks and supervisors have many lessons to draw. Some involve going 'back to basics' on issues such as liquidity, off-balance-sheet operations, and the ability to close and reopen banks. Others require a careful look at incentives – in executive pay, rating agency roles and loan production systems. Supervisors also need to take better account of boom-bust cycles when they assess risks, and address cross-border issues in EU banking.
- Moral hazard has been partly addressed by pain inflicted on bank managements and shareholders. But at the macro level it may be building up as policy-makers act to limit losses in a setting where they cannot trace the ultimate fallout from risks. In future, their discretionary interventions need to be truly exceptional and much more symmetrical, or the money supply and the public debt will ratchet up amid serious resource misallocation.

## The challenge of renewed turbulence

The past decade has seen the emergence of asset price booms and wide current account deficits in a range of advanced and emerging market economies – from the United States and the United Kingdom to Spain, Estonia and Bulgaria. These booms and deficits developed in a period when liquidity and credit were growing rapidly, globally and locally, and when risk premia in international markets stayed low for an unusually long period. Financial innovation and regulatory arbitrage accelerated amid a search for yield, and rating agencies took on more entrepreneurial activities in designing new products for their customers.

Now, however, waves of financial problems have spread out from the US markets in mortgage-related and other complex products. Through various transmission channels these are acting as a drag on global growth.

Recent events, in other words, have stress-tested regulators, and the results seem troubling. The first line of responsibility, of course, is with the management of financial institutions, some of which have paid a penalty, as have their shareholders. But one is forced to ask also whether regulators and other policy-makers failed to learn the lessons of history.

More specifically, there are questions as to whether easy macroeconomic policies allowed problems to build up in the capital market system, which are now coming home to roost. Should regulators have taken more account of macroprudential risks when evaluating bank activities, during a period when monetary and fiscal policy settings were easy and when credit was growing rapidly? Or are we asking the impossible of regulators – given the incentives that exist in a world of swiftly adjusting financial markets, sticky prices and wages, and public guarantees of the banking industry?

These questions are urgent for Europe now, if we are to understand the potential risks in Europe's own imbalances, and also avoid potential hazards in the future.

EU economies have been feeling a backwash from the US sub-prime crisis, which has already slowed global growth. There is a temptation to blame the credit chill in Europe wholly on cold winds across the Atlantic, and to wait for these to pass. But Europe has its own asset booms and imbalances also. Could the EU economy face home-grown stresses as booms wind down and current account deficits decrease?

There must be a concern that the aftermath of asset booms in Ireland, Spain or the UK, as well as much of eastern Europe, could still see real and financial sector disruptions. In the four EU member states that have hard pegs to the euro (Bulgaria, Estonia, Latvia and Lithuania), for example, current account deficits have reached levels that are very high by any standards. Portugal's continuing real income 'divergence' from the EU average, in the wake of a major credit boom and external deficit, underscores this concern.

The answer to the questions posed above lies partly in the sources of Europe's imbalances, and partly in the adjustment mechanisms that come into play as national booms wind down. It is therefore important to ask:

- Are the imbalances and asset booms in Europe basically a product of errors such as unduly easy monetary and fiscal policies, a lulling of risk awareness and lagging regulation; or do they reflect favourable changes in the real and financial economy?
- Whatever the source of these imbalances and booms, how flexibly will firms, households, banks and governments respond as booms come to an end and imbalances are reversed? Will there be adjustment problems in the aftermath?

These are the questions addressed in the remainder of this paper.

## The situation in the EU-15

### The euro area

Policy-makers have worried for some time about protracted inflation differentials, which have been associated with prolonged periods of changing intra-euro area competitiveness and quite wide 'external' current account imbalances. These divergences in the euro area touched a raw nerve: significant imbalances and shifts of competitiveness in a monetary union are to be expected, but their persistence has surprised policy-makers (Figure 1).

The concern is that the euro area could have fallen victim to what is often called the Walters' Critique, after

Margaret Thatcher's economic adviser Alan Walters. With a single European Central Bank (ECB) interest rate, the theory goes, booming economies will experience low real interest rates as inflation rises, powering booms to excessive heights. Later, on the downside, they will be trapped in symmetrically persistent recessions. (The more sticky the prices of goods and labour, the more pronounced will be such perverse real interest rate effects.) This sounds suspiciously like the experience of Spain on the upside, and Germany or Portugal during their recent slow growth phases.

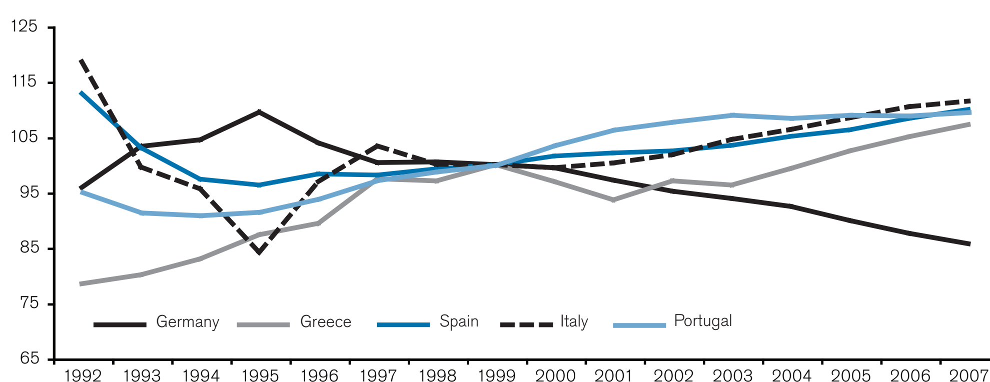
The European Commission was sufficiently interested in these issues to deploy a team of analysts to model these phenomena and report their findings in the 2006 EU Economy Review (which the present author co-edited). This report focused on whether the euro area is adjusting well to shocks – or whether, at the other extreme, it risks being dynamically unstable.

The results are moderately reassuring. Perverse real interest rate effects indeed show up, and housing markets amplify them. But in the medium term, fundamentals triumph: competitiveness gains and losses bring euro area economies back in line. So the euro area is dynamically stable – or more accurately, its performance can be replicated by a model that is dynamically stable. If housing market effects were rather larger, however, this benign outcome would no longer be so clear, so policy-makers were right to worry.

But the study goes further, and highlights several factors that help explain why imbalances and inflation divergences have gone on so long. These are highly germane to our present financial market concerns:

- Financial market effects were stronger than expected in influencing activity, inflation and imbalances, which were typically driven by the compound effects of real and financial shocks. Spain exemplifies this: a fall in risk premia, and continuing financial integration, led economic agents to borrow more, and this combined with shocks such as migration and labour market reforms to drive the current account into a large and prolonged deficit.
- Policy-makers have failed to recognize the full impact of financial booms on budget outturns. During financial booms, budget receipts benefit, for example, from high taxes on asset transactions and capital gains, consumption (notably durables) and bank profits. This kind of effect, which one might term a fiscal 'super-cycle,' can easily add 2% of GDP to revenues in a typical financial boom, and conversely in a downswing – leading to unjustified tax cuts or spending increases.
- In several ways, indeed, there was scope for pro-cyclical interactions between financial markets, wages and fiscal policy. Asset price increases amplify a consumption boom; fiscal receipts rise temporarily; taxes are cut; and this boosts employment and wage increases, prolonging the cycle. The Netherlands, for all its experience of *de facto* monetary union with Germany from 1983, fell prey

Figure 1: Intra-euro area real exchange rates – indices: 1999=100




Source: European Commission.

to just such a pro-cyclical interaction under the euro, but then moved swiftly to correct it.

- In other cases, by contrast, wages responded poorly to emerging cyclical slack at the end of a country-specific boom, and there was no strong productivity growth to restore competitiveness by a painless route. This resulted in a long-drawn-out adjustment phase as competitiveness was rebuilt. This risk is well illustrated by the case of Portugal, where real convergence went into reverse for an extended period, and pro-cyclical fiscal errors intensified the adjustment strains.

Meanwhile, the full adjustment benefits of financial integration are not yet being felt in the EU or euro area. On one accepted measure, EU member states experience four times less income-smoothing from this source as the United States. But such benefits are much more crucial in the euro area, with no federal government to smooth shocks, and far lower labour mobility.

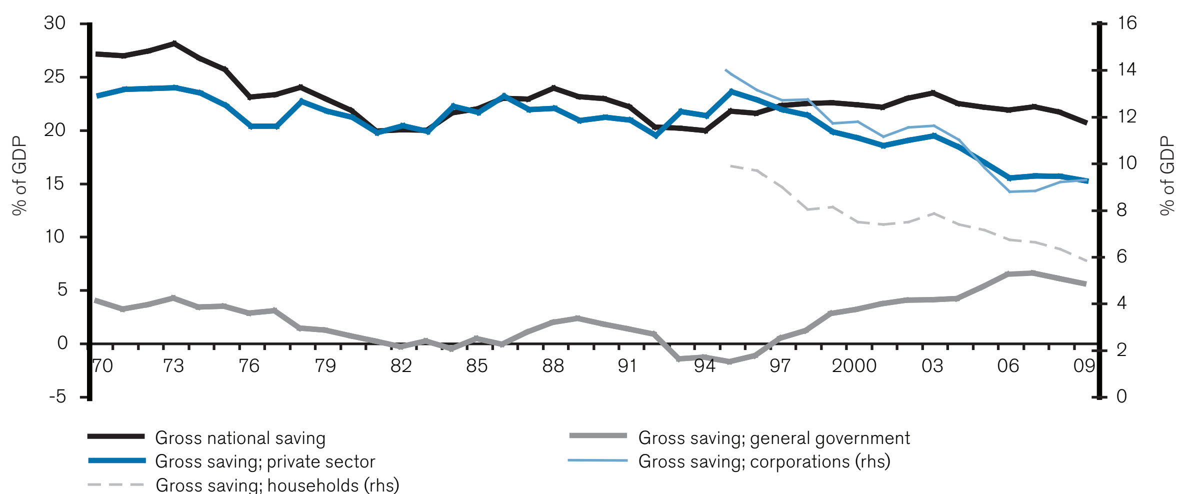
Some euro area member states could therefore face protracted periods of slow growth when they need to adjust, as occurred in Germany until recently and is still the case in Portugal. The mixture could turn out to feature wage compression, slow productivity growth, gradual restructuring and at times a pro-cyclical fiscal tightening.

This is a problem in the case of the demand shocks discussed above, but the structural and fiscal problems of Italy underscore that the problem is wider than this. Supply shocks from globalization too can call for major readjustments of relative prices and production. A fully developed financial sector is also key in facilitating this kind of resource reallocation.

Moreover, there are balance-sheet effects to consider. Some euro area members (notably Spain) may have seen households decreasing their financial savings as they experienced a rise in their housing wealth, owing to property price increases. In the future, such households may cut their spending quite sharply as house price rises taper off or reverse – an issue that is relevant in the United Kingdom and is already a source of concern in the United States. In addition, fiscal positions in some euro area members could be less robust than they currently seem, when financial booms unwind. In Spain, it is notable that household savings have fallen significantly, but the government has also been increasing its surplus over time (Figure 2).

This also answers the question whether these euro area current account balances matter. Imbalances in a currency union do matter if they reflect serious resource misallocation or if the inter-country adjustments to resolve them give rise to stress. In the latter respect, the mechanisms to achieve such adjustment in the euro area

Figure 2: Spain: gross saving, 1970–2008




Source: European Commission.

look fairly incomplete compared with those that exist in, say, Massachusetts or California.

These issues need to be addressed if euro area members are to ride out future shocks and restore growth quickly in the wake of existing imbalances. Moreover, the euro area may face further adjustment challenges in the aftermath of the US-driven financial shocks. The effects of these shocks on banks, firms and households have not yet been fully seen.

Importantly, the adjustment process in the euro area could prove less resilient than the responses of the public- and private-sector actors in the Pacific rim region. For example, its prices and wages might adapt less flexibly, and monetary policy might be constrained by the stubbornness of costs in economies with cyclical slack.[1] Monetary policy could face tougher challenges in the future, particularly in a world where the financial sector is transmitting differentiated shocks across countries, and where the 'great moderation' of price increases resulting from the recent phase of globalization tends to taper off. There are also important unresolved questions about how a cross-border bank insolvency in Europe would be handled in practice.

### The rest of the EU-15

The adjustment outlook in the UK deserves special attention. Its situation resembles that of the United States more closely than most other EU economies. The Northern Rock débâcle and wider mortgage funding stresses contrast with Germany's more favourable mortgage market experience and owe something to over-imaginative leveraging by some UK institutions in a setting of easy global liquidity conditions. On the other hand, major UK banks appear to have been more prudent in their exposure to new capital market instruments.

An even closer parallel between the UK and the US is in the balance sheets of households and the public sector. The long housing boom has left domestic demand in the UK vulnerable if households decide that reliance on housing wealth for saving has been overdone. Moreover, fiscal performance has no doubt been boosted by the long financial boom, while the leeway within fiscal targets has been exhausted in a period when the economy was strong. Adjustment in the household and fiscal sectors could coincide, as it did in Portugal, although this would occur in the setting of a fairly flexible economy with a floating exchange rate.

### Summary

A summary judgment on the EU-15 might be that there were benign sources for many of its imbalances. But there are adjustment risks. As booms taper off and external positions adjust, there may be rigidities in labour and goods markets (especially in the euro area) or pressures on household balance sheets (especially in the UK and Spain) that mean the corrective phase is not plain sailing.

## Europe's emerging markets

The largest current account deficits in the world, however, are in the EU's eastern member states (Table 1). In the four 'hard peg' economies the deficits average some 18% of GDP. Firms and households borrow heavily in foreign currency, mainly but not only euros. Current account deficits tend to be larger in the hard peg economies, but these are broadly also countries with lower income levels and more rapid rates of catching-up.

**Table 1: External current account deficits in eastern Europe, 2007 (as % of GDP)**

| Hard peg exchange regimes | | Floating and intermediate exchange regimes | |
|---|---|---|---|
| Bulgaria | -18.1 | Czech Republic | -2.8 |
| Estonia | -14.6 | Hungary | -4.4 |
| Latvia | -23.8 | Poland | -4.3 |
| Lithuania | -13.9 | Romania | -13.7 |
| | | Slovakia | -4.4 |
| BiH | -15.3 | Albania | -7.4 |
| | | Croatia | -8.5 |
| | | FYRoM | -2.8 |
| | | Serbia | -14.7 |

Sources: European Commission for EU member states and candidates and IMF for others; this table excludes economies that use the euro as a currency.

1. The 2006 *EU Economy Review* documents the problem of asymmetrical downward wage and price rigidity, which varies across countries in the monetary union.

The region's safe exit to the euro, meanwhile, is not immediate. The relative price changes that accompany successful catching-up, and that will lead to a rise in aggregate price indices under a fixed exchange rate, are not distinguished from demand-driven inflation under the Maastricht criteria. Such changes can thus disqualify countries from adopting the euro.

Finally, a small number of EU-15 banks own some 80% of eastern Europe's banking systems (by asset value): this is reminiscent of the 'common lenders' that brought crisis to Asia in the late 1990s. However, when financial stress hit global markets last summer, it was not eastern Europe that bore the brunt. In this liquidity- and valuation-driven shock, the first impact was in the United States and (to a far lesser extent) the United Kingdom, as well as certain economies in the Commonwealth of Independent States (CIS) where the foreign bank presence was low, not high. Indeed, it was commentators who had considered eastern Europe the first region in line for a crisis who seemed discountenanced, not the authorities in Europe's emerging market economies.

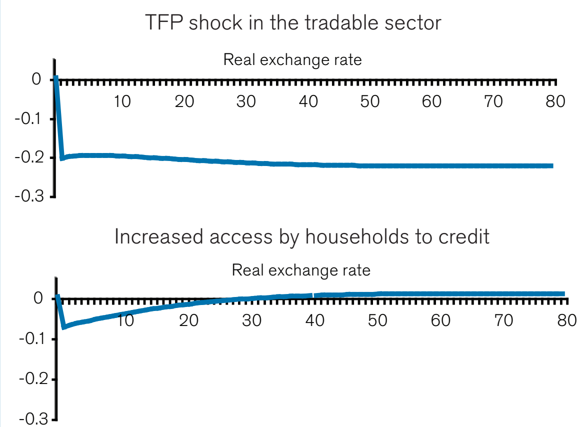
Are these imbalances truly a sword of Damocles hanging over economies that have been among the most dynamic in the EU and its immediate neighbourhood? The answer needs to be sought not in headline current account numbers – or even in studies of so-called 'equilibrium credit growth' – but in a deeper probing of the imbalances themselves, and the price rises/real appreciation that accompany them.

Here we find the diagnostic dilemma that has so confused commentators. We can imagine two credit booms that take place against a backdrop of falling risk premia and growing financial integration in a converging EU economy:

- The first accompanies a favourable shock to productivity in traded goods. Prices rise as a result of relative productivity differentials (the Balassa-Samuelson effect); the real exchange rate appreciates; the current account deficit widens as savings are imported; credit and asset prices are buoyant; and growth accelerates.
- The second is caused by a new availability of mortgage collateral on which households can borrow. Prices rise as a result of demand pressures on the non-traded goods sector; the real exchange rate appreciates; the current account deficit widens as savings are imported; credit and asset prices are buoyant; and growth accelerates. (One should, of course, expect such an effect in eastern Europe, where the housing stock was poor, property was not always registered, banking was repressed, and incomes are now rising: it is in itself an equilibrium phenomenon, not a distortion.)

In other words, it is extremely hard initially to tell the two booms apart (Figure 3).

Figure 3: External adjustment after credit booms



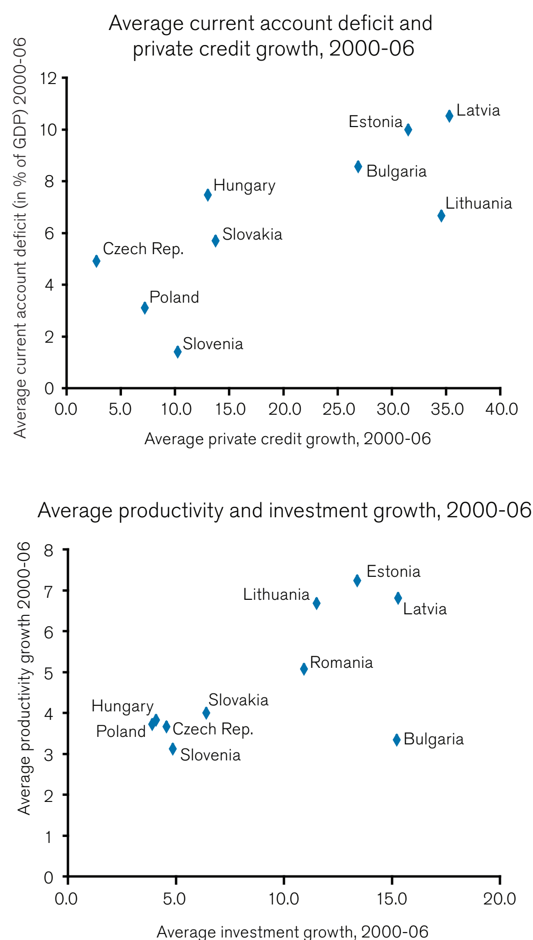

Source: Szekely and Watson (2007).

Of course, accurate real-time productivity data by sector would tell us in an instant, but even in advanced economies those are hard to come by and unreliable. So policy-makers may at first find it hard to discern which type of boom they are facing.

But now consider the end of the story. In the first case, the real effective exchange rate ends up in equilibrium, as a result of sustained productivity gains. In the second case, there may be a large real depreciation to achieve, since the economy has borrowed resources abroad but has not generated income to service them. Radically different adjustment challenges thus lie at the end of the two booms.

What kind of booms and imbalances do we in fact face? Many imbalances seem, on the face of it, fairly healthy. Those countries in eastern Europe that have rapid credit

## Figure 4: Opportunities for real convergence




Source: Ko (2006).

growth and large imbalances are typically also experiencing good productivity gains and strong investment (Figure 4) – though in some cases that investment may include a significant proportion of flows into real estate.

So basically there may be a rather favourable story: one indeed of 'water flowing downhill,' as eastern Europe pools its economic and financial sovereignty with the EU-15, rather than building up reserves as insurance along the lines that are more typical in Asia and Latin America. Moreover, the main banks that have invested in eastern Europe assert strongly that they see this as a strategic engagement, and that they are there for the long haul.

Nonetheless, just as in the euro area, the risks in eastern Europe lie in the way economies adjust as the present booms and imbalances taper off:

- The fact that it is hard to distinguish a mortgage cycle from a productivity-driven boom means we should be cautious about the extent of competitiveness adjustment that each economy will face over the medium term.
- If some economies need to restore competitiveness, there may be challenges in achieving this while maintaining growth. Under pegs, that might require sharp wage and price adjustments, if there are no strong productivity gains to boost competitiveness in a painless way; and this would be in a context where domestic labour markets are really tight, in some cases reflecting outward migration flows due to income differentials. Under floating, costs will adjust flexibly; but depreciation could trigger sizable balance-sheet risks that depress activity for a long period. The extent of balance-sheet risks is growing, and it is notable that foreign currency borrowing is higher and credit growth more rapid in those countries that have hard peg regimes (Table 2).

## Table 2: Monetary regimes and balance-sheet risk

| | Monetary & exchange regimes | Real credit growth % | Foreign currency credit/total credit % | Credit/ GDP % |
|---|---|---|---|---|
| BiH | CBA | 27.7 | Indexed Deposits | 45 |
| Bulgaria | CBA | 27.5 | 45 | 37 |
| Estonia | CBA | 57.5 | 73 | 42 |
| Hungary | Rigid | 14.7 | 39 | 44 |
| Latvia | Hard Peg | 35.5 | 60 | 51 |
| Lithuania | CBA | 52.5 | 60 | 51 |
| Croatia | Rigid | 14.3 | 65 | 62 |
| Slovenia | Rigid | 20.2 | 32 | 48 |
| Average | | 31.2 | 53 | 44.8 |
| Czech Rep. | Float | 19.6 | 11 | 32 |
| Poland | Float | 8.5 | 24 | 31 |
| Slovakia | Float | 21.8 | 38 | 24 |
| Average | | 16.6 | 24 | 29 |
| Romania | Recent Full Float | 55.0 | 65 | 18 |

Sources: European Commission, IMF and national publications. Data are for end-2005, except for credit/GDP which is end-2004. CBA = Currency Board.

- There is a question whether the role of a small group of banks financing eastern Europe's current account deficits could leave the countries exposed to contagion. So far, the effect has been the reverse. Unlike in some economies farther east, it is precisely the presence of foreign banks that seems to have shielded the east European countries in the recent liquidity shocks. Whether this would be the case in a more regional asset-driven shock is much harder to say.
- In the event of a banking, external or 'twin' crisis, analysts talk of an 'EU umbrella'. But are adequate safety nets and resolution procedures truly in place? Cross-border 'war-games' suggest that supervisors have a long way to go in this respect. Deposit insurance schemes are uncoordinated, and European Commission resources for balance-of-payment support are quite limited. These are important concerns; and since they are now common knowledge one can wonder, too, about the incentives they create. Banks may feel not just *too big* to fail but *too complex* to fail.
- Finally, during booms, policy-makers may feel that they have 'no brakes'. With hard pegs, they may hesitate to raise interest rates and float. Under floating, some economies (such as the Czech Republic or Poland) make clear that monetary policy can be effective; but as systems become more 'euro-ized', domestic interest rates have less bite. Moreover, unhedged borrowing by firms and households may make revaluation expansionary, since it reduces the value of their debts (see Table 2). And credit controls (for example, in Bulgaria) have not worked in a very open setting. In such a setting, fiscal policy becomes crucial in managing risks in the economy, although in practice there may limited further scope for tightening in cases such as Bulgaria or Estonia where the budget is already in sizable surplus.

With rapid financial integration, and impaired macrofinancial brakes, the extent of risks to financial stability – for example, the scale of current account swings – may depend strongly on whether the business environment draws resources into productivity-enhancing investment, dampening imbalances and facilitating competitiveness adjustments, or whether mortgage booms predominate.

In sum, the factors driving eastern Europe's growth in most ways reflect favourable fundamentals: falling risk premia; financial integration; strong trade and investment flows; and institution-building under the *acquis communautaire*. These are the true 'umbrella' that the EU offers. But it remains uncertain whether there may be a tough adjustment at the end of the booms in some economies, and the risks of financial stress – or a 'growth crisis' *à la* Portugal – cannot be ruled out in some cases.

## The risks to Europe's growth

The financial sector story in the EU emerges from this analysis as quite complex. Easy global liquidity certainly helped to foster excessive exuberance and some poor risk assessments. But, whether we are speaking of the euro area or eastern Europe, the sources of booms and external imbalances appear to have been, on balance, quite benign. They were not just bubbles. And while they were strongly driven by lower risk premia and financial integration, there was not a big issue about innovative products: lending was usually of a 'plain vanilla' kind.

The concern in some cases could relate to resource allocation and adjustment. It is that, during some of the recent booms, asset allocation seems to have quite strongly favoured the real estate sector, and the non-traded goods sector in general. Productivity growth in the traded goods sector has been slow or unspectacular. Spain is a clear instance of such a pattern, but there are some mixed performances in eastern Europe too, for example Latvia.

To the extent that mortgage booms dominated the picture in some countries, there will be real exchange rate or relative price adjustment effects. And where countries have rigid exchange rates and sticky prices, or flexible exchange rates with balance-sheet risks, there could be periods of low growth (or even financial market disruption) ahead. One of the clear policy messages, especially relevant to the euro area, is to press ahead with actions to improve the efficiency of labour and product markets and thus reduce the asymmetry in adjustment speeds between the real and the financial sectors.

## Are supervisors to blame?

Against this global and regional macrofinancial backdrop, were Europe's bankers and regulators asleep at the wheel?

First, in some cases supervisors need to go back to basics: liquidity supervision, for example, has long been neglected; and regulatory arbitrage – as occurred through special purchase vehicles (SPVs) – is not a new story. In the United Kingdom, for example, liquidity supervision appears to have been far from tough, and crisis coordination procedures (widely considered a model) did not work smoothly. In Germany, the impact of innovative products and techniques seems to have caught regulators by surprise. In Spain, by contrast, supervision appears to have been rather vigilant – with counter-cyclical provisioning and action to prevent the abuse of SPVs. Another area for urgent attention, which is indeed under active review in the UK after the Northern Rock débâcle, is the need for insolvency regimes under which banks can be closed quickly and then swiftly reopened under new (private or public) ownership.

Second, there appears to have been a set of problems that are more on the frontier of supervision. These mainly came to light during the backwash from US-originated problems and a global search for yield. A common theme was a failure to think about incentives: for example, possible conflicts of interest for credit rating agencies; the management of originate-and-distribute loan production systems; and the influence of executive remuneration systems. There may also have been excessive reliance on bank- and market-driven ratings of risk.

Third, it does seem that regulators need to internalize better the implications for risk-taking of the broader macroeconomic setting. Whether that means adjusting capital ratios in terms of the business cycle is an open question. One can reasonably ask which national conditions a global bank is meant to adjust to. More generally, the macroprudential challenge is not easy for regulators: they rightly fear being called on for forbearance in a downswing, which is a dangerous road. It is hard too for tax and accounting authorities, who are averse to (what they see as) buffers built up in good times. But these authorities need to bite the bullet and take fuller account of the microprudential risks that flow from a given macrofinancial setting.

Fourth, there is a set of cross-border issues that are particularly relevant in the linkages between the EU-15 and eastern Europe. Systemically large subsidiaries can have rather undiversified local balance sheets; supervisory responsibilities are divided between home and host; and burden-sharing and deposit insurance issues blur the incentive picture. These problems may have interacted with the macroprudential issue noted above. It can be asked whether the head offices of banking groups active in certain east European countries should have reined in credit earlier on macroprudential grounds, building into their assessments the fact that external imbalances in some cases were historically very large, and that the environment of very low global risk premia and ample liquidity could not last. Home country supervisors could have pressed banks earlier and more strongly to review these macrofinancial factors.

Finally, concerns about moral hazard still need to be borne in mind. At a micro level, the recent crisis has seen shareholders and managers suffer. But it remains to be seen how far markets perceive there to have been a 'macro bail-out', whatever the true intention and concerns of policy-makers may have been.

In one sense there is nothing new here: supervisors largely exist because government cannot allow depositors to suffer the effects of major volatility in financial markets. But perhaps there has been a subtle change, which may matter more and more in a world of innovative and integrated global markets. Policy-makers now have to cope with the risks of turbulence in an environment that features universal financial intermediaries, widespread interstate and cross-border banking, complex instruments, and untransparently dispersed risks. If problems break out in one part of the system, no one knows where they will spread to if a fire extinguisher is not applied quickly. That fire extinguisher might be emergency liquidity support to save an individual bank; but it might alternatively be broader liquidity injections or fiscal action to avoid destabilizing swings in financial markets or in savings behaviour.

To the extent that markets perceive such a broader macro guarantee, a tide that lifts all boats, then they may rely on it for excessive risk-taking, particularly when many systemically important institutions are in the same trade. There are questions and lessons here that go far beyond bank supervision. Indeed they transcend national policy authorities *en bloc*, since the risk environment in global markets is not a divisible fabric.

## Conclusion: the broader policy challenge

Let us return now to the broader questions we posed at the outset, which potentially extend well beyond the sphere of bank regulation. Recent events have certainly stress-tested policy-makers more generally. What lessons should they draw?

It is hard to imagine that the wave of asset booms across many countries solely reflected very local conditions. Globally, very low risk premia and high liquidity prevailed for an unusually extended period. These conditions interacted with more specific local developments such as declining risk premia when EMU was created, as well as the policy reform and deepening financial integration under way in eastern Europe. So there is a question how far the aggregate stance of policies at the G-7 level (or, for example, the G-7 plus Russia and China) created a setting that was unusually prone to high leverage and excessive risk-taking, trends that then interacted with ongoing financial innovation.

Rather than criticizing supervisors and regulators, who are easy game, does this mean that we need to rethink the revamping of policy toolkits that took place after the Asia crisis? That IMF-led review emphasized self-insurance through adequate official foreign exchange reserve levels; safer exchange regimes; greater transparency; and enforcement and monitoring of standards and codes in key areas, including supervision. Was that much-vaunted 'New Financial Architecture' not up to snuff?

In terms of broad policy-making, there seem to be two levels of answer to this question, and it is clearly an issue that deserves a much wider and focused debate.

- The first is that there are many problems not of regime design but simply of *policy implementation* (Box). A first and obvious step is to correct macro policy problems, including notably a pro-cyclical stance in fiscal policy (although *ex post facto* this was not the case in the euro area as a whole). Another step is to address distorted incentives (such as mortgage subsidies) that markets have amplified. Others include: to put right some basic issues in supervision; to ensure that all countries have effective special insolvency regimes for banks; and to deal more quickly with some of the coordination weaknesses that mark the system of cross-border crisis prevention and resolution. Possibly, monetary policy-makers should take greater account of asset prices in inflation targeting in a systematic manner; or, at a minimum, their time horizons could be extended.
- At the second level, there needs to be more explicit recognition that *discretionary action* in terms of fiscal support or liquidity expansion is sometimes warranted. But if this is purely ad hoc, it risks muddying transparency and it will almost always be asymmetrical – responding to busts in ways that ratchet up global liquidity and public debt. Monetary and fiscal policy-makers' approaches to 'risk management' need to become more symmetrical. Perhaps we need to have in mind a meta-framework: a set of considerations that explains in advance when there should be discretionary action outside conventional policy rules, which also clarifies how symmetry is to be ensured. This topic deserves urgent attention, and is complex – especially in the case of monetary policy. Calls for symmetry in discretionary monetary policy are, of course, subject to the critique that pre-emptive tightening in a warranted asset price upswing is tantamount to 'killing the goose that lays the golden egg'.

The reasons for discretionary action could indeed be various: the risk of a loss of policy traction, as with deflation; the risk that an asset boom will end in territory where there is either an unacceptable bust or a further proliferation of guarantees (when one might puncture this with an interest rate hike, even if this means abandoning a hard peg); the need, in national policies, to 'lean against the wind' in a monetary environment that is dangerously easy relative to local conditions – something that can often occur within a monetary union or currency zone.

The danger is that it will frequently prove difficult to achieve symmetry in such actions. It is hard to tighten fiscal policy at all, let alone 'by more', in good times. And successive shocks can make it difficult to claw back liquidity at the national and global level. The past decade abounds with cases that prove these points.

By contrast, we should reject frameworks that are based on re-restricting financial markets (capital controls,

### Improving policy implementation

- Avoiding fiscal pro-cyclicality, by symmetrical pre-emption policies, and allowing for fiscal 'super-cycles' during financial booms
- In the euro area, better understanding of wage/competitiveness dynamics, and pro-cyclical interactions of fiscal policy, labour and financial markets
- Internalizing macroprudential risks through compound stress-tests, and by even provisioning through the cycle and addressing tax and accounting obstacles to such provisioning
- Greater supervisory emphasis on liquidity and on reputational risk
- More attention to incentives facing banks, including reviewing with bank managements the incentive effects of executive remuneration schemes
- Consideration whether too much reliance is being placed by supervisors on market-based criteria for risk assessment
- Discouraging unhedged foreign exchange lending – e.g. through stress-tests of banks and consumer awareness campaigns
- Removing gaps and conflicts in cross-border supervision
- Enhancing the arsenal for Prompt Corrective Action and for closing banks (e.g. through special insolvency regimes)
- Removing tax and other distortions such as mortgage relief
- Reassessing possible conflicts of interest facing credit rating agencies
- Prioritizing business environment reforms in catching-up economies

narrow banking). This is not just a philosophical preference. Nor even a recognition that the genie is now well and truly out of the bottle. It is because ultimately the only global trend that can resolve the moral hazard issue is more complete financial integration. Our problem is in part the incomplete nature of financial integration, not its existence: we lack markets to insure many macro and mezzanine risks, and we find in the euro area a monetary union where cross-border risk-sharing is only one-fourth as developed as in the United States.

Over time, private financial markets will offer a growing number of routes to insure incomes against risks, and to hedge more fully against volatility. In principle this should mitigate the income fluctuations associated with financial market variability, and thus also lessen the need for recourse to the kind of policy palliatives that create moral hazard. Moreover, actions to improve the working of goods and labour markets will reduce the asymmetry in their adjustment speed *vis-à-vis* financial markets.

In that sense, the policy route map described above is a half-way house. By better policy implementation, and emergency action when essential, we are effectively buying time for private markets to become more stabilizing through a fuller and more integrated global financial economy.

But meanwhile the stakes are high.

If we fail to handle this transition well, we risk one of two bad outcomes:

- First, that we succeed too well in stabilizing markets, artificially, by 'guaranteeing' more and more asset values. Not just bank deposits but, perhaps indirectly, bank-owned investment trusts. Not just money markets but bonded and hybrid instrument markets. Not just fixed value instruments but asset classes such as housing and equity markets – in which very large fluctuations could destabilize firm and household behaviour. This would seriously distort risk behaviour in financial institutions and, of course, more widely: resources could be misallocated on a truly global scale.
- Second, the opposite: that we fail, because central banks or supervisors drop the ball at a key moment, and this results in very serious swings in output and employment, of the kind that, as history has shown, can jeopardize open markets and private ownership.

These concerns are to be taken seriously. We are at risk of entering what some economists have called an inverted Bretton Woods system: one where the capital market 'tail' is wagging the real economy 'dog', and where the irreversible freedom of capital flows could threaten the sustainability of free trade.

A fuller debate is clearly needed. Supervisors in many cases have made mistakes. They need to strengthen cross-border coordination, though the constraints here are often at the political level. And they also need to think more in the future about macroprudential risks. But they should not be made a scapegoat for problems which have far deeper policy and market roots.

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Max Watson is an Associate Fellow of Chatham House and a Fellow of Wolfson College, Oxford. Work on this Briefing Paper was completed while he was a Visiting Fellow at the Center of Excellence in Finance, Ljubljana. The paper is based in part on research carried out with Mary McCarthy, Werner Roeger and others at the European Commission in connection with the 2006 EU Economy Review, and on research concerning economic convergence conducted jointly with Istvan Szekely, Julia Lendvai and others also at the European Commission.

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Chatham House
10 St James's Square
London SW1Y 4LE
www.chathamhouse.org.uk

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