Lorenzo Bini Smaghi: Towards the G8 – strategies for emerging from the crisis

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Università LUISS Guido Carli, Rome, 27 May 2009.

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I would like to start by thanking the organisers of this conference for the invitation to reflect together on the topics related to the next G8 summit. There is no doubt that the economic and financial crisis, the most serious of the post-war period, will take centre stage at the upcoming international meetings.

Today's conference is entitled "Strategies for emerging from the crisis". It is right to speak of strategies, because intervention is required at a number of different levels. These concern financial regulation, the governance of institutions and companies, the ethical behaviour of economic agents and legislators, and economic policies. Looking at the composition of the panel for this conference, it seems to me that my comparative advantages chiefly relate to this last area, that of economic policies.

There is no doubt that the economic policies of recent years have played a role in creating the conditions which have led us to this crisis. They were not the only factor, perhaps not even the main one, but they were important, because they tended to heighten, rather than to counter, the procyclical behaviour of agents. For example, in countries where the private sector was already highly indebted, economic policies sometimes promoted further borrowing, in particular through low interest rates and fiscal incentives.

If we wish to avoid recreating the conditions which led to this crisis, we must carefully examine the motives behind the economic policies that were implemented during this period. This exercise can be conducted at two levels. The first implies analysing the economic policies on the basis of the specific reference criteria of those policies. A policy may turn out to be inappropriate, for example, because it is based on incorrect economic forecasts or because it is implemented through ineffective instruments. Thus far, the discussion has mainly taken place at this level, and the remedies suggested have mainly been aimed at correcting these aspects. It is an important discussion, without a doubt, but there is a risk that such discussion is insufficient because it does not tackle the fundamental causes that led economic policy-makers to take certain measures. For this reason, a second, more profound level of analysis is necessary.

Let us proceed in order. Let us begin with the first level of analysis. This involves examining the way in which the conduct of economic policies contributed to the emergence of the imbalances which caused the crisis. Various policies can be considered: structural, regulatory, fiscal and monetary policies. For reasons of time, I would like to concentrate briefly on monetary policy in order to provide an example of the type of analysis which will be conducted, and is being conducted, also in other areas.

There is now a broad consensus that the policy of very low interest rates, especially in real terms, which was followed in particular in the United States in the period 2002-04, increased the incentives for financial institutions, households and businesses to raise their levels of indebtedness and to take high-risk speculative positions.[1] In a recent paper, John Taylor illustrated that if the Federal Reserve had implemented a less expansionary monetary policy, and had instead followed a simple rule to determine interest rates, in line with past

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[1] J. Taylor (2009), *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis*, Hoover Institution Press.

behaviour, less liquidity would have accumulated at the global level. Clearly, this is an ex post evaluation. And it is too easy to lay the blame at the door of the US monetary authority. Looking back at the analyses conducted at the time, it can be seen that this policy met with the approval of the academic world, market analysts and political parties. Following the bursting of the technology bubble and 11 September, there was a general consensus that deflation represented the greatest risk and needed to be countered by strong and sustained monetary expansion.[2]

This line of reasoning was so widespread, propagated by the media (and not just the Anglo-Saxon media), that anyone making different choices was subject to criticism. The European Central Bank (ECB), which had refused to cut interest rates to the same level as the Federal Reserve, keeping them at 2% (compared with the Federal Reserve's 1%), was for a long time the subject of criticism.[3] Not just academics, commentators and market analysts, but also Heads of State and Government were moved to call upon the ECB to ease monetary policy. It was as if the only criterion when deciding on interest rates were not the underlying economic conditions, from a medium-term perspective, but the need to act at all costs, in a single direction, in imitation of what had been done on the other side of the Atlantic. Some even called on the ECB to intervene in the exchange rate markets to establish parity between the euro and the dollar. If this had been done, the speculative bubble would have been larger and the effects of it bursting even more devastating, particularly for Europe.

When the ECB decided in December 2005 to raise interest rates, it again met with a flood of criticism. Many observers thought that the decision would hinder economic recovery.[4] With hindsight, the policy followed by the ECB, with a more medium-term orientation, clearly turned out to be appropriate.

The effects of monetary policy on financial market developments, in particular in fostering the subsequent financial bubble, have led to a reassessment regarding the conduct of monetary policy. The debate is under way and concerns various aspects, which I will summarise briefly.

The first concerns the tools of monetary policy. Recent experience has shown that the approach followed by most central banks, based on inflation targeting (which involves forecasting inflation on the basis of an economic model and changing interest rates so as to ensure that inflation forecasts are in line with the target), does not sufficiently take into account financial developments, in particular with regard to asset prices, which may affect the stability of the markets and, in time, inflation. It is argued by some that monetary policy should act proactively to avoid the excessive tendencies of the financial markets, known as "leaning against the wind".[5] In other words, one should be ready to hinder the creation of speculative bubbles, among other things by raising interest rates, before inflationary pressures emerge. This is easier said than done. If it is difficult to forecast inflation, it is even

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[2] Ben S. Bernanke (2002), "Deflation: Making Sure "It" Doesn't Happen Here", remarks before the National Economists Club, Washington, D.C., 21 November 2002; Alan Greenspan (2004), "Risk and uncertainty in monetary policy", remarks at the Meetings of the American Economic Association, San Diego, California, 3 January 2004.

[3] See for example this comment which appeared in the July 2005 edition of The Economist: " *[…] The pursuit of price stability is a means to an end (to achieve maximum sustainable growth), not an end in itself. While the ECB's prime task is price stability, it is also legally charged with supporting growth. Last year it could have cut interest rates to offset the impact of the rising euro; today it should stand ready to ease monetary policy to cushion the impact of structural reform and fiscal discipline."*

[4] See, for example, O. Blanchard e F. Giavazzi (2005), "Credibility does not require dogmatism - only clarity of purpose", at www.voxru.org.

[5] S. Cecchetti, H. Genberg and S. Wadhwani (2002), "Asset Prices in a Flexible Inflation Targeting Framework," NBER Working Paper No. 8970, June, and N. Roubini (2006), "Why Central Banks Should Burst Bubbles", International Finance 9, No 1.

harder to interpret financial asset prices and to derive from them indicators regarding the risks of instability. And it is even more difficult to adjust the course of interest rates on the basis of these indicators. For this reason, the proposition of leaning against the wind remains an abstract concept for now. It would be important to develop economic models which give a more precise idea of the quantitative dimension of these phenomena, in particular of the correlation between monetary policy variables and financial asset prices.[6]

The ECB has for some time tried to use information relating to money and credit markets when forecasting inflationary pressures. The ECB bases its strategy on two pillars, an economic pillar and a monetary pillar, which collects various short and medium-term indicators, including aggregates and prices of financial assets. These indicators are not used mechanistically, but rather to gauge whether the conduct of monetary policy is broadly consistent with achieving the target. It was on the basis of these indicators, which showed strong dynamics, that the ECB decided to increase interest rates at the end of 2005 – that very controversial decision which subsequently proved to have been correct, as I mentioned earlier.[7]

The second aspect on which a debate is developing concerns the objective of monetary policy. In most countries monetary policy has price stability as its primary objective. There are also other, secondary objectives to be pursued insofar as they are consistent with price stability. The question which has been asked as a result of the crisis is whether the central bank also ought to have financial stability as an explicit objective, on the same level as price stability. Indeed, if price stability is a necessary condition for the achievement of financial stability, it is not sufficient. On the other hand, without financial stability, there is a risk that price stability will not be durable. It thus seems reasonable to assign central banks the objective of financial stability too.

If we plan to follow this route, the central banks need to have the instruments to achieve the objectives assigned to them. Interest rates are typically used to adjust monetary conditions to the objective of price stability. If the central bank is also to pursue financial stability, it needs to have another instrument at its disposal. In particular, if the objective is to counter the procyclical behaviour and excessive accumulation of leverage on the part of agents which are at the root of speculative bubbles, the central bank must be able to use instruments which affect the structure of bank balance sheets. It must be able to affect, for example, borrowing capacity, leverage, liquidity management methods or the way in which reserves are recorded in favourable phases of the cycle in order to be able to face the negative phases. These are the instruments of what is known as macro-prudential supervision, which are used in a preventive manner.

In this regard, the de Larosière report was prepared in Europe in order to draw some conclusions from the crisis.[8] However, the report restricts the central banking system's scope for action to simply issuing recommendations, while direct interventions with regard to the variables at the root of financial imbalances are not foreseen. The responsibility for implementing, or not implementing, the macro-prudential recommendations remains a national choice, to be made by the relevant supervisory authority. There is no guarantee that these measures will be taken in a uniform manner and in line with the need for stability within the Single Market. Competition between national financial centres in reality risks deterring national authorities from adopting measures proposed by the European authority.

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6 K. Assenmacher-Wesche and S. Gerlach (2008), "Can monetary policy really be used to stabilise asset prices?", available at www.voxeu.org.

7 J. C. Trichet, "Closing address at the Fourth ECB Central Banking Conference" on "The role of money and monetary policy in the twenty-first century", Frankfurt, 10 November 2006 (*http://www.ecb.int/press/*).

8 Report of the High Level Group on financial supervision in the EU, Brussels, 25 February 2009.

It is not only in advanced economies that monetary policy has encountered problems. Alan Greenspan has claimed in particular that the increase in global liquidity of the past few years was not caused by the interest rates decided by the US central bank, but by the financing flows stemming from Asia, and China in particular.[9] In other words, in a world characterised by high levels of financial integration, the monetary conditions within individual countries, including large ones, are no longer determined solely by the respective policies of those countries, but also by those implemented in emerging economies, particularly if the latter, as China has done, fix their exchange rates at levels which lead them to accumulate extensive foreign exchange reserves. The link to the dollar has meant China adopting the same monetary policy as the United States, a policy which is undoubtedly too expansionary for the domestic conditions of an emerging economy. But it has also meant that large amounts of international reserves were invested back into the US financial market, in particular in government bonds, thus affecting that market. The same phenomenon occurred among oil-exporting countries, which accumulated substantial dollar reserves over this period.

Looking ahead, if we want to avoid a renewed accumulation of global imbalances, systemically important countries such as China must equip themselves with their own monetary policy and must allow the exchange rate of their currency to fluctuate on the basis of relative competitiveness, avoiding the systematic accumulation of international reserves. This requires coordination at the international level. Since 2003, the G7 has exerted pressure, in particular on China, to reduce the accumulation of international reserves and to adopt a more flexible exchange rate system. Since mid-2005, China has announced the progressive decoupling of the yuan from the dollar. In the first two years, the yuan appreciated by 21.5% vis-à-vis the dollar. But the appreciation came to a halt in July 2008. The accumulation of international reserves continued, reaching around USD 2,000 billion in March this year. Now that the dollar has depreciated slightly, the problem of pegging the Chinese currency to that of the United States returns with force.

To conclude the first part of my remarks, the crisis has revealed the need for economic policies, and monetary policy in particular, to have a largely medium-term orientation, rather than supporting the procyclical behaviour of agents. To this end, central banks must pay considerable attention to developments in the financial markets, both domestic and global, in order to identify potential imbalances and forestall their effect on monetary and financial stability.

The analysis that I have just conducted with regard to monetary policy clearly needs to be extended to other policy areas, such as fiscal policy or financial regulation. It is essential to conduct an in-depth analysis of these subjects in order to fully understand which problems caused this crisis and how to rectify them in order to prevent them from happening again.

An interesting aspect, in some ways worrying, is that despite the consensus that has developed with regard to the analysis of the past, and the causes of the crisis, there does not seem to be a great deal of willingness to incorporate the lessons learned into present and future behaviour. To paraphrase St Augustine, give economic policy-makers more chastity and continence, but not yet.

It is this apparent contradiction that leads to the view that this level of analysis is insufficient. I believe that we need to ask an additional series of "why" questions in order to understand thoroughly what induced economic policy-makers to make certain choices.

A traditional response to this question is the short-sightedness of politics, which also applies to economic policy. According to this theory, political time – dictated by electoral terms – is too short to tackle far-reaching issues effectively. There is a considerable body of literature on this theory, according to which some areas of economic policy, in particular monetary

[9] A. Greenspan (2009), "The Fed Didn't Cause the Housing Bubble", Wall Street Journal, 11 March 2009.

policy, should not be determined by discretion but should instead be subject to rules.[10] This stream of analysis, while certainly relevant, does not seem sufficient to explain behaviour which is repeated over time, particularly in democratic systems where such behaviour should ultimately be penalised.

An alternative theory is that the presumed short-sightedness of economic policy only reflects a more general short-sightedness in advanced societies, in particular with regard to the potential for economic development. A certain level of indebtedness may be appropriate if income is expected to grow at a sustained pace, but excessive if such expectations turn out to be too optimistic. It would not be surprising if, in a society in which citizens have excessively optimistic expectations with regard to increases in their income, economic policy-makers were to implement policies aimed at systematically stimulating aggregate demand.

This has happened on various occasions in the past. In the mid-1970s, after the first oil shock, most industrial economies did not realise that the increase in energy prices had substantially reduced the growth potential of their economies. They thus implemented economic policies aimed at returning economic activity to levels consistent with growth potential prior to the crisis.[11] This resulted in the Great Inflation of the second half of the 1970s, the correction of which required drastic policies which led to the global recession of 1981-82.

The experience of the past decade should lead to reflection with regard to the motives which led certain societies, such as the United States, to overestimate their income growth potential. One must ask in particular what are the factors which in the past 20 years resulted in the progressive misalignment between potential economic growth and the target considered to be sustainable, but which clearly was not. It was not a drastic shock as experienced in the 1970s, but a more complex phenomenon, which operated gradually.

One theory, which was suggested a few years ago, is that the growth sustained by emerging economies tends to suppress the potential of advanced economies. This theory was rejected, perhaps too hastily, because it is not in line with the neoclassical theory of international trade, based on comparative advantages, which holds that when a country grows at an elevated rate, it benefits not only the country in question but also others. Higher disposable income makes it possible to increase imports from other countries, thus fostering production and growth in those countries too.

The theory of mutual benefit is based on certain specific assumptions, which are not always reflected in reality. It is worth returning to this theory and considering in particular the exceptions. We will consider six such exceptions.

The first occurs, as illustrated a few years ago by Paul Samuelson, when emerging economies record an elevated rate of increase in productivity in high value added sectors, forcing advanced economies to re-specialise in low value added production, with a resulting loss in income for the latter.[12]

The second exception concerns the adjustment costs which have to be absorbed by advanced economies in order to face the new competition.[13] The faster and more enduring the transition is, the greater are such costs. In particular, if one considers the point from

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[10] L. Bini Smaghi (2006), "Democratic Representation and Economic Policy Rules in an Ageing Society", Eumoniamaster – Institutional and Political Higher Education, 28 September 2006.

[11] A. Orphanides (2003), "The quest for prosperity without inflation", Journal of Monetary Economics, 50, 3, pp. 633-663.

[12] See, for example, P. Samuelson (2004), "Where Ricardo and Mill rebut and confirm arguments of mainstream economists supporting globalization", Journal of Economic Perspectives, 18, 3, pp. 135-146.

[13] See Chapter 5 of the *World Economic Outlook* of the International Monetary Fund, April 2007.

which emerging economies start, and their size, in terms of population, the adjustment resulting from their current process of growth could take a very long time and could be of considerable magnitude. Take emerging Asia (excluding Japan), for example, which represents over 50% of the global population and 21% of GDP.

The third exception to the conditions specified in the international trade theory relates to the high savings rate of some emerging economies, in particular those in Asia. Such savings, which are in part precautionary, stem from the lack of a system of social shock absorbers and a developed financial system. Income growth in these countries does not translate into comparable increases in consumption, and thus in imports.

The fourth exception concerns protectionist practices, explicit or implicit, which are applied in many of these countries and discourage imports.

The fifth exception involves the exchange rate policies implemented by various emerging economies, which favour an undervaluation of the currency, creating a competitive advantage in favour of their own products and net savings vis-à-vis the rest of the world.

Finally, the strong growth of emerging economies puts pressure on the world's scarce resources, increasing their prices and thus resulting in a loss of terms of trade for importing countries. The case of raw materials, the global demand for which increases at a higher rate than supply, is well-known. But there are other, less obvious examples, such as that of secondary and tertiary education. In this sector too, supply has grown less than global demand, leading to greater competition and higher costs for attending the best universities in the world.

The experience of recent years suggests that each of these exceptions to the assumptions on which the theory of international trade is based is plausible. This would perhaps explain why the past decade was characterised, at least until the outbreak of the crisis, by a sustained rate of growth among emerging economies but a decreasing rate for advanced economies. It also explains the increase in income dispersion among the latter.

If economic policies ignore such developments and continue to aim for unchanged income and consumption dynamics, they will create internal and external imbalances in the economy which will build up over time. Such imbalances may also exist for a prolonged period of time, owing to the financial system and the ability to issue debt securities in the national currency. But, by definition, what is not sustainable will sooner or later generate instability, with negative repercussions for the whole economy.

The way out of this crisis depends on the ability, in advanced economies, to align the expectations and behaviour of agents with the new global context. This does not mean passively accepting the consequences, but avoiding side-stepping them through policies which put off the problem until later, in an attempt to win time. Which means, in other words, shifting the emphasis from macroeconomic to structural policies.

These problems will be tackled not just by individual countries but also at the international level. From this perspective, too many have been quick to judge obsolete the meetings attended only by advanced economies, such as the G7, and to consider that only those which also involve emerging economies, such as the G20, have the legitimacy to discuss global problems. As we have seen, there are important questions on which the interests of advanced economies diverge from those of emerging economies. In some cases, such divergences stem from specific characteristics or distortions in international relations created by emerging economies. It is thus essential that the advanced economies find common points of interest to be discussed subsequently in larger fora.

This crisis began and developed at the centre of the advanced economic system, and ultimately originates from an objective difficulty among more developed countries to accept the consequences of the process of international integration, which has accelerated in recent years. Such countries, even the larger ones, have become smaller individually, to a greater

extent affected by, and vulnerable to, the external environment. It is only by strengthening the cooperation between them that they will be able to maintain global leadership.

Thank you for your attention.