Lorenzo Bini Smaghi: Europe, the United States and the new challenges to the global economy

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at a conference organised by The Council for the United States and Italy in Venice, Venice, 11 June 2010.

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It is a pleasure to attend this workshop, and especially to have an opportunity to consider relations between Italy – as well as Europe more generally – and the United States. I must admit to having felt, in recent months, a growing frustration to hear it claimed at conferences and to read in articles that the transatlantic relationship is in crisis and is disintegrating – irredeemably.

I won't go into the arguments put forward by those who hold this view, but I would rather report on how far it is from reality – at least from the perspective of those working in an institution responsible for the conduct of economic policy. The starting point of my analysis is the common challenge we face, which is to restore sustainable growth after the deepest economic and financial crisis of the post-war period, against a background of great global change. This challenge has been approached by Europe and the United States mainly through three lines of action: macroeconomic policies; financial market reform; and relations with the other major players in the world economy.

I would like to examine these three factors, indicating where perspectives and transatlantic action converge.

Let's start with the economic situation. I won't dwell on describing Europe's economy, particularly that of the euro area, or the US economy. Both started to grow during last year, at a pace that looks faster in the US, as is typically observed in this phase of the cycle. Domestic demand seems stronger on the other side of the Atlantic, thanks to the dynamism of private consumption, which for now remains subdued in Europe, where exports are the main engine of growth.

The main risk factors underlying the recovery are the same for the two areas, namely:

- uncertainty about whether growth can be self sustained, without relying mainly on the policies aimed at stimulating demand which have been put in place by most industrial countries in response to the crisis;
- turbulence in financial markets, which has shifted to sovereign risk;
- unemployment, which remains high, although it seems to have peaked;
- the situation on the capital markets, particularly the soundness of banking systems in the aftermath of the economic and financial crisis, and their ability to provide adequate credit to the economy.

The economic policies implemented in the two areas in response to the crisis have been broadly similar. Monetary policies have mainly aimed to ensure market liquidity. Technical modalities have differed somewhat, due to the different structure of the financial markets, which are typically more bank-centred in Europe than in the US. Interest rates have fallen rapidly, both in the euro area and in the United States, although the decline across the Atlantic took place earlier, in line with the lead in the cycle. Throughout the crisis there has been close coordination between the monetary authorities, which even led to a joint reduction in interest rates in October 2008, immediately after the failure of Lehman Brothers.

The fiscal policy of the US has been relatively more expansive than that of continental Europe, largely because of the smaller role played by automatic stabilisers in the US federal budget, which demanded a much larger discretionary adjustment. The reservations expressed in Europe at the time about very expansionary measures were later found to be justified in the ongoing financial turmoil. I'll come back to this point shortly.

Looking ahead, the economic policy objectives look similar. There is, however, a debate about the extent to which economic activity can quickly return to pre-crisis levels; in other words, a debate about whether the crisis has had a permanent impact on the growth potential of economies, reducing it. This issue is crucial when assessing the suitability and sustainability of economic policy, particularly that of the budget. If the pre-crisis situation is regarded as an achievable goal in the medium term, it is justified to implement highly expansionary policies, in particular fiscal ones, designed to stimulate aggregate demand to achieve the objective as quickly as possible. If, however, the pre-crisis situation is not considered as sustainable because of the structural – as well as economic – nature of the recession, a strong fiscal expansion risks being excessive and producing unsustainable debt dynamics over the medium term and jeopardising the soundness of public finances.

One gets the impression that across the Atlantic there is a more optimistic view of the ability of the US economy to get back onto a growth path like the one before the crisis. The large difference built up in these two years concerning potential revenue would justify the continuation of policies to stimulate demand in the near future. The envisaged return to sustained growth rates would allow the deficit and debt to be quickly reabsorbed. In Europe attitudes are more cautious. The pre-crisis situation was probably unsustainable everywhere, partly due to the over-indebtedness of the private sector. Trying to return to those levels of activity may bring about financial conditions that could reinflate the bubble or turn it into a public debt bubble.

This diversity of views may partly reflect differences in the underlying positions of the economies. There is no doubt that the potential for US growth is higher than Europe's, if only because of the stronger demographics and greater market flexibility. Several European countries, where growth was stronger before the crisis, have shown a loss of competitiveness and will have to profoundly reform their markets in order to grow again. On the other hand, there is no doubt that the pre-crisis economic growth in the US was accompanied by large internal and external imbalances, influenced by the expectations of firms and households being above potential. Growth was also favoured by deregulation and policies to stimulate demand that fed the imbalances. Trying to return to high growth rates may lead to behaviour that could again prove unsustainable and lead to new excessive fluctuations.

Financial markets are assessing the policies implemented in different countries also on the basis of countries' ability to meet their commitments over time, particularly as regards debt repayment. This has an impact on the effectiveness of fiscal policy. As long as agents have confidence in a state's ability to repay its debts, owing to higher future tax revenues, fiscal policies can stimulate aggregate demand and offset the decline in private consumption and investment caused by the economic slowdown. If, however, agents are concerned that future growth will not be enough to generate sufficient tax revenue to ensure the sustainability of public debt, they will tend to increase savings, weakening the effectiveness of the stimulus and exacerbating in this way the debt dynamics.

This brings us to address current issues, particularly as regards the euro area. As I mentioned earlier, the euro area has generally implemented a more restrained fiscal stimulus, and has more contained debt dynamics than other countries. However, some countries *within* the area have experienced a much greater deterioration in public finances than others, with higher debts. Moreover, the euro area is not a fiscal federation. Furthermore, individual countries no longer have their own money to tackle public finance problems or to stimulate growth in the short term. This is why financial markets have focused their attention on the euro area and on some of its member countries.

There are – in theory – two ways to tackle the crisis. The first is to question the euro, and give back to the member countries the opportunity to resort to devaluations or revaluations of their currencies. The second is to ensure that countries restore fiscal discipline, possibly providing them financial support in the adjustment period.

Europe has *clearly* and *unambiguously* chosen the second path. I dwell briefly on this point because while this choice was strongly supported by the political authorities of the United States and other G7 and G20 countries, it seems instead to be questioned by several observers, academics and financial professionals across the Atlantic.

The choice made by Europe is based both on economic and on political reasons. Some observers believe that the euro was created solely for political reasons, for example, as a counterweight to German unification. According to this view, the sustainability of the euro would be at risk if the political integration process were to stop or go into reverse. The events of the last few months do not suggest at all that the integration process has stopped, on the contrary. Full support has been expressed for the euro and there is no intention to challenge it. All governments and national parliaments have adopted not only the financial support measures to Greece but also taken the necessary measures for the creation of the European Financial Stability Facility. The Heads of State and Government have agreed to strengthen the economic governance of the euro and will take concrete decisions in that respect, based on proposals of the Van Rompuy task force which has already started working.

Some object that the political process underlying the European integration is restricted to the elites of the member states, but not shared among the population at large. They interpret the dissatisfaction expressed by several Europeans about the euro as an element of political fragility and as a risk of going into reverse. These opinions are based on the results of opinion polls showing that in some countries two third of citizens would like to get their national currency back. However, it is often forgotten to clarify that in the same countries a vast majority answers positively when asked if they believe that the euro will still exist in ten years time.

I do not want to deny that European institutions currently have a problem of affection. However, European institutions, and the euro, are expected to be here to stay.

Let me also remind that the reactions we are observing in Europe, and in particular in some member states, to the recent crisis – which is the worse since World War II – is not that different from the one experienced in other parts of the world, in particular the US in the face of disruptive developments associated with financial turmoil. Let me just remind the opposition of the US Congress, and the US people in general, to support with 20 billion dollars the rescue of Mexico in 1995. Many of the arguments used today against the support for Greece are similar to those used against Mexico. With the benefit of hindsight the decision taken in 1995 by the US Administration is now widely praised, as will be the case in a few years – I believe – for the European decision to support Greece. Let me also recall the lack of support of the American people, and of Congress itself, for providing the US Administration with the funds necessary to sustain the US financial system through the TARP programme in September 2008. The US President had to go public, stating that *"the instability can ripple throughout and affect the working people and the average family and we won't let that happen"* before Congress finally voted the package.

Let me move to the economic reasons underlying the choices which have been made over the past few months, which are equally important. They are not always clearly perceived, especially across the Atlantic. Let me list a few.

First, past experience has shown clearly that within an economically integrated area like the euro area a currency devaluation does not allow a growth stimulus that would support faster fiscal consolidation. The countries which had to make strong corrective fiscal manoeuvres before the euro – as was the case in Italy after leaving the ERM in September 1992 – have suffered large interest rate spreads for a protracted period, because of renewed uncertainty about the monetary regime after the devaluation, as well as about the fiscal system. With every devaluation, inflationary risks rapidly appeared, which required more monetary tightening than would be the case within the euro. Several countries, like Belgium, Ireland and the Netherlands implemented fiscal consolidation while maintaining a stable exchange rate and a high primary budget surplus (i.e. net of debt interest).

Another forgotten aspect is that the possibility of revaluing the currency has not allowed more virtuous countries to insulate themselves from the exchange rate instability affecting neighbouring countries, particularly in those which devalued. After the exchange rate realignments, Germany recorded in 1993 a recession comparable in size to that of France and Italy.

Another aspect that is also often ignored is that the return to a national currency is not an event comparable with a change in the exchange rate parity. It would involve a renegotiation of all contracts, especially financial ones, within individual countries and between residents of different countries, with conflicting interests between debtors and creditors. One can expect that in case of disputes the international courts would rule against the country which took the decision to change its currency of denomination. This means that residents of that country would be severely affected by a change in the denomination of their contracts. This applies both in the case of a debtor country that devalued its currency against the euro and in the case of a net creditor that revalued its new currency. A debtor country which imports capital from the rest of the euro area and devalues its currency would immediately suffer from an increase in its debt burden, which would further exacerbate its difficulties. A creditor country with substantial financial assets from other euro area residents which revalues its currency would suffer huge capital account losses, particularly for its financial institutions, with consequent severe effects on its public finances.

The contagious effect on other countries would be devastating, as demonstrated by the correlations in place on financial markets.

To sum up, given the financial and economic integration achieved over recent years in the euro area, the hypotheses voiced by some about a country abandoning the euro or about reconstituting the euro area in a reduced form would have highly detrimental effects on everyone, be they net creditors or debtors. The impact would be far more expensive than the alternative – standard – approach, which is to implement a strict plan of fiscal consolidation in all countries, starting with Greece, accompanied by structural reforms aimed at sustaining growth, and a plan to strengthen the economic governance of euro area. This is the way chosen by the countries of the euro area and implemented in the form of successive decisions both at national and European level.

As I mentioned before, there is a consensus among our partners within Europe but also across the Atlantic in the G7 and G20 that this is the correct path to take. This consensus stems from the conviction that financial markets would be seriously affected by an event that calls into question the solvency of a developed country. That is why our partners, in particular the US, have strongly supported the action of the International Monetary Fund, which has provided Greece with the highest funding in history in proportion to the country's IMF quota. This is also why the euro area countries have approved the support package for Greece and then the funds necessary for the creation of the European Financial Stability Facility agreed this week by Ecofin.

The consolidation of public finances will remain a major theme in the coming years, not only in Greece but also in the rest of Europe and in the developed countries. The experience of recent months highlights some points on which it is worth reflecting.

First, it is best to take the necessary steps before being put under pressure by the financial markets, which often do not move in a linear fashion and tend to go from white to black in an instant. And when something passes to the black part of the markets' radar screen it takes a long time to convince them that it can get back in a quiet location.

Second, in assessing the sustainability of budget measures financial markets seem to be taking into account not only the direct effects, namely the impact on the deficit and debt, but also indirect, i.e. the effect of specific measures on economic growth. A highly restrictive move allows a reduction of the deficit but may adversely affect growth and thus slow down the adjustment of the debt. An extreme interpretation of this view has pushed some to consider that a strong restrictive fiscal action may create a negative spiral between debt and growth that worsens even further the public finance situation and makes budgetary rigour politically unsustainable. It seems to me that the hypotheses necessary for this spiral to occur are quite exceptional, requiring the fiscal multiplier effect to be greater than 1. The empirical evidence does not seem to be consistent with such a hypothesis.

An alternative interpretation of the risks associated with fiscal retrenchment is that they are not easily sustainable politically, especially if they have strong negative effect on growth. The hypothesis is that public opinion in many advanced societies might not be fully prepared to cope with the budget cuts needed to restore public finances on a sustainable path, because these cuts would lead to a substantial downsizing of the current welfare system – a system which may no longer be financially sustainable in an environment of slower economic growth, partly due to lower population growth and the higher public debt burden. So this is not just a matter of discussing the economic sustainability of the move that many developed countries have to make, but its political and social sustainability.

I do not want to dwell further on this, but the lesson to be learnt is that to be credible fiscal consolidation must be accompanied by deep reforms of the functioning of our economies, in particular as regards labour and goods markets, so as to restore economic growth. The objective is to increase labour productivity, so as to make the welfare system sustainable.

The problem is no different for societies like the US, where the funding of welfare rests largely on the private sector, rather than the public. If the economic growth potential is reduced, investors must also adjust their expectations of being able to finance their health care, education plans and their pensions.

I would now like to move on to the second area of intervention – aimed at restoring sustainable growth, to which the US and European authorities are committed. It concerns financial regulation. There’s close cooperation on this agenda item and it’s taking place in various working groups, in particular in the Basel Committee and the Financial Stability Board, which includes representatives of 20 major industrial countries. Coordination is undoubtedly more difficult in this field, not only because of the structural differences between the financial markets but also because these markets are partly in competition with each other, and operators are seeking to influence the respective authorities to shift regulatory changes in the desired direction.

I do not want to list here the areas of convergence and divergence between the two sides of the Atlantic in negotiations that are not yet finished. I would rather express – in my personal capacity – a number of concerns on issues which have not yet been clarified and are still marked by much uncertainty.

The first concerns the scope of application of financial regulation, which should be strengthened to give greater credibility and stability to the system. The Basel Committee is focusing mainly on the banking system in order to strengthen the capital and liquidity requirements, and particularly to reduce the pro-cyclicality of the rules. There is a commitment to establish new rules no later than the G20 summit this autumn, for gradual implementation by the end of 2012. However, while in Europe it is already known that the new rules, once agreed, will be included in a Community Directive with immediate application in all Member States, it is unclear what the degree of implementation in other countries, particularly the US, will be. In the light of what happened with Basel II, the risk of only partial application is a concern.

Another source of concern is the “shadow” financial system not previously subject to regulation. The G20 summit a year ago in London indicated the general commitment not to leave significant parts of the financial sector, such as investment banks, hedge funds, private equity funds and so forth, outside the regulatory perimeter. Work on this part of the financial system is not progressing as hoped, however. There is a risk, again, of focusing only on banking, and overlooking an important part of the financial system, whose influence has come to dominate the overall stability of markets, with contagion effects on the banking system itself. Europe has recently adopted what may appear as somewhat restrictive legislation in this regard. In particular, equity and investment funds from outside Europe are only authorised to operate to the extent that the law of the country of origin is comparable with European law. This has caused concern across the Atlantic about the risk of protectionism. On the other hand, the failure of the strategy pursued in recent years, of trying to convince our partners that this area should be regulated like any other, has necessitated a turnaround of the basis of the discussion. The talks now start on a more precise basis.

One area in which there is broad convergence between the US and Europe concerns the concentration of derivatives trades, which would allow the supervisory authorities to have adequate information so that they can monitor the ability of financial institutions to cope with risks that are taken. However, financial lobbies are actively working to try to break this convergence of views.

These are just a few areas of financial system reform currently under discussion in the main fora. The stakes are high. The deadline for the work is the G20 summit in South Korea this autumn, two years after the crisis intensified. It is essential to meet deadlines to lend credibility to the financial system and ensure that it plays a supporting role in real economic activity.

Now I come to the third area of common interest, which concerns international cooperation, based not only on the G7 but extended to the G20, with the participation of key developing countries. Both Europe and the United States have an interest in the G20 functioning as a new forum for international cooperation.

The G20 agenda currently has two main items. The first, as just indicated, is the reform of the financial system. The success of the ongoing work is in the hands of the developed countries, which are largely to blame for the current crisis and must agree on how to reform the system. Other countries are basically waiting for signs of reform and have shown, overall, a willingness to comply with the new rules in due course.

The other item on the G20 agenda concerns the economic policies needed to promote sustainable growth of the world economy. There is less agreement on this point. At the heart of the financial and economic crisis there were – without doubt – excessive imbalances, within and among major economies. These imbalances were derived from the savings and investment flows not adequately spread among the various countries. After the temporary reduction in imbalances in international payments linked to the recession, the recovery is broadening imbalances again. China’s current account surplus, in particular, is expected to increase again. The accumulation of international reserves by many developing countries, particularly those in Asia, is continuing. The mechanisms that fuelled the destabilising financial flows before the crisis are reappearing. In emerging countries there is a substantial capital inflow, which is not, however, finding an equivalent outlet in domestic investment and consumption; it is thus being recycled to the developed countries. The economic performance in developing countries should encourage them to tighten domestic monetary conditions and sever their ties with the policies of the developed countries, deriving from the fixed or semi-fixed exchange rate regime. The fear of letting the exchange rate appreciate, so as not to damage the sector exposed to international competition, leads to an overheating of economic activity that may inflate a bubble not unlike the pre-crisis one in developed countries. The risk is that, by maintaining the currency link with the developed countries, the emerging countries import financial instability. The accumulation of international reserves can offer a partial protective buffer, but it won’t necessarily be sufficient to avoid the repercussions on the real economy.

Europe and the United States would both benefit from a better functioning world economy, but they depend on decisions taken by other G20 countries. The rigidity of the Chinese monetary regime is slowing down the adjustment of relative competitiveness and the recovery of the developed countries.

In this area, Europe and the US have common interests, and are more likely to succeed if they pursue them in a joint and coordinated strategy. The experience of recent years shows that separate action is unlikely to succeed.

However, the cooperative mechanisms developed within the G20 are still at an embryonic stage. Not all countries are willing to openly discuss their economic policies, accepting critical comments, as happened within the G7. Some issues are neither discussed nor mentioned in communiqués if views are not unanimous. This limits the capacity for self-examination and peer pressure, which has been the basis of international cooperation.

There is a risk that, once the crisis has passed, the pressure on G20 countries to develop an open method of cooperation, geared to the challenges of our times, may fade away. If this occurs, it will confront Europeans and Americans with a new dilemma on the way towards global economic relations.

But one thing is certain: whatever form the international cooperation takes, the US and Europe will be part of it, not only because they are currently, and will be for many years, the two main economic and financial areas worldwide, but also because they share important values – such as the freedom of private enterprise, freedom of expression, social equity – without which there can be no cooperation.

These values could be put to the test in the future, especially in this difficult phase for the world economy. Defending these values will require even stronger transatlantic relations.

Thank you for your attention.