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Tackling Macroeconomic Risks

A Case for Stronger Transatlantic Cooperation

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The financial and economic crisis that was triggered by the collapse of Lehman Brothers in 2008 has vastly altered risk perception and management on both sides of the Atlantic. But the perception of macroeconomic and financial risks and policy responses do not always align in the United States and the European Union. In the US, policies have focused primarily on systemic financial and macro-prudential risk (e.g. risks from real estate, securities and banking markets); in the EU, the focus has been on risks stemming directly from the macro economy (e.g. economic and fiscal imbalances) and, in the context of the euro area, the adverse link between sovereign debt and the banking sector. While the US largely views itself as having exited the crisis, the EU is still mired in it, and this almost by definition puts the transatlantic partners in different positions going forward. Also, the euro area must address fundamental issues of its governance whereas the US must overcome political stalemate within the parameters of divided government. Nonetheless, the transatlantic partners have an interest in strengthening cooperation and coordination, even if this is not always easy.

Currently, the greatest source of macroeconomic risks to the *United States* is perceived to be external rather than domestic, with contagion from Europe's sovereign debt crisis at the top of the list. But this focus may well be diverting attention away from home-grown risks to US growth. Aside from the looming »fiscal cliff« (see below), the US faces several risks involving structural impediments in the economy that have the potential to harm the economy in the longer term. Such impediments in the labor market include the historically high share of long-term unemployment and challenges relating to skill mismatching, both of which could lead to an increase in the natural rate of unemployment. Another domestic risk factor is growing income inequality, which could dampen public sentiment and reduce the social cohesion needed to tackle the country's fiscal challenges. Yet another issue is the eventual need for a rebalancing of US growth away from an over-reliance on consumption and borrowing, a process that will involve investments in education and infrastructure. While these challenges are not likely to trigger a crisis in the short run, they could contribute to general instability and vulnerability and lower potential GDP

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growth. This would make the U.S. economy less resilient and dynamic, and prone to future shocks and crises.

With respect to sovereign debt and political risk, the US, unlike some euro area countries, has not been judged to be in a true solvency crisis – even though the presidential candidates, Congress, rating agencies and investors are widely debating the lack of long-term sustainability of public finance and potential remedies. The prevailing view seems to be that the US has time to work through its political conflict. Destabilizing economic factors are not judged to be of great importance by investors, though this could change abruptly in the unlikely event that Congress fails to avoid the »fiscal cliff« and/or raise the debt ceiling in late 2012 and early 2013. Political stalemate, however, extends far beyond fiscal issues and affects a broad range of policy issues which arguably matter for long-term economic growth such as education, infrastructure, and financial regulation. Given the lack of a political agreement, the job of promoting growth and employment rests to an unusually large extent with monetary policy.

In the *European Union*, sovereign risk re-emerged in 2010 as key pre-occupation in several crisis-afflicted euro area member states, and remains so. As investors increasingly rediscovered credit risk, they charged painfully high interest rates or in some cases refused to buy government bonds of countries deemed to be at risk of insolvency. Harsh solvency judgments by investors regarding several euro area countries seem to have been based on equally harsh judgments on the political economy of fiscal stabilization, structural reform and political-institutional upgrading of the countries in question. The response in the euro area has been bolstering the political case of reform and adjustment while providing unconditional balance of payments financing and conditional bond financing through official schemes.

Tackling macroeconomic risks in the euro area has been an evolving policy process since the onset of the financial and economic crisis. Since the first phase of the crisis, European policymakers have needed to shift strategy and focus many times. The policy focus shifted from a stabilization of financial institutions and markets to the stabilization of output and price levels, then moved on to coping with public and private debt sustainability, liquidity and solvency, and finally arrived at tackling the macroeconomic and financial architecture risk of EMU. The stabilization of financial institutions and markets has yet to be completed across the euro area. While the stabilization of output worked well initially in 2009–10, it reversed when an increasing number of countries were pulled back into recession. A more resilient governance structure of EMU has only just begun to be addressed comprehensively. Most progress in this last respect has been made on policies of deeper economic union and enhanced fiscal adjustment. The biggest uncertainty, however, remains the issue of delegating proper banking supervision and management tools (deposit insurance, resolution regime including resolution funding) and fiscal stabilization and enhanced distributional functions to the federal level of the euro area.

It goes without saying that these deeper structures of European integration require improved political and legal mechanisms and procedures of democratic legitimacy, democratic oversight and broader public support. In the medium run, this might well require a new treaty. The medium-term success on managing traditional macroeconomic risks fundamentally depends on much deeper political and economic integration. The political economy of such reforms is highly complex, given varying national interests, economic ideas and institutional configurations which still have to be marshaled into a larger political compact towards a more stable EMU. Market pressures will remain high until significant progress is made.

Macroeconomic Stability

Policymakers in the US and the EU (more specifically, in the euro area) pursue similar macroeconomic objectives of stabilizing economic activity along a fundamentally determined path of economic growth and modest inflation. In normal times, monetary policy is largely devoted to the monetary objective (i.e., price stability and, to a greater extent in the US, full employment) while economic policies are designed to affect capital and labor utilization as well as to increase productivity. In crisis times, and given the differing size and role of the government in the US and euro area member state economies, output stabilization requires, beyond monetary policy, a higher degree of discretionary fiscal policy in the US than in the euro area, where automatic stabilizers play a much larger role and additional discretionary levers are applied more rarely and in smaller doses. This was evident in the financial crisis of 2008–09. The US Federal Reserve and the ECB lowered benchmark interest rates and used unconventional policies of liquidity provision to the financial system at great length in order to stem deflationary risks, and fiscal policies in the US and in major euro area member states also initially reacted in a similar manner with strong anti-cyclical programs.

Fiscal policy responses later diverged, however, with a stronger exit from fiscal stimuli in the euro area compared to the US. In addition to structural differences, credit rationing of euro area sovereigns due to doubts about sovereign debt sustainability (or private debt sustainability with a risk of socialization of debt) played a substantial role in the shift from expansionary to restrictive fiscal policies in the euro area in 2010–11. Capital markets simply were not prepared to continue financing additional deficit spending in crisis states. In the US, the federal level did not experience a credit rationing from bond markets; on the contrary, it could finance large budget deficits at ever-lower borrowing costs due to safe haven flows (this increasingly also has been the case for Germany and some other »core« euro area members, whose bond yields have declined as the euro crisis intensified and interest rate spreads on most »peripheral« member state bonds continued to increase).

Fiscal Austerity and Growth

As a consequence of the financial and economic crisis of 2008–09, public debt levels rose sharply as governments found themselves at least temporarily functioning as the sole engines of the economy after the private sector – households, financial institutions and businesses – retrenched and credit markets seized up. A sharp decline in tax revenues and increased spending, in the form of automatic stabilizers and additional fiscal stimulus measures, led to a rapid and severe deterioration of public finances and, in turn, to sharply elevated sovereign risk. This was particularly true for select European countries, but also for the US, where the ratio of gross general government to GDP, predicted to be over 100% in 2012 and still rising, is higher than the EU and euro area average.

Early on in the economic and financial crisis, the unsustainable nature of US debt grew in political importance and resulted in the emergence of the Tea Party in 2009–2010. A number of fiscally conservative Republicans were swept into Congress in 2010 on campaign pledges to slash government spending. While the Tea Party remains a political force and an influential faction of the Republican caucus in the House of Representatives, the pendulum has swung back somewhat to greater emphasis on economic growth. Heading into the November 2012 elections, the focus has shifted away from austerity and toward preventing the »fiscal cliff«, a severe fiscal contraction (as much as 4% of GDP next year) that will hit the US economy starting January 1, 2013, if a raft of tax cuts and spending measures scheduled to expire are not extended. Most observers expect Congress will eventually extend many of these measures, including most (if not all) of the

so-called Bush tax cuts of 2001–03. Delaying this sharp fiscal consolidation would be positive for economic growth but would only lead to a worsened US fiscal position and, in the absence of a credible plan to get the US eventually onto a fiscal sustainable path, increased US sovereign risk.

In the EU, the focus shifted even more swiftly in favor of fiscal consolidation as interest rates on government bonds surged for Greece and other countries. As economic output started to slow in 2010–11, it became clear that there needed to be a better balance between fiscal consolidation (»austerity«) and measures to stimulate growth, through more accommodative monetary policy and more gradual fiscal consolidation in countries with greater »fiscal space«, that is, countries with lower deficit and debt ratios and/or those not under immediate market pressure. European leaders have recognized the risks of too much austerity in the current environment and have responded with an increased focus on the growth agenda. They agreed at summits earlier this year to step up growth-enhancing structural reforms and boost EU funding for investments, particularly in member states most hard hit by the crisis. Most recently, there appears to be a growing consensus to give »program« countries more time to reach their fiscal targets in order to support economic growth. The challenge has been in convincingly communicating a complex, differentiated and multi-faceted crisis response that simultaneously puts public finances on a sustainable path, does so without strangling growth in the short- to medium-run, and fundamentally reforms the governance and structure of EMU. This is a tall order.

Unlike several euro area member states, the US has managed to avoid the pitfalls of increased sovereign risk, not least thanks to the »exorbitant privilege« of the Dollar and US Treasury bonds. Indeed, Treasury yields remain at record lows. Although the downgrade of US sovereign debt by the rating agency Standard & Poor's in August 2011 did not have much tangible impact (10-year Treasuries are at a 60-year low), it was a reminder that rating agencies and bond market investors might start demanding higher rates of return for holding US government debt at some point. And even before those severe consequences happen, high deficit and debt levels present a risk to the macro economy because they restrict the government's ability to respond with stimulus measures in the event of another shock or crisis. Moreover, a potentially massive spillover effect to Europe and the global economy, in the form of rising global interest rates and currency and other market volatility, could materialize if the US does not start making real progress soon on addressing its fiscal challenges.

Ensuring Financial Stability

Achieving banking and financial market stability became an important additional objective since the onset of the financial crisis in 2008 for both the US and the EU. Here, too, the general approach has been similar. After the failure of Lehman Brothers, the US initially intervened heavily in the stabilization of its financial institutions through recapitalization and liquidity schemes of the Federal Reserve, the Treasury, the Federal Regulator FDIC and other institutions. A broad range of regulatory changes followed, some of which are still being implemented. Similarly, euro area member states (and other EU states) and the ECB pursued similar policies of stabilizing solvent banks, nationalising insolvent banks, creating bad banks and providing liquidity to the financial system in general. Again, both member states and the European System of Central Banks, in particular the ECB, were very active. As the importance of securities markets compared to banks is much higher in the US, measures targeting securities markets were at least as important as banking policy measures in the US, whereas banking policies dominated in the euro area.

Financial stability policies via direct interventions into financial institutions and

markets are in the process of being phased out in the US, while in the euro area the interventions of governments in crisis states in financial institutions is still very much in progress, particularly with respect to the program of bank recapitalization in Spain. ECB policies to support financial stability are still at work and, as in the case of purchases of sovereign debt and long-term refinancing operations for banks, may soon be stepped-up. The reason for this difference is that in the US there is currently no strong feedback loop between sovereign debt and financial stability whereas there is such a connection in the euro area.

The US has arguably been at the forefront of addressing domestic financial systemic risk and has taken the lead on risk assessment and management in this area. US regulators responded to banking sector risk by setting up the Troubled Asset Relief Program (TARP) and by conducting stress tests on large US financial institutions early and frequently in an attempt to reveal and close the liquidity gaps of banks whose health was integral to the overall stability of the financial sector and to reverse the »financial accelerator« phenomenon, by which strains in financial markets and the banking sector spill over to the broader economy, adversely affecting output and employment. The Federal Reserve and Treasury also set up a process for identifying Systemically Important Financial Institutions (SIFIs), which are so integrated and/or large that they are, by definition, a potential source of systemic risk. Another key action on the part of US officials to help identify and address risk stemming from the banking sector was to set up the Financial Stability Oversight Council within the Department of the Treasury. Established under the Dodd-Frank Act, the Financial Stability Oversight Council (FSOC) is the first institution designed to provide comprehensive monitoring to ensure the stability of the financial system. While the TARP and stress tests were deemed to have solved the immediate stresses in the US financial sector, some issues of potential future vulnerability remain, including the continued "too-big-too-fail" problem and contingent liabilities of US banks.

Europe's efforts to manage financial sector risk have been judged insufficient by markets in comparison to the US response. Stress tests conducted by the European Banking Agency were deemed not tough enough and the results not credible. Contrary to this widespread perception, the management of financial sector risks is improving gradually. Most clear-cut cases of failing financial institutions have by now been put under public management (involving closure, recapitalization, sale, reorganization or asset transfers into »bad bank« structures) or are in the process of being restructured under the guidance of the Competition Directorate of the European Commission. In the largest still unresolved case of Spain, a banking program was agreed in the euro group to fix the capital shortfall mainly stemming from the real estate crisis, and is on track to be implemented soon. Problems resulting from the "evil nexus" of sovereign risk and bank risk through the holdings of sovereign bonds on banks' balance sheets, require a comprehensive approach tackling sovereign risk itself, portfolio adjustment by those banks and broad-based policies improving capital and liquidity. The implementation of the respective Basel II.5 (trading book and securitization) and Basel III capital standards in European Union law is progressing and will, once implemented, further strengthen the resilience of the financial sector in Europe. Many more G20 financial sector reforms play into these matters as well.

Governance Risks

Some of the greatest macroeconomic risks confronting Europe and the United States stem either directly or indirectly from the respective domestic policies, political and governance environments. These are types of risk normally associated with developing and emerging market countries, but which

have gained prominence in advanced economies.

In the European context, macroeconomic and governance risks are clearly intertwined. Containing risks at the euro area level involves coping with »EMU architecture«. Given the fact that EMU is not a political union with a single political system able to determine allocation, stabilization, distributional and regulatory policies in a legitimate, coherent and timely manner, the incomplete architecture of pooled monetary policy, but segregated fiscal, economic, banking and financial market policies has to be addressed by governance reforms.

Up until the summer of 2012, the policy approach had been dominated by strengthening national fiscal responsibility and macroeconomic surveillance (enhanced Stability and Growth Pact, »Fiscal Compact«), improved ex ante policy coordination considered to assist economic convergence (European Semester, Economic Imbalances Procedure), a partial deepening of banking and financial market policies, in particular in the realm of the supervisory institutions, and by the strengthening of growth-oriented policies at the national and the EU level (»Euro-Plus«- Agreement).

Now, however, an evolution toward deeper integration – i.e., toward a banking union, fiscal union, economic union – has commenced and was officially endorsed at the June European Council of Heads of States and Governments. A comprehensive work program shall be delivered to the leaders by December. National decision-makers are recognizing (some more gradually than others) that constitutional issues pertaining to both the fiscal and the financial market architecture will require a deeper pooling of sovereignty, a stronger delegation of powers to EU/euro area institutions, a larger role of distributional policies, a more comprehensive approach to financial market integration involving all the essential elements of supervision, crisis prevention, crisis resolution and deposit insurance and a much more comprehensive political oversight at both the national and the euro area/EU level. The start of this evolution was marked by the Commission proposals for a banking union on September 12, with a single European supervisor, European banking resolution, and common deposit guarantee scheme, and by the September 6 ECB announcement of a program of unlimited purchases of sovereign bonds on the secondary market (OMTs) on the condition that countries agree to pre-cautionary or normal macroeconomic programs with their European partners, and, desirably, with the IMF. The timetable and the scope of this deeper integration remains unclear, including the issue of how many member states ultimately will sign on. (Of course, the decisions of the United Kingdom in this respect are relevant in this transatlantic context, as deeper European integration without the UK could be seen as troubling from a US perspective.) Governments clearly have committed themselves to addressing these risks comprehensively. In the recent past, investors generally viewed the responses of European leaders throughout the euro crisis to have been too little and too late, and this dimension in and of itself continues to be a major source of downside risk.

For the US, political and policy risks are driven less by structural governance issues, as in EMU, and more by the current political environment. US lawmakers of both parties have chosen to harden their political positions rather than compromise on a solution to the nation's fiscal challenges – apparently regardless of the impact this growing ideological rift is having on the economy. Indeed, political stalemate resulted in the US nearly defaulting on its debt payments in 2011. Even more troubling than the ideologically hardened disagreement over taxation and spending policies, from a risk perspective, is the apparent readiness of some lawmakers to put political tactics ahead of preserving the creditworthiness of the United States. Certainly, when looking ahead to the likely oncoming partisan debates surrounding the »fiscal cliff« and the debt ceiling, political risk

looks almost certain to manifest itself in increased market volatility and economic uncertainty toward the turn of the year. Yet while most people agree that these consequences should be avoided, it is impossible to quantify and assess how political risk will develop over the coming months. As a result, risk mitigation in this area may depend on business and other interest groups, think tanks, and the public putting pressure on lawmakers to compromise.

In addition, the US faces policy risk associated with the »exit« from current fiscal and monetary policy, as well as with potential unintended consequences of unprecedented economic policy measures. With respect to fiscal »exit«, this is already an issue for the United States, as the automatic unwinding of fiscal stimulus initiated in 2008 and 2009 resulted in a drag on GDP growth of about one percentage point in 2011 and 2012. And it will become a bigger risk issue as the impending »fiscal cliff« approaches. Exit from monetary policy, in contrast, has not yet begun and potentially carries larger and more 'unknown' risk. The Federal Reserve launched a third round of quantitative easing September 13, 2012, with the announcement of a program to purchases agency mortgage-backed securities and other measures of initially USD 85 bn a month until year end which would decrease to a monthly USD 40 bn operation beginning next year. This policy shall be pursued until a clear improvement in labor market conditions is achieved. Also, the Fed extended its exceptionally low interest rate policy well into 2015, or some six months longer than indicated earlier. This move is designed to increase lending to companies and households thereby stimulating maximum employment, though some observers are skeptical that the Fed's most recent move alone can have a significant impact on the economy when rates are already so low. The Fed says it is confident it will be able to unwind monetary stimulus rather quickly if the economic recovery accelerates and inflation (and inflation expectations) start to rise. But the Fed in many respects is navigating uncharted waters, and its ability to maneuver an exit from unprecedented monetary stimulus could prove more complicated once the need arises. An exit is not difficult on technical terms, but reducing the role of the Fed in the economy may be as politically contested as increasing it has proved to be. At the same time, there are also risks associated with a continuation of unconventional monetary easing and expansion of the Federal Reserve's balance sheet. These include the risk of fueling new bubbles and contributing to economic and financial imbalances and the global effects of unconventional Fed actions, for example on the real trade-weighted exchange rate of the dollar, on global commodity prices and on capital flows, the latter of which have been articulated by US foreign partners as diverse as China, Germany and Brazil.

Transatlantic Cooperation

With respect to solely US-EU risk management initiatives, perhaps the best example is the strong cooperation between the Fed and ECB, and in particular the use of central bank swaps at a time when US money market fund disinvestments from euro area securities limited access to dollar funding for European banks. While quite effective, this tool is narrowly focused on bank liquidity, compared to the broader spectrum of sources of macroeconomic risk. As such, the most effective transatlantic cooperation on macroeconomic risk management has been via multilateral institutions like the G20, IMF and OECD, rather than within transatlantic fora. Under the G20 Framework for Strong, Sustainable, and Balanced Growth, agreed at the Pittsburgh Summit in 2009, G20 nations pledge to pursue policies aimed at preventing credit and asset price cycles from becoming forces of destabilization and to seek a more balanced pattern of global demand growth. Progress on meeting these shared objectives is measured through the Mutual Assessment Process (MAP), with the IMF tasked with providing technical assessments and developing

indicative guidelines for evaluating imbalances. Moreover, via the IMF, the US has supported the programs for Greece, Ireland and Portugal, even though it has opted not to contribute funds to a further enlargement of IMF resources.

A notable example of progress on risk assessment at the global level is the Early Warning Exercise, initiated in the G20 and carried out by the IMF and Financial Stability Board. The EWE is aimed at strengthening assessments of low probability/high impact risks to the global economy and identifying national or international policies to mitigate these »tail risks«. The IMF has adapted many of its traditional surveillance methods to the changed risk environment. Notably, it has introduced »spillover reports« that serve to strengthen IMF surveillance and policy recommendations, by focusing on global economic and financial interconnections and on how policies in the larger economies impact the rest of the world.

A challenge with many of the risk assessment and management tools is that they are still largely in crisis management mode (rather than prevention) and highly focused on Europe. While this may be prudent in the current environment, it may result in less attention to other risks, for example emanating from the US or risks associated with persistent global macroeconomic imbalances. In other words, the crisis of today, despite the best of efforts, may be distracting policymakers from focusing on the crisis of tomorrow. To guard against this, US and EU leaders could put more political weight behind the G20 Framework for Growth as well as the results of the surveillance and risk assessment work of the IMF. Clearly, the difficulty with these processes is less a matter of agreeing on desirable policy objectives and the right course of action but with actually pursuing a stringent course of action, in particular in the fiscal field in Washington and in the structural fields in the EU.

In the transatlantic context, there may also be scope for more intensified information-sharing, for example between banking regulators on financial institutions' exposure to sovereign debt, and the complexities of transatlantic financial links. In particular on financial regulatory issues affecting cross-border financial institutions, there is clearly a case for closer coordination and attention to potential extraterritorial impact of regulations being adopted on either side of the Atlantic. Transatlantic cooperation on macroeconomic risk management could also potentially be improved through a greater discussion focused on the less »obvious« risk factors, such as political and policy risks. The US has provided advice to the EU and key Member States on the response to the euro crisis, though this has been met with both a mixed reception and mixed results. By the same token, US leaders don't take warmly to appeals from their European partners on fiscal issues.

For both the US and the EU, achieving a political, structural and financial environment conducive to stronger economic growth is an essential element of macroeconomic risk management. Without sustained higher growth rates and in the absence of a working engine in the global economy, risks relating to sovereign debt and financial instability, as well as longer-term fiscal sustainability will be all the more difficult to surmount. Moreover, new risks of a socio-political nature could arise if unemployment rates fail to come down. This is particularly the case in Europe, where still-rising unemployment and negative growth rates in many countries at present threaten to undermine popular support for fiscal adjustment and reform measures. In this respect, one of the more promising transatlantic initiatives currently appears to be the High Level Working Group on jobs and growth. If successful, the efforts to further liberalize transatlantic trade in products and services could help support economic activity and employment, and thus provide a larger buffer against macroeconomic risk.

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