Securing stability and growth in a post-crisis world

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Having experienced the worst financial and economic crisis of the past decades, the international community embarked on an ambitious reform agenda to secure strong, sustainable and balanced growth in a post-crisis world. The most prominent issues on this agenda are the reform of financial regulation and the problem of macroeconomic imbalances. With regard to regulatory reform, a major step has already been taken by drawing up the Basel III framework. Nevertheless, there are still unresolved issues, such as the detailed treatment of systemically important financial institutions and an adequate approach to the shadow banking system.

Global macroeconomic imbalances have to be addressed because they not only reflect underlying barriers to sustainable growth but, in themselves, pose a threat to stability. On a regional level, the euro area, while recording a balanced account vis-a-vis the rest of the world, is marked by divergencies between member states, which place a strain on the monetary union. In both cases, a sensible policy approach has to focus on structural reforms to address the underlying causes instead of just the symptoms. Therefore, direct interventions, such as the attempt to steer current accounts or exchange rates within specific target zones, are not advisable.

When the US housing market was showing increasing signs of stress in the summer of 2007, few observers could have imagined what the ultimate fallout would be. Three and a half years later, we can look back on the worst financial and economic crisis of the past few decades. Not only did the crisis cause enormous costs in terms of growth, employment and government budgets, it also challenged our economic models as well as the institutions and policies which are based on them. Furthermore, the crisis also revealed that the high growth rates of the global economy in the years prior to the crisis had been, at least to some extent, exaggerated and unsustainable. Therefore, policymakers throughout the world have made the commitment to prevent major crises like the one we have just witnessed from happening again and to secure stability and growth in a post-crisis world.

This goal is of paramount importance. But it is also ambitious and must not be allowed to overburden economic policy with expectations that are hard to fulfil: that is true not only because of the far-reaching and complex measures that have to be implemented as lessons to be learned from the crisis, but also given the often rather indirect impact of economic policy on macroeconomic outcomes in market-based economies and the role played by policy measures in the emergence of the crisis.

While economic growth is usually treated as a macroeconomic phenomenon, it can ultimately be traced back to microeconomic activities. It is this level which determines whether the resources that fuel the engine of growth are allocated in a way that maximises output and welfare. In this process, the financial system plays an important role as it allocates investment capital, which is one of the main drivers of economic growth. Nevertheless, the crisis highlighted that the financial system can also be a major source of instability. Consequently, we have to reform the financial system so that it can once again become an efficient and stable prerequisite for economic growth. The ways and means to achieve this objective are discussed in chapter 1.

A well-functioning financial system is a necessary, but not sufficient precondition for sustainable growth. Consequently, the attempt to secure stability and growth has to focus on other aspects as well. Macroeconomic imbalances at the global level are a prominent issue in this connection. That is not to say that current account imbalances were one of the causes of the financial crisis. The deficient financial system played a far greater role in this respect. Even so, the imbalances not only reflect underlying barriers to sustainable growth but, in themselves, add an element of instability to the system. Thus, the problem of global imbalances and their causes has to be addressed so that the global economy can return to a more balanced and sustainable pattern of growth. This issue is discussed in the first part of chapter 2.

Although the euro area as a whole has a roughly balanced current account vis-a-vis the rest of the world, significant divergencies within the monetary union do exist. Just like the imbalances at the global level, they reflect underlying distortions in individual member states. Given close integration within the euro area, the resulting developments can eventually have a serious effect on all member states, as was made all too clear by the sovereign debt crisis. Therefore, the problem of macroeconomic imbalances within the euro area has to be addressed in Europe's own interest as well. This issue will be discussed in the latter part of chapter 2.

1| The reform of the global financial system

As stated above, a well-functioning financial system is an important prerequisite for economic growth. At the same time, the crisis has shown that shortcomings within the financial system can also be a major source of instability. Consequently, any attempt to secure stability and growth in a post-crisis world must begin with a reform of the global financial system. In this context, it is essential that the reforms are not just guided by the lessons of the current crisis, since the next one might emerge from a completely different angle. Acknowledging both this and the need for a global approach, the G20 has drawn up a comprehensive plan to reform financial regulation. The general objective is to make the financial system as a whole more resilient to potential shocks.

The natural starting point for such a reform was the existing global rulebook known as Basel II. After implementing some ad hoc adjustments in July 2009, the Basel Committee on Banking Supervision (BCBS) proposed far-reaching reforms in December 2009.

In effect, these reforms were so sweeping that Basel II was to become Basel III. By requiring banks to hold more capital of better quality and to build up adequate liquidity buffers, the new rules will make individual banks more stable and will constitute a first line of defence against systemic crises. Now that the rules have been endorsed at the G20 Summit in Seoul, they should be transposed into national law and applied without falling behind the agreed timetable.

However, failure of individual institutions can never be entirely ruled out. Thus, a second line of defence is needed to prevent the failure of individual banks from triggering a systemic crisis. Systemically important institutions (SIFIs) are a special issue in this context, that is banks which are so big or so interconnected that their failure might provoke a chain reaction which could eventually lead to a systemic crisis. Thus, SIFIs have an incentive to engage in risk-prone behaviour and gamble on being bailed out whenever they get into trouble. Consequently, regulation has to be designed to counter such moral hazard behaviour. An initial step could be to introduce a capital surcharge as well as more intensive supervision for SIFIs in order to enhance their stability. However, since failure still cannot be ruled out entirely, minimising moral hazard ultimately requires a system that allows for an orderly restructuring of SIFIs. Only then will it be possible to credibly bail-in investors and thus impose the necessary market discipline on SIFIs. With regard to international regulation, only globally active institutions should be addressed by an international SIFI regime. A pragmatic approach would be to start with a limited number of institutions which are indisputably of global systemic relevance. In the meantime, it would be necessary to develop a methodology for identifying SIFIs by applying the criteria of size, interconnectedness and substitutability, supplemented by judgement.

Nevertheless, the crisis demonstrated that systemic risks not only emanate from SIFIs but also emerge from outside the regular banking system. Prior to the crisis, bank managers had moved risky activities out of the regular banking system in order to circumvent regulation. As a result, a shadow banking system emerged where institutions such as special-purpose vehicles operated outside the realm of financial regulation. As these institutions replicated the general functions of banks, such as maturity transformation, huge risks built up in an uncontrolled way. Regulatory reform must not allow this process to resume, especially given that tighter reins for the regular banking system might squeeze even more activities out of it and into the shadow banking system. Therefore, it is important to increase transparency requirements for the shadow banking system and, where necessary, extend supervision and regulation beyond the regular banking sector. The guiding principle behind this should be that similar activities have to be regulated in a similar way, no matter who pursues them.

With regard to these loose ends of regulatory reform, it is important that momentum is not lost once the Basel III framework is in place. Further effort and international cooperation are required for the eventual creation of a financial system that is stable and efficient enough to serve the real economy and thus secure a sound foundation for sustainable growth. Nonetheless, a well functioning financial system is only one necessary condition for strong, sustainable and balanced economic growth. The global attempt to secure growth and stability has to focus on other aspects, too. At the moment, global imbalances are the most prominent among these.

2| Macroeconomic imbalances as a problem for stability and growth

2|1 The global level

Over the past several decades, the economies of the world have become increasingly integrated. With the removal of barriers to the worldwide flow of ideas, services, goods and capital, a global economy emerged. This has brought about a large increase in welfare and still harbours a huge potential for further economic growth and prosperity. During the past years, growth in the world economy has become increasingly unbalanced, however. Whereas the current account of the euro area has been more or less balanced in the past, some economies, most notably the United States, have been posting large and persistent current account deficits. Others, such as China and the oil-exporting countries, have been reporting equally persistent current account surpluses. In 2006, the US current account deficit peaked at 6% of gross domestic product (GDP). The Chinese surplus reached 10.6% of GDP in 2007. In the wake of the financial crisis, these imbalances have narrowed to a certain extent. In 2009, the US current account deficit was down to 2.7% of GDP; the Chinese surplus had decreased to 6% of GDP. However, this reduction in current account imbalances has been due in part to cyclical factors, such as a steep decline in oil prices. Current account positions may therefore be expected to diverge again. The International Monetary Fund (IMF) estimates that the US deficit will reach 3.3% of GDP in 2015; for the same year, the Chinese surplus is estimated to reach 7.8% of GDP.[1]

In principle, a current account surplus or deficit is not a problem in itself. Technically, it reflects the difference between –public or private– domestic saving and investment. Countries that save more than they invest domestically run current account surpluses. Countries that invest more than they save have to borrow abroad and record current account deficits. And, as for individuals, there is no reason why an economy as a whole should not be a net saver or borrower, even for an extended period of time. For countries with an ageing population it is a matter of rationality to save more than to invest domestically, since the number of investment projects with good prospects is declining, whereas households want to maintain their level of consumption in old age. Similarly, countries that export an exhaustible resource would be well advised to invest some of the proceeds abroad so that future generations can benefit from the resources as well. Therefore, these countries have temporary current account surpluses and build up net foreign assets. At the same time, countries that are catching up on economic development usually invest more than they save, as they have ample investment opportunities but are usually short of capital. As a consequence, they have to borrow abroad and run temporary current account deficits. By allowing economies to separate domestic absorption from output, current account imbalances are welfare-enhancing since consumption is smoothed over time and capital flows to those economies that offer the highest return.

However, current account imbalances are less benign when they are caused by distortions. In that case, they merely reflect underlying barriers to sustainable growth while adding an element of instability to the global economy. The imbalances we observe today began to develop in the mid-1990s. Until the turn of the century, they were driven mainly by differences in perceived profitability. Investment in the United States increased due to the hi-tech boom and an expected increase in productivity. At the same time, investment in some Asian countries declined as a result of the Asian crisis and the recession in Japan. The outcome of this was that current account divergencies between these countries and the United States increased. From 2001, the picture changed, which indicates that unsustainable developments were exercising a growing influence.

The widening US current account deficit, for example, was increasingly a reflection of a general decline in saving. Despite an ageing population and foreseeable increases in health and age-related expenditures, public saving deteriorated. Moreover, US household savings declined due to increased borrowing against rising house values. In the years prior to the financial crisis, a general boom in asset prices became another key factor leading to low saving rates. The counterpart to the US current account deficits were surpluses in emerging markets, most notably China and some oil-exporting countries. For the latter group of countries, the surpluses can partly be explained by an increase in oil prices. Nevertheless, current account surpluses were also caused by the fact that some countries pursued exchange rate policies to artificially support their export sectors. The resulting revenues were, to a large extent, channelled back into the United States, leading to an accumulation of large foreign exchange reserves by the surplus countries. While this strategy might not appear to be irrational from the surplus country's point of view, it is partly responsible for making the global economy more vulnerable to adverse shocks.

Altogether, the persistent large current account positions have too often not been the result of efficient decisions to save or invest. Instead, they reflect underlying barriers to growth and make the global economy vulnerable to shocks. In this sense, the term "imbalances" is justified, and it is necessary to address them. However, when designing relevant measures, it is imperative not to underestimate the complexity of the problem. A country's current account position is driven by a very diverse set of underlying factors from within and outside its

1 *See IMF (2010), World Economic Outlook, October 2010, pp. 195-197.*

borders. Consequently, any sensible approach to reducing current account imbalances should not aim at steering them directly. Instead, the objective should be to create circumstances in which current account positions are determined by efficient and unbiased market decisions. In this context, it is important to recognise that the statistical symmetry of current account deficits and surpluses does not necessarily reflect a symmetry in the reasons for imbalances. Hence, the question of which countries have to act in correcting the global imbalances can be answered only by identifying the ultimate causes of these imbalances.

In general, emerging economies with current account surpluses as well as oil-exporting countries should remove any structural distortions that limit the expansion of domestic demand. In countries with an undervalued currency, for example, more flexible exchange rates would strengthen purchasing power and thus help to redirect growth from exports to domestic demand. This, however, is not a panacea and should be supplemented by structural reforms. In China, for example, such reforms might include measures to improve social security, which would reduce precautionary household saving, strengthen domestic demand and ultimately lead to a more balanced current account. Economies with current account deficits, on the other hand, should adopt measures to support private saving, reduce public deficits and stabilise their debt ratios. Moreover, measures to strengthen export sectors, while maintaining open markets, would also help to reduce current account deficits. To the extent that growth before the crisis persistently exceeded potential output growth, sizeable declines in domestic absorption are inevitable –the income levels and growth rates prevailing before the crisis are no longer the appropriate benchmark. In the end, there is no single remedy for the problem of global imbalances. Hence, it is important to address the underlying causes and allow market forces to rebalance the global economy.

The need to address the problem of global imbalances was recognised early on. An agreement on measures to reduce global imbalances was struck as long ago as 2006 by the International Monetary and Financial Committee of the IMF. This concerned, in particular, the United States as the main deficit country as well as the main surplus countries in Asia and among the oil-exporting nations. While the United States pledged to increase domestic private saving and to consolidate the federal budget, the Asian emerging economies committed themselves to strengthening domestic demand and to allowing for greater flexibility of exchange rates. Progress in implementing the agreed measures proved to be rather slow, however.

Another attempt to address the problem of imbalances on a political level was undertaken by the G20. The "Framework for strong, sustainable and balanced growth" was launched in September 2009. This framework includes a pledge to "promote more balanced current accounts". As a general objective, this certainly points in the right direction. However, it is essential to address the problem of imbalances on a structural level. As has been argued above, current accounts reflect a very complex set of determinants. Thus, any attempt to steer them directly within more or less arbitrary limits would overburden the relevant authorities. Similar objections apply to attempts to stabilise major exchange rates around given target values. Such efforts at macroeconomic fine-tuning raise public expectations that economic policy cannot live up to; rather, they risk creating new frictions that require further interventions.

With this caveat in mind, the framework could indeed usefully support the process of restoring more balanced global growth. In contrast to the multilateral consultations that were held in 2006, the G20 commitments are backed by all the major stakeholders and are driven at the highest level by the G20 leaders. Moreover, a Mutual Assessment Process forms part of the framework. This process could provide an opportunity for exerting peer pressure among members to undertake the required structural reforms. In the end, however, it is up to the national authorities to implement the necessary measures to allow for a market-based reduction of imbalances.

2|2 The European level

Divergencies within the euro area have existed since the beginning of monetary union. It was, however, the financial crisis that brought them to the top of the agenda. Countries such as Germany or the Netherlands have been posting persistent current account surpluses, while countries such as Greece, Portugal, Spain or Ireland have posted persistent current account deficits. Again, such phenomena are not a problem *per se*. Rather, it depends on what the capital flows are used for.

In the euro area, these capital flows were increased by the introduction of the euro. There were two reasons for this. First, exchange rate risk was eliminated, making cross-border investments less risky. Second, the risks of sovereign default were perceived to be converging towards a relatively low level. This in itself might have set the wrong incentives for investors, but the main problem was that the deficit countries did not always invest the inflowing capital efficiently. In Ireland and Spain, capital went mainly into booming but, ultimately, unsustainably dynamic real estate markets. In Greece, it funded high government deficits, and in Portugal it supported private consumption. This allocation boosted domestic demand and, owing to inflexible labour markets, wages rose faster than productivity. This, in turn, reduced the price competitiveness of the deficit countries –imports increased, exports dwindled and the current account deficit widened further. In a monetary union, an important corollary of the common monetary policy is national economic policymakers' increased responsibility for coping with idiosyncratic shocks. Failure to acknowledge this fundamental relationship was at the root of the divergencies we observed.

Although these imbalances are domestic in origin, the associated problems have not been confined to the national level. Given spillover effects in the closely integrated euro-area financial markets, the imbalances have also become a problem for other member states and for the monetary union as a whole, culminating in the debt crisis that began in 2010. As a result, it became obvious that the existing imbalances within the euro area had to be dealt with if major harm to the monetary union were to be avoided.

As the deeper causes of the imbalances are domestic factors within the deficit countries, it is mainly incumbent on them to take action. A number of structural reforms are necessary to enhance the competitiveness of domestic companies by increasing productivity and keeping costs in check. At the same time, the deficit countries have to increase labour market flexibility and consolidate government budgets. In this context, a much-debated question is whether surplus countries should adjust, too. On a rather general level of abstraction, they certainly have to. Once import demand from deficit countries declines, surplus countries will have to reallocate some resources towards satisfying domestic demand.

Even though structural reforms in surplus countries can facilitate this process, such reforms are beneficial in themselves, quite apart from the question of macroeconomic divergencies within the euro area: Germany, for example, would always benefit from more flexible labour markets, which reduce low-skilled unemployment, and from deregulated services and product markets. Germany is also a case in point with regard to the benefits of comprehensive and, sometimes, painful structural reforms. The dividend from this was a robust labour market during the recent downturn, which meant comparatively robust private consumption, while the significantly improved state of public finances had a major stabilising role in Germany as well as in the euro area as a whole. The unemployment rate has now gone back down below its pre-crisis level, economic growth is increasingly being driven by domestic demand, and the government is benefiting from high market confidence in the soundness of public finances through low refinancing costs.

This has led to calls to use the supposedly larger available room for manoeuvre to actively boost domestic demand. However, this would do little to ease the adjustment burdens of deficit countries: since trade flows are highly diversified, an increase in the imports of surplus countries would improve the current account in deficit countries only by a small margin. Given the current trade structure, a 10% increase in German imports would improve the current account balance in Spain, Portugal and Greece by a mere 0.25 percentage point. In Ireland, the current account would improve by 1 percentage point.[2] Furthermore, the options for actively boosting demand are themselves very limited. Raising wages to support domestic demand and lower competitiveness is hardly possible as wages are not a political control variable. Moreover, simulation studies show that the effects would be confined almost entirely to the home economy in the form of changes in employment. Also, the options for using fiscal policy to stimulate domestic demand and imports should not be overstated: public finances in surplus countries are also strained, and ambitious consolidation efforts are required there as well. Consequently, it is inevitable that most of the burden of adjustment will fall on the deficit countries.

2 *See Bundesbank (2010): "On the problems of macroeconomic imbalances in the euro area". In: Bundesbank Monthly Report, July 2010, pp. 17-38.*

In addition, calls for expansionary macroeconomic policies in surplus economies are hard to reconcile with the goal of balanced and sustainable growth. Given the limited spillover to deficit countries, additional stimulus measures in surplus economies already undergoing a brisk recovery would be highly procyclical, thereby increasing heterogeneity within the euro area and forcing monetary policymakers to take a more restrictive stance in order to ensure price stability.

The financial and economic crisis has shown that a global effort is required to prevent future crises of a similar magnitude. This has been acknowledged by governments around the world, and the G20 has emerged as the main forum for discussing relevant measures on a global level. The undisputed objective is to secure stability and growth in a post-crisis world, and, accordingly, the G20 has developed an encompassing agenda for reform. Two of the main issues in this context have been discussed in this article –the reform of financial regulation and the problem of macroeconomic imbalances.

However, in the face of this ambitious work programme, it is important to have a clear understanding of what economic policy can and cannot achieve. It is certainly necessary to strengthen institutions, such as the regulatory framework for financial markets. It is also necessary to remove structural barriers to strong, sustainable and balanced economic growth, such as rigidities on product and labour markets, managed exchange rates which are out of line with fundamentals, and unsustainable public finances. However, economic policy and policymakers cannot directly make growth strong, sustainable and balanced, and they should not strive to do so. One reason for this is that the financial crisis was not caused solely by market participants' behaviour; economic policy also has to take its share of the blame. A more fundamental reason is that the market economies are far too complex to be micromanaged by governments. Therefore, "more government and less market" cannot be the solution. Rather, it should be "better government for better market outcomes". In terms of policymaking, the only way to achieve this is by creating a strong institutional framework in which market forces can act to efficiently rebalance the global economy and generate sustainable growth.