PART III
SOLUTIONS IN EUROPE

Chapter 5
Crisis, Response, and Innovation in Europe

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The Impact of the Crisis on Europe

The close economic ties between Europe and the United States and the crucial global monetary and financial role played by the City of London were the conduits for the lightning-fast spread of the crisis triggered by the sub-prime mortgage defaults in the U.S. and the consequent fall in global real aggregate demand in 2008. The effects of this crisis differed among euro area countries, among non-euro European Union countries, and among such neighbouring non-members as Turkey and Russia. The differences appear to have been sharpest within the euro group.

It is well known that the euro area is not an optimal currency area, and the consequences of this condition are manifold.[1] Banking and financial arrangements remain differentiated within the euro area, and national supervisory authorities differ in vigour and efficacy. Some analysts hold that certain countries, Italy among them, lack a truly modern financial system, which is why their banking and securities markets were less exposed to the global financial crisis of 2007–08. This analysis has been presented as a criticism, but, by comparison with the consequences of the more 'modern' American and British systems, it may not be such. Some members of the European Union have not completed a return to a market economy after their experiences of central planning and being 'governed by outside' (i.e., by Soviet Russia). Turkey is torn between modernism in the broad sense and Islamic revival. Post-communist Russia is a case apart for a few reasons, including its large territory outside of physical Europe.

It is also well known that although the euro was created in the hopes that it would bring political union in its wake ('money first', in the famous slogan of former European Commission president Roy Jenkins, although his own country opted out of the EU single currency), no such union has ever come about. Rather, the goal may have receded, leaving a legacy of lame institutional arrangements in the EU in which the rules of competition apply to all countries but are concentrated on industry (which represents no more than a quarter of European gross domestic product [GDP]), while the single currency (with its irrevocably fixed exchange rates) applies to only half the members. Meanwhile, fiscal policy remains in the hands of the single member states, but under the constraints of the Stability and Growth Pact agreed to in Amsterdam in 1997, which has at its heart a ceiling on the general government deficit of 3 percent of national GDP. Given these patchwork arrangements, more than anything else the financial crisis has eaten up the stock of household savings, in all its various forms, and taken a huge bite out of banks' capital and reserves.

European banking and financial systems have withstood the trans-Atlantic tidal wave. There were a few instances of nationalization. Some cases sizable were sizeable (such as the Royal

[1] Robert Mundell (1961), the author of the optimal currency area theory, won the Nobel Prize in 1999 at the start of the euro.

Bank of Scotland in the United Kingdom and Fortis in Belgium), but they were extremely modest by comparison with those undertaken in America. In any case, the institutional and economic set-up of the EU was not altered. In the real economy, by contrast, the crisis struck the only sector exposed to competition, namely industry. Agriculture was sheltered and services were semi-sheltered, due to the amendment of the Directive on Services in the Internal Market (the Bolkestein directive) to prevent firms doing business in any EU country from applying home-country labour contracts.

In short, in Europe the impact on real economic activity was more severe in manufacturing given its growth model based on exports. It suffered because of the decline in global demand, which was due to decreased domestic consumption. Consequently the most vulnerable countries, apart from the United Kingdom, were Spain, Austria, and Ireland in the euro area, Poland among the other EU member states, and Turkey and Russia outside the EU. The initial drop of financial wealth in the euro area was half the value of European stocks. The decline in real economic activity averaged 5.8 percent in 2008 alone, with spikes of 8.2 percent in Germany and 7.5 percent in Italy, while the French economy contracted by 4.6 percent. The average drop in the GDP becomes less significant because of differences among the three main sectors of the economy as well as within each sector in terms of dependence on world trade. The true cost of the crisis will be increased public debt as a result of lower revenues and higher public expenditures.

Europe's Macroeconomic Policy Response

Historically, the euro area's monetary policy has been shaped by powerful monetarist orthodoxy. The Treaty of Maastricht assigns the single mandate of price stability to the European Central Bank (ECB). The French economist Jean-Paul Fitoussi aptly summed up this policy approach in his description of the U.S. as a producer of ideas that has no intention of consuming domestically, but produces exports because there is someone willing to import them. The main buyer, in this case, is the German Bundesbank. EU fiscal policy is equally orthodox — 'not flexible' is perhaps a more appropriate term — under the old principle that to inculcate a particular type of behaviour, prohibition beats toleration.

The current crisis has dispelled this twofold orthodoxy. The growth rate of M3 — the broadest measure of money supply — followed a peculiar trend from the middle of 2004 to the end of 2008, rising from 5 percent to 12 percent and then, in the first quarter of 2009, dropping to 6 percent as a result of a small increase in credit and portfolio reallocation, both domestic and foreign.[2] Since March 2009 official interest rates have been kept relatively high (with respect to inflation and the comparative rates in the U.S. and in the rest of the world) to permit the 'non-conventional' creation of a monetary base serving all the market demand and accepting a large and unusual number of financial assets. In the meantime the EU average government deficit soared to 4.6 percent of GDP in 2008: for the first time since the Stability and Growth Pact was signed, no country has been subjected to an excessive deficit procedure for violating the 3 percent ceiling.

These policy choices were late in coming, so that the doses of monetary and fiscal stimulus were larger than would have been necessary had the moves had been timely. The efficacy of the measures, inevitably, suffered. Except for providing the indispensable liquidity eliminated by the paralysis of the interbank market and the withdrawal of bank deposits, most of the decisions, especially on the fiscal policy front, did not come until nearly the end of 2008, almost two years after the crisis began. Those decisions took effect in 2009 and continued into 2010. Late in 2008

[2] The ECB discloses the entire data set on money and interest rates on its website.

British prime minister Gordon Brown budgeted a deficit of 8 percent of the UK's GDP, after the Bank of England — as stated by governor Mervyn King in October 2008 **[[it's not clear which part of this sentence King's statement refers to — and if we're going to mention a statement by him we should include the source]]** — "created a monetary base to an extent unprecedented in its 340 years of life". The British pound fell below parity with the euro — at the height of 'irrational exuberance' in the British financial market, it had been worth more than twice the continental currency. Germany budgeted a deficit of 3.3 percent, after giving guarantees of €400 billion on new bond issues; France had a GDP deficit of 8.75 percent plus a very large number of guarantees and much recapitalization of financial intermediaries. Other European countries experienced a soaring deficit, in particular overall economic conditions in Portugal, Ireland, Greece, and Spain (unpleasantly referred to as the PIGS) were poor in terms of production, employment, and consumption. In particular, Greece reached an unexpected deficit of 12.5 percent of GDP in 2009 and remains close to bankruptcy. European countries and the International Monetary Fund (IMF) intervened to rescue the country, which was unable to raise funds in the international market.[3]

It was not only monetary and fiscal orthodoxy that suffered, but the fundamental principles of political economy also dissolved as consequences of the American-based crisis. Rescue packages everywhere shifted the burden onto future generations in the form of public debt.

A further constraint came from the Maastricht Treaty. It left sovereignty over foreign exchange rates to the 27 member states of the EU, even though they are divided into the 16 eurozone-members and 11 non-members. This relegation of sovereignty essentially had the effect of negating the existence of the common market. Moreover, after the introduction of the euro in 1999, its market value went down by one third and then climbed up nearly two times the minimum reached before.[4] The situation has been reinforced by the ECB's interest rate policy, which sets the euro systematically higher than the dollar, strengthening the euro's appreciation. The official reaction was that the exchange rate was irrelevant in determining the level of exports, but that would not be true without the exceptional growth of world trade in that period. When the situation reversed following the sub-prime crisis and exports dropped, most authorities started to be concerned about the effects on exports, admitting that the euro exchange rates plays a role. But the appreciation of the dollar reduced pressure on governments to take political decisions on the subject. Things stayed as they were ten years before. Over the same period, unlike Europe the UK manoeuvred its interest rates, quantity of money, fiscal deficit, and exchange rate according to its needs without any strong reaction from any other EU state.

The EU exists within an incomplete institutional framework, which precludes any future possibility of regaining a satisfactory level of income and employment. The slowness of decision making and the absence of all but sporadic coordination in response to the financial crisis stemmed from the lack of will to proceed like a political union and from the constraints of European institutions, which had been designed for stability, even at the cost of deflation, rather than for growth. This approach has been criticized by international organizations. But differences in economic structure have also been a factor. Saving, as reflected in national balances of payments, still has sharply divergent characteristics. Germany has a current account surplus that rivals China's and the Netherlands and Austria also exhibit surpluses; Spain, Greece, and Ireland above all — but also Italy and France, albeit to a much lesser extent — went into deficit. Rationally, the surplus countries should take up the burden of stimulating internal demand within the euro area, while the deficit countries should benefit from this impulse. But in practice all euro

[3] The spread between Greek and German bonds reached 600 basis points in the spring of 2010.

[4] The exchange rate between the euro and the U.S. dollar was fixed at 1.11 on 1 January 1999; its minimum value since then has been 0.82 and its maximum 1.60.

area countries — regardless of whether their foreign accounts show a deficit or a surplus — found themselves struggling to comply with the limit on public budget deficits.

This institutional, political, and economic stalemate is the cause for the EU's protracted inaction. In rational terms, such a stance could be justified by the fact that the EU has an export-led model of growth, and that trade with the rest of the world is so massive that its decline could never be made up for by domestic demand. This approach remains valid if trade within the euro area is considered as external trade, as it actually is conducted by euro members, instead of being considered as consumption or investment — an approach that creates persistent differences in the institutional framework. This consideration is especially powerful in a country such as Italy, where the public debt is enormous and trade plays a relevant role. So 'political' Europe chose to concentrate on the social costs of the crisis, investing resources in assistance to the most disadvantaged, awaiting impulses from the rest of the world. However, since the countries running large external deficits, such as the U.S. and the UK, did not hesitate to reflate their domestic demand by relying on their neighbours' savings, the inactive European policy could not prevent crisis from worsening — it could not prevent social costs much higher than what public intervention could alleviate.

The world now faces the classical problem in economics, the search for the right measure, which can be tested only after the fact. Given the circumstances, not even European-wide coordination would have sufficed to overcome the crisis: as the final communiqué of the G20 London Summit succinctly observed: 'A global crisis requires a global solution' (G20 2009). Disunity in action increases the cost of the crisis and, together with the time delay, decreases the efficacy of the antirecession measures taken. This is what actually happened. The only initiatives that suggest that economic geopolitics is moving in the right direction — if not on the right track — are those managed by the IMF. The obstacle to the efficacy of this coordination still lies in having no uniformity in the foreign exchange regimes among members of the World Trade Organization (WTO): some are allowed to peg and some have flexible exchange rates. Nor is there a single global monetary standard that can be managed independently of any national currency. The sooner the G20 (or G8) faces these institutional weaknesses, the better the coordinated decision will be in pushing sustainable world growth. The later it acts, the higher the probability of a dollar crisis.

Despite this sad scenario, European Commission economic commissioner Joaquín Almunia immediately rejected the proposal of Zhou Xiaochuan, the governor of the People's Bank of China, to expand the use of special drawing rights (SDRs) and toward a coordinated management of international reserves at the IMF. Almunia's reaction underestimated the relevance of the problem for the future of the European economy in facing America's growing indebtedness. It reflects the strong attraction of the European ruling class to the idea of the euro as an international reserve currency. This was suggested by the ECB, not for the welfare of Europe but as an expression of good monetary policy management.

The management of reserve currencies by official authorities interferes with the basic requirement for fair competition and trade, and influences the terms of trade. Monetary and financial flaws prevail on them. European growth is subject to the fate of the dollar as an international monetary standard. China's initiative to free Europe's economic future from the U.S. dollar would be in the EU's interest. It would create a new standard or would improve the current agreement on SDRs, pushing the international monetary system away from the uncertainties of managing a national currency, including obviously the euro.

The idea of pushing the euro as a new international monetary standard would preserve the possibility of continued instability because of imbalances in the foreign accounts financed by growing international indebtedness. The system would remain vulnerable because of the risk of collapse of the standard and because of an unequal distribution of international labour and

incomes. It is the old dilemma that the use of national money cannot perform the two tasks of internal and external stability. With respect to Europe's currency, it is not supported by any state leader. The dollar keeps its strong position as the world's primary standard for the exchange of goods and financial assets because the U.S. remains the international leader despite the weakness of the economic factors behind its money. But for how long?

Europe's Financial Regulatory Response

The European Commission and Parliament began addressing the financial crisis in 2008 by creating an ad hoc technical working group to analyze the roots of the meltdown. It suggested the main modifications to the present financial architecture in order to restore confidence and create the basis for stronger financial markets. In February 2009, the High-Level Group on Financial Supervision in the EU (2009), chaired Jacques de Larosière, produced a report that proposed a new regulatory agenda, stronger coordination of supervision, and more effective procedures for crisis management. With respect to the global financial architecture, the group issued 31 recommendations aimed at dealing with the institutional, regulatory, and business practices of the global financial system that has contact with Europe. In particular, the recommendations address key points of policy and regulation reform, supervisory reform, and global reform.

The report addressed the main issues in the regulatory system and stressed the weaknesses of capital requirements rules set out by the Basel Committee on Banking Supervision (BCBS). As a first point, it called for the procyclicality of Basel II rules to be diminished, since they were in part responsible for the European credit crunch and recession. European countries should adopt a common definition of capital requirements for banks, in order for the homogeneous application of the Basel rules without causing asymmetric effects among countries. A gradual increase of capital from 2007 levels should be imposed on all financial intermediaries, especially those not considered banks.

With respect to regulation, the report recognized the 'parallel banking system', such as hedge funds and other financial intermediaries, as a weak link in the financial web, since, without any deposit base or liquidity, they are more exposed to liquidity problems. As a result, their maximum size and freedom should be reduced, to limit their potentially negative influence on the global banking and financial system.

The key role of credit rating was affirmed by the need to consider the evolution of financial markets and practice and to stop the application of standard practices to structured and exotic financial products, which have non-standardized payoffs.

With respect to financial derivatives, the report recommended a higher level of simplification and standardization for over-the-counter (OTC) transactions. This is, however, just one side of the coin[5]. The European Commission stated in July 2009 that in order to ensure a safe, efficient, and sound derivatives market the chosen model was the central counterparty (CCP). This model of a centralized body was to be introduced in Europe by the end of that year by means of proper regulation. It would differ from the bilateral netting system where the two parties involved bear the risk of the operation. The CCP could be implemented by financial institutions purchasing only standardized OTC contracts. It would be 'effectively a mutual insurance with mutual defences. It makes collateral management simpler, as it is the CCP that collects and manages collateral. It is also safer, as the CCP is the central guarantor and is an institution solely focused on managing risks with several layers of protection' (Commission of the European Communities 2009, 6). Incentives to 'dismantle any commercial hesitation to take up CCP clearing wherever possible'

[5] See Oldani (2008) for further analysis of the contribution of derivatives to global instability.

would be introduced at a European regulatory level (11). These advantages would come at a cost for participants, and could not be used for non-standardized contracts, where bilateral clearing applies. The use of a CCP in this manner represents the first step toward better market disclosure and enhanced transparency of OTC transactions, which constitute more than two thirds of the global derivatives market. These principles should be applied at the global level. If European OTC securities are subject to heavier rules, monitoring, and control, there is a clear incentive to trade OTC contracts outside the EU.

In June 2009, the G7 finance ministers (2009) adopted the Lecce Framework: Common Principles and Standards for Propriety, Integrity, and Transparency, proposed by Giulio Tremonti, the minister responsible for the Italian Treasury. The Lecce Framework moves in the direction of the de Larosiere report's recommendations. The financial rules that are necessary should be global, rather than European, as should the authorities that deal with the weaknesses of the global financial system.

Furthermore, standardization should not apply to the security's payoff, risks, and settlement procedures, as the situation can change after the rule takes effect. Rather, it should apply to the counterparty (at any stage of the transaction). The counterparties involved in OTC transactions should be registered. Sufficient capitalization and liquidity should be a prerequisite to trade OTC.

The de Larosière report also sought simplification, which is a very vague term: if it refers to the pay-off of derivatives, it does not mean a smaller risk is involved. If it refers to contractual rules (which are absent at present), then any proper and effective rule would represent an improvement with respect to the present 'anarchy' of OTC transactions by non-banking institutions. The report encourages the introduction of a central clearing house for European credit default swaps (CDS), following risks and losses observed during the sub-prime crisis and the September 2008 Lehman Brothers bankruptcy. However, it can become an empty house. If the clearing house is compulsory only for European-based transactions, the above-mentioned criticisms basically apply. It would be not very difficult for traders to settle transactions outside European markets to avoid the regulatory constraint. Nevertheless, any derivative surfing in the global financial system — not only credit default types of contracts — should be collateralized. Otherwise market players will find a way to exchange the credit risk without calling it a credit default, shifting any risk out of control.

The de Larosière report recommends '[guaranteeing] that issuers of securitized products retain on their books for the life of the instrument a meaningful amount of the underlying risk (non-hedged)' (High-Level Group 2009, 25). This guarantee is highly welcome. If applied to the global financial system, it would break the fundamentals of the originate-to-distribute (OTD) model, which is at the root of the global financial crisis. However, the OTD model is also at the base of European domestic banking and financial systems. An alternative structure needs to be clearly identified before the old one is cancelled.

From the domestic institutional point of view, the report suggests that Europe set up the European Systemic Risk Council (ESRC) and the European System of Financial Supervision (ESFS). The ESRC would have macroeconomic duties, while the ESFS microeconomic ones. The EU adopted these proposals in September 2009, and in July 2010, moved to make it possible for the ESRC to be up and running by 1 January 2011.

The ESRC will be chaired by the ECB president and will be composed of members of the boards of the ECB, the European Commission, and other European supervising and monitoring bodies. The ESRC will pool and analyze relevant information, prioritize, and issue macroprudential risk warnings. There should be mandatory follow-up and, where appropriate, action will be taken by the relevant authorities in the EU. At the global level, the ESRC will warn the IMF, the Bank of International Settlements (BIS), and the Financial Stability Board (FSB) in case of global dysfunction of the monetary and financial system. The establishment of such an

institution to deal with risk management is certainly positive. This institutional design has various good points, such as the coordination of European procedures and authorities for financial risk management. But it could be stronger. The European Commission and Parliament should issue directives and laws to impose these changes, which a technical body cannot introduce. Moreover, some international financial institutions, such as the IMF, have been unable to deal with the financial crisis and its effects. It is unclear how the global warning system can be successful if it involves the Bretton Woods institutions.

The ESFS should be independent from industry and politics. It is a centralized body to coordinate local vigilance and supervision. The European Commission, Parliament, and Council should appoint managers and staff of the ESFS for a period of eight years. The ESFS should be established in Europe gradually, after harmonizing local financial rules and practices. Its microprudential supervision task with respect to European banks, insurance companies, and financial intermediaries is closely connected to global regulation, especially the American and British regulation.

The Achilles' heel in the new European institutional design is that the European institutions involved in the ESRC have no authority over the European exchange rate. This flaw undermines the accountability and reputation of the ESRC itself in the medium and long terms. Exchange rate risk is a financial risk. It must be managed as with other risks, and not left to the market, if the other countries do not leave it alone. At present the euro is unmanaged, while the American and Chinese exchange rates and reserves drive the foreign exchange market.

The new European financial architecture, as depicted in the de Larosière report, would restore confidence and stabilize the financial system. But cross-border interactions and gaps in the global financial system can remain and diminish the effectiveness of the reform.

The Need for Behavioural Finance Theory

The 2007–08 crisis underlined the limited rationality of financial operators and regulators. Standard finance theory is based on the efficient markets hypothesis, which states that financial markets are 'informationally efficient', or that prices on traded assets, such as stocks, bonds, or property, already reflect all known information. Agents are utility maximizers, have perfect information, and have rational expectations.

Nevertheless, the sub-prime crisis was the result of a chain of interlinked securities, which sensitive to house prices, through which risk was distributed, as well as the result of the asymmetry of information that was created via complexity and the opaque way that risks were spread though the financial system (Gorton 2009). Such a framework cannot be operated by purely rational operators, utility maximizers players, perfect financial markets, and rational regulators.

The limited rationality is ignored in most analysis, but most dangerously in most policy responses to the crisis. The European de Larosière report was not immune from this criticism. The effectiveness of its recommendations will be heavily reduced.

One alternative stream of finance theory, behavioural finance, does not support the efficient markets hypothesis (Thaler, 1993). It tries to explain finance theory puzzles, such as the equity premium puzzle, the earnings forecast bias, or the overconfidence of investors. The hypotheses at the base of behavioural analysis are those of psychology. Players have limited rationality, use the information available in a biased way, and follow the market in a very irrational manner.

Behavioural finance can be particularly helpful in analyzing crisis and turbulence, since they are the products of irrational behaviour and inefficient markets and rules. The shadow banking system (or parallel banking system, in the words of the de Larosière report) contaminated the

savings sector, and the absence of a global regulatory framework for international investment funds played a massive role in amplifying the crisis (Avgouleas 2009, 26). The 'system failed to provide rational actors with suitable incentives to conduct appropriate credit controls and disclose borrower information' (39). The overconfidence of investors and falling risk premium were assumed as though credit risk was reduced. Following the principles of behavioural finance, Avgouleas suggests several regulatory reforms that explicitly consider the limited rationality of financial agents as observed in financial markets. These reforms include the following:

- *Containing homogenization:* The segregation in the financial business is the only policy tool to lead the global financial system to decouple and diversify the activity. The universal bank model, together with the OTD model, should be radically revised.
- *Choosing suitable policy tools:* Containing liquidity risk is as crucial as avoiding bank bankruptcies. The massive injection of liquidity by central banks is an expensive policy, and is probably more expensive than limiting *ex ante* the credit ability of unregulated financial operators.
- *Restricting deposit insurance and moral hazard:* Limiting the size of the insurance scheme limits the moral hazard.
- *Protecting public funds and preventing free riding on the public guarantee:* Segregation limits the possibility of banks to access public funds, but should be consistent with the major role played by the banking sector. Rescue plans of banks should not produce a mispricing of banking risks.
- *Reducing complexity and ensuring effective supervision:* External limits on securitization of assets would reduce complexity and make supervision more effective.
- *Lowering leverage:* Imposing a limit on leverage also limits the tendency to focus on short-term profit. The effective definition of such a limit is, however, quite difficult.

These regulatory improvements would change the present shape of the financial system and its incentives' scheme, to the detriment of speculative operators, who earned enormous fees thanks to free securitization and the lack of transparency. Although the de Larosière report did not consider this alternative approach and philosophy of financial markets, it should be considered in the effective implementation of the new European financial system. **[is there any evidence that it is, now that the ERSC and EFSF are being established?] no**

Financial derivatives were responsible for spreading the crisis throughout the global financial system; credit derivatives, especially swaps and options contracts, gained tremendous popularity after 2004. The IMF's *Global Financial Stability Report* devoted its attention to them in 2007 (IMF 2007). With respect to the global OTC market, credit default contracts now represent less than 6 percent of the notional amount (see Table 5-1). The U.S. Security and Exchange Commission (SEC) has imposed a centralized compensation mechanism (i.e., clearing house) for such contracts to improve market liquidity practice and transparency. This regulatory decision and the global attention paid to credit derivatives is the result of a misleading interpretation of the phenomenon. Credit defaults are different types of transactions from mortgage-related debt and structured debt securities. The payoff of the two types of financial products can be radically different. The excessive loss in mortgage-related debt securities was the result of a lack of transparency and full information and of the inability to price the risk that caused a drop in the credit multiplier with a liquidity scarcity. The loss in credit defaults is basically the result of losses in the underlying market, but does not reflect a weakness in the market infrastructure or risk management procedures (Shadab 2010). This awareness was not translated into any recent regulatory improvements, in either the U.S. or Europe. Both believe that a stronger regulation of derivatives will simply diminish existing risks. In the absence of proper capitalization and

liquidity, any traditional security, and not only financial derivatives, can represent a danger to financial stability.

[insert table 5-1 here]

The G8 and the Crisis

After the Japanese-hosted G8 Toyako-Hokkaido Summit in 2008, most countries applied the same exit strategy: heavy public spending. The Italian-hosted G8 L'Aquila Summit in 2009 pointed out the urgent need for a common legal standard for financial markets and players.

Central banks started to supply any amount of monetary base to cover the drastic reduction of the velocity of money. After September 2008, when the slowdown turned into recession, G8 countries decided to spend a trillion dollars in rescue plans for banks, financial institutions, and public firms and tried to alleviate the worse effects in the labour market. U.S. president Barack Obama reinforced the intervention in the banking system and rescued banks, which were heavily involved in the crisis; this decision did not come without a cost, since the industrial sector was in crisis too, but it left no money on the floor. The EU failed to take decisions and Greece is paying a huge cost for this inaction. Britain, France, and, to a lesser extent, Italy adopted rescue plans. The abundant liquidity injected into the global financial system and the zero or quasi-zero interest rates policy adopted by central banks alleviated the worse effects in the short run. But they created the conditions for inflationary effects in the medium term. The negative effects in the medium and long term need to be reduced by clearly stating the exit strategy, for which central banks are responsible.

Some estimates presented in the G20 London communiqué stated that the fiscal stimulus reached about 10 percent of global GDP in 2009 (G20 2009). The same amount came in the form of monetary base. However, the small amount of coordination among G20 countries with respect to the quality of their intervention (i.e., social security for some, consumption for others) diminished the efficacy of the interventions. Different speeds of recovery and asymmetric effects of globalization can modify the efficacy and success of rescue plans.

The loss of confidence in 2007–09 caused the credit market to dry up and led to the massive selling in stock exchanges, together with the drop in the real estate prices. Consequently the effects spread to the real sector, mainly to that part of it driven by exports. More liquidity and more public expenditure in 2009 helped restore confidence. The first signs of recovery appeared in 2009, thanks also to emerging economies. If recovery means a positive sign in macro-data rather than a return to the economic conditions that existed before the crisis, indications were already evident by the second quarter of 2009. By August 2010, of the 42 countries monitored by the Economist Intelligence Unit 9 showed negative figures; in the first quarter of 2009 there had been 28 (EIU, Output data). If this exit strategy were true, the recovery was the result of the 'old' model, with a significant difference in a more cautious behaviour of banks and financial institutions, and a renewed attention of supervisory authorities.

A recovery process relying on massive public spending and liquidity looks much like those policies that brought the global financial system into crisis. They allowed global imbalances, free but asymmetric exchange rate regimes under WTO agreements, and massive foreign exchange reserves accumulation irrespective of current account surplus and national savings. The world thus needs new global rules for the financial and banking system, and also for foreign exchange management. It is no longer sustainable to have a global currency system with the fixed and artificially devalued exchange rate of the Chinese yuan and a euro left free — or more correctly unmanaged — to float, like a lonely child in a swimming pool.

If the G8 — or, perhaps more appropriately, the G20 — focuses only on the financial conditions, regardless of regulating securities, forgetting about counterparties, and without considering the entire global financial architecture, there will be large costs to pay in the future.

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Table 5-1: Amount Outstanding of OTC derivatives

End December 2009 (Billions of U.S. dollars)

Risk category/instrument	Notional amount	Gross market value
Foreign exchange	49,196	2,069
Interest rate	449,793	14,018
Equity linked	6,591	710
Commodity	2,944	545
Credit default	32,693	1,801

Source: Bank of International Settlements (2010).