The Future of European Integration: Some Economic Perspectives

Summary of the 39th Economics Conference of the Oesterreichische Nationalbank

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The recent financial, economic and debt crises have posed a serious challenge to the European institutions and the process of integration. The euro has fostered European integration and shielded the countries of the euro area against exchange rate fluctuations within the area of the single currency. At the same time, however, the crisis revealed shortcomings in the procedures for safeguarding sustainable public finances, in the regulation and supervision of financial systems and in national structural and growth strategies. Against this background, the Economics Conference of the OeNB on May 23 and 24, 2011, brought together renowned national and international experts and leaders from politics, business, finance and academia to discuss the long-term implications of the crisis for the process of European integration.

EU Is Facing Great Challenges

In his opening remarks, *OeNB Governor Ewald Nowotny* stressed the high relevance of the conference theme, which had been on top of the European and international agendas for the past few months. Europe's historical development was comparable to a spiral stair, Nowotny said: With periods of integration alternating with periods of disintegration, each cycle was accompanied by an upward movement. Over the past 66 years, a model of European integration has been created that – for the first time in history – was based neither on strategic alliances nor on involuntary association.

Nevertheless, Europe today is facing great challenges, and finding the right answers to these challenges is not easy. Politicians, economists, and commentators are in disagreement on the causes of the crisis and the ways to resolve it, and this disparity of positions is also mirrored in public opinion. Nowotny identified a "double heterogeneity" as the main cause of the crisis: a heterogeneity of national economic developments and a heterogeneity of supranational institutions. A majority of EU countries has ceded sovereignty in monetary policy to a supranational institution, the ECB; economic policy, however, has to a large part remained the responsibility of the individual Member States. The lack of centralized economic governance became particularly obvious when the crisis laid bare the heterogeneity between the individual countries. Countries differ in their institutions, but also in their preferences as regards the role of the market and the welfare state. While these structural differences are rooted in the history of countries, they are not exclusively individual countries' concern, as the situation in one Member State has implications for other Member States and the EU as a whole.

Call for Stepped-Up Implementation of Reforms

Some euro area countries are faced with structural problems, in particular in terms of competitiveness. European institutions repeatedly warned against these unfavorable developments in the past, and while they excelled in analysis, they were weak in implementing counter-measures. This situation implies the following two challenges: First, the long-

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standing structural problems of certain countries need to be resolved, which will take some time. Second, the time span between identifying a problem and launching counter-measures needs to be reduced. Some reform progress has already been made, including, for instance, improved monitoring of fiscal decision making and macroeconomic imbalances. The following guidelines will prove useful in the ongoing reform process. First, reforms should be implemented not only in economically difficult times but in particular also during boom times; since it is politically difficult to adopt anticyclical measures when the economy is humming, there is a need for automated rules. Second, a gradual approach to reforms should be followed given their uncertain impact. In other words, new elements should be integrated in existing and working structures on a step-by-step basis. Third, it is necessary to reduce public debt and safeguard the sustainability of public finances. These challenges notwithstanding, Nowotny expressed his confidence that European integration will continue.

Fair Reforms

Rudolf Hundstorfer, Federal Minister of Labour, Social Affairs and Consumer Protection, discussed the upcoming challenges to integration in Europe. There has been considerable progress recently, including the adoption of the Lisbon Treaty, which, however, has been seriously thwarted by the financial crisis. Greece and Portugal are struggling to consolidate their finances; it is necessary to support these two countries in this difficult situation, not only to demonstrate European solidarity but also to defend our common interest in protecting the process of integration and, in particular, the euro. The consolidation measures demanded from Greece and Portugal must be well balanced and fair and must not jeopardize economic recovery. Achieving a balanced budget cannot therefore be the only objective. Despite all the challenges it is facing, the EU is still in a better position than the U.S.A. and Japan; the euro area's debt level is lower than that of these two countries. Europe has successfully maintained the stability of the euro area. The main task now is to consolidate public finances and at the same time to implement the Europe 2020 strategy aimed at fostering sustainable and inclusive growth. The following two elements should provide the basis for all reforms: First, a symmetrical approach should be followed in removing imbalances; in other words, both countries with budget deficits and those reporting surpluses must contribute. Second, the focus of efforts must be on the real economy. For Greece and Portugal this means that they must be supported in growing out of the crisis.

Austria's reform program mirrors its commitment to the objectives of Europe 2020, which to a large degree reflects the involvement of the social partners in formulating this program. Austria will continue to fight for a Europe serving the interests of its citizens, including qualitative growth, full employment and a strong system of social security. More and better jobs must be on the top of the European agenda. Also, functioning pension and health systems should be seen as a prerequisite for sound public finances. This requires effective financial market supervision and regulation with a focus on security. The financial sector must serve the real economy; high-risk financial products must be banned. An international tax on financial transactions would on the one hand contribute to stabilizing the financial sector and on the other hand generate additional rev-

enues that could be used for promoting social security.

Excessive consolidation in the wake of the crisis would slow down the recovery in labor markets and, consequently, hamper economic growth. Fighting youth unemployment should be one of the main priorities. The Austrian government will continue to give young people job guarantees. One of the goals should be to establish a system that legally entitles young people to the education and training they need for finding a job. Consolidation measures must not affect those who have already suffered most severely from the crisis. The working conditions for European employees must be improved, the measures against illegal employment and wage dumping must be reinforced. Austria has already taken first steps in this direction by adopting a law against wage dumping and lowering social protection standards, which entered into force in May 2011. Safeguarding employment and social peace must remain key objectives as they are prerequisites for protecting democracy and successfully continuing the European peace project.

Euro Area Needs Fundamental Reform

Martin Wolf, Financial Times, claimed that the euro area needed radical reform to safeguard its future. Economic and Monetary Union was the attempt to impose the 19th century gold standard mechanism on heterogeneous democracies with generous welfare states, rigid labor markets and government-insured financial systems. This did not work because the members of EMU are not willing to accept the implications. Sovereign default would lead to loss of confidence in the financial markets, political friction between creditor and debtor countries would ensue. The crisis was caused not only by a lack of fiscal discipline; excessive credit growth and asset price bubbles in the private sector prior to the crisis had played an even bigger role. Generating procyclical real interest rate effects, EMU has been consistently contributing to regional boom-bust cycles in the euro area. The current account imbalances within the euro area reflect these adverse developments.

Crisis management in the euro area has been overshadowed by conflicts between Member States; therefore, the measures launched so far – like the establishment of the European Financial Stability Facility (EFSF) or the European Stabilisation Mechanism (ESM) – were not successful in calming financial markets. The announcement of introducing a regime allowing the bail-in of investors starting from 2013 contributed to the drying up of funding for the countries under pressure. Large current account surpluses cannot be sustained for an indefinite period of time. Possibly, the countries posting surpluses will eventually lose a part of their outstanding claims. The close links between banking systems and governments cause problems and must therefore be loosened, enabling banks to cope with sovereign debt restructuring and governments to deal better with bank failures. Therefore, minimum capital ratios for banks should be raised considerably and the role of capital market funding, in particular through equity, should be reinforced. Countries in distress should be able to obtain liquidity on affordable conditions while meeting strict policy requirements. Systems of automatic wage flexibility should be introduced to overcome persistent competitive disadvantages; such a mechanism will allow cutting nominal wages quickly and considerably in situations where countries face problems concerning their competitiveness.

EU Launched Extensive Reforms

European Commissioner for Economic and Monetary Affairs Olli Rehn, by contrast, painted a much more optimistic picture of the new economic governance architecture in the EU. He started his contribution by quoting Joseph Schumpeter, who famously said that nothing would be more telling about a country's strength than its monetary policy.[2] 80 years later, Rehn continued, many would ask themselves how strong Europe is. What we see now is support fatigue on the one hand and reform fatigue on the other. People ask whether the crisis will never end, whether the support measures are necessary, whether the reforms are too demanding. Rehn pointed out that Europe was on the right track. The immediate action to support countries on the brink of sovereign default was as necessary as the reform and adjustment measures required from these countries. The EU must be firm in insisting on the implementation of these measures; at the same time, patience is called for, since many measures need time to show effect.

Before the crisis, the euro area enjoyed macroeconomic stability and stable inflation rates and saw some improvements in fiscal policy. Over the past decade, macroeconomic imbalances had built up across the euro area, however. The integrated financial market channeled savings from countries with low private demand to countries where demand was high and the current account in deficit. In some places, funds went to the housing sector, contributing to an unsustainable growth of asset prices. At the same time, wages increased faster than productivity, which affected some countries' competitiveness. Current forecasts show that Europe will reach the pre-crisis production level in 2012.

Common Currency Shielded Euro Area from Crisis

Counterfactual scenarios may be difficult to devise, but there can be no doubt that without EMU, the financial crisis would have caused detrimental currency crises in Europe. The euro acted as a shield in this situation, protecting the euro area countries, including Austria. The ECB's responsible action as well as policy decisions and reform efforts in many countries made it possible to contain the sovereign debt crisis to a few countries. Substantial effort is required in these countries to achieve the surplus that is necessary to redeem the debt. Relevant, positive examples from the past show that such reforms can be done. In the 1990s, Belgium achieved large primary surpluses over an extended period of time; Latvia and Romania had received financial assistance tied to a program of conditionality before EU accession, which resulted in successful reforms.

Europe is currently reviewing its economic governance structures. In September 2010, the European Commission adopted a package consisting of three main elements: strengthening the Stability and Growth Pact to correct promptly unsustainable fiscal developments, monitoring macroeconomic imbalances, and introducing a more effective mechanism for automatic sanctions in case of noncompliance with the rules. The EU will be faced with difficult decisions also in the future. Yet, substantial progress has been made, as demonstrated by the economic recovery in most Member States, including Austria. Europe will tackle the remaining chal-

[2] *„Nichts sagt so deutlich, aus welchem Holz ein Volk geschnitzt ist, wie das, was es währungspolitisch tut."*

lenges through perseverance and determination. Coming back to Schumpeter's question, Rehn concluded that Europe is cut from tough cloth.

Fiscal Crisis Affects Only a Few Countries

Professor Wolfgang Franz (Centre for European Economic Research, Mannheim) and Daniela Schwarzer (Stiftung Wissenschaft und Politik, Berlin) analyzed the reform of the Stability and Growth Pact in a panel discussion chaired by *Ernest Gnan (OeNB). Professor Franz* emphasized that the fiscal crisis was essentially the crisis of individual countries and not of the euro area as a whole; nor is the euro the reason for some countries' budget and current account deficits. After all, other large currency areas – Japan, the U.S.A., and the U.K. – posted much more unfavorable deficit and debt figures than the euro area. Still, there are some euro area countries that apparently have not yet internalized the framework of a currency union (a single stability-oriented monetary policy, no monetization of government debt, no possibility of devaluation and the ensuing necessity of wage moderation). The economic policy reforms pushed ahead by the EU are not sufficient. The Stability Pact should stipulate tougher sanctions, financial supervision at the European level should have more far-reaching powers, and crisis management mechanisms should feature a bail-in of private creditors, which is highly unlikely under the current rules. Therefore, the ESM should be renegotiated to make financial aid contingent on whether and for how long a country applying for aid has been subjected to an excessive deficit procedure. In the absence of such a procedure, aid would be granted directly; if a deficit procedure had already been opened, aid would be granted only subject to strict conditionality; and if the country had been under an excessive deficit procedure already for a prolonged period of time, a bail-in of private creditors would be required.

Seizing the Impulse for Reform Triggered by the Crisis

Daniela Schwarzer analyzed the reform of the Stability and Growth Pact from a political-economic angle. Experience so far has shown that the Pact very much lacked credibility, that the Member States did not take the requirement to consolidate their finances seriously, that national interests often take precedence over European interests, that structural problems have remained unresolved, that the role of the European Commission must be strengthened, and that exit strategies are insufficiently specified. The sovereign debt crisis was also due to wrong incentive structures and ineffective instruments for dealing with liquidity and solvency crises. The markets failed to act as a mechanism sanctioning excessive deficits; currently, aid programs and undefined insolvency risks are making it difficult to price risks. The pressure currently exerted by creditors on debtor countries as well as the EU's influencing national fiscal policies are met with resistance in many EU countries and provokes the question of legitimacy. Many politicians have not embraced the idea of EMU and its economic implications, which harms the euro area as a whole. There is the danger that we will miss out on the opportunity for far-reaching reform created by the crisis and that populist sentiment fueled by the crisis diminishes people's willingness for change. History has shown that increasing unemployment goes hand in hand with waning public support for European integration. Against this background, it is likely that the EU will fail to live up

to people's expectations about its capability to tackle the crisis.

Will the new supervisory framework for banks and financial markets be able to prevent future crises? Are the current reforms far-reaching enough? These were the questions discussed in the afternoon of the first conference day by ECB Executive Board Member Lorenzo Bini Smaghi, Professor David T. Llewellyn (Loughborough University), Professor Hans-Helmut Kotz (Universität Freiburg) and Professor Andreas Pfingsten (Universität Münster).

Monetary Policy Is Greatly Intertwined with Macroprudential Supervision

Lorenzo Bini Smaghi, Member of the Executive Board of the ECB, opened the session, chaired by *Andreas Ittner, Executive Director of the OeNB, addressing* "Macroprudential Supervision and Monetary Policy – Linkages and Demarcation lines." Price and financial stability are communicating vessels, Smaghi said. Volatile prices and inflation expectations go hand in hand with volatile asset prices, and financial stability is essential for the transmission of monetary impulses. Too loose a monetary stance can spark a search for yield, excessive financial leveraging and risk appetite, thereby causing asset price bubbles. Short-term interest rates do not only influence expectations but also have direct effects by determining the costs of financial leveraging for financial institutions, the majority of which fund themselves through the short-term market. Securitization may amplify the implications. Empirical evidence shows that low interest rates lead to a loosening of credit standards in the euro area. Given insufficient regulation, a financial system exposed in such a way can be shaken to its core when a negative shock to confidence occurs. Fundamental market failure implies that unregulated private money creation leaves the financial system fatally exposed to systemic risk; in a systemic crisis, fire sales, which are justified from the point of view of each institution in isolation, cause a systemic crisis that also damages otherwise sound financial institutions. Responding to such developments ex post with conventional monetary policy measures is inadequate. Rather, appropriate measures should be taken already in advance. While before the crisis, the doctrine of inflation targeting prevailed, it is now obvious that monetary policy should give consideration not only to asset prices, but also asset price over-valuations, measures of risk appreciation as well as monetary and financial quantities. In particular, an asset price bubble progressing in symbiosis with excessive credit growth is a dangerous development. The Eurosystem has long met this requirement of acting ex ante by pursuing its two-pillar monetary policy strategy. This is where the instruments of macroprudential supervision come in, which are currently being developed; they should reduce the procyclicality of the financial sector on the one hand and improve the resilience of the financial system on the other hand. One tool to tame procyclicality are counter-cyclical capital buffers; on the demand side, ceilings on the loan-to-value ratios for collateralized loans could be established. Both measures raise credit costs, as does an increase in interest rates – so why do we need another set of instruments? Macroprudential measures can counter risks to financial stability already at a time when there is no visible danger to the stability of consumer prices. In a financial crisis, interest rate cuts can support an expansive macroprudential policy. These two policy areas interact in many ways, therefore close coordination is

warranted. Measures to improve the resilience of the financial sector can be aimed at strengthening existing institutions (e.g. raising minimum capital ratios for systemically important institutions) and at changing the structure of the financial sector (e.g. establishing central clearing counterparties or separating commercial banking from other business areas). Apart from solvency issues, macroprudential supervision should also take into account systemic liquidity risk, a field in which further work needs to be undertaken. Moreover, given the degree of integration of international financial markets, the question of how to coordinate macroprudential policies at the international level will also have to be resolved. Going even further, the interplay between macroprudential and monetary policies will eventually raise the question about the coordination of monetary policies, which will require discussion in the years to come.

EU Needs Reform of Strategic Approach to Supervision and Regulation

Professor David T. Llewellyn (Loughborough University) addressed the question as to what extent the new regulatory and supervisory framework in the EU will be able to prevent future crises. The recent crisis happened despite the existing extensive set of complex internationally agreed rules for the banking business (Basel II). This raises the fundamental question of whether the crisis was due to isolated deficiencies in the existing framework or whether the strategic approach to regulation was inappropriate. Financial regulation always involves the risk of distorted incentives and circumvention of regulation. Hence, regulation may precipitate the kind of events it was designed to avoid; in other words, the crisis may be endogenous to the regulatory framework. Regulation is aiming at a moving target, and the target, in turn, moves partly because of regulation itself. This involves the risk of entering a spiral of circumventing regulation, which sends the macroeconomic costs of regulation higher and higher. Incremental measures to improve the regulatory regime therefore always imply new forms of regulation, that is, Basel III would be followed by Basel IV and, eventually, Basel "N". To avoid this spiral, a fundamental change in strategy is required; Basel III would have to be supplemented by a fourth pillar that changes the incentive structure by defining clear resolution rules that prevent the socialization of risk.

The causes of the crisis are numerous. Hence, we need a fundamental and strategic approach to reforming regulation and supervision instead of relying on incremental measures. For instance, financial regulation could aim at lowering the probability of bank failures and their costs; although there is a certain trade-off between these two objectives, they both have to be fulfilled. Traditional banking regulation focuses on crisis prevention and considers the costs of bank failures only when a crisis has materialized. Before the crisis, the absence of bank resolution rules contributed to moral hazard and, in the end, market failure. This problem must be addressed as quickly as possible. The costs for the taxpayers need to be limited. Furthermore, the issue of too-big-to-fail financial institutions needs to be addressed, and arrangements to confer credibility on a no-bailout policy which addresses the time consistency problem must be put in place. Also, the practice of providing financial institutions with de facto insurance cover for free must come to an end. The distribution of the costs of bank failures must be explicit, fair and coherent. The costs should be borne by stakeholders and unsecured

creditors. Regulation must be based on the principle of competitive neutrality and include all institutions that can potentially create systemic vulnerability (including "shadow banks"). Finally, cross-border crisis management also needs to be improved.

Is Post-Crisis Regulatory Reform Far-Reaching Enough?

Whether the reform of financial market regulation is far-reaching enough was one of the questions raised by *Professor Hans-Helmut Kotz (Freiburg University and Center for Financial Studies at the Goethe University Frankfurt)* on an academic panel chaired by *Martin Summer (OeNB).* The Basel II rules essentially focused on the sufficient capitalization of banks, relying on – presumably – refined internal models to establish the degree of sufficient capitalization. This implied that banking supervision broadly relied on self-control. The crisis revealed how fragile and error-prone credit risk models really are: The samples of data are too small, the value-at-risk approach is of an overly simplifying nature, and the models cover neither the systemic dimension nor the endogeneity of risk. While the academic discussion has long addressed the underestimation of systemic risk, the procyclicality of capital requirements and the potentially strong significance of liquidity risks, regulators have tended to neglect these issues in formulating policies. The crisis – understandably – sparked a discussion about the actual role of the financial markets. The appropriateness of a regulatory framework – and of its implementation in supervision – must be judged on the basis of its ability to ensure the efficient, cost-effective allocation of capital and risks. The financial system should facilitate the efficient allocation of capital and risk at reasonable costs; it should not represent an end in itself. Financial regulation should correct externalities (market inefficiencies or lacking markets) and safeguard financial stability as well as consumer protection (a merit good). For regulation to fulfill this purpose, some strategic decisions need to be made. Should regulation be geared at institutions, markets or functions? How can regulatory arbitrage be avoided? A functional approach may be the best way to achieve regulatory goals, including the closing of loopholes. Regulatory standards can be implemented effectively only if the supervisory authorities are independent and capable of enforcing these standards. Only then will they be in a position to ensure the stability of financial institutions. The crisis has revealed deficiencies and the necessity to reform Basel II; the microprudential perspective must be supplemented by a macroprudential perspective. The reforms implemented so far have generated considerable progress. In microprudential supervision and regulation, capital requirements have been adjusted to better reflect risk profiles; also, leverage ratios (in acknowledgment of the inadequacy of risk weightings) and liquidity requirements have been introduced. Furthermore, new European supervisory authorities have been established, and there has been a redistribution of tasks and coordination responsibilities between national and European supervisors. At the macroprudential level, the monitoring of systemic risks has been institutionalized. The newly created European Systemic Risk Board (ESRB) has been mandated to monitor risks and issue recommendations. Many issues, however, for instance the exact definition of systemically important financial institutions, are still waiting to be resolved. The estimates of the costs created by increased regulation vary broadly but must be seen in relation to the benefits of higher financial stability.

The questions that need to be addressed include not only some microprudential aspects (the level of capital and liquidity requirements, the calculation of risk-weighted assets), but also systemic issues (resolution of banks, in particular cross-border institutions, increased requirements for systemically important institutions, EU-wide deposit guarantee scheme) and the activities of the European supervisory authorities and the ESRB. What has been achieved are compromises, which also reflect the constellation of interests in Europe. It remains to be seen whether the measures taken so far will suffice. In any case, the direction the reforms are taking is the right course of action.

New Banking Regulation Involves also Disadvantages and Costs

Professor Andreas Pfingsten (Universität Münster) first illustrated the new rules of Basel III using a stylized balance sheet of a typical commercial bank. While the more stringent minimum capital requirements differentiate between asset positions by risk class, the newly introduced liquidity coverage ratio and the net stable funding ratio differentiate between asset positions by their degree of liquidity. The stricter capital definitions will increase the scarcity of core capital and probably decrease the return on equity, which in turn will lead to even more core capital scarcity. The supply of necessary capital through other financial intermediaries to banks may destabilize the sectors concerned. Market participants may respond to the new situations in various ways: Debtors with a good credit history may turn to the – less, or at least differently regulated – capital market; banks may shift their activities to less capital-intensive lines of business; banks may increase their risk exposure to increase their return on equity, which would imply that no (or at least less) risk mitigation is forthcoming for the financial system as a whole; upward pressure on interest rates may increase banks' credit risk (adverse selection, moral hazard); and higher interest rates may dampen economic growth. The reduction in banks' proprietary trading may affect the information content of financial market prices, and reducing OTC derivatives while giving more weight to products dealt through central counterparties may increase costs and crowd out hedging activities. The leverage ratio may jeopardize some low-risk business models (e.g. specialized real estate lending) and make investments in no-risk government bonds unattractive. The net stable funding ratio restricts long-term bank lending and significantly affects one of the major tasks of banks (maturity transformation). The negative impact of these developments on investment and growth will be felt in particular by small and medium-sized enterprises that do not have access to the capital market, and countries without a large corporate bond market, such as Germany.

Austria Weathered the Crisis Well

In his after-dinner speech, *Thomas Wieser, Director General* in the *Austrian Federal Ministry of Finance* and former long-serving *President of the EU's Economic and Financial Affairs Committee,* reviewed the key developments during the economic and financial crisis. While in the early stages of the crisis, Europe had considered the turmoil a purely Anglo-Saxon affair, it soon became obvious that it was a global phenomenon significantly affecting Europe and the EU too. The counter-measures were being developed as the crisis progressed. Unlike the U.S. authorities, their European counterparts put great emphasis on avoiding effects that would distort

competition in setting up their measures to rescue distressed financial institutions. Keynesian-style stimulation of demand was one of the most widely used instruments to tackle the crisis, yet evidently also fraught with the problem that exiting from expansive policies was difficult, and budget deficits and debt ratios in several countries started to get out of control. Austria too was almost sucked into the vortex of the crisis when international investors questioned Austria's fiscal position in light of its banks' large exposures in Central, Eastern and Southeastern Europe. In this stage, the "Vienna Initiative" crucially contributed to stabilizing the situation, bringing banks to stay in the region in exchange for international support. When it became known that Greece had forged its fiscal statistics, the financial and economic crisis turned into a fiscal crisis. Greece is still working to implement the extensive austerity measures on which the provision of international aid hinges. Meanwhile, Ireland and Portugal applied for aid from the funds established to support EU countries in distress. Despite the comprehensive aid measures, the financial markets have remained skeptical, in particular as regards the sustainability of Greece's public finances. The causes of the fiscal crises differed in these three country. Greece is the only economy whose public finances were already unsustainable when the crisis broke out; in Ireland, the high costs of saving the financial system had a disastrous impact on the public purse; and Portugal suffered from the combination of high public and private debt. These examples show that it does not suffice to monitor the sustainability of public finances; the private sector must not over-borrow either. In the years preceding the crisis, globalization laid bare the structural weaknesses of many Western European countries. Against this background, the financial situation of low-skilled workers deteriorated, which was masked by generous government transfers and/or excessive lending growth. The crisis made it clear that emerging imbalances must be thoroughly analyzed, monitored and tackled much earlier and much more resolutely. Macroprudential supervision must ensure a more critical approach to financial market risks. Before the crisis, many international organization, with the exception of the BIS, paid too little attention to risk and trusted too deeply in the market's self-regulation ability.

Crisis Created Major Challenges for IMF

The challenges faced by the real economy were the central topic on the second day of the Economics Conference. Chaired by *Wolfgang Duchatczek, Vice Governor of the OeNB,* a panel discussion with Anne O. Krueger, Professor at Johns Hopkins University in Washington, D.C., and former IMF Chief Economist, and Thomas Wieser, Director General in the Austrian Federal Ministry of Finance and former long-standing President of the EU's Economic and Financial Affairs Committee, sought to identify strategies to correct macroeconomic imbalances.

Anne O. Krueger pointed out the role of supranational organizations such as the IMF, the World Bank or the World Trade Organization (WTO). Having contributed crucially to remarkable global growth in the past 60 years, these organizations are now facing a range of challenges. It is a crucial task of the IMF, for instance, to put into practice a common regulation of the international financial system. A globally uniform framework is necessary to prevent countries from creating their own competitive advantage by subjecting their financial markets to weak regula-

tion. At the same time, however, it is vital that regulation does not hamper competition and innovation (and, consequently, improvements in efficiency) in finance.

Correcting global macroeconomic imbalances, for instance the U.S. current account deficit, must be another priority of the IMF. The U.S. current account deficit has been funded by the current account surplus of China, whose consumption-to-GDP ratio has meanwhile come down to only 35%, and is therefore unsustainable in the long run. The IMF pointed out this global imbalance already several years ago but did not succeed in instigating correction measures, as both sides insisted on sticking to their policy, calling upon the other party to implement changes. The maintenance of this imbalance was a central cause of the financial crisis. Chinese investors' extraordinarily high demand for U.S. bonds was instrumental in keeping U.S. interest rates low, and the low level of interest rates, in turn, contributed to the real estate boom and the increased risk appetite of creditors seeking to maximize their returns.

Krueger also identified new challenges for the World Bank and the WTO. The World Bank has to intensify its efforts to support growth in developing countries and in particular foster lending to private borrowers, which continues to be low. Promoting the liberalization of the trade in services, which still holds immense potential for growth, is one of the key tasks of the WTO.

In conclusion, Krueger mentioned some issues that equally concern the IMF, the World Bank and the WTO alike. First, governance has become an issue; the international role of some economies, for instance China, India or Brazil, has increased significantly over the past few years while their representation in international organizations has remained largely unchanged. Second, supranational organizations often have problems recruiting senior staff as candidates' countries of origin tend to be given more consideration than their qualifications. Finally, it has not been generally acknowledged that the world economy is a multi-level system. The global economy, in particular globalization, much too often gets the blame for national weaknesses.

Macroeconomic Imbalances Must Be Identified Earlier and Tackled More Effectively

In his contribution, *Thomas Wieser* focused on macroeconomic imbalances within the EU and ways to correct them over the short and the long run. EU policymakers have always been aware of possible macroeconomic imbalances but assumed that coordination mechanisms like the Stability and Growth Pact would keep these imbalances in check. Particular attention has been paid to asymmetrical shocks within monetary union, whereas diverging competitiveness among the Member States has been considered to be of secondary importance. Although ECB President Trichet repeatedly pointed out that the different levels of competitiveness within the EU were not sustainable, financial ministers did not take action. This is attributable to a number of reasons. Among other things, there seems to have been a lack of incentives to initiate and coordinate corrective measures, as in the absence of interest rate differentials the countries concerned were not punished for wrong policies. Moreover, it was assumed that sooner or later there will be an automatic correction of imbalances.

Finally, the debt crisis revealed the serious deficiencies of the available instruments. Measures such as the establishment of the European Financial

Stability Facility (EFSF) and the European Systemic Risk Board (ESRB) have become necessary, and fiscal and macroeconomic monitoring has been reinforced. They aim at creating an incentive for politicians to act responsibly, thereby seeking to ensure the sustainability of their action and, consequently, the sustainability of the euro area. A fiscal union is unthinkable for political reasons; it should be possible, however, to establish institutions that proxy such a union.

In the closing panel discussion, chaired by *Peter Mooslechner (OeNB), Stefan Collignon, Professor of Political Economy at the Sant'Anna School of Advanced Studies, Pisa,* and *Harald Badinger, Professor of International Economics at the Vienna University of Economics and Business,* looked into the key question of whether Europe needed a new growth strategy.

Growth Differentials in Europe

Stefan Collignon likened the global financial crisis to an economic earthquake of a global dimension, which, like a tsunami, wreaked havoc in the public finances of most industrialized countries. The majority of economies have returned to a growth path since the second half of 2009, albeit at different paces. Collignon identified three post-crisis models of adjustment: There are countries whose economies are now growing more strongly than they did before the crisis, e.g. Germany and the U.S.A.; these countries are able to compensate for the reduction in output suffered during the crisis. Most European economies, including Austria, are expanding at the same rate as during the pre-crisis years, but they are unlikely to compensate for the lost output over the medium term. Then there are countries whose growth rates have not yet recovered and whose income levels are still significantly below the pre-crisis level, such as the Southern European countries suffering most severely from the crisis.

Precisely Measuring Competitiveness

Sovereign debt exploded throughout Europe during the crisis essentially as a result of declining revenues as economic growth turned low or even negative. Therefore, Europe should give priority to stimulating growth, thereby paying close attention to competitiveness. Politicians tend to address the issue of competitiveness from the wrong angle, however, by concentrating on current account imbalances. Yet the current account is a misleading indicator for two reasons: First, the current account balance does not show net exports but rather includes factor income and transfers; second, within a currency union, any current account position can be sustainable, as it does not matter whether the creditors are domestic or foreign banks. But this does not imply that a currency union allows unlimited indebtedness; it simply means that the borrowing risk is debtor- rather than country-specific.

Unit labor costs, on the other hand, are a more appropriate indicator of competitiveness. At the same time, the conventionally used unit labor cost index is also flawed, because it does not reflect the level of costs. Given that labor is only one factor in production (next to capital), these levels are different in equilibrium across countries. Hence, capital productivity also needs to be taken into account. As a result, competitiveness levels in some countries would look much different from how they look today. As a case in point, Greece's competitiveness in fact increased rather than decreased over the past few years.

Collignon then analyzed the sustainability of public debt for some Euro-

pean countries, examining whether they will be able to earn sufficiently large primary surpluses in the next few years. While this will be the case in most European countries (in particular Spain), the situation looks gloomier for France, Portugal and Greece.

In concluding, Collignon emphasized that Europe needed higher growth and therefore higher investment; this, in turn, would require reducing uncertainty in capital markets and eventually the introduction of euro area wide bonds ("eurobonds").

Implementing Growth Strategies

Harald Badinger in his presentation confirmed that Europe needed a growth strategy but not necessarily a new one; improving the way the current strategy is being implemented would suffice. Badinger referred to several items of the growth agenda formulated in the Sapir Report of 2004 to underpin his suggestion. For instance, the European single market for services must become more dynamic and competitive. Furthermore, investment in human capital as well as research and development is of key importance. A reform of education systems would not only provide a substantial growth impetus but also have positive effects on crime rates, health and the people's participation in democratic decision-making processes. At present, there is no reason to expect that the EU will reach its knowledge goals set out in the Lisbon Treaty. Similarly, investment in research and development in the EU is low, compared with the U.S.A. and Japan.

Furthermore, Badinger identified room for improvement in the macroeconomic policy framework. The establishment of independent monetary policy-making institutions was one of the big achievements of the past century. It is now time to accomplish a similar success in fiscal policy. What is needed is an improved coordination and monitoring of national policies, which involves giving more weight to decisions made at the supra-national level. It is not clear, however, whether the people are ready for such a move. Public support for European integration and collaboration is a prerequisite for bringing the "EU flotilla" back on course.

Presentation of the OeNB's Klaus Liebscher Award

Like in the previous years, the presentation of the Klaus Liebscher Award was another highlight of the Economics Conference. Following some introductory remarks by *OeNB President Claus Raidl* and a short presentation of the 2011 winners of the Award by *OeNB Governor Ewald Nowotny,* it was the authors' turn to present their winning papers. In their paper "Bank Bailouts, International Linkages and Cooperation," *Friederike Niepmann* and *Tim Schmidt-Eisenlohr* discuss crisis management issues during international banking crises. *Steffen Osterloh* investigates empirically whether regional transfer payments in the EU have an impact on the people's acceptance of the institutions in his paper "Can Regional Transfers buy Public Support? Evidence from EU Structural Policy." The awards were presented to the winning authors by *former OeNB Governor Klaus Liebscher.*