Looking for the Right Lessons

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After The Storm: The Future Face of Europe's Financial System

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CZECH CNB NATIONAL BANK

Key points

- ***Too much focus on the micro level*** (accounting, pay, CRA, hedge funds), ***too little on the macro level*** (fiscal, monetary policies prior to the crisis) in the European discussion so far

- **Let‘s try to avoid *half-baked measures* in the future** (especially in the area of supervision and regulation)

- **How to find a new inspiration for the CEE?**

1. Macro Policies Matter and Might Share the Blame

Monetary policy focused too narrowly on CPI?

⇒ should MP look for different anchors/targets in the future/be generally more strict?

⇒ after all, interest rate a **key regulated price** in the economy (improper IR setting = huge consequences)

CEE - many countries sticked to their FX pegs/currency boards („switching-off" MP, i.e., no mitigation of imbalances)

⇒ importing the lax monetary conditions from outside

= high internal/external imbalances – these do matter a lot in good times, even more in bad times!

(The same is true for many EM in the world pegged to the US$)

1. Macro Policies Matter and Might Share the Blame

Current crisis - a case for MORE monetary stabilisation, not for LESS

Even an autonomous small currency in the converging country might be a reasonable idea, if there is no other way for mitigating imbalances and absorbing shocks (the convergece trap: impossibility of high growth + fixed ER + low inflation/small imbalances at the same time)

But: i) really autonomous monetary policy + ii) effective lender of last resort must be attached (paradoxically for many, the more credible the domestic monetary policy, the less demand for € adoption) – the Czech case

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1. Macro Policies Matter and Might Share the Blame

The key role of macro policies before the crisis omitted in the whole EU, not just in the CEE

- 2000s not bad times for the EU, yet **fiscal policy** was at bad-times levels = rather pro-cyclical

- Also the **monetary policy's** problem seen almost exclusively on the other side of the Atlantic

2. Beware of Half-baked Measures

Preliminary Lesson: **There are too many institutions dealing with supervision and regulation, not too few**. We need fewer institutions, not more

Czech suggestion based on a real experience: **national-level regulation/supervision should be simplified, merged, concentrated under a single roof first** - before introduction of any new supra-national structures - otherwise even more mess might come! (CZ: MP + financial stability + supervision in the central bank)

All the important details of **any** new system must be worked out **well in advance** (responsibilities, powers, burden sharing, insurance, home/host etc.)

2. Beware of Half-baked Measures

- Such a careful approach has not been typical so far:

\- Single banking passport: burden-sharing?, deposit insurance?, level playing field?
\- Memorandum of Understanding/Crisis Cell: not used in fact

- The regulatory debate in the EU is very often caught in the trap:

<u>Grand Pan-European ideas vs. national money and national interests (dL again caught in this trap, could be worse than the status quo)</u>

- *Rather well prepared small steps than airy-fairy grandiose ideas*

- *Putting on a fire vs. changing fire regulations – fire regulations should not be changed in a haste, analyses, time and cool-headedness needed desperately*

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2. Beware of Half-baked Measures

Another suggestion: financial intermediation should not be seen as a specific „public good“

The Czech Republic has a rich experience with state-run banks:

Pressure on banks to favour politically important clients

$\Rightarrow$ Bad loans

$\Rightarrow$ Collected into a government-run „bad-bank“ agency

$\Rightarrow$ Loans sold back to the debtors = moral hazard

$\Rightarrow$ Loans not sold to the debtors = middlemen, bypassing of the ban

$\Rightarrow$ Think twice before you put banks into the hands of the state!

3. The CEE Universe

Recently, we could read in the media, int. institutions, analysts' reports (for instance the case of Austria):

(1) *Due to the crisis and accumulated imbalances, CEE economies are deeply in trouble, including local banks.*

(2) *CEE branches and subsidiaries of Austrian banks have lent a sum corresponding to 70% of Austrian GDP*

Therefore

(3) *CEE banks need help, or they will endanger also their mothers (or even the public finance) in Austria and other EU15 countries.*

3. The CEE Universe

Information asymmetry: the CEE knows more about the West than vice versa

(1) Some CEE economies (CZ , SI, SK, PL) and banks cope with the crisis better than is the case in much of EU15 so far

(2) Big Czech banks have not borrowed from their mothers (their loans-to-deposits ratio is below 0.8) and actually have been the source of a hefty part of total profits of their mothers for years and are rather net lenders to their mother companies

(3) Czech banks are mostly subsidiaries and so the deposits they have taken are based locally and in local currency, loans to local subjects etc.

„70% to Austrian GDP“ figure (BIS data) does not say anything about anything ☺, it just reveals the depth of misunderstanding

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3. The CEE Universe

(1) Clean the table at home first – the key issue for the whole EU and the CEE as a part of it

(2) Hard to find good macroeconomic models to follow in the Western Europe for the CEE – an easy „copy and paste“ approach not viable anymore

(3) „Bailout mania“ – not a way forward, helping hand must always be first searched for at home, too much solidarity might mean too little responsibility and might promote free-riding

(4) Int. institutions – looking for business for themselves by big bailout manias??

(5) The best the Western countries can do now for the CEE is to fix their own problems first

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Thank you for your attention

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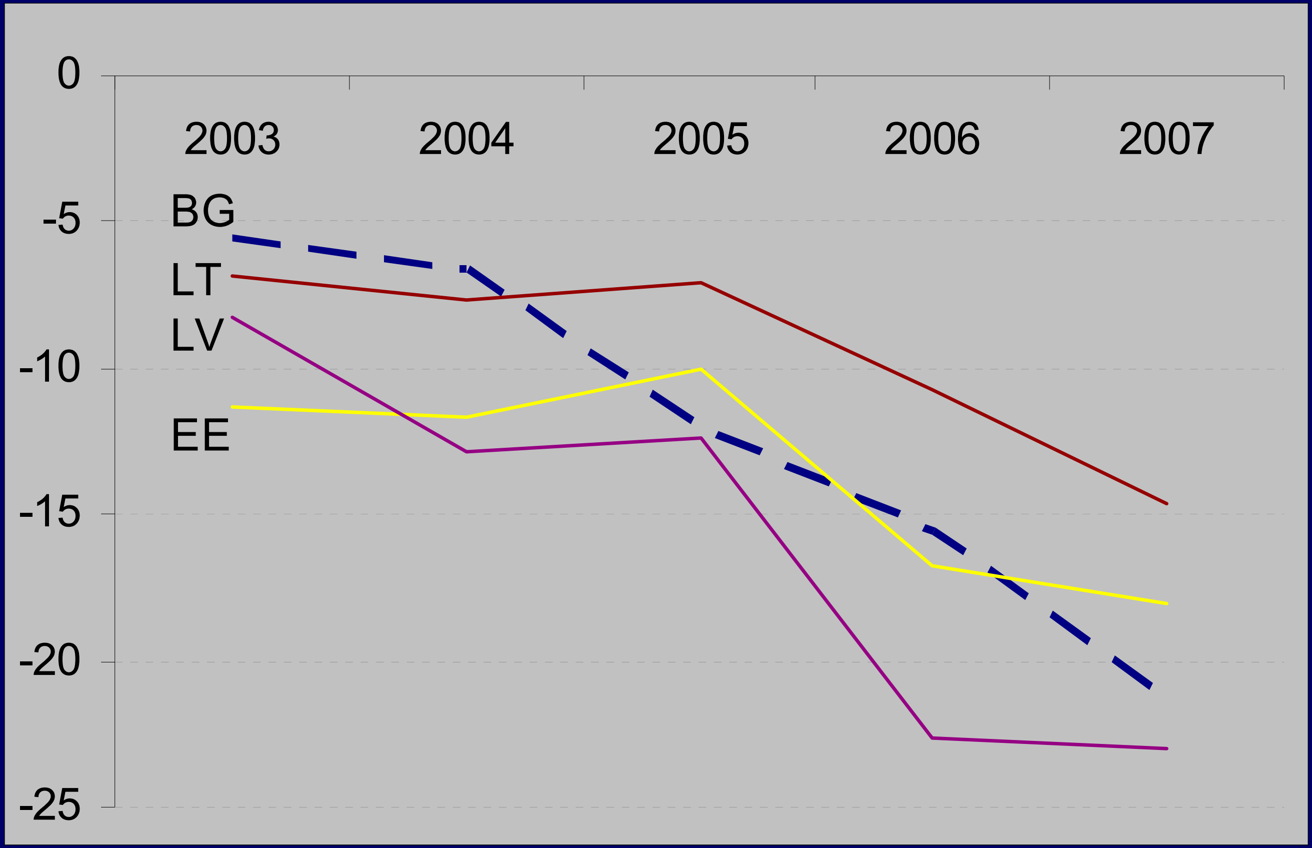
An FX peg can harm your CA

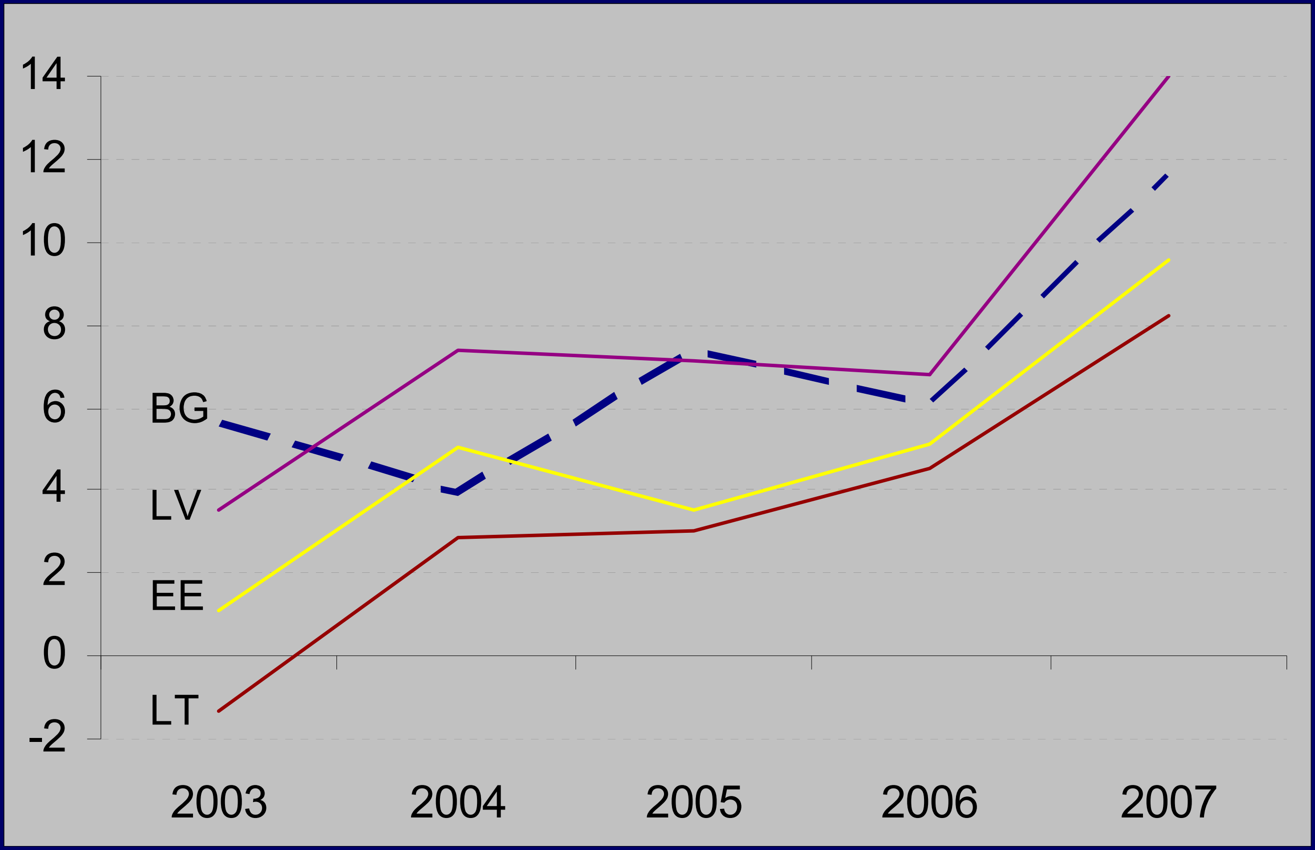
Current-account deficits in CEE economies with an FX peg



Source: IMF.

An FX peg can harm your inflation

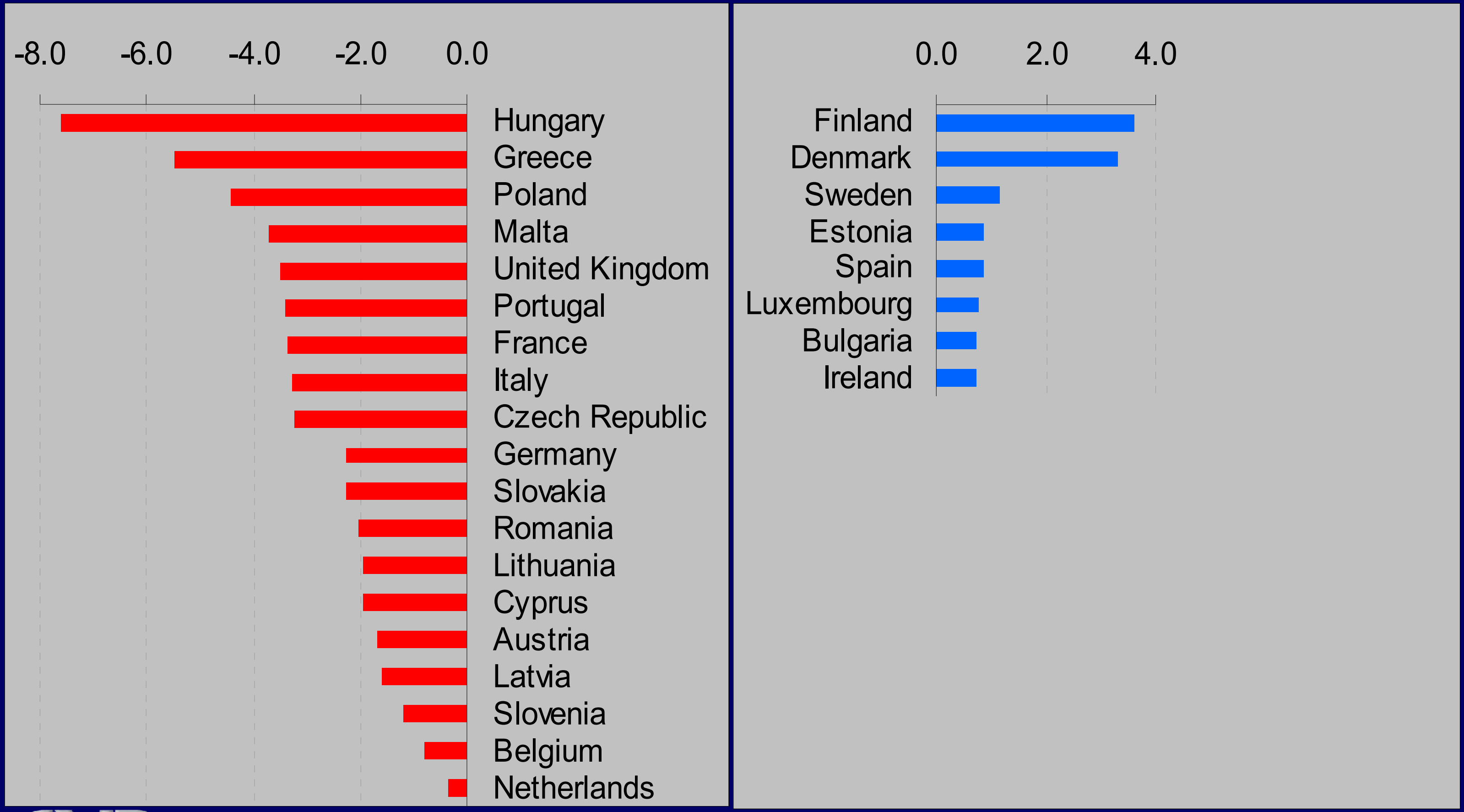
Inflation in CEE economies with an FX peg



Source: IMF.

Heating when there was no winter

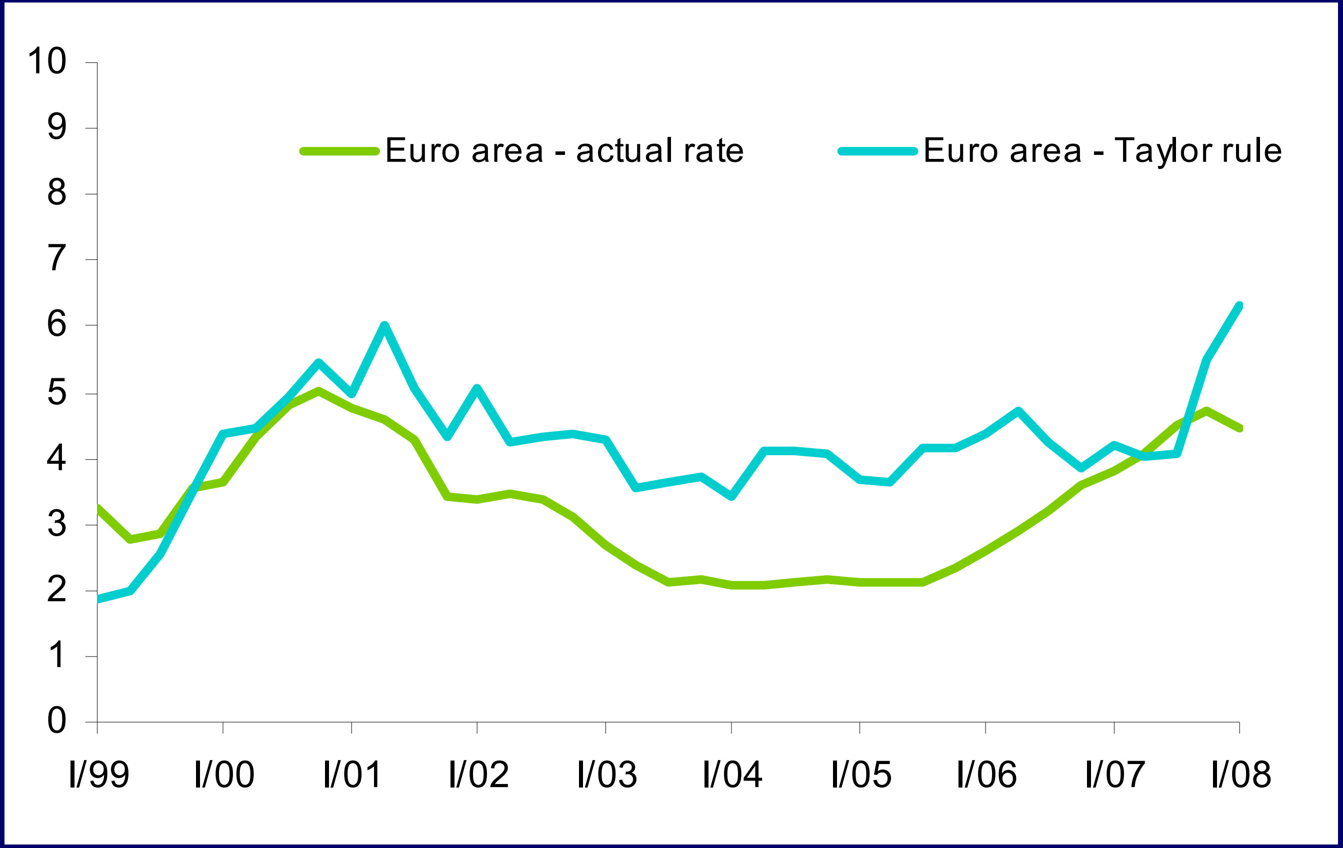
General government budget deficits to GDP, cycl. adj., 2003-07



Source: European Commission.

The Fed was not alone

In retrospect, monetary policy of the ECB was too easy.



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Source: Eurostat, CNB calculations.

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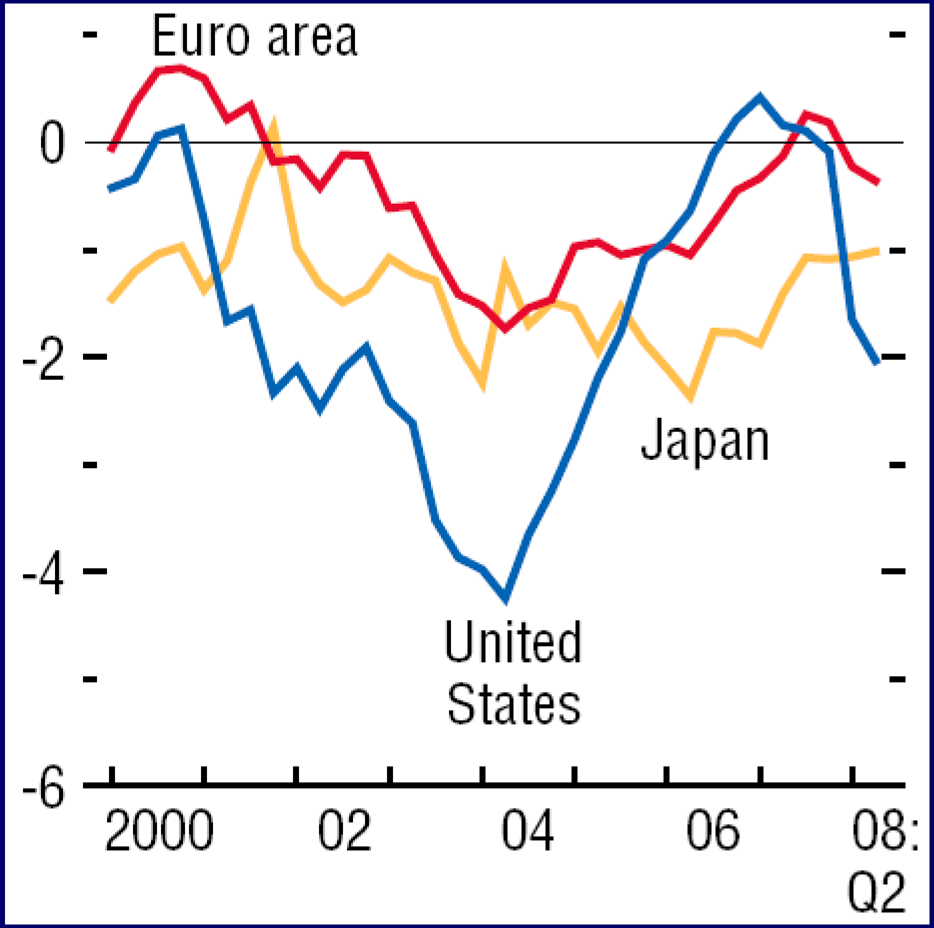

Source: IMF WEO October 2008.