

The crisis of fiscal imagination



Traders work at the stock exchange in Frankfurt, Germany, on Sept. 12, 2011. Germany's share index DAX temporarily fell below the mark to 5,000 points. Banking stocks were the biggest losers, with both Deutsche Bank and Commerzbank shares down around 7.5 percent amid persistent concerns about the eurozone debt crisis. (AFP)



Dani Rodrik
Project Syndicate

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Greedy banks, bad economic ideas, incompetent politicians: there is no shortage of culprits for the economic crisis in which rich countries are engulfed. But there is also something more fundamental at play, a flaw that lies deeper than the responsibility of individual decision-makers. Democracies are notoriously bad at producing credible bargains that require political commitments over the medium term. In both the United States and Europe, the costs of this constraint on policy have amplified the crisis - and obscured the way out.

Consider the US, where politicians are debating how to prevent a double-dip recession, reactivate the economy, and bring down an unemployment rate that seems stuck above 9 percent. Everyone agrees that the country's public debt is too high and needs to be reduced over the longer term. While there is no quick fix to these problems, the fiscal-policy imperative is clear: The US economy needs a second round of fiscal stimulus in the short term to make up for low private demand, together with a credible long-term fiscal-consolidation program.

As sensible as this two-pronged approach - spend now, cut later - may be, it is made virtually impossible by the absence of any mechanism whereby President Barack Obama can credibly commit himself or future administrations to fiscal tightening. So any mention of a new stimulus package becomes an open invitation to those on the right to pounce on a Democratic administration for its apparent fiscal

irresponsibility. The result is a fiscal policy that aggravates rather than ameliorates America's economic malaise.

The problem is even more extreme in Europe. In a futile attempt to gain financial markets' confidence, country after country has been forced to follow counter-productive austerity policies as the price of support from the International Monetary Fund and the European Central Bank. Deep fiscal cuts, privatization and other structural reforms of the type that Greece has had to undertake, simply risks greater unemployment and deeper recessions. One reason that interest-rate spreads in financial markets remain high is that distressed eurozone countries' growth prospects look so weak.

Here, too, it is not difficult to discern the broad outlines of a solution. Stronger countries in the eurozone must allow these spreads to narrow by guaranteeing the new debts of countries from Greece to Italy, through the issuance of Eurobonds, for example. In return, the highly indebted countries must commit to multi-year programs to restructure fiscal institutions and enhance competitiveness - reforms that can be implemented and bear fruit only over the medium term.

But, once again, this requires a credible commitment to an exchange that requires a promise of action later in return for something now. German politicians

and their electorates can be excused for doubting whether future Greek, Irish, or Portuguese governments can be counted upon to deliver on current leaders' commitments. Hence the impasse: with the eurozone becoming mired in a vicious circle of high debt and economic austerity. Democracies often deal with the problem of extracting commitments from future politicians by delegating decision-making to quasi-independent bodies managed by officials who are insulated from day-to-day politics.

Independent central banks are the archetypal example. By placing monetary policy in the hands of central bankers who cannot be told what to do, politicians effectively tie their own hands (and get lower inflation as a result). Unfortunately, US and European politicians have failed to show similar imagination when it comes to fiscal policy. By implementing new mechanisms to render the future path of fiscal balances and public debt more predictable, they could have averted the worst of the crisis.

Compared to monetary policy, fiscal policy is infinitely more complex, involving many more trade-offs among competing interests. So an independent fiscal authority modeled along the lines of an independent central bank is neither feasible nor desirable. But certain fiscal decisions, and most critically the level of

the fiscal deficit, can be delegated to an independent board. Such a board would fix the maximum difference between public spending and revenue in light of the economic cycle and debt levels, while leaving the overall size of the public sector, its composition, and tax rates to be resolved through political debate. Establishing such a board in the US would do much to restore sanity to the country's fiscal-policy-making.

Europe, for its part, requires a determined step toward fiscal unification if the eurozone is to survive. Removing national governments' ability to run large deficits and borrow at will is the necessary counterpart to a joint guarantee of sovereign debts and easy borrowing terms today. Yet this cannot mean that fiscal policy for, say, Greece or Italy would be run from Berlin. A common fiscal policy implies that the elected leaders of Greece and Italy would have some say over German fiscal policies, too.

While the need for fiscal unification is increasingly recognized, it is not clear whether European leaders are willing to confront its ultimate political logic head-on. If Germans are unable to stomach the idea of sharing a political community with Greeks, they might as well accept that economic union is as good as dead.

Politics, it is said, is the art of the possible. But possibilities are shaped by our decisions as much as they are by our circumstances. As matters currently stand, when future generations place our leaders in historical perspective, they will most likely reproach them, above all, for their lack of institutional imagination.

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A dramatic end to the Greek tragedy

“Speculation is growing that Greece will eventually default, and that it will surely be seen as a messy ordeal.”



Anna Nicolaci da Costa
Reuters

Greece is in the danger zone. Even as the country's finance minister sought to reassure his euro zone counterparts at a meeting in Poland, Greek credit default swaps were pricing in a more than 90 percent chance of default, according to Reuters calculations of Markit data. Economists in a Reuters poll see a 65 percent chance of that happening, probably within a year.

Such fears recently sent jitters across financial markets, prompting some words of comfort from German Chancellor Angela Merkel and French President Nicolas Sarkozy that they are determined to keep Greece in the euro zone. But speculation is growing that Greece will eventually default, and that it will be seen as a messy ordeal. Here are some of the potential dangers in the likely event that it occurs:

- Greece may be seen as setting a precedent for Portugal and Ireland, analysts said. Yields on peripheral euro zone debt could surge rapidly, making funding costs increasingly unsustainable as yields on Italian and Spanish 10-year bonds surge back towards 7 percent. The ECB could have to intervene more aggressively in the secondary bond market to the detriment of its balance sheet.

- European banks may have to make more significant write-downs of their Greek holdings than they already have. This would hit French banks especially hard, since they are the most heavily exposed to Greek debt, with 56.9 billion US dollars in their portfolio - more than double as much as Germany's equivalent holdings. French banks are also the most vulnerable to Italian debt, with a hefty \$410.2 billion.

- Fears of more contagion and further write-downs could make banks even more reluctant to lend to each other. A key measure of financial stress - the three-month spread between euro Libor and overnight index swap rates - hovered near its highest in over two years. Said Gary Jenkins, head of fixed income research at Evolution Securities: You would get the loss on the Greek debt of course but I think much more important is the funding situation. Who is going to be lending the banks money if you have got euro zone sovereigns defaulting and you are unsure about what is going to happen next?

- Banking sector problems could hurt equity markets at large: stock valuations could fall significantly, raising concerns over the ability of corporations to raise capital. That would hurt business and consumer sentiment and further diminish the likelihood of a meaningful global recovery, says Richard McGuire of Rabobank.

- The euro could fall sharply versus the dollar towards around \$1.20 or below, according to currency strategists, from around \$1.38 currently.

Even if Greece gets the next tranche of bailout aid and makes it through October, its future looks bleak.

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The banking conundrum



Xavier Vives
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Central bankers and regulators tend to worry that too much competition in the financial sector increases instability and the risk of systemic failure. Competition authorities, on the other hand, tend to believe that the more competition, the better. Both can't be right. There is a trade-off between competition and stability. Indeed, greater competitive pressure may increase the fragility of banks' balance sheets and make investors more prone to panics. It may also erode the charter value of institutions.

A bank with thin margins and limited liability does not have much to lose, and will tend to gamble - a tendency that is exacerbated by deposit insurance and too-big-to-fail policies. The result will be more incentives to assume risk. Indeed, for banks close to the failure point in liberalized systems, the evidence of perverse risk-taking incentives is overwhelming. That is why crises began to increase in number and severity after financial systems in the developed world started to liberalize in the 1970s, beginning in the United States.

This new vulnerability stands in stark contrast to the stability of the over-regulated post-World War II period. The crises in the US in the 1980s (caused by the savings-and-loan institutions known as "thrifts"), and in Japan and Scandinavia in the 1990s, showed that financial liberalization without proper regulation induces instability. In an ideal world, the competition-stability trade-off could be regulated away with sophisticated risk-based insurance mechanisms, credible liquidation and resolution procedures, contingent convertibles, and capital requirements with charges for systemic institutions.

The problem is that regulation is unlikely to eliminate completely market failures: the competition-stability trade-off can be ameliorated, but not eliminated. For example, the United Kingdom's Independent Commission on Bank-



Finance ministers and central bank governors of the group of industrialized nations pose at the Palais du Pharo for family photo of the G7 finance ministers and "Deauville Partnership" in Marseille, southern France, on Sept. 10, 2011. Investment-banking operations might need to be rescued if they pose a systemic threat, analysts said. (AFP)

ing (ICB) has proposed ring-fencing retail activities from investment-banking activities in separately capitalized divisions of a bank holding company. This is a compromise aimed at minimizing the incentive to gamble with public insurance while allowing some economies of scale for banking activities.

But the devil is in the details, and, even in the most optimistic scenario, the trade-off between competition and stability will remain. One shortcoming of the measure consists in the fact that the crisis has hit both universal and specialized banks. Furthermore, the definition of the boundary between retail and investment-banking activities will leave an important grey area and generate perverse incentives. And the regulatory boundary problem persists: risky activities may migrate to areas where regulation is lax and reproduce the problems with the shadow banking system that we have witnessed during the crisis.

As a result, investment-banking operations might need to be rescued if they pose a systemic threat. The massive regulatory failure exposed by the financial crisis that began in 2008 underscores the need to concentrate on reforms that

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provide the correct incentives to banks. But, if the past is any guide to the future, we should be aware of the limits of regulation. The UK's ICB has rightly stated that there is room to improve both competition and stability, given the current weak regulatory framework, but it would be imprudent to strive for the complete elimination of market power in banking.

The design of optimal regulation has to take into account the intensity of competition in the different banking segments. For example, capital charges should account for the degree of friction and rivalry in the banking sector, with tighter requirements in more competitive contexts.

It follows, then, that prudential regulation

and competition policy in banking should be coordinated. This is all the more true in crisis situations, in which a protocol of collaboration should be implemented to delineate liquidity help from recapitalization, and to establish the conditions for restructuring in order to avoid competitive distortions.

What implications does this have for market structure? Concentration in well-defined deposit and loan markets is linked with competitive pressure. In more concentrated markets, banks tend to offer worse terms to customers. The crisis has affected both concentrated banking systems (for example, the UK and the Netherlands) and non-concentrated systems (e.g., the US and Germany).

In both cases, it has brought consolidation, leaving fewer players with increased market power and too-big-to-fail status. Witness the takeover by Lloyds TSB of the troubled HBOS (Halifax/Bank of Scotland) in the UK, or post-crisis consolidation in the US. All this would not be so problematic if the increased market power of the merged institutions were a temporary reward for past prudent behavior. In that case, the benefits would wane in importance as new competitors entered the banking fray. But if banks' market power increases due to barriers to entry, consumers and investors will suffer.

An active competition policy will be needed. But the degree to which the authorities will be able to push for more competition in banking will depend crucially on the regulatory framework. Let us fix and strengthen that framework, while bearing in mind that a simple mandate to maximize competitive pressure in banking is no more possible, or desirable, than one that would aim at eliminating instability completely.

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