16 September 2013

The Limits of Surveillance and Financial Market Failure: Lessons from the Euro-area crisis

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Prepared for an international conference to be organised by the International Policy Studies Association in co-operation with La Maison de l'Europe de Paris on 23rd September 2013 in Paris

1. Introduction

The lesson that regulation and supervision of banks and financial markets must improve has now at last become conventional wisdom among politicians in Europe in the wake of the ongoing crisis. Much work, and much EU and BIS meeting time, has been devoted to these issues and much more will be needed. EU capitals will be busy analyzing and negotiating for some time yet.

Separate from, but closely related to the issue of regulation and supervision of banks and financial markets is the issue of macroeconomic surveillance. This is a much more difficult issue as it touches the very heart of national sovereignty as well as politics and ideology. This area too has been subject to upgraded mechanisms as regards surveillance in general as well as the more controversial issue of what actions to be taken when surveillance indicates that things are about to go wrong.

Much hope is attached to these planned reforms, expectations are high. We do not know yet how efficient the new rules will be, but it is important to consider the limits to what these kinds of supervision, regulation and surveillance can achieve in preventing future crises of the kind we have seen first gradually accumulating and then exploding in Europe over the past decade.

In order to shed light on this important question we can try to assess whether it would have made a difference to the crisis of the past five years if these reforms had been in place from the beginning.

2. Would better surveillance have made a difference?

The mechanisms leading to the eurocrisis had two distinctly different characters.

A. For Ireland and Spain, joining a monetary union with Germany meant low interest rates, credit expansion, inflation and even lower real rates of interest. Resulting growth meant low unemployment and strong public finances, both recognized as signs of success and basis for international admiration as well as domestic enthusiasm and pride. Similar patterns could be seen in other countries like Iceland and Latvia, and 20 years earlier in Sweden, Finland and Norway.

Would better regulation have prevented the problems? I believe not. If Irish or Spanish banks had been subject to tighter regulation irish and spanish demand for credit would have been met by lending from other countries as capital moves freely in the whole single market for financial services, which consists of some 30 countries. In Ireland for example, competition for customers was strong not only from neighbouring UK, but also from financial centres like Iceland and Liechtenstein.

When countries with monetary independence face a property bubble, bank lending can to some extent be held back by funding for the banks becoming gradually more difficult or expensive, as foreign lenders become more cautious and risk averse. In the monetary union this mechanism is almost non-existent since banks have an automatic right to borrow from the Eurosystem via their central banks. This way Spanish banks were able to borrow €400 billion or 37% of GDP from the Eurosystem when market confidence evaporated in 2011-12. When international banks lost confidence in the Spanish banks, bank deposits in surplus countries like Germany were channelled via the Bundesbank and the payments system Target 2 to the Spanish central bank and then on to Spanish banks who had lost normal market access. Being in a monetary union thus postponed adjustment and transferred risk from banks to taxpayers.

Assessment values for real estate was and is based on actual transaction prices, and as market prices do rise, it's hard to see how assessed values could be effectively regulated. For individual countries inside a monetary union, cosmetic or temporary measures could be introduced but their influence on market prices or price expectations would at best be limited and temporary.

This is also illustrated by the Spanish experience. Spain had much-vaunted dynamic provisioning rules enforced on banks (forcing them to hold higher capital when they expanded lending quickly) but this did not prevent the boom. BIS and IMF analysis of countries where this have been tried suggest that quite large decreases in loan to value ratios have only modest and temporary effects on house prices. Such rules protect the banks but had only limited effect on the property price dynamic[1].

To effectively put the brakes on an emerging bubble is extremely hard inside a monetary union, maybe not even possible. The only really effective measure would be a rise in interest rates, which is of course an instrument not available for countries like Ireland and Spain.

Fiscal policy is sometimes mentioned as an alternative to stem a rising bubble. As it is virtually the only remaining option once monetary policy is taken away from national decision-makers this is a natural way of thinking. But the magnitudes involved are such that this is not a realistic way out of the problems.

A draconian fiscal tightening would amount to something like 3-5 per cent of GDP, or in extreme cases even some more. But in countries where borrowing by households and

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[1] C Crowe, G Dell'Ariccia, D Igan, and P Rabanal: How to Deal with Real Estate Booms: Lessons from Country Experiences; IMF Working Paper WP/11/91

non-financial companies reach 100 per cent of GDP over three or four years, money that can be spent on consumption and investment, this is clearly not going to work. The forces of financial markets are simply too powerful for fiscal policy to really make a difference. Private borrowing of this magnitude is not uncommon in crises like these. Ireland, Spain, Portugal, Iceland and Latvia are other examples in recent years, and Sweden, Norway and Finland in the 1980s.

In theory, fiscal measures could work if they were applied early, long before problems become visible. And they must be effectively targeted at housing and real estate, like reduced or abolished deductibility of interest payments and higher property taxes.

I don't believe this is possible in practice. Economists aren't that good. Experience from the run-up to the eurocrisis, or the Swedish, Latvian or Icelandic crises demonstrate this. Not even the Fed with all its mighty resources and hundreds of bright economists had a clue what was going on in the US until it was too late (See Annex I)[2].

And even if the problems were identified at an early stage, it remains that EU is a union of democracies. To implement extremely unpopular measures needed in a situation like this is not an easy thing to do. In order to stem a housing bubble early, before it's too late, measures must aim at housing and rents, the most important items in voters private economy, often much more important for their economic security and standard of living than even their salaries. Increases in taxes, especially on housing, is close to suicidal for politicians in normal times. But in a situation characterized not by deficits and debts, but by strong budgets, maybe even in surplus, and where the economy is praised by a unanimous chorus of economists and international organizations, that is a challenge one can not count on to be feasible anywhere.

In Europe, fiscal policy is in the hands of democratically elected Governments and Parliaments. And all over Europe, majority governments are very rare, and where they occur they are usually fragile coalitions of several parties. This reinforces the conclusion that relying on fiscal policy to stabilize emerging bubbles is simply unrealistic.

My views on this point are based on my experience in Sweden in the late 1980s. Following the deregulation of bank lending in 1985, a massive credit expansion (100 per cent of GDP in three years) fuelled a dramatic overheating of the economy. Because of a self-imposed fixed exchange rate policy, monetary policy could not be used and the entire burden of stabilising the economy fell on fiscal policy. Strong growth, full employment and fiscal surpluses made the Finance Minister Kjell-Olof Feldt the star of the international financial press. Public opinion, banks, real estate investors, trade unions and employers alike, all lost touch with reality and voters expected ever-growing wages and apartments. Under

[2] "Fed red-faced as notes reveal officials failed to grasp dangers of 2007 crisis", Financial Times, January 19, 2013 http://presscuttings.ft.com/presscuttings/s/3/articleText/68325740#axzz2LRlcJv7r

these circumstances there was no way a Social Democratic minority government could negotiate drastic tax increases in a Parliament where all opposition parties demanded lower taxes and higher benefits. Absurdly, at this time of exploding private debt there were demands in Parliament for even more expansionary monetary policy. I believe these are the kind of attitudes that are fostered in times of booms and surpluses. That was the context in which the Government tried to tighten fiscal policy. But it failed and resigned. It ended with 500 per cent interest rates, implosion of the banking system, collapse of the fixed exchange rate regime and a new start with flexible exchange rates, inflation targeting and monetary policy independence. Then we experienced the 15 best years of growth in a generation.

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B. The other mechanism leading to the eurocrisis is the one associated with countries like Greece and Italy, where the problem was not credit expansion and property bubbles but long periods of sustained mismanagement of public finances and severe loss of competitiveness. The public administration was inefficient and the political system had little legitimacy. Property bubbles or bank lending to the private sector was not a part of the build-up to the crisis.

Would better macroeconomic surveillance have prevented these problems?
This is an easier question to address than the previous one, whether better regulations would have prevented the bubbles in Ireland and Spain. I believe that better macroeconomic surveillance would not have made any difference to problems in countries like Greece and Italy. Current efforts to intensify surveillance, although welcome, may nevertheless risk sending the message that things are now under control while risks in reality remain as before. The trauma of the eurocrisis will most likely lead to intensified vigilance whether new institutional arrangements are put in place or not. But, as memories of this trauma fade, I fear risks will be back where they were before 2008 irrespective of the changes now being introduced or considered.

Macroeconomic statistics are no secrets. Current accounts, GDP, competitiveness indicators and inflation are available to anyone all the time. Public deficits and debts are published every month. All numbers are analysed all the time by many public and private institutions. This has been the case all the time when these economies gradually developed unsustainable levels of debt and competitiveness. The problem was not that the numbers were not known, but that they were not understood. The severity of the gradual deterioration was not taken seriously.

All through the decade-long period from the start of the Monetary Union to the outbreak of the acute phase of the crisis in 2009 macroeconomic developments were subject to surveillance by many different institutions. The EU Commission pursued an ambitious annual review process including a peer review hearing in the Ecofin Council of EU Finance Ministers all the time since the mid 90s. I defended the Swedish policies at such an examination when our deficit was 10 per cent of GDP, I can certify that there was no lack of procedures or resources. IMF and OECD also pursue regular annual or biennual reviews followed by detailed hearings with policy-makers. In the private sector, banks, rating agencies, media all published regular reviews of the macroeconomic performance of every country without sounding alarm bells. Consequently, this led neither investors or creditors nor policy makers or voters to react. It's hard to see lack of macroeconomic surveillance as a key factor behind the present problems. The problem was rather the quality of the surveillance and the way it was followed-up.

3. Will macroeconomic surveillance make a difference?

Macroeconomic surveillance is now being upgraded in EU as a consequence of the crisis. It is now given more weight and structure, but it's pursued along the same lines and by the same institutions as before. The EU Commission now publishes an Alert Mechanism Report which identifies countries where the economic situation motivates deeper analysis, which in turn can lead to a Macroeconomic Imbalance Procedure where the Commission can recommend measures[3].

In my view, there are two main problems surrounding the macroeconomic surveillance.

The first is the intellectual climate that has characterised macroeconomic debate in Europe and European institutions for a long time. In economic policy-making it is necessary to permanently be on the watch for risks and uncertainties. But this instinct has often been overrun by the drive to pursue, implement and then defend the groundbreaking reforms of ever closer European integration. Identification and analysis of risks have not been given proper attention, on the contrary, such activities have been met by suspicion or even animosity. The result has been that problems that should have been expected occurred as surprises to unprepared politicians.

One example is the risks involved in the one-size-fits-all interest rate that is the starting point of a monetary union. Instead of analyzing its risks it was postulated that once the monetary union was established, economies would converge and the risks would disappear. Serious American economists argued otherwise, like Martin Feldstein in his important article in Foreign Affairs in 1997. He argued that monetary union in Europe would on the contrary lead to divergence and conflict [4]. They were all dismissed and

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[3] European Commission: Alert Mechanism Report 2013 http://ec.europa.eu/economy_finance/economic_governance/documents/alert_mechanism_report_2012-11_en.pdf

[4] Feldstein, Martin. "EMU and international conflict". *Foreign Affairs*, November/December 1997.

ignored without any analysis or arguments. We know now that monetary union in Europe has led not to convergence but to divergence, and not to fraternity but to animosity, just like Feldstein envisaged. The problem was not that the mechanisms were unheard of but that they were somehow outside the range of serious debate. I fear that there was a climate where potential problems were dismissed or overlooked in order not to risk weakening public support for a project that was deemed all-important. An internal critic, Bernard Connolly, was fired from the European Commission for "damaging the institution's image and reputation" when he published his, as we know now, well-founded concerns about the risks inherent in the monetary union (see Annex II)[5].

The second problem I see has to do with the fact that all surveillance aims at influencing economic decisions. The problems occur when alarm bells ring and a member country needs to take difficult and unpopular measures. If outside surveillance was necessary to identify the risks, it must be assumed that the measures required are not obvious to all and that they are controversial. They may also indicate that the elected Government of the country made mistakes or that the picture of the economy they provide their citizens is too rosy. This could lead either to withdrawal or the watering down of the results of the surveillance, or that it will be seen as a foreign interference in domestic politics. This is a very real risk that everybody who has been in contact with such affairs have seen. For my part, I have seen examples of both alternatives, watering down as well as accusations of politcizing, in order to diminish the credibility of analysis of international organizations. My experience is also that the mere possibility of such pressure risks leading to self-censorship.

In the case of IMF, the Managing Director is always appointed by the Eurozone and represents their view of the Monetary Union. Nobody can become Secretary-General of OECD without seeking and receiving active support from the Euro-countries, all of which are members of OECD. This influences the analysis and impartiality of these two heavyweight organizations.

Then there is the further severe question of legitimacy. Who is to decide what is needed, elected decision-makers who are responsible to voters who can fire them, or unelected civil servants who reports to nobody? Are the measures proposed objective science or based on values? I don't believe any economic policy measures are free of values, even though that is sometimes assumed. We have seen how measures that are perceived as having been imposed from outside have led to problems for national democracies. Voters feel their votes mean little when any Government has to implement the same measures irrespective of elections. In many countries, nationalist and anti-EU parties have made big gains as the only alternative to policies perceived to be imposed from outside. This is the experience not only in indebted countries like Greece and Spain where anti-EU and

[5] "Euro-court outlaws criticism of EU",The Telegraph, March 7, 2001
http://www.telegraph.co.uk/news/worldnews/1325398/Euro-court-outlaws-criticism-of-EU.html

separatist parties have grown, but also in countries like Finland and Netherlands where voters feel they have to pay bills decided somewhere else beyond their control. Decisions taken by elected bodies at EU-level, like the Council of Ministers or the European Parliament, are more democratically legitimate than those taken by civil servants, but the distance between voters and decision makers becomes big. Democratic accountability becomes almost equally remote.

Another serious difficulty is added, that of national sentiments. Being the most powerful nation, Germany symbolises power to those being subject to the harsh and unpopular measures too tough for national politicians and therefore perceived to be imposed from outside. We have already seen how such emotions trigger centrifugal forces in the Eurozone, some of them nationalistic and ugly.

Most debate and analysis is focussed on heavily indebted countries and their deficits. But a balanced development of the eurozone also needs adjustment of surpluses. I see no signs of any pressure on surplus countries to take action to reduce their part in the tensions that has built up between deficits and surpluses inside the eurozone. The political difficulties in trying to impose measures in those countries appear formidable. The only adjustment on the table is the squeezing of demand in some countries resulting in further austerity in the eurozone as a whole, with a widening current account surplus and even higher unemployment.

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4. Concluding remarks

Recent efforts to reform supervision and regulation of banks as well as to intensify macroeconomic surveillance will not be enough to avoid renewed crises in the eurozone. The following are some reflections on areas where progress can be made in this area.

1. My first conclusion is to reduce expectations to a realistic level. Some risks and problems are inherent in a monetary union. They will not go away and member countries would be well served by learning to live with them. Then they would be better prepared to be alert to those risks. The most important one concerns the fundamental element that there is only one interest rate and no national monetary policy. For some, the common interest rate will be too high while for others it will be too low. This must be discussed and analyzed in the open, not hidden or defined away as was the case in the first decade of the euro.

2. This factor has to some extent now changed as market forces have fragmented the eurozone by differentiating risk premiums between countries. Although in violation of the

fundamental idea of the monetary union to have just one financial market and one interest rate, this change has done away with the unrealistic and dangerous assessment that there is no difference in risk between different parts of the eurozone. Market forces have now re-nationalized interest rates. It remains to be seen whether this will contribute to convergence by resulting in higher interest rates in countries with high growth and low unemployment than in countries in recession. So far the result has been the opposite, the stronger the economy, the lower the interest rate, while the countries with the highest unemployment have faced the highest interest rates. Thus this re-nationalisation of markets contributes to the centrifugal forces that increase tensions within the eurozone.

This fragmentation of markets carries with it one aspect that reduces the risk of some of the problems leading to the eurocrisis. Countries running big deficits and rising levels of debt may face higher interest rates and higher debt servicing costs. This should provide powerful signals to address deteriorating public finances earlier than was the case when everybody could borrow unlimited amounts at German interest rates irrespective of whether their fiscal situation was perfect or totally out of control. Markets have this way reintroduced the early warning system that European politicians abolished, this has, paradoxically, made the system more robust for the future.

3. A realistic view of the limits of what ongoing reforms can achieve reduces the risk of complacency and could contribute to continued vigilance. It also reduces the risk of disappointment and backlash if new problems occur in spite of the reforms undertaken.

Efforts to identify risks and to discuss them in public should be encouraged or even rewarded. Too often in the past such debate have been supressed for the misguided belief that admitting risks would undermine confidence or support for monetary union. I believe the opposite is true. If citizens are convinced that policymakers are aware of risks and prepared also for unlikely but possible outcomes, I believe this would make them they feel less insecure about the future and trust the system more. I’m convinced that passengers feel more confident on board an unsinkable ship with lifeboats than on one without such safeguards. Nobody would argue that being prepared for unexpected accidents would make people scared because such caution would make them feel they were preparing for disaster. In other spheres of life, seat-belts, fire extinguishers, life insurance on the contrary make people feel safer.

4. The IMF has a most important role to play in averting risks for future eurocrises. Priority should be given to strengthening its role and authority to fulfil its responsibilities. That requires a change in the way the Managing Director is appointed. The present system that guarantees that the MD is former Finance Minister or Central Bank Governor from a eurocountry is counterproductive. It is a paradox that the present MD, the watchdog in charge of ensuring responsible management of the euro economies, in her previous position as Finance Minister undermined the disciplinary elements of the Monetary Union.

In 2007, the newly elected French government, where she was Minister of Finance, decided unilaterally not to implement the fiscal adjustment program that the previous government had agreed upon with other Member States and the Commission[6], thus signalling to other, smaller countries that the rules of the Stability Pact were not to be taken seriously. The outdated European entitlement to appoint the head of IMF must be replaced by a merit-based recruitment system in order to strengthen the authority and credibility of this important institution.

5. The eurozone is now heavily burdened by the large disparities between its many members and the lack of efficient mechanisms to deal with this heterogeneity. Changes in the eurosystem are now taking place and more are under way. Until these changes have been put in place and experience shows that they are working, it would be unwise to add further burdens and complexities to to the system. More members would mean still more heterogeneity and even more complex decision-making procedures to an already overburdened monetary union. Enlarging the eurozone further by admitting new members should therefore wait until the changes to the system have been introduced and proved working. A moratorium on enlargement is motivated until there is confidence that the eurosystem can handle the challenges a large and diverse monetary union imposes.

Finally, when discussing the role of financial regulation, supervision and surveillance it is relevant to have the context in mind. Interest rates and exchange rates are extremely powerful instruments in addressing severe imbalances that have already occurred as well as in avoiding future imbalances. When these instruments are abolished as instruments for economic policymakers in individual countries the burden falls heavier on the remaining instruments: fiscal policy and administrative, bureaucratic, regulatory instruments.

My conclusion in this paper is that this burden is too heavy for administrative policy instruments alone to make a substantial difference. Nevertheless, some of them can contribute to making the system less vulnerable in the future, e.g. solvency requirements, governance issues, regulation of bonuses, bank resolution mechanisms, improved auditing etc. But to put too high expectations on such measures will lead to disappointment. They can not take away the risks inherent in a monetary union of sovereign nations. These risks one must accept to endure.

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[6] Icard: Global and Regional Surveillance: Lessons from the Euro-area crisis

Annex I

FT 19/1 2013

Fed red-faced as notes reveal officials failed to grasp dangers of 2007 crisis

By Claire Jones in London and Robin Harding in Washington

Top officials at the US Federal Reserve took months to realise that the 2007 financial crisis would rock the world's largest economy, according to embarrassing meeting transcripts released yesterday.

The transcripts reveal that some Fed policy makers viewed the crisis, which erupted in August 2007 on the back of problems in the market for subprime mortgage loans, as good news because markets were pricing in more risk.

The records of the Federal Open Market Committee's 2007 meetings, which are released with a five-year delay, raise the question of whether the recession would have been less severe if the Fed had reacted faster instead of continuing to forecast steady growth.

On August 7 – two days before the European Central Bank made its offer of unlimited funds to eurozone banks to counter a liquidity shortage – one Fed governor described the subprime crisis as "quite a good thing" because it was forcing people to reassess the quality of financial information.

"The point of the subprime market is just that we now trust the credit rating agencies less," said Frederic Mishkin. "Basically what I think is happening in a way is quite a good thing: We were concerned that the markets were a little too optimistic, that there was too much opacity, and that people weren't worried about it. Now, in fact, they are worried about it, and I think that is fundamentally a healthy situation."

Important information – such as the extent of insurer AIG's exposure to subprime debt – was unknown at the start of the crisis, and the minutes show the Fed wrestling to understand the scope of the problem as it changed from subprime housing to a run on parts of the "shadow banking" system such as asset-backed commercial paper.

Some Fed policy makers viewed the crisis as good news

But while some officials worried about the extent of financial market problems, they did not see much risk of recession and forecast only a modest slowdown in growth.

"My forecast for the most likely outcome for output over the next few years is . . . growth a little below potential for a few quarters, held down by the housing correction, and the unemployment rate rising a little further," said Donald Kohn, vice-chairman, in August 2007.

"I agree that this reassessment is a fundamentally healthy but somewhat messy correction to more-sustainable term and risk premiums," he added.

"The most likely outcome is that it will be limited in duration and effect."

Annex II

The Telegraph

Euro-court outlaws criticism of EU

By Ambrose Evans-Pritchard in Brussels
12:00AM GMT 07 Mar 2001

THE European Court of Justice ruled yesterday that the European Union can lawfully suppress political criticism of its institutions and of leading figures, sweeping aside English Common Law and 50 years of European precedents on civil liberties.

The EU's top court found that the European Commission was entitled to sack Bernard Connolly, a British economist dismissed in 1995 for writing a critique of European monetary integration entitled The Rotten Heart of Europe.

The ruling stated that the commission could restrict dissent in order to "protect the rights of others" and punish individuals who "damaged the institution's image and reputation". The case has wider implications for free speech that could extend to EU citizens who do not work for the Brussels bureaucracy.

The court called the Connolly book "aggressive, derogatory and insulting", taking particular umbrage at the author's suggestion that Economic and Monetary Union was a threat to democracy, freedom and "ultimately peace".

However, it dropped an argument put forward three months ago by the advocate-general, Damaso Ruiz-Jarabo Colomer, which implied that Mr Connolly's criticism of the EU was akin to extreme blasphemy, and therefore not protected speech.

The Telegraph, March 7, 2001