Crisis, Response and Innovation in Europe

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Part I: The Impact of the Crisis in Europe and the ineffectiveness of Uncoordinated Policies

1. The close economic ties between Europe and the United States and the City of London's crucial global monetary and financial role were the conduits for the lightning-fast spread of the crisis triggered by the subprime mortgage defaults in the U.S. and the consequent fall in global real aggregate demand. The effects of this twofold crisis have differed among euro area countries, among non-euro EU countries, and among such neighboring non-members as Turkey and Russia. The differences actually appear to have been sharpest in the euro group.

It is well known that the euro area is not an "optimal currency area," and the consequences of this condition are manifold. Banking and financial arrangements remain differentiated within the euro area, and supervisory authorities differ in vigor and efficacy. Some analysts hold that certain countries, Italy among them, lack a truly modern financial system, which is why their banking and securities markets have been less exposed to the crisis. This analysis was presented as a criticism, but upon due reflection, by comparison with the consequences of the American and British "modernities", it may not be such. The other members of the European Union have not yet completed the return to the market economy, after their experience of central planning "governed by outside". Turkey is torn between modernism in the broad sense and Islamic revival. Russia is a case apart for a lot of reason, included its large part of the territory outside physical Europe.

It is also well known that although the euro was created hoping that it would bring political union in its wake ("money first," in the famous slogan of former Commission President Roy Jenkins, though his own country opted out of the EU single currency), this has never come about. Rather, the goal may actually have receded, leaving us with

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the legacy of lame institutional arrangements in which the rules of competition apply to all countries, but are concentrated on industry (which counts for no more than a quarter of GDP), while the single currency (with its irrevocably fixed exchange rates) applies to only half the EU members and fiscal policy remains in the hands of the single member states, but under the constraints of the Stability and Growth Pact agreed to in Amsterdam, whose heart is a ceiling on the general government deficit of 3 per cent of GDP. Within these patchwork arrangements, more than anything else the financial crisis has eaten into household savings, in all its various forms, and taken a huge bite out of banks' capital and reserves.

The banking and financial system withstood the trans-Atlantic tidal wave. Nationalizations have been few in number, if sizable in some cases (Royal Bank of Scotland, Fortis in Belgium), but extremely modest by comparison with those undertaken in America and in any case not such as to alter the institutional economic set-up of the European Union. The crisis of the real economy, by contrast, has struck the only sector exposed to competition, namely industry; in fact, agriculture is sheltered and services semi-sheltered, due to the amendment of the Bolkestein directive to prevent firms doing business in any EU country from applying home-country labor contracts.

In short, the European banking and financial system has held up under the shock from America, and the impact on real economic activity has been more severe in manufacturing given its growth model based on exports, which suffered more to the decline in world demand than to the fall in domestic consumption. Consequently the most vulnerable countries, apart from the UK economy centered on financial activity, have been Spain, Austria and Ireland in the euro area, Poland among the other EU member states, Turkey and Russia outside. The initial drop of financial wealth in the euro area was on the order of half value of their stocks, about 50% already regained, and the decline in real economic activity averaged 5.8 per cent in 2008 alone, with spikes of 8.2 per cent in Germany and 7.5 per cent in Italy, while the French economy contracted by 4.6 per cent.

In perspective the true cost of the crisis will be a relevant increase of the public debt as a result of a drop in tax receipts and an increase in public expenditures.

2. Historically, the euro area's monetary policy has been shaped by powerful monetarist orthodoxy; because among other things the Treaty of Maastricht assigns the European Central Bank a single mandate, namely price stability. The French economist Jean-Paul Fitoussi has aptly summed up this policy approach in his description of the United States as a producer of ideas that it has no intention of consuming domestically but

exports, since there is someone willing to import. Everyone knows that the main buyer, in this case, is the German Bundesbank. EU fiscal policy is equally orthodox — perhaps "not flexible" is a more appropriate term — under the old Christian principle that if you want to inculcate some particular type of behavior, prohibition beats toleration.

The present crisis has dissolved this twofold orthodoxy, like snow on a summer day. The growth rate of the M3 followed a peculiar trend from the middle of 2004 to the end of 2008, raising from 5 to 12%, then dropping to 6% in the first quarter 2009 as a jointly effect of small increase in credit and portfolio reallocation, both domestic and foreign. The official interest rates have been kept relatively high (with respect to inflation and the comparative rates in the USA and the rest of the world) since March 2009, to permit a "non conventional" creation of monetary base serving all the market demand accepting a large and unusual number of financial assets. In meantime the government deficit has soared to 4.6 per cent of GDP; for the first time since the Stability and Growth Pact was signed no country has been subjected to an excessive deficit procedure for violating the 3 per cent ceiling.

These policy choices were tardy, so that the doses of monetary and fiscal stimulus were larger than would have been necessary, if the moves had been timely. And the efficacy of the measures, inevitably, has suffered. Except for providing the indispensable liquidity that the paralysis of the interbank market and the withdrawal of bank deposits had eliminated, most of the decisions made, especially on the fiscal policy front, did not come until nearly the end of 2008, two full years after the crisis began, and their implementation in practice will only come in 2009 and 2010. Prime Minister Gordon Brown has budgeted a deficit of 8% per cent of the United Kingdom's GDP at the end of 2008, after the Bank of England — as stated by Governor Mervyn King in October 2008 — created monetary base to an extent unprecedented in its 340 years of life. British pound has fallen below parity with the euro — where at the height of "irrational exuberance" in the British financial market it had been worth more than twice the continental currency. Germany has budgeted a deficit of 3.3%, after given guarantees of 400 billion of euro on new bond issues; France has a GDP deficit of 8.75% plus a very large amount of guarantees and recapitalization of financial intermediaries; Spain has a GDP deficit of 2.8% plus other financial supports. The last two countries decided their fiscal measures despite a huge deficit on their foreign current account. Anyhow the final impact on the budget deficit will be known only ex-post and presumably it will be higher.

Not only monetary and fiscal orthodoxy, but also the fundamental principles of political economy dissolved like snow on a summer day as consequences of the American crisis!

Everywhere the anticrisis policies were such to switch the burden onto future generations.

3. The slowness of decision-making and the absence of all but sporadic coordination stemmed from the lack of will to proceed like a political union and from the constraints of European institutions, which had been designed for stability, even at the cost of deflation, rather than growth. This approach had been criticized also by international organizations. But differences in economic structure also weighed in. Saving, as reflected in national balances of payments, had and still has sharply divergent characteristics. Germany has a current account surplus rivaling China's, the Netherlands and Austria also exhibit surpluses, while Spain, Greece and Ireland above all but also Italy and France, albeit to a much lesser extent, went in deficit. Rationally, the former should take up the burden of stimulating internal demand within the euro area, while the latter should benefit from this impulse. But in practice all the euro area countries — despite a deficit or a surplus in the foreign accounts — have found themselves struggling to comply with the public budget deficit limit.

This institutional, political and economic stalemate is the cause for the protracted inaction of the European Union. In rational terms, such a stance could actually be justified by the fact that the EU has an export-led model of growth, and that trade with the rest of the world is so massive that its fall could never be made up for by domestic demand. This consideration is especially powerful in a country like Italy, where the public debt is already enormous. So "political" Europe decided to concentrate on the social costs of the crisis, investing resources in assistance to the most disadvantaged. However, since the countries running large external deficits — like US and UK — have not hesitated to reflate their domestic demand by relying on their neighbors' savings, the European policy could not prevent the worsening of the crisis, i.e. an aggravation of the social costs well beyond what public intervention could alleviate.

In a word, we face the classical problem in economics, the search for the right measure, which can be tested only after the fact. Given the circumstances, not even European-wide coordination would have sufficed to overcome the crisis; as the final communiqué of the G20 meeting in London succinctly observes: "A global crisis requires a global solution." Disunity in action increases the cost of the crisis and decreases the efficacy of the antirecession measures taken. This is what has actually

happened, and the only initiatives that suggest that economic geopolitics is moving in the right direction — if not on the right track — are those to be managed by the IMF. The obstacle to the efficacy of this coordination still lies on no uniformity of foreign exchange regimes among WTO members, nor is there a single global monetary standard that can be managed independently of any national currency. The sooner the G20 (or G8) should face these institutional weakness, the better the coordinated decision will be efficient in pushing a sustainable world growth. The latter they will act, the higher will be the probability a dollar crisis.

Part II. The European response to the crisis: behavioral finance and derivatives

1. The European Commission and Parliament have addressed the financial crisis, started in July 2007, by creating an *ad hoc* technical commission to analyze the roots of the meltdown, and suggest the main modifications to the present financial architecture. The high-level working group on financial supervision in the EU, under the presidency of Jacques de Larosiere, concluded in Febr.09, worked toward a new regulatory agenda, stronger coordination supervision, and more effective crisis management procedures. With respect to the global financial architecture, the group issued 31 recommendations, which aim at dealing with the institutional, regulatory, business rules and practices of the global financial system, which has contacts with Europe. In particular recommendations address key points of the policy and regulation repair, the supervisory repair, and the global repair.

The Report addresses the main issues in the present regulatory system, and stresses the weaknesses of Basle II capital requirements rules; first, the pro-cyclicicality should be diminished, European countries should adopt a common definition of capital requirement, and a gradual increase of capital should be imposed. The credit rating agencies regulation should explicitly consider the evolution of financial markets and practice, and stop applying standard practices to structured and exotic financial products. With respect to weakness of players' regulation, the "parallel banking system", such as hedge funds and other financial intermediaries, should be reduced in their maximum size and freedom, since, being absent any deposit base or liquidity, they are more exposed to liquidity problems, and can influence directly the global banking and financial system.

With respect to financial derivatives, the Report recommends a high level of simplification and standardization for OTC transactions, which is, however, just one side of the coin. The Report does not clarify the application of these principles;

derivatives have become so popular over the last four decades because they are able to circumvent regulation, and are tailored on customers' needs. European OTC securities can be subject to heavy rules, monitoring and control, but if the rest of the world does not follow European rules, the OTC transactions will appear to take place out of the EU, and regulation becomes ineffective. Standardization should be not with respect to the security, but the counterpart (to be considered at any stage of the transaction). Simplification is a very vague term; if it refers to the pay-off of derivatives, this does not mean smaller risk involved. If it refers to contractual rules (which are absent at the present) then any proper and effective rule would represent an improvement with respect to the present "anarchy". The Report recommends the introduction of a centralized Clearing House (CH) for European Credit Default Swaps, which, however, can become an empty house. If the CH is compulsory only for European-based transaction, the above-mentioned critiques apply. Nevertheless, any derivative surfing in the global financial system should be collateralized, not only Credit Default (CD) derivatives. Otherwise market players will find a way to exchange the credit risk, without calling it a CD, shifting any risk out.

The "guarantee that issuers of securitized products retain on their books for the life of the instrument a meaningful amount of the underlying risk (non-hedged)" is highly appreciated, and, if applied in the global financial system, would break the fundamentals of the Originate To Distribute (OTD) model, at the roots of the present global financial crisis.

From the domestic institutional point of view, the Report suggests that Europe sets up the European Systemic Risk Council (ESRC), and the European System of Financial Supervision (ESFS).

The ESRC should be chaired by the ECB President, and composed of members of the Board of the ECB, of the European Commission, and other European supervising and monitoring bodies. The ESRC has the duty to pool and analyze relevant information, prioritize and issue macro-prudential risk warnings: there should be mandatory follow up and, where appropriate, action shall be taken by the relevant competent authorities in the EU. At the global level, the ESRC should warn the International Monetary Fund, the Bank of International Settlements, and the Financial Stability Forum in case of global dysfunction of the monetary and financial system.

This institutional design has various good points, like the coordination of European financial risk management, but is not strong enough. The Parliament and Commission should issue directive and laws to impose these changes, a technical body cannot introduce. Moreover, some international financial institutions have been proved to be

unable to deal with the recent financial crisis, and as a result it is unclear how the global warning system can be successful. The European institutions involved in the ESRC have not competence over the European exchange rate management, and this hole undermines the accountability and reputation of the risk council body in the medium and long term.

The ESFS should be independent from the industry and politics, and is a centralized body to coordinate local vigilance and supervision. The European Commission, Parliament and Council should appoint the managers and staff of the ESFS for a period of eight years. The ESFS should be established in Europe gradually, after harmonizing local financial rules and practices. Its micro-prudential supervision task with respect to European banks, insurance companies and financial intermediaries has strong interconnections with the global regulation, especially the American.

The European financial architecture, as depicted in the Report, would restore confidence and stabilize the financial system, but cross border interactions and gaps in the global financial system can remain and diminish the effectiveness of the reform.

2. The 2007 crisis has underlined how limited is the rationality of financial operators, and regulators. The standard finance theory is based on the efficient markets hypothesis (EMH) that states that financial markets are "informationally efficient", or that prices on traded assets, e.g., stocks, bonds, or property, already reflect all known information. Agents are utility maximisers, have perfect information and their expectations are rational. Nevertheless, the subprime crisis is the result of crunchy chains of interlinked securities, all sensitive to house prices, of the asymmetry of information created via complexity, and of the opaque risks spread though the financial system, as explained in great details by Gorton (2009). Such a framework cannot be referred to rational operators, and perfect financial markets, and rational regulators.

The limited rationality is ignored in most analysis and policy response to the crisis. The European Report cited above is not immune from this critic, and as a result we believe that its effectiveness will be heavily reduced.

An alternative stream of literature, the behavioral finance theory, tries to explain most of finance theory puzzles, and can be of particular help in analyzing crisis, and turbulence. The shadow banking (or parallel banking system in the words of the European Report) contamined the "savings sector, and the absence of global regulatory framework for international investments funds played a massive role in the building up and amplification of the crisis" (Avgouleas, 2009, p.26). The "system failed to provide rational actors with suitable incentives to conduct appropriate credit controls and

disclose borrower information” (idem, p.39); overconfidence of investors and falling risk premium were taken as if there were a reduction in credit risk. Following behavioral finance, Avgouleas (2009) suggests a number of regulatory reforms, which explicitly consider the limited rationality of financial agents.

a. Containing homogenization: the segregation is the only policy tool to lead the global financial system to decouple and diversify the activity.
b. Choice of suitable policy tools: containing liquidity risk is as crucial as avoiding bank bankruptcies.
c. Deposit insurance and moral hazard: limiting the size of the insurance scheme limits the moral hazard.
d. Protection of public funds and prevention of free riding on the public guarantee: the segregation (sub a) limits the possibility for banks to access public funds, but should be coherent with the major role-played by the banking sector.
e. Complexity reduction and effective supervision: external limits on securitization of assets and would reduce complexity and make supervision more effective.
f. Lower leverage: imposing a limit on leverage limits also the tendency to focus on short-term profit.

These regulatory improvements would change the shape of the financial system and its incentives’ scheme, at the detriment of speculative operators, which earned amazing fees thanks to securitization and the lack of transparency.

3. Financial derivatives are considered to be the vehicle used to spread the crisis in the global financial system; credit derivatives, especially swaps and options contracts gain incredible popularity over the recent five years, and the Financial Stability Report of the IMF devoted its attention to them in 2007.

The US Security and Exchange Commission recently imposed centralized compensation mechanism (i.e. clearing house) for such contract, to improve market liquidity practice and transparency. The regulatory decision and the global attention paid to credit derivatives is the result of a mislead interpretation of the phenomenon. CDs are different types of transactions than mortgage-related debt and structured debt securities. The payoff of the two types of financial products can be radically different although there might be some similarities. The excessive loss in mortgage related debt securities has been the result of lack of transparency and full information, inability to price the risk which caused a drop in the credit multiplier with a liquidity scarcity. The loss in CDs is basically the result of losses in the underlying market, but does not reflect a weakness in the market infrastructure or risk management procedures (Shadab, 2009).

This awareness is not translated into any recent regulative improvement, in the US or Europe, which both believe that a stronger regulation on derivatives will diminish existing risks. We believe, in the contrary, that the result of stronger regulation will be "the sand in the wheel" first, and then push further new financial innovation.

Conclusion: The G8 and the crisis and the EU response

The Japanese G8 of 2008 did not address the financial crisis explicitly, but most Prime Ministers applied the same exit strategy: heavy public spending. After September 2008, when the slowdown turned into recession, G8 countries decided to spend trillion dollars in rescue plans for banks, financial institutions, public firms and tried to alleviate the worse effects in the labor market. The new American President, Barack Obama, decided to reinforce the intervention in the banking system and rescued banks, which are heavily involved in the crisis; this decision will not be costless, since the industrial sector is in crisis too, but no money is left on the floor. The EU failed to take common decisions, and UK, France and to a smaller extent Italy adopted rescue plans to save the economies of their own country. The abundant liquidity injected in the global financial system and the zero-interest rates policy adopted by the central, banks, ECB excluded will alleviate the worse effects in the short run, but create conditions for a possible inflationary effects in the medium term. The small coordination observed over the last years, especially with respect to financial regulation and monitoring, can diminish the efficacy of the G20 coordinate intervention.

The loss of confidence caused the drying up of the credit market and the massive selling in the stock exchange, spreading the effects on the real sector, mainly that part of it driven by exports. More liquidity and more public expenditure started to restore the confidence in the future. First signs of recovery appear in data, also thanks to emerging economies. If we believe that recovery means not achieving the economic condition before the crisis, but a positive sign in macro-data, it is already evident in 1Q2009 data; today 21 countries out of 42 monitored by "The Economist Intelligence" Unit show non negative figures; in 4Q2008 there were only 14. If this exit strategy were true, our conclusion is that the recovery is the result of the "old" model, with a significant difference in a more cautious behavior of banks and financial institutions.

A recovery process relying on massive public spending and liquidity would look very similar to those policies that brought the global financial system in crisis, allowing global imbalances, free but asymmetric exchange rate regimes under WTO agreements and massive foreign exchange reserves accumulated so far. We believe that the world needs new global rules for the financial and banking system, but also on foreign exchange

management, and if the G8 focuses only on the first, without considering the global financial architecture, it makes a mistake we will have to fix in the future.

There are two dangerous consequences of the strategies adopted to exit the crisis: the first is that Governments play actively in the market, instead of limiting itself as a regulator of it. Regardless of the recent statements, it will be difficult to bring Government out the market shortly. Secondly, the massive increase in public debt, around 10% on average, breaks definitively the inter-generation pact, and shifts the entire cost of present generation's welfare on the shoulders of future. With this last respect, the EU, which in the past strongly opposed such policies regardless of growth, today tolerates an excessive debt and derogates from the Amsterdam and Maastricht Treaties.

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