

## **ECONOMIC POLICIES FOR A TWO-SIDED CRISIS: COMPLEXITY IS HARD TO MANAGE, BUT DON'T GIVE UP**

This crisis has two sides: finance, which is where it all began, and the recession. Most economists are at fault for a grave lack of foresight, at least in respect to the financial side. However, this is a guilt that we must share with many others, and especially with bankers and policymakers. Perhaps a more interesting observation is that the occurrence of this two-sided crisis documents an impressive failure of systemic coordination. We know that invisible hands work rather well in many contexts. However, even the simplest single market would not be efficient, unless strict rules are adhered to: property rights must be well defined and contracts abided to.

The two-sided crisis is teaching us a similar lesson, only of a higher order of complexity: we must realize that the global economy is remarkably more complex than we might have thought only a couple of years ago. Hence, if we want to resume growth and stability, we also need to adopt more articulate rules and policies than those we used to rely on. Existing rules have proved dramatically inadequate to enforce transparency, to disseminate sufficient and reliable information and to ensure the solvency of budget constraints in the rather complex world of derivatives' finance. Most automatic stabilizers built in the system have provided too little stabilization, while existing firewalls have been unable to prevent the spreading of contagion. Also discretionary fiscal and monetary policies have been embarrassingly ineffective, at least so far.

So what? The point that we are painfully taking home is that, unless we quickly adopt some more effective and coordinated actions, the crisis will linger on for a long time, or possibly even get worse.

### **Obstacles**

This requirement for better and fast-to-operate policies, however, runs into two obstacles. First, the "coordination table" is quite large: larger than the EU and the US alone, not to mention single EU members.

Second, we (and by "we" I refer to a large community of academics, policy makers and business leaders) do not know exactly how effective the policies which should be adopted are going to be, and in what sequence they would work best. This uncertainty drags along a further obstacle, as it aggravates existing attitudes to free ride, that is letting someone else make the first move.

But assume, for the sake of the argument, that we can go past these obstacles, and ask: which new rules and policies should be adopted? I will discuss actions related to the two main (but unfortunately not the only) problem areas: the credit crunch and the global depression.

### **PROBLEM 1: OVERLEVERAGING AND BAD LENDING**

Banks have been lending too much and taking too many bad risks. As some (possibly yet not all, but hopefully most) of these risks exploded, bank capital (which was already over-extended) has been largely annihilated.

### **Consequence: Bank Defaults and Credit Crunch**

Some banks (even those who once seemed too big to fail) have been let to their own demise, as with Lehman Brothers. Others have been forced to consolidate, many have been virtually nationalized. Many other firms in the finance sector have followed the same route: investment banks no longer exist, and mortgage lenders and insurers have also been nationalized, mostly in the US. Meanwhile, credit flows have stopped: banks do not lend to each other (because they do not trust each other any longer); nor do they

lend to “good” customers (because they must de-leverage and re-capitalize, and because in a recession even good customers suddenly look riskier).

### **Solution: Bad Banks for Everyone?**

Two solutions are required: banks need less leverage and more capital, and industry needs banks to resume lending. Below, I discuss the first solution, and postpone the second under Problem 2.

How to **rebuild bank equity**? Here there is a clear tradeoff. If capital requirements are tightened as of now, banks will deleverage even more, thus adding to the credit crunch. This points to the fact that capital requirements (including the yet to be fully implemented Basel-II criteria) were not so smartly designed, after all. However, knowing this is not of much help right now. Two solutions have been proposed, and partly enacted: inject new capital into banks, and help them to get rid of bad assets. The US and UK have nationalized *de facto* large parts of their banking sectors, but credit flows have not resumed yet. The proposal to set up “bad banks” is thus again at the top of the agenda. But can it really be done, and how? And which will be the side effects?

The economics of bad banks is a fascinating topic on its own (and a good example of the complexities I was referring to earlier on), and it has been sparking a lively debate ever since the earlier proposal of TARP (the Troubled Assets Relief Program) by former US Treasury Secretary Hank Paulson. I can only give a short list of the main issues debated:

- ◆ Who puts capital in the bad bank? How much should old shareholders contribute?
- ◆ Should there be one “government” bad bank or several “private” ones? Or perhaps just a scheme to provide government insurance for the most troubled assets within each bank?
- ◆ Who decides which are the troubled or toxic assets? And will banks have the incentives to openly declare which are which?
- ◆ At what price should these assets be valued?

Clearly, there are opposing points of view on all these issues, and different countries are likely to emerge with rather different versions of the same idea. Stay alert. Actually, Italy’s plan, taking its constraints into account, looks quite smart.

### **PROBLEM 2: CREDIT CRUNCH & NO DECOUPLING**

The bursting of the housing bubble led to mortgage losses, to the default of securitized assets, to the default of insured credits, to the erosion of bank capital and the virtual default of the investment and commercial banking industry in the US. Losses abruptly contaminated the banking sectors of several European countries (with Iceland and the UK at the forefront). In a short while, there was no country where the banking sector was still able to extend loans “as usual” to private and industry customers. As confidence deteriorated, industry orders contracted. And as the credit crunch generalized, orders contracted even further.

#### **Observation**

For a while, the idea took hold that the rest of the world could decouple from the US, or that Germany could decouple from Europe, or that Asia or Latin America could decouple from the more industrialized countries. It was all wishful thinking. We now know that we are all in the same downturn. Why couldn’t the rest of the world decouple from the US? For at least three reasons:

- first, because the credit crunch did not stop in the US, but for different reasons extended to countries as diverse as Iceland, Japan and Hungary (and many others of course);

- second, because all the fast growing economies were also the more open ones, hence the more dependent on exports;
- third, because multinationals from the US and the EU had outsourced such a large share of their production of intermediate goods to other countries, that the fall of aggregate demand in the US and the EU immediately reverberated to intermediate goods produced in Asia and commodities produced everywhere in the developing world.

### Consequence: Global Recession

Contraction of production in one sector leads to contraction in another sector, contraction in a country leads to contraction in another country. Layoffs in the US (3.6m jobs lost since December 2007, of which one third in the three months up to January 2009) are a promise of more layoffs in Europe and in Asia. This is the largest recession – or better, the beginning of a true depression – the largest since 1929-33. Can any country get out of this spiral on its own? No.

### Solutions

How to get out of the depression? At least four instruments or policies have been put to work in this direction (on the first two I made some remarks under Problem 1, so I won't repeat):

1. The first idea to be put in practice was for governments to **inject new capital into bank** coffers: badly needed, but hardly enough.
2. A related idea is to **clear banks' balance sheets** of the bulk of their bad assets: we shall see more of this in the coming months, but so far it has not really worked at all.
3. Central banks have also been **pushing interest rates down**, and boosting money creation by lending liquidity to banks. The purpose is again to encourage banks to resume lending to each other and to their normal customers. Central banks have been doing this in full disregard of the once-honored suggestions of Walter Bagehot: they have been lending *below* market rates, against *bad* collateral, and to virtually *insolvent* banks. Nevertheless, it still is not enough, as we are in a liquidity trap: awash with liquidity but with little capital and with many loan losses still to be discounted, banks will simply not lend – they'd rather hoard liquidity. The buzzword for this new policy, especially in the US, is "quantitative easing": but so far it has hardly proved effective.
4. Thus, governments are trying the **fiscal stimulus** - everywhere. Budgeted amounts are impressive: in the US \$827bn (as of February 7th, or €640bn), in Australia €21bn, in China €460bn, and perhaps €200bn across the EU.

Summing all this up however, and as the Financial Times remarked on Feb. 6<sup>th</sup>, "economic stimulus packages worth up to \$2,000bn globally and dramatic cuts in official interest rates have brought little relief so far".

Of course we should give fiscal policy a little more time. For the moment, the planned budgets – no matter how large they are – are just that: planned. Little action has been seen, only promises. And with consumers and businesses so hard pressed for cash, it is actions not promises that matter. Still, even when actions materialize, the doubt remains: will the fiscal boost suffice to end the recession?

This requires more discussion. In fact, not all fiscal expansions are alike: despite the emergency, it is crucial to be selective. Here is a short list of warnings for fiscal policy makers:

- i. Fiscal expansions of today must not endanger long run sustainability: government debt must not be left to explode. For several high-debt countries, sovereign risk credit ratings have already been down-graded: Spain, Ireland, Greece, Russia,... Other ratings, such as Hungary's, are already quite uncomfortable. Meanwhile, spreads over German Bunds have widened considerably. Some countries are clearly

facing a genuine danger of a debt crisis: they are not the ones that should engage in fiscal expansions. Italy is not in this lot, but it is neither too far away from it: it must exercise the greatest prudence.

- ii. Fiscal expansions must be targeted. One aim is to provide assistance for those who face the highest risks of losing their jobs. Where adequate unemployment insurance is not available, it is the right moment to adopt an efficient labor market insurance mechanism. And to ensure long run sustainability of these expenditures, they should be financed by proportionate increases of the retirement age: such a switch would be beneficial in all dimensions. Again, Italy should take notice.
- iii. This crisis is not a good Darwinian or Schumpeterian mechanism: it is not selecting out those unfit to survive. Instead, it places the highest burden on those firms that have grown more, and more aggressively, on the foreign markets: the collapse of exports is especially damaging to such firms. Paradoxically, those who aimed for the more cozy and less contested domestic markets face fewer dangers. Hence fiscal policies should also be focused on supporting – with measures of tax relief or easier terms on export credits – those firms that are struggling to defend their positions on the wider, international markets.

I have listed four instruments to fight the depression. Unfortunately there are two other solutions, much more in the spirit of *"beggar thy neighbor"*, which some countries are seriously considering:

5. **Protectionism.** America has started this, with the "Buy American" proposition (for now limited to some aspects of government procurements policy). This is bad enough. Correctly, the EU is threatening retaliations. But also the UK and France (the latter with the suggestion that French companies should retreat into their French locations) have been providing bad examples. Protectionism is a negative-sum game: it is important to speak out clearly about this. Even more worrying, the hope that the crisis might provide an opportunity to resume the Doha talks, and reach an agreement, has proved short-lived: after the meetings in Davos, the road to reaching an agreement on trade issues is more uphill than ever. The outlook is truly dark.
6. **Devaluation.** Firms must find all ways to enhance their competitiveness. The German way (which began a few years ago) is clear: increase productivity. At the opposite end, the British can only count on the rather dramatic devaluation of the pound. Both ways increase competitiveness, but the latter – although possibly unavoidable in their case – is a poor man's solution: because it will be short lived (as devaluation will then cause inflation) and because it impoverishes the country (with the weakening of the terms of trade). Here, Italy (which in any case cannot and should not devalue) should have taken notice a long time ago: as a country it did not, although many firms and some regions did, fortunately.

### **On problems and risks ahead**

Before concluding, I must point out some of the other, most obvious dangers that lie ahead: after all, hopefully, some of us will not be dead in a few years' time.

1. New **rules for the financial systems** and new regulatory schemes must be devised, in every country and – hopefully – for the EU as a whole. The danger is that veto actors will regain voice and authority after the more immediate dangers have been avoided: this should not be let happen.
2. Governments must spend now, but without accumulating **too much debt** for the future. From this viewpoint, I fear Japan (with public debt over 170% of GDP) has already lost its cause. Other, wiser countries should take every precaution to make sure that what they spend today will come back in the future: this is especially relevant to all schemes that require some sort of interim nationalization of banks or other businesses.

3. Central banks must avoid the Scylla of deflation today, but also the Charybdis of inflation tomorrow. **Deflation** must be avoided at all costs: if prices start collapsing, with interest rates at or near zero, real interest rates would begin to increase out of control, debtors would be unable to repay their loans, and the depression could only precipitate further. However, **inflation** is almost as bad: after 1973, it took the US at least 10 years to subdue inflation and resume reasonable growth. Thus, while the foot is now on the monetary accelerator, it must be ready to step on the brakes.
4. The EU Commission and the ECB should consider the perspectives for fiscal policy and the euro with broader minds. This is a good time as any to refocus the **Stability and Growth Pact** and especially to rethink conditions and criteria for adopting the **euro**. There is little or no risk that the euro area will collapse: but also there is no gain (and possibly a lot of risk) in letting some neighbors stay out to endure the cold.

Still, I have not mentioned where I believe the greatest risks lie. This would occur should one new EU member state go through a **currency and sovereign default crisis**. While such a crisis is perhaps more likely in Russia or Ukraine, that will have fewer consequences for the EU. Instead, I am quite scared about what would happen in the case of a EU member state. Depreciation of domestic currencies is already extremely painful for residents who have accumulated liabilities in foreign currency (euros, Swiss francs or dollars). But notwithstanding depreciation, the recession is taking the hardest toll on industry and exports. In addition, provisions for unemployment insurance are scarce or inadequately funded in many of the new EU members. The combination of these shortcomings is very worrisome and, due to financial integration within the EU, may well spillover from one country to others.

Hence I believe that everyone involved (with the Commission and the ECB at the forefront) should perceive as an overriding common concern to prevent any new EU member state from precipitating in such a crisis.

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