D. Systemic Risk, Regulation and Supervision.

D1. Reading recent history: US and European approaches

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- Scope and limits of this contribution: I intend to provide a summary account of post-crisis macroeconomic developments in the US and the EU, mostly focuses on macroeconomic relations and on the broad trends in financial regulation reform.
  Financial de-regulation and re-regulation in advanced countries underwent broad common swings over the last century and especially in the financial globalization decades. Significant albeit subtle differences in normative details between countries still allow for regulation arbitrage and regulation gaming, further advantaging large financial institutions with respect to locally 'connected' finance. As extensive inequality is likely to increase systemic risks, I intend to highlight a crucial, largely unaddressed issue in reforming finance within the so-called advanced countries – namely, ***how finance can contribute to providing inclusive growth***.

Post-crisis macroeconomic developments in the US and the EU

- Despite obvious differences between EU and US in the causes and the timing of financial distress and in post-crisis reform actions (the main difference being that the US are a country while EU is a unique and complex multi-country economic and political entity), the basic lines of immediate post-crisis action were quite similar. Within a broad reference to the G20 'London' consensus, both the EU and US undertook a significant re-regulation of the financial sector (actors and instruments) after providing massive support to preserve its functioning and make it more resilient.
- In both EU and US, ***monetary and fiscal stimulus*** immediately after the crisis provided necessary short run relief from abrupt reduction in average levels of consumption and income (albeit with serious problems of outreach to the disadvantaged part of the population, such as informal workers, young people, unemployed people). Signs of recovery could be detected in both areas by 2010.
- As the financial crisis muted into the Eurozone sovereign debt crisis, the relative performance of the two areas diverged. Over the period 2011-2013, cumulated GDP growth (Gros, 2014) was 6.5% in the US and a mere 0.5% in the Eurozone (obviously, average Eurozone performance reflects significant intra-area differences).
- It is worth exploring the underlying causes of this different performance: was it macroeconomic policy (***'austerity' versus 'growth'*** oriented policy decisions), or there were more structural explanations? While the narrative referring to macroeconomic policy decisions in the two areas was quite different on the two sides of the Atlantic, the substance of macroeconomic policy actions was quite similar. Over 2011-2013, public consumption fell by 0.8% in the US and by 0.1% only in the Eurozone (despite the 'austerity' narrative so often recalled and criticized in the Eurozone). Private consumption followed different paths in the two areas (+4.6% in the US, -1.0% in the Eurozone), as did investment (+2.2% in the US, -0.9% in the Eurozone).
- ***Sluggish current and long term growth*** is now recognized as a feature of macroeconomic development on both sides of the Atlantic.

Financial re-regulation and supervision

- As to financial regulations and supervision, the post-crisis landmark event in the US was the Dodd-Frank, while landmark events in the Eurozone include financial policies reforms (towards single surveillance mechanism, close monitoring of systemically relevant financial institutions, banking union) and monetary policy innovations (most notably OMTs). Institutional reforms are still work-in-progress in both the US and EU (Dodd-Frank will require filling in many details on the side of regulators, as the completion of Eurozone reforms).
- The post-crisis re-regulation efforts highlight the ***'specialized' nature of financial legislation*** within national legal system. The 'specialty' of financial law relates to both the large influence of supra-national sources on national practices, and the increasing role of specialized financial laws within countries. After the financial crisis, they were largely redirected from providing a large space for self-regulation on the side of financial institutions, to enhancing transparency and consumers' protection (De Carli 2012), thus addressing power asymmetries between large institutions and citizens. One could note that besides prudential regulation and enhanced disclosure rules, addressing asymmetries in information and contractual power may also require business conduct rules and civil responsibilities rules (Perrone 2012).
- A serious concern remains that ***re-regulation can itself produce significant asymmetries***, as complex rules tent to favour large institutions with respect to small, the former being more equipped in finding cheaper ways to rule compliance. That is, re-regulation may have added to the tendency of financial sector to exhibit a highly concentrated oligopolistic structure. Business is in facts highly concentrated in crucial segments of business (rating agencies, clearing facilities, and asset management companies - which are now a major source of credit). Realism calls for remembering that both financial de-regulation and re-regulation can be captured, and are likely to reinforcing oligopolistic economic, financial and political structures.

Assessing the current (2014) macroeconomic situation

- The current macroeconomic situation is quite similar in the US and the Eurozone: sluggish growth, very low levels of interest rates, very low inflation rates, while financial markets are back to 'business as usual' (possibly underestimating systemic risk once again).
- Explaining ***current sluggish growth*** is relatively easy. Consumers, firms and financial institutions remain focussed on repairing their balance sheets, which explains the low levels of aggregate demand growth. Moreover, misallocation of resources in the pre-crisis period due to financial euphoria requires time for correction, and for resources to be allocated to truly productive uses. Two cautionary remarks: first, consumption may boost GDP, but increased consumption is no indication of improved common well-being, especially when consumption increase only for privileged groups within a country; second, boosting consumption tents to have shorter run impact on growth than investment.
- Monetary policy remains characterized by very ***low interest rates***, possibly necessary but clearly dangerous for two connected reasons. One is scarce effectiveness in supporting growth: cheap money does not stimulate aggregate demand when agents are focussed on adjusting their balance-sheet ("you can pull the string, not push it"). The second relates to increased attractiveness of speculative activities: low interest rates, combined with the expectations that monetary conditions will remain easy for a long time, ultimately favour financial risk-taking. As a matter of facts, we see that accommodative financial conditions do not seem to be conducive to corporate investment.
- ***Investments rates*** are indeed very low and declining in advanced countries (around 19% of GDP in 2013); in part, this trend reflects a needed reduction in previously excessive investment in real estate, but it also signals a dangerous and diffuse reduction in expenditure for plants and

equipment (BIS 2014, p.57). Investments in emerging countries are quite dynamic, on the contrary (above 45% of GDP in China, 30% in emerging Asia, above 25% of global GDP as a world average).

- Aggregate ***debt levels*** have continued to grow to date: debt/GDP ratios are respectively 275% in the advanced economies and 175% in emerging economies (BIS 2014). They seem to be no panacea for resuming growth: debt-driven growth remains a short run device for enhancing expenditure, but it remains highly uncertain whether increased demand will sustainably generate higher incomes.
- ***Increased inequality*** in advanced countries, especially within-country inequality (and within Eurozone, with a clear North-South divide), is likely to persist; it is also likely to feed a vicious circle of marginalization and exclusion. This urgent problem need to be tackled with an 'investment' approach, not with the (easier, both in economic and political terms) a 'consumption' approach. Broad access to basic goods (health, education, social participation) represent a powerful investment, possibly capable to resist vicious cycles. The good news in this proposal: health, education and participation are structurally 'relational' goods (they necessarily occur in a relationship – good or bad); hence, the relationship between expenditure levels (cost of provision) and effective access to these goods (receiving adequate care, human flourishing in learning and participating) is at best spurious. That is, much could be achieved even with little money, along a subsidiarity approach.
- A cautionary note: Financial policies, monetary policies, the network of international borrowing and lending, the current account positions and exchange rates dynamics are ***closely interconnected***. Policy-making requires awareness of such interconnectedness; no "best practices" in policymaking relative to any single item of the above list automatically produces "best" outcomes, irrespective of the complex overall situation. There is much need to better understand the inter-sectoral, international transmission channels of domestic policies of large countries such as the US and EU, and especially a much clearer understanding of inter-institutional, international financial networks.

The US and EU global interconnectedness, and systemic risk

- The US and EU monetary and financial policy decisions produce important spillovers in the global scenario, as documented by distress experienced in emerging countries bond markets in 2013; at the same time, one should also consider that much of what happens to EU and US depends on decisions taken on other systemically important countries (China, and more in general other G20 countries)
- Just to mention an important example, excessive international reserve hoarding by emerging economies (to be used as self-assurance in face of expected financial distress) proved to create both local and global problem (under-investment locally, artificial support to the balance of payments and exchange rates of advanced countries whose currency is perceives as reserve currency).
- To make a long story short, interconnectedness suggests intellectual ***prudence*** when discussing how to keep systemic risk under control. That is, systemic financial distress can find no easy, strictly financial, solutions. Finance is also a 'real' thing.

Deleveraging strategies

- Who will bear the burden of post-crises adjustment has been – and remains – a key point for conflict and a key space for cooperation in both domestic and international political space. Unaddressed or unresolved problems of adjustment lay at the roots of instability and institutional collapse, since they create situations of patent injustice by asymmetrically concentrating the costs of adjustment on the weakest part. Justice – desirable in itself - is also key in preserving the space for desirable interactions. *Caveat creditors*! (BIS 2012)

- Failure to address asymmetric adjustment in external balances, with provisions involving surplus countries' involvement, has been the weak link in a number of international exchange arrangements, causing their abandonment or collapse. The Bretton Woods system was no exception. Asymmetric adjustment between surplus and deficit countries is also key in fuelling the persisting divergence in growth within the Eurozone (De Grauwe, 2012).
- Deleveraging is itself a form of adjustment, sharing with external deficit adjustment a serious issue of ***asymmetry***: the tendency to concentrate costs on the debtor, normally the weaker side of the debt relationship. Again, addressing issues of justice are unavoidable for preserving the vitality of the system.
- The post-crisis deleveraging process has been problematic to say the least: there has been no aggregate deleveraging in any of the advance countries, yet the real costs of trying to reduce debt overhang proved very high. The efforts – or the dire need – to adjust balance sheets on the side of households and firms (typically the weakest among debtors) played an important role in depressing growth. From 2007 to 2012, advanced countries' total debt increased, with diversified sectoral deleveraging processes: in the euro area and the UK, private debt did not decrease and government debt substantially increased, while financial sector's debt and especially households' debt significantly reduced in the US over the same period (Pisani-Ferry 2013). Actually, the transatlantic growth gap can be explained (Gros 2014) by the prevalence of 'no recourse' mortgages and fast bankruptcy procedures for individuals and small businesses in the US, which allow for a relatively 'debtor friendly' micro-deleveraging process there.
- Debtor-friendly deleveraging can be good for growth, and indirectly also for creditors, as we can learn from previous episodes of debt management and from existing procedures for international debt restructuring and cancellation – typically involving low-income or emerging countries as debtors ("times they are a-changing..."). moreover, recent and not-so-recent historical experience shows that many industrial countries (including France, Germany, Japan, US and UK) have been involved over la last century in a number of episodes of domestic and/or external debt default, restructuring and conversions (Reinhart and Rogoff 20q3, pp.13-14). All of these 'unusual' forms of deleveraging require either debtor-creditor cooperation, when the political feasibility for the debtor country to impose adjustment costs on creditors is non-existing.
- Opening a frank discussion on domestic and international 'debtor-friendly' deleveraging procedures, in a world of globalized finance, seems very useful to me. Contingencies may lead economies that seem to be very similar to each other to tread divergent paths, when facing a critical junction (Acemoglu Robinson). The financial crisis could represent a 'critical junction' for EU and US, and an institutional contingency such as the existence of debtor-friendly procedures (more in general, reinforcing institutions for inclusive growth) may make the difference.

Providing inclusive long run growth

- There is evidence of ***long run decline in productivity growth in all advanced economies***; moreover, there is striking evidence that productivity fell most in the financial 'euphoria' period. There is in fact little incentive to 'real' innovation when financial innovation is expected to provide large benefits with small effort.
- Moreover, debt-financed growth is very likely to ***endogenously feed inequality***. Debt-financed growth benefits those who can get credit in the first instance (reinforcing the economically powerful), or creates a class of politically powerful '*rentier*'. After the financial crisis, we can

witness a wider recognition of the fact that increasing levels of inequality make economic growth unsustainable. It is thus a good time to address the issue of providing conditions for inclusive growth, and exploring how 'good' finance can support it.

- The real determinants of growth are easily summarized: resources, technologies, 'preferences' (especially short versus long run objective for households, firms, financial institutions) and institutions (inclusive or extractive, in both the political and the economic sphere). All items of the list remarkably relate to the 'human factor' (even resources are never 'given', as human beings recognize them as such). Hence, real growth requires a decided investment in ***education***, that is the possibility for each and all persons to open to reality as a whole, realizing the aspiration to "do more, know more and have more in order to be more" (Paul VI, *Populorum progressio* 14)
- Inclusive growth has many dimensions, including intergenerational and international. Aging, for example, is a highly relevant determinant of low aggregate savings and investments. Unsurprisingly, aggregate savings (a rough proxy for society's caring for the future) are very low and declining in most advanced countries. International migrations should also be frankly discussed, not dealt with as an 'emergency' issue only.
- Now: *Can ideas trump interests*? (Rodrik 2014)