“Globalisation: can Europe manage it?”

Conference held on Tuesday 22 January 2008, at the Conference Centre of the Jean Monnet Building have pleasure in inviting you to a conference on

"Globalisation: can Europe manage it?"

to be held at the Conference Centre of the Jean Monnet building, Kirchberg, room M6

Tuesday 22 January 2008 at 6 p.m.

under the chairmanship of

Yves Mersch

President of the Banque centrale du Luxembourg,
President of the Bridge Forum Dialogue

The guest speakers will be

Kenneth S. Rogoff

Professor of Economics, Harvard University

Lucas Papademos

Vice-President, European Central Bank

and

Lars Heikensten

Member of the European Court of Auditors,
Member of the Bridge Forum Dialogue

The conference will be followed by questions.

A reception will be held as from 8 p.m

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INTRODUCTION

The Bridge Forum Dialogue together with the Banque centrale du Luxembourg hosted a conference on “Globalisation: can Europe manage it?” on 22 January 2007, chaired by Mr. Yves Mersch, President of the Banque centrale du Luxembourg, President of the Bridge Forum Dialogue.

This note summarizes the intervention of the guest speakers: Kenneth Rogoff, Professor of Economics at Harvard University, Lucas Papademos, Vice-President of the European Central Bank and Lars Heikensten, Member of the European Court of Auditors, Member of the Bridge Forum Dialogue.

Kenneth S. Rogoff, Professor of Economics, Harvard University

Professor Rogoff proposed discussing some major positive and negative sides of globalisation before asking whether the 2007 US subprime financial crisis is different from the eighteen bank-centred financial crises from the post-war period.

Global economic system of the 2000s has been characterised by a globalisation that has entailed the spread of free market capitalism, and a period of strong economic growth. Globalisation has contributed maintaining inflation to a level rather below than our expectations, thanks to China that has become the main exporter of cheap finished goods.

Nevertheless, there have always been glaring weaknesses or imbalances around the world. Indeed, China is more vulnerable and dependent on world economies. Despite its centrality in the global trade, nobody does really know how stable China is. It is therefore essential to remind and keep in mind that social inequality is more dramatic in China than in the United States. Moreover, it has provoked no less than 1900 riots last years. Social measure will be required in China, notably in the fields of legislation on weekly-worked hours and minimum wage. This in turn, should change the pace of inflation development in China adversely. The increasing demand for both agricultural and energy goods from emerging countries has not only caused a surge in their price, but also contributed to climate change. How to manage these developments remains a daunting problem that has faced the global economy. As for the Middle East, it is characterised by its geopolitical instability which has lead to risks to oil prices and shipping.

The world has also experienced global imbalances development together with fragilities in new age financial markets. On the one hand, China's and Japan's financial reserves are huge, around $US 2.8 trillions, as well as those of several oil-exporters countries. These have lead to growing worries about the rise of sovereign wealth funds. They are indeed blamed from not being transparent enough. On the other hand, the US has been forced to borrow $US 800 thousand million each year to China, Japan and oil-producer countries to support its deficits. Besides, the US has experienced a striking contraction in wealth, an increase in risk spreads, and deterioration in credit market functioning since the summer of 2007. The 2007 US subprime crisis has it roots in falling U.S. housing prices, which have in turn led to higher default levels particularly among less creditworthy borrowers. The impact of these defaults on the financial sector has been greatly exaggerated due to the complex bundling of obligations that was supposed to spread risk efficiently. Unfortunately, that innovation also made the resulting instruments extremely non transparent and illiquid in the face of falling house prices.

Considering the big five financial crisis from the post-war period as a benchmark, Professor Rogoff argued that the run-up in housing prices in the United States, which has been a typical characteristic of financial crisis, in the case of the 2007 crisis exceeds that of the "Big Five". In terms of real growth rates of equity market price indices, he noticed that the Big Five crisis exhibited equity price falls earlier than that of the US has in the early part of the most recent episode. This may due to the fact that the US Federal Reserve pumped in an extraordinary amount of stimulus at this time. Regarding the current account as share of GDP, it appears that the US is on a typical trajectory, with capital inflows accelerating up to the eve of the crisis. As to real GDP growth per capita in the run-up to debt crises, it follows during the 2007 crisis the same inverted V-shape that characterizes the earlier episodes. However, the growth shock during the Big Five appears larger and more prolonged than for 2007. All in all, these suggest that if the United States does not experience a significant and protracted growth slowdown, it should either be considered very lucky or even more "special" than most optimistic theories suggest. Indeed, given the severity of most crisis indicators in the run-up to its 2007 financial crisis, the United States should consider itself quite fortunate if its downturn ends up being a relatively short and mild one.

Lucas Papademos, Vice-President of the European Central Bank

ECB Vice-President Lucas Papademos focussed on three major issues. First, how globalisation could undermine the effectiveness of monetary policy as a result of its impact on both domestic aggregate demand and aggregate supply? Second, how does globalisation alter the functioning of financial markets? And third, how globalisation may affect this interrelation between monetary policy and financial stability?

Relying on both economic theory and empirical evidence, he argued that globalisation does not fundamentally undermine the effectiveness of monetary policy in preserving price stability, and this even if it impacts both domestic aggregate demand and aggregate supply.

Turning to the effects of globalisation on the functioning of financial markets and institutions, L. Papademos underlines the three following points before discussing empirical evidence and then the ongoing financial turmoil. (1) Both financial integration and development have been driven by several factors, which have contributed, in a mutually reinforcing manner, to the exceptional growth of the overall size of financial markets relative to GDP. These factors are deregulation, capital liberalisation, financial innovation and advances in communication and information technology. They have also contributed to the exponential growth of new financial instruments, the adoption by banks of the "originate and distribute" business model and the increasing presence of new financial intermediaries. (2) Moreover, the securitisation of bank loans and the development of credit risk transfer (CRT) instruments and complex structured finance products have fundamentally changed the functioning of the financial system and the distribution of risk across sectors and borders. While initially the focus was on transferring market risk, credit risk transfer instruments have increasingly gained in importance since the 1990s. (3) One prominent feature of the development of the financial system is that it has become much more "leveraged", as indicated by the ratio of total monetary and financial assets relative to the monetary base.

There is empirical evidence supporting the view that the development of the financial sector has had positive effects on the efficient functioning of product markets and has fostered (total factor) productivity gains and output growth. Financial globalisation, together with other factors - such as the rapid growth of new financial instruments, an increase in risk appetite, and the increasing presence of very active and highly leveraged financial market participants - played an important role in explaining reducing volatility and increasing liquidity in financial markets. Another important point is the resilience of financial asset prices to negative shocks is improved when the market is more liquid and the investor base more heterogeneous.

Four features concerning the ongoing financial turmoil should also be highlighted. First, the property price overvaluation is a main factor of the financial market recent turmoil, as it has been for previous turbulence episodes. Second, the functioning of the market for structured finance products exhibited several weaknesses, in particular the imperfect availability of information about the underlying asset characteristics and the inadequate appreciation of risks by investors. Third, these weaknesses fostered moral hazard and contributed to the inadequate assessment and management of credit and funding-liquidity risk. Fourth, the structured investment vehicles which partly reflects the poor assessment and management of the funding and market liquidity risks as well as the reputational risks faced by a number of banks.

Overall, these aforementioned weaknesses in the functioning of the financial system lead to the general conclusion that financial integration and development have not been accompanied by adequate appreciation of risks, effective risk management and sufficient market discipline. Therefore, actions and an institutional framework that encourage prudent behaviour and adequate risk assessment and management are necessary to enhance the resilience of financial systems. Actually, these are currently being examined both by market participants and policy-makers. At this stage, it would be wrong to conclude that financial globalisation is to be blamed for the financial ongoing turmoil as it cannot be considered responsible for the fundamental causes and key weaknesses identified earlier. It has rather acted as a key factor that had contributed to boosting market liquidity, reducing market volatility and fostering financial development in the preceding years. Financial globalisation has also facilitated the propagation of shocks and the spreading of sub-prime related risks to

Europe, together with contributing to cushioning the impact of shocks on national financial systems and economies. Lastly, the recent financial market episode has shown that effective cooperation and coordinated action by central banks in managing liquidity and ensuring the efficient functioning of interbank money markets is necessary; and closer cooperation and improved information-sharing between financial supervisors and central banks are beneficial.

In any case, a monetary policy strategy that monitors money and credit developments is likely to contribute to the detection of potentially destabilising financial imbalances at an early stage.

Lars Heikensten, Member of the European Court of Auditors, Member of the Bridge Forum Dialogue

Lars Heikensten, Member of the European Court of Auditors adopted a more broad, long-term and structural perspective to discuss globalisation. The motivation is that it is important for European to ask themselves what globalisation requires in terms of adjustment and changes in policies. After having given a broad outline of the globalisation, he underlined two particular points of the current one.

This wave of globalisation is different from previous ones as countries –most importantly China and India- that have entered into the world market are strongly populated this time. Moreover, they were relatively much poorer (in terms of GDP per capita) than industrialised countries.

Concerning Europe, he noted that growth performance has been reasonable, employment has recovered somewhat and productivity has been disappointing over the last years. In comparative perspective however, European economy features are less favourable. Indeed, both growth and productivity have been substantially higher in the US since beginning of the nineties.

Another important aspect relates to the substantial differences that remain between European countries. These differences show up not only in terms of growth, GDP per capita, but also in many various categories as illustrated by the components of the OECD composite indicator of ability to cope with globalization for instance. They are built on several components, among them: immigration rate, school results, public expenditure on active labour market programmes, participation rate in life long learning and an indicator of labour market flexibility. According to this international organization, US but also Nordic countries perform well whereas both Southern and Eastern Europe do the worst.

Another illustration of European differences stands in a study by the Belgian economist Andre Sapir. He has shown that (Nordic) countries that do well in terms of both employment rate and probability of escaping poverty combine generous benefits for unemployed, sticks/carrots for adjustment and weaker employment protection. (Mediterranean) Countries which have problems miss out on one or the other of these aspects.

The upshot of all this is that it is necessary for Europe to reform, and to grow to improve its standard. Many delicate issues (going from aging population to climate change or integration of young workers) are easier to deal with in growing economies. Addressing these issues is important, especially as when one faces a context of accelerating globalization. Consequently, Europe needs to have flexible labour and product markets and well functioning capital markets. In that objective, it can probably find many of the solutions within the methods which are used in the continent.

Contribution by Muriel Nguiffo-Boyom, Economist at the Banque centrale du Luxembourg, May 2008