INSTITUTUL ASPEN ROMÂNIA

Global Economic Governance – a US - EU Dialogue – Policy Roundtable Report

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Athenee Palace Hilton Hotel, Le Diplomate Ballroom, Bucharest

Report

The latest Aspen Institute Romania contribution to the critical topic of economic governance was the policy roundtable 'Global Economic Governance – A US - EU dialogue' organized on June 27, 2011. The event aimed at offering a two-sided perspective on the causes, the evolution and the aftermath of the great recession, and the policy choices on the table to overcome the current global economic development challenges and persistent local financial predicaments.

The keynote speaker at this event was Dr. **Robert F. Wescott** (photo), President of Keybridge Research LLC, and former chief economist of President Clinton's Council of Economic Advisors. Dr. Wescott is a highly esteemed scholar with professional experience in macroeconomic, financial, and public policy. Throughout his career engagements, Dr. Wescott tackled a vast array of problems, most of them still recurrent today. His professor tenure at University of Pennsylvania, when he set up the Japanese International Centre for the Study of East Asia Development, has offered him insight into the contemporary risks the Chinese economy is facing. Furthermore, working in the private sector as a chief economist at Wharton Econometrics gave him exposure to the US debt problems of the early '90s. He was part of the team that helped the Clinton administration to discipline the country's wayward public finances by devising the tax policy pack that reigned in the largest US peacetime budget deficit (6% of GDP), overlooking the current one. His roles in the National Economic Council and at the IMF helped him get acquainted with international debt crises (Russian Crisis, SEA Crisis) and the policy packs that have to be implemented when markets are in turmoil.

The respondent was Prof. **Daniel Dăianu**, professor of Economics at SNSPA, a leading Romanian and European authority on financial and macroeconomic policies and coordinator of the Aspen Romania task force on economic governance.

The discussion was moderated by Mr. **Valentin Lazea**, chief economist at the National Bank of Romania, and long time contributor to a healthy and balanced debate on EU convergence and its implications for Romania.

The round table participants were representatives of national and international financial institutions present in Romania, of corporations, businessmen associations, think tanks and media, but also representatives of the Romanian National Bank and IMF office.

The debate centered on three main issues: **the Eurozone sovereign debt crisis**, the **outlook of the US economy and global risks** induced by decoupling movements, **imbalances** and the **new regulatory framework**.

1. The future of the euro and the sovereign debt crises: "The Greek problem"

Although it was generally agreed that a million words had already been written on the subject, the discussion put an emphasis on the two main problems that have to be overcome by European governments:

- *The economic problem*:

There is clear evidence that the Greek economic distress did not originate as a short-term liquidity problem, but as a more structural, solvency-related problem, augmented by a soaring debt overhang.

A simple comparison with Argentina's economic indicators before its default in 2001 depresses even more the financial markets' confidence and boosts contagion fears: Greece has a three times bigger debt/GDP ratio (150%), a 2.5 larger deficit (12%) and a massive current account shortfall (12%). The traditional resolution in a similar situation for a Non-Eurozone country would be a default. Besides its stigma and the failure to access debt markets, this would imply a currency debasement of 35% (to give a lift to internal competitiveness) and would adversely affect labor markets, pushing unemployment to over 20%. In spite of all the above, the involved pain is transitory and there are several examples of countries, like Brazil or South Korea, that defaulted or were assisted by the IMF, and that managed to overcome their hurdles and boom again.

The case of Greece is somehow different because it is a member of a monetary union. This status was achieved by relinquishing its independent monetary policy and pegging its currency to the euro. As a consequence, the only instrument left on the table to tackle the debt problem is fiscal policy. By pushing through parliament tough austerity and privatization measures, the Greeks hope they can buy time and gain more support from the EU member states. But as long as Greece can't service its public debt due to a stagnation of its economic growth, austerity on its own is not the way out. The Greek restructuring process will be a long journey that will take 10-12 years. Despite the hardship, there is no other alternative.

- *The political economy problem*

The Latin America crisis, for example, was resolved by the creation of Brady bonds, collateralized by 30 year new issued T-bonds. Although the bondholders bearded some brunt, the haircuts implied were linked to investors' horizon and risk aversion. In the Greek case, the ECB and some Eurozone member states ruled out haircuts on Greek bonds because their national banks are heavily exposed and will incur losses. The officials fear that such an event will trigger default and bring rampant contagion that would lead to public outcry for another bail out.

In general terms, the contagion/ the area effect, although exogenously determined, can have an adverse impact on a country. The spread out process starts with a penalization by financial markets, which charge higher interest rates and then extends to the local market, by scaring investors and undermining household's propensity to consume. The breaking point is when the debt payments become prohibitive (a jump of over 1000bp over German debt bonds in a couple of months).

The EU's problem is structural: it lacks a proper mechanism for evening economic progress within the EU block: a political and fiscal union. Although some may argue that the

Euro area as a whole is in better shape than the American economy at an aggregate level (smaller deficit, no CAD), the problem within EMU is its internal imbalance. There are no burdens sharing arrangements, no Eurobond issuance mechanism, no significant budget or fiscal transfers, no powerful insurance tools to sail through a crisis. On the other hand, the US has this exact mechanism. Take for example California's lesson from 1993. With an unemployment rate of 10%, it did much worst than the rest of the country (average 6.3%). As Greenspan started raising interest rates, because the rest of the economy was heating up, the democrats started worrying that they would lose California at the next election. The nature intervened through the earthquake of '94. The state suffered major damages, but a short order $ 40 billion federal transfer put downward pressure on California's unemployment rate, which bottomed at 6.8% within 6 months.

Because there are no resolution schemes in the EU, the fear of contagion is mounting. The solutions must come from the political leadership, by pushing for political union; if not, the scenario for the next few months incorporates major upheavals.

2. The outlook of the US economy

It is generally agreed in the Eurozone that the US is not supportive enough and wants to exploit Europe's tailspin to strengthen the confidence in the dollar as a reserve currency. This criticism doesn't have solid ground and US is a strong ally, not a competitor. A resolution can't be found by blaming the others.

The outlook of the US economy from a growth point of view is positive. There are numerous harbingers of recovery: commercial industrials have been up for twenty months; consumer credit and credit card lending have expended; household debt sustainability is looking much better; debt/income ratios are down to 1998 levels.

The subprime crisis has had an adverse effect on the American households, which were using their houses as ATMs to support consumption. After suffering a massive shock followed by a severe deleveraging process, American consumers are finally getting their act together and start spending again. Furthermore, although businesses were initially hoarding $2 trillion of cash and operating under an uncertain environment, they have stared to direct these funds into investments and a robust hiring process. The CEO economic outlook index released in mid June 2011 is at all times heights.

There are two main challenges for the American economy:

- The *lackluster economic growth*, caused by a *tepid job market recovery*

The great recession brought about an increase in unemployment: companies laid 8 million workers off and they have rehired since only 1.5 million. This level is below equilibrium, although a bundle of public policies were aimed to address this shortfall, there have hardly ameliorated the situation.

Another hiccup suffered by the American economy was caused by the earthquake in Japan. This event halved the production of Honda and Toyota and spawned a shortage of auto parts, which affected the whole auto industry, leading to a 10% fall in the market (accounts for 5% of GDP). Although some may argue that the US economy entered a soft patch in the second quarter, there are signs that it will experience a nice rebound in the second half of the year.

- The *political wrangling* regarding *the debt ceiling*

The debt ceiling (14.3.tr) was hit on May 16th, 2011 because US can't make the next pension payments to the elderly due on the 3rd of each month. Timothy Geither, the US Treasury Secretary, is currently borrowing against pension plan balance sheets to keep the government funded. There are 75 - 80% chances that the process will work out smoothly and come to an agreement, but at the moment the debate doesn't feel like is coming together. There is a not completely negligible chance for things to go wrong; the risk is underestimated. There are several examples of situations when congress reached political will to pass bills. Iowa, one of the top 2 corn producers, received $ 6 billion as ethanol subsidies, an absurd measure that will adversely impact the budget and food prices. The law was unanimously passed because this state carries a lot of clout in the next election campaign.

3. Global Risks

Although some may consider that to blame for the great recession is the deregulation of the financial system (the abolishment of the Glass Steagal Act in 1999 and adoption of the Commodities Markets Modernization Act of 2000), others may state that crises are recurrent events which build up constantly and subscribe to Minsky's theory of unstable equilibrium in financial markets.

Despite the lack of consensus on the above-mentioned issue, there is higher degree of agreement regarding the current worldwide risks mounting both in emerging and developed economies:

- *Inflationary pressures*

One of the major pitfalls of the emerging economies is the threat of inflation, a product of transitory shocks from commodities boom and energy bubble that could materialize in second round effects.

Some of the Federal Reserve's actions of last year, the sustained 0% interest rate policy and even QE2, induced a bias towards inflation at a global level. An interesting study of Neil Ferguson, Harvard professor, hinted that unexpected inflation might be used by some countries to boost growth (nominal GDP).

- *Political Fragility*

Even though there are slim chances of 'a perfect storm' forecasted by Nouriel Roubini for 2013, there is a constellation of very disturbing election campaigns in key countries, a tumultuous period that may alter not only politicians' behavior, but also increase budget shortfall. The entire Europe and the US are threatened by political fragility/ quasi-paralysis at the political level. Both Spain and Italy are at the end of an era, stuck with lame duck governments. There will be a quasi solution for the American economy that would resurface for the next year election campaign.

- *The new regulatory framework*

The question is how to optimally regulate the system, given the need in developed economies to enhance banks' lending volumes. Basel III implies an increase in capital adequacy ratios and a mandatory buffer, which will make banks more reluctant to lend. Banking executive pay is still a red-hot issue in Europe, and there are attempts to cap it. The historical records prove that since 1970s, CEOs payroll has outpaced profits in the S&P 500 by shocking statistics and this practice led to misaligned incentives. In the US, the momentum for strict regulation of executive pay has passed with the priority today being given to financing growth and job creation. However it is conceivable that regulation will evolve to insure longer term performance and include claw back provisions.