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Post-crisis Economy of the European Union in the Global Context

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Abstract. *The recently economic crisis represents a new global economic turn. The question is whether, besides the necessary tools and actions to get out of the crisis, additional policies are needed on medium and long term to prevent a future crisis. In this essay I try to give some answers, integrating into the analysis both global and European levels, highlighting the necessary policies and their features in the Economic and Monetary Union and in the ex-socialist Central and Eastern countries, members of the European Union.*

Keywords: solutions and strategies to the economic crisis; the micro and macro-prudential supervision and regulation; fiscal consolidation of the financial sector and the sustainability of the public finances; the new institutional framework of the European Union; the Warsaw Consensus.

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1. Pre-crisis economy

1.1. Pre-crisis consensus

I will begin with a description of the pre-crisis consensus related to monetary policy, fiscal policy, and financial regulation.

Regarding monetary policy, low and stable inflation was considered the primary mandate of central banks. The theoretical framework was given by the New Keynesian model, which says that constant inflation is the only optimal policy choice for keeping economic growth at its potential rate. Therefore, keeping inflation at low and stable levels was the best method to ensure the optimal performance of the economy.

Regarding fiscal policy, it was considered secondary to monetary policy, for many reasons: skepticism about the effects of fiscal policy, based mainly on Ricardian equivalence explanations; concerns about temporal lags and political influences in the implementation of fiscal policy; the need to stabilize and reduce high debt levels; automatic stabilizers were considered sufficient to respond to changes in the economic cycle.

Regarding financial regulation and supervision, the focus was on the soundness of individual institutions and markets, and aimed at correcting market failures resulting from asymmetric information. Other macroeconomic implications of financial sector risks were ignored. Taking into consideration the great enthusiasm of financial deregulation, the use of prudential rules for cyclical purposes was considered as an inadequate interference in the credit markets functioning.

For about a quarter century, this macroeconomic framework seemed to work properly. The "Great Moderation" involving declining output volatility and moderate inflation, made us believe that the world knew how to conduct the macroeconomic policy.

1.2. What we have learned from the crisis?

Then the crisis came, which revealed the weaknesses of the pre-crisis consensus. The crisis has shown us that threats to macro-financial stability may develop beneath an apparent tranquil situation of stable prices, reduced output gaps and healthy public finances.

The crisis has also shown us that financial regulation can have a major macroeconomic impact. Regulatory weaknesses, including the regulation and supervision areas, allowed major risks to build up, enabling the explosion of the United States housing bubble to transform into a global crisis.

So, even if many ideas of the pre-crisis consensus remain valid (as low inflation and fiscal discipline), others need to be reconsidered. The crisis has also demonstrated that macroeconomic policy must have many targets. Fortunately, the crisis has also reminded us that we have many instruments to reach them.

The crisis has also emphasized the role of international policy cooperation. During the crisis, unprecedented cooperation allowed us to avoid another Great Depression. In the post-crisis period, such cooperation is necessary required to create the policy framework to support strong and stable economic growth.

1.3. The current juncture…

From an economic point of view the crisis has shown that we live in a multi-polar world. The crisis has affected the entire global economy, but the speed of recovery differs, with the United States and Europe still struggling while Asia and Latin America started to grow much earlier and at a faster speed. The de-coupling between the emerging and the advanced economies has taken place, but this doesn’t mean that there is less interdependence. The explanation is that there can be autonomous poles of growth in the world economy.

From a financial perspective, the world is not yet multi-polar because of the different stages of development of various regions, which shows why the dollar is still the most used currency worldwide. This is the result of the decision of countries and market participants to use the dollar as a means of exchange, unit of account and store of value, and not the result of decision by the United States to impose the dollar on other countries. The crisis has shown that the dollar maintains its safe status, status unlikely to change soon.

Meanwhile, the Euro, as a result of the economic weight of the Euro area and of the stability of its currency, has become the world’s second most important currency. But the Euro lacks some of the American dollar characteristics, such as the depth and liquidity of its markets or the existence of a major financial centre. The recently debt crisis in the Euro area has underlined these shortcomings.

In the case of other important players, such as China, the financial development is lagging behind their economic development. The renminbi is not convertible and the Chinese financial system is subject to multiple controls. A process of liberalisation has started but it will take some time before China will achieve the financial sophistication of the advanced economies. The progress would make the international monetary system more balanced.

This imbalance implies that the dollar-denominated financial market will remain important in the next years, in spite of the emergence of new economic powers in Europe and in Asia. This is the result of the slow speed of financial development and integration of Europe and Asia.

From a policy perspective, the world is far from being multi-polar. Many countries in Asia and the Middle East do not have independent monetary policies, but rather "import" their monetary policy from the United States by pegging their currencies to the American dollar.

So, we have a multi-polar economic world, but no multi-polar financial or policy world yet. This asymmetry is cause of the misallocation of resources at global level, which results in misalignments of asset prices, such as the exchange rate, and producing policy incentives which lead to sub-optimal results at national and global level.

1.4. ...and its consequences

Taking into account the above, I will briefly analyze a few examples of distortions and disincentives.

First, the existence of one major reserve currency leads to exchange rate fluctuations, conducting to abrupt shifts in risk aversion, rather than to changes in economic fundamentals, exacerbating longer-term imbalances instead of correcting them. The appreciation of the dollar after September 2008 is a example of this and has been one of the factors in the slow recoveryof the United States.

Second, the lack of independent monetary policies and the peg of relevant countries to the dollar affect the exchange rate of third currencies. For example, the peg of Asian currencies to the dollar has distortiond the exchange rate of those countries which have a flexible exchange rate system against the dollar.

Third, the limited diversification of reserve currency assets limits the scope for markets to discipline macroeconomic policies, dragging out the financing of unsustainable imbalances which may turn into a crisis. The ease with which the United States has been financed its external deficit has conducted to prolonged unsustainable imbalances and delayed the policy adjustment necessary to increase national savings.

Fourth, the insufficient adjustment or the overshooting of exchange rates may conduct to disorderly policy reactions and encourage beggar-thy-neighbour policies.

2. Post-crisis economy

2.1. The way forward

Taking into consideration the above conditions, how can the functioning of the international monetary system be improved? There is a twofold strategy.

The first strategy is to build a new institutional framework designed for this new multi-polar world. This type of cooperative framework would manage the multiple interactions between the main economic powers and their effects on the global markets, both in normal times and at times of crisis. Even in a complete multi-polar world financial markets will be characterised by instability, overshooting and self-fulfilling expectations. No matter the number of economic powers, there must exist a forum to bring together the responsible for monitoring market developments, assessing underlying conditions and intervening to counter instability. This will require a G3, G4, G5 or more, depending on the number of relevant players. They are needed in particular in order to manage highly sensitive issues such as exchange rates, address major financial market instabilities and be able to act quickly and in a coordinated way. Such groupings will not substitute for stronger multilateral institutions, such as the International Monetary Fund or the G20. The larger is the number of power centres, the greater is the need for an independent assessment of the policies pursued by each of them and their impact on the others.

The second strategy implies the implementation of policies consistent with the transition to a more complete multi-polar world, taking into consideration all its dimensions. This involves a speedier shift to an independent policy framework in Asia, especially in China, with a progressively more flexible renminbi. The international community should convince the Chinese authorities that there are considerable gains for the Chinese economy, even though some protected sectors, currently subsidised by the currency peg, might lose out in the short term. The experience of Japan and Germany in the 1970s has shown that a country can remain a strong exporter with a strong currency.

A more balanced multi-polar world also requires a deeper financial and economic integration in Europe, particularly in the Euro area. This involves addressing some of the uncertainties and inefficiencies affecting the current institutional framework underlying the Euro. It is necessary for the euro to be a key pole in the emerging new world that policy-makers in Europe look at the current problems not only from a closed-economy perspective; they also must be able to explain the advantages of being a global player. If Europe cannot find its place in the new multi-polar world, it will be squeezed between the other centres of economic power, and will suffer from their spillovers.

2.2. How to face the challenges: from global to local

Now I'm going to focus on three key areas that characterize the reform agenda.

First, macro-prudential supervision must be strengthened. This includes the global monitoring of systemic stability and the supervision of systemically important cross-border institutions, while properly addressing interlinkages among themselves, with other financial and non-financial institutions and markets. Therefore, one step was made by the broadened mandate and stronger institutional basis was given to the Financial Stability Board. The G20 Leaders, together with the Bank for International Settlements, re-established the Financial Stability Board, in order to develop macro-prudential tools, to identify the macro-prudential risks across the financial system and in order to limit the build up of systemic risk for regulated entities. In addition, the cooperation between the International Monetary Fund and the Financial Stability Board for the conduct of Early Warning Exercises will be crucial for the success of the global monitoring of systemic risks.

Second, we must undergo the global regulatory and supervisory repair. The Basel Committee has already set some milestones in this regard including the publication of the principles for sound liquidity risk management and supervision and its current work on strengthening the Basel II framework. The Basel Committee is developing proposals for countercyclical buffers. Some other important strands of work of the Basel Committee to strengthen the resilience of banking systems, are: a) the introduction of a non-risk based supplementary measure, b) strengthening the quality of banks' regulatory capital and the review of the minimum level of regulatory capital with the aim to arrive at a total level and quality that should be higher than the current Basel II framework (the importance that increases in the minimum regulatory capital, as a result of the aforementioned initiatives, should not take place in periods of economic and financial stress).

Third, regulatory gaps need to be closed. Therefore, the G20 Leaders endorsed the extension of the regulatory net to all systemically important institutions, markets and instruments. These include important hedge funds, credit rating agencies and over-the-counter derivatives markets.

2.3. European Union

Regarding to European Union, it is important to build the notable achievements and stable foundations of the single monetary policy.

The credibility of the European Central Bank rests on its independence, the transparency of its strategy and the consistency of its words and actions. Euro area's new surveillance framework must be built on these three principles of independence, transparency and consistency.

2.3.1. The achievement of price stability in the Euro area

The European Central Bank's single objective is the one of price stability (the annual inflation in the euro area below of 2%, but close to 2%, over the medium term).

Since its establishment in 1998, there were 12 years of low inflation and low interest rates. The average annual inflation rate in the euro area has been 1.97% being the best result in terms of price stability for any large Euro area country over the past half a century. As a result, millions of Europeans had preserved their purchasing power and the value of their savings.

The steady course of monetary policy also contributed to stabilize medium to long-term inflation expectations at a level consistent with price stability, despite the numerous economic and financial shocks that European Central Bank had to face.

One important fact that these achievements have not come at the expense of employment. On the contrary, since Economic and Monetary Union began, employment in the euro area has risen by over 14 million. More important is that these achievements have not come at the expense of economic growth either. Adjusted for population growth differences, growth in the Euro area has been about 1% per year in terms of gross domestic product per capita growth, over the past decade.

2.3.2. Responding to the crisis: bold actions in line with steadfast policy orientation

All these achievements have been possible due to the actions that have been taken in the medium-term oriented monetary policy strategy.

The financial crisis has changed neither the strategy, nor the objective. The European Central Bank's response to the crisis has always been connected with the strategy and medium-term objective of price stability.

The European Central Bank also have broaden the range of tools to adapt monetary policy to the challenges of the crisis, ensuring the euro area banks against present and future liquidity shortfalls. Banks are very important to the financial system: 70% of firms' external financing comes from banks. Therefore, banks finance a very large share of the investments made in Europe.

The lack of banks' ability to lend would have meant jeopardising the jobs of millions of Europeans.

Yet, monetary policy responsibility can not substitute for government irresponsibility through excessive government borrowing leading to a rise of the government paper market. This market has a central role in the financial system and constitutes an important element in the transmission of monetary policy to the real economy. Therefore, the European Central Bank had alerted all governments that they had to correct drastically their fiscal policies and restore fiscal sustainability with no delay.

2.3.3. The need for a rigorous and credible surveillance framework

So the period ahead is about two things: fiscal consolidation and measures to strengthen the growth potential of the economies. These need to be monitored by a credible and rigorous surveillance framework.

At the moment there are different points of views about the concrete design of the new surveillance framework.

Regarding the European Central Bank's view on such a framework for fiscal policies, three elements are indispensable: a) shorter deadlines under excessive deficit procedures; b) quasi-automatic application of sanctions; c) ambitious targets for the reduction of public debt towards the 60% of gross domestic product ceiling.

The severity of the breach should determine the severity of the sanction. Therefore, fines, reduced access to European Union funds, and other pecuniary sanctions are necessary.

There should be inflexibility in applying sanctions if rules are breached. This implies that decisions are necessary for the sanctions to be credible. Decisions only will give national policy-makers the right incentives. This is called quasi-automaticity.

There should be greater focus than ever before on government debt levels, more automaticity, improved national fiscal rules and better statistical data.

Regarding the European Central Bank's view on such a framework for macroeconomic policies, national developments of prices and costs must take into consideration that it is a union of monetary stability. This implies that national price and cost developments that are higher than the union average implies considerable losses of competitiveness, losses that cannot be sustained forever; therefore, this requires adjustments in the unsustainable economic policies. Fiscal and structural policies have to keep domestic demand in line with rates of sustainable growth and price stability.

A new framework for monitoring macroeconomic policies requires: a) a limited number of defined quantitative indicators to identify undesirable developments; b) transparency about the procedures and the sanctions; c) and a set of reliable statistical data, interpreted by independent arbiters.

A specific scoreboard should be designed for every Euro area countries.

Credibility of the analysis is the key. The credibility of the European Central Bank stands on its independence and transparency of the chosen strategy and consistency. Europe's new surveillance framework must be built on these principles: a) of independence in the assessment of the fiscal situation as well as of the soundness of macroeconomic policies; b) transparency of the procedures; c) consistency.

2.3.4. The way forward

The Euro area and the European Union requires some initiatives in key areas in order to guarantee the public authorities' ability to continue delivering macroeconomic and financial stability. The components of plan of reform for Europe are the following: a) implementing fiscal consolidation and securing the sustainability of public finances; b) promoting sustainable growth and job creation; c) enhancing the crisis management framework; d) strengthening the financial sector.

2.3.4.1. Implementing fiscal consolidation and securing the sustainability of public finances

The financial and economic crisis has led to a deterioration in the fiscal positions of Euro area countries, in terms of large budget deficits and rising government debt. The economic recession amplified imbalances in fiscal policies that had built up gradually long before the crisis, reflecting the failure by many countries to implement sound fiscal policies during past periods of strong economic growth. On the institutional side, the European Union's fiscal framework, embedded in the Stability and Growth Pact, proved to be too weak to enforce fiscal discipline and was not implemented with sufficient rigour.

However, the need to pursue more ambitious consolidation targets is more general. Fiscal consolidation is essential to ensuring an environment conducive to output growth and price stability.

Looking ahead, implementing fiscal consolidation and securing the sustainability of public finances are among the major challenges faced by policy-makers. The consolidation of public finances requires a comprehensive policy comprising: (i) the timely correction of excessive deficits; (ii) the

reduction of government debt to more sustainable levels; and (iii) the reorganisation of banks in order to limit strong links between the balance sheets of governments and financial sectors, which typically result in the socialisation of banks' liabilities in times of crisis. These measures need to be complemented by pension and healthcare reforms to alleviate the fiscal burden arising from population ageing.

Moreover, fiscal governance in the Euro area needs to be reinforced by means of the strengthening of the Stability and Growth Pact. This means establishing stricter and more binding rules for fiscal policy, backed up by stronger sanctions or mechanisms to ensure compliance with the rules. At the same time, the effectiveness of budgetary institutions needs to be improved at the national level. In this context, effective rules on expenditure should be regarded as a means of promoting fiscal discipline and limiting fiscal vulnerabilities in the event of adverse economic shocks occurring in the future.

2.3.4.2. Promoting sustainable growth and job creation

Euro area countries also need to increase their efforts to strengthen their growth potential and their ability to create jobs in a sustainable manner. European countries have made reasonable progress over the past ten years in the area of employment. Indeed, over 14 million jobs were created in the Euro zone since the introduction of the Euro, far more than in the previous ten years (around eight million). The employment increase in the Euro area since 1999 was even significantly larger than in the United States (7.6 million).

This is an important achievement, but it remains insufficient, especially against the background of the massive employment destruction observed in some Euro area countries during the crisis. Unemployment rates have reached unacceptably high double-digit rates in some countries and segments of the population (i.e. the young workers), that, as a result, carry extremely large economic and social costs. This is socially unfair and economically inefficient.

European countries must make more efforts to resolutely pursue – and with far greater urgency than in the past – the necessary structural reforms in product markets, labour markets, pension systems and so on. In this respect, a key contribution to the strengthening of the Euro area's long-term economic prospects will come from the thorough implementation of the Europe 2020 strategy, with its focus on key areas such as: (i) education, research and innovation; (ii) resource efficiency; and (iii) high levels of employment and social cohesion.

2.3.4.3. Enhancing the crisis management framework

In response to the sovereign debt crisis, the Euro area has recently armed itself with an important tool to safeguard area-wide financial stability. At the European Council meeting of 24 and 25 March 2011 the Heads of State or Government of the European Union agreed to establish a permanent European Stability Mechanism based on the existing temporary European Financial Stability Facility (which will remain in place until June 2013).

The European Stability Mechanism will grant financial assistance to countries in distress in the form of credit, with the assistance provided under strict conditionality and on the basis of a strict analysis – conducted by the European Commission and the International Monetary Fund, in liaison with the European Central Bank. The establishment of the European Stability Mechanism represents an important addition to the institutional fabric of Economic Monetary Union.

However, the existence of a mechanism to provide financial assistance to countries facing temporary distress should not be seen as a source of moral hazard. Such risks are prevented both by the strict conditions under which any assistance would be provided and by the fact that the mechanism will be activated only if deemed indispensable in order to counter threats to the financial stability of the Euro area as a whole. In addition, the establishment of this permanent stabilisation mechanism will be accompanied by the strengthening of the framework for economic governance in the Euro area, particularly as regards the framework for the multilateral vigilance of national policies in the areas of public finances and competitiveness.

2.3.4.4 Strengthening the financial sector

The financial crisis has also revealed a number of deficiencies and vulnerabilities in the regulatory and supervisory frameworks in the economies. The massive economic and financial impact of the crisis has clearly indicated that addressing such deficiencies through far-reaching reforms is essential in order to prevent similar crises in the future.

In Europe, important steps have been taken with a view to addressing the long-standing friction between, on the one hand, the international dimension of the operations of commercial banks and financial institutions, and, on the other hand, the national boundaries that constrain regulatory and supervisory measures. The Heads of State or Government of the European Union have agreed on a new structure for financial supervision in the European Union – the

European System of Financial Supervision – with a view to improving coordination and cooperation.

As regards micro-prudential supervision, three newly established European Supervisory Authorities for banks, insurance companies and financial markets became operational at the beginning of 2011. These are designed to enhance coordination between micro-prudential supervisors and to ensure the application of European Union wide standards in the area of technical supervision.

In addition, a new authority – the European Systemic Risk Board – has been established with a mandate to conduct macro-prudential supervision within the European Union.

2.3.4.4.1. Macro-prudential risk monitoring and assessment

The first component of strengthening the financial sector is enhancing the capacity of public authorities to identify and address systemic risk at the European level, both from an analytical and an institutional perspective.

Prior to the crisis, the lack of an institutional mechanism to translate the financial stability analysis made by central banks and the European Central Bank into policy actions was a major lacuna. In response, the European Systemic Risk Board has been set up to monitor and assess macro-prudential risks. Given that the new framework began operating in January 2011, it is difficult to assess its effectiveness comprehensively.

But the purpose of the European Systemic Risk Board is not to predict crises. The academic literature on early warning signal models, developed over the years, suggests that, for a number of reasons, the scope for error predicting in crises is substantial. Either the eruption of a crisis is missed or a period is wrongly identified by the start of a crisis. For this reason, the European Systemic Risk Board's analytical toolbox is based on early warning models and indicators designed to identify emerging vulnerabilities or imbalances that could lead to financial instability.

These models aim to perform three functions in particular.

First, to identify the variables which are associated with financial instability. To this end, an index of aggregate macro-financial imbalances, or of institution-specific vulnerabilities, is tested against variables such as credit growth, property price changes, private sector leverage and current account deficits, to discover which variables predict that index. Measures of bank leverage, balance sheet growth and maturity mismatches may also be used in order to gauge the extent to which the financial sector is developing.

Second, to assess the relative importance of different risks for financial stability. This is done using "adverse scenarios" that are designed and stress-tested to establish the potential severity of different types of risk and the overall resilience of the financial system to severe shocks. Such models, including top-down stress test of individual institutions, allow risks to be assessed more broadly and at a higher frequency than is possible with bottom-up exercises run by financial institutions, thus enhancing the "real time" information on systemic risk available to policymakers.

Third, to assess the financial channels through which risk can be propagated. The use of contagion and spillover models allows, for example, the assessment of the impact on the financial system of the failure of a particular financial institution or of turbulence in a particular sovereign debt market.

It could be considered how this framework would have functioned if applied retrospectively. For example, the monitoring of the credit-to-gross domestic product ratio as an early warning indicator of widespread asset-price misalignments would have initiated early warning signals as early as mid-2005. If the European Systemic Risk Board had been operational at that time, a risk warning would have been issued drawing attention to substantial price misalignments in mortgages and equity prices. Corrective measures could then have been recommended to curb credit growth, potentially distinguishing across countries depending of the magnitude of the imbalances. If followed, these policy measures could have deflated the asset price bubble before its dramatic burst in 2007.

This example suggests that the analytical framework employed by the European Systemic Risk Board could significantly strengthen macro-prudential risk assessment.

Ultimately, the effectiveness of the European Systemic Risk Board's recommendations will depend on the quality of the analysis behind them. Macro-prudential authorities will have to justify concrete policy changes, and so their analysis must be beyond reproach. For this reason, in order to support the work of the European Systemic Risk Board, the European Central Bank is in a process of enhancing its analytical tools with regard to risk surveillance and assessment. The European Central Bank has now operational models and tools to fulfil the three functions previously mentioned and continues to work hard to improve them.

2.3.4.4.2. An European framework for micro-prudential supervision

A more comprehensive European-wide understanding of systemic risks needs to be complemented by an effective micro-prudential supervisory framework to monitor and prevent these risks. This implies a more consistent set of regulatory and supervisory rules across Member States, together with

stronger rules and practices for cooperation between supervisory authorities on cross-border groups, both in normal and crisis situations.

In this context, the European Supervisory Authorities have been allocated a significant set of competences related to rule-making, enforcement of rules and coordination of supervision. Through these tools, the European Supervisory Authorities are expected to develop a single "European Union rulebook" which has to be enforced consistently throughout the whole single financial market. This should address a major weakness in the current framework, namely the divergences across countries in key regulatory elements – for example the different components of regulatory capital used across member states.

Furthermore, the European Supervisory Authorities have the power to take legally binding decisions addressed to national supervisors or, in case of non-compliance, to specific financial institutions if warranted by financial stability considerations. These powers can be triggered by a breach of European Union law by supervisors; disagreement between national supervisory authorities in cross-border situations; and the declaration of an emergency situation by the Council. However, in the latter two cases the European Supervisory Authorities' powers are subject to the "fiscal clause", which provides that the European Supervisory Authorities' powers cannot impinge on the national fiscal responsibilities.

I have described the way forward for the Euro area economy. However, I haven't considered some of the "shortcuts" that, according to some economists are supposedly available to countries unwilling to bear the costs of structural and fiscal reforms. In particular, it is often argued that Greece would be better off rescheduling or renegotiating some of its sovereign debt, rather than continuing to implement the adjustment programme negotiated with the international authorities as part of the financial assistance provided by the European Commission and the International Monetary Fund.

The argument is typically presented as follows: "Greece's key problem is not a temporary lack of access to liquidity, but rather a solvency crisis. The country is too weak to bear the economic and social costs of implementing the institutional and economic reforms foreseen by the adjustment package. The country may, therefore, be better off announcing some form of renegotiation or restructuring of its debts with private creditors. Of course, such a step should not be taken lightly, since it may be tantamount to a sovereign default, and the economic literature suggests that the costs of defaults can be both multiple (reputational loss, exclusion from financial markets, trade sanctions, and so on) and substantial.

2.3.5. The new growth model – The Warsaw consensus

Given that the global crisis has undermined the credibility of the current growth model, the ex-socialist Central and Eastern countries, members of the European Union, will need to adjust its growth strategy to accelerate post-crisis growth rates and better insulate the region from outside shocks.

This applies to the Baltic States, Bulgaria and Romania, which were hit hardest by the crisis, but also to the Czech Republic, Slovenia and Slovakia, which despite having maintained macroeconomic discipline before the crisis, suffered more than countries at comparable levels of development in other parts of the world. Even Poland, which avoided the recession, is projected to develop slower in the medium-term than many high-achieving emerging markets such as Korea, Singapore, Malaysia, Mexico and Brazil.

There is therefore a need to develop a new growth model. This could be called the Warsaw Consensus in order to reflect the large economic role of Poland in the region, with a 40% share in the ex-socialist Central and Eastern countries, members of the European Union income, its successful post-1989 political and economic transition and the way it managed the global crisis.

The Warsaw Consensus should be based on the best features of the pre-crisis development model – openness to trade, capital inflows and movement of labor, high quality of human capital, a common European Union institutional framework, low social inequalities, attention to social values, well-being and quality of the natural environment – and on the best characteristics of the Asian development model high savings, diversified exports, mixed ownership, conservative financial markets, strong financial supervision and controlled real exchange rate appreciation.

The Warsaw Consensus has to be different from growth models for other parts of the global economy. This is largely because of the unique characteristics of the region: its common post-socialist background, medium level of economic development and, above all, its location in the middle of Europe, along with its European Union membership.

Moreover, these countries could not follow other growth models: the neoliberal Washington Consensus is viewed in many quarters as discredited as a result of the recent global crisis; the Beijing Consensus, based on the Chinese strategy of development, would not apply to these countries, given their democratic credentials, increasingly service-oriented economies and European Union membership; and the Mumbai Consensus, reflecting the unique characteristics of the Indian growth model, is likely to be of interest only to developing countries at a much lower level of development. Finally, these countries could not fully follow what could be called the Berlin Consensus, a

set of economic principles, which have worked well for Germany, especially in the past decade, but would need to be adjusted to reflect different levels of incomes and the likely divergent development paths of the poorer the ex-socialist Central and Eastern countries, members of the European Union.

The Warsaw Consensus would be based on the following ten pillars: 1) high domestic savings; 2) high employment rate; 3) high labor productivity growth; 4) controlled real exchange rate appreciation; 5) labor markets open to immigration; 6) strong financial sector supervision; 7) efficient use of European Union funds; 8) further European Union integration and enlargement; 9) diversified exports; 10) focus on well-being and quality of life beyond gross domestic product.

2.3.5.1. High domestic savings

The issue: the ex-socialist Central and Eastern countries, members of the European Union, do not save enough to support high investment rates and help insulate them from future crises by lessening reliance on imports of foreign capital.

The solution: raise private and public saving through second and third pillar pension reforms; higher effective retirement ages; stricter domestic and European fiscal rules, including introduction of constitutional debt limits; pan-European tax harmonization and establishment of fiscal councils to monitor the fiscal situation; and increased transparency. In addition, adopt the Euro at a competitive exchange rate. The target should be for the domestic savings rate to amount to at least 25% of gross domestic product, up from around 20-21 % currently. Together with imported savings of up to 5% of gross domestic product, mostly in the form of foreign direct investment, this should allow domestic investment to amount to least 30% of gross domestic product, in line with the high investment ratios experienced in the past by successful catch-up countries, such as Japan, Korea, Singapore and Taiwan.

2.3.5.2. High employment rate

The issue: despite substantial improvements in the last two years, the average employment rate among 20-64 year old amounted to 67% in 2009, below the 75% target of the EU 2020 Strategy.

The solution: the raise of effective retirement ages; streamline access to disability pensions; guarantee the right mix of skills through education reforms and lifelong learning, especially for older generations; and develop insurance instruments to help finance re-skilling and job search. The goal should be to

raise the employment rate to the 75% target of the EU 2020 Strategy by 2020, boosting economic growth and helping to stabilize public finances.

2.3.5.3. High labor productivity growth

The issue: insufficiently high growth in total factor productivity.

The solution*:* increase total factor productivity growth to at least 2% per year by fully opening domestic and European Union markets to competition, particularly in the utilities and services sectors; promote labor immigration, especially among high-skilled workers; improve business climates; promote export-sector foreign direct investment; enhance human capital and labor skills through further educational reforms and lifelong learning; increase the efficiency of public administration, including through the introduction of e-government; reform public research and development institutions; and increase the value and efficiency of public spending on technology absorption and innovation.

2.3.5.4. Controlled real exchange rate appreciation

The issue: uncompetitive exchange rates before the crisis led to unsustainable asset booms and reallocation of resources from export-oriented sectors toward other sectors, mainly real estate, which undermined growth and the stability of the balance of payments.

The solution: following in the footsteps of all previously successful catch-up countries, including Japan, Korea, Taiwan and Singapore, EU-10 countries should ensure that wage growth never exceeds growth in labor productivity. This should be done through maintaining labor market flexibility, opening labor markets to migration, controlling increases in public wages and implementing active fiscal policies.

2.3.5.5. Labor markets open to immigration

The issue: Impending demographic decline and population aging, which undermine economic growth and the stability of public finances.

The solution: Given that pro-natalist policies, while important, would be insufficient to raise fertility ratios to replacement levels, the ex-socialist Central and Eastern countries, members of the European Union, should fully open its labor market to immigration, re-attract their citizens working abroad and actively promote migration inflows, especially among high-skilled workers from Eastern Europe.

2.3.5.6. Strong financial sector supervision

The issue: insufficient control over excessive credit growth, leading to asset booms and
financial instability.

The solution: strengthen supervisory control over foreign banks operating in the region – which hold the dominant share in the region's banking sector assets – through domestic and European Union-wide anti-cyclical macro-prudential policy; limit foreign currency borrowing; close cooperation with financial supervisory authorities in home countries; emphasize conservative business models.

2.3.5.7. Efficient use of European Union funds

The issue: Incomplete utilization of the available European Union funds; insufficient efficiency in spending.

The solution: Ensure full utilization of the available European Union funds, particularly in lagging countries, such as Bulgaria and Romania, and increase their efficiency by spending it on infrastructure, human capital development, technology absorption and innovation.

2.3.5.8. Further European Union integration and enlargement

The issue: incomplete integration of the European Union product, service and labor markets; pause in the enlargement process.

The solution: promote all European Union-wide initiatives, such as the most recent "Pact for the Euro", that aim to achieve a real integration of the European Union's product, service and labor markets and increase the European Union's competitiveness; argue for continued European Union enlargement, which brings economic benefits to both old and new members.

2.3.5.9. Diversified exports

The issue: too narrow focus on the European Union export markets, which weakens growth potential and increases the risk of economic instability.

The solution: rebuild economic ties with emerging markets, including the BRICs (Brazil, Russia, India and China), increased financial support and the introduction of partnership agreements promoting foreign direct investment inflows into the region from non-European Union countries, in exchange for

access to their domestic markets. The long-term target should be for the share of non-European Union oriented exports to represent at least one-third of the total, up from less than one-fifth currently.

2.3.5.10. Focus on well-being and quality of life beyond gross domestic product

The issue: excessive focus on gross domestic product as a measure of social and human development.

The solution: focus strategic economic policies not only on expanding gross domestic product, but also on promoting well-being, including life expectancy, educational attainment, quality of governance, quality of natural environment, level of personal freedom, safety and security, availability of leisure time, public trust and strength of social networks.

Full implementation of the Warsaw Consensus should allow New Europe to accelerate post-crisis growth rates and to better insulate the region from future global and regional economic shocks.

Conclusions

The international community is working towards a post-crisis financial architecture that gives more prominence to having a strong macro-prudential orientation, is based on strengthened regulatory and supervisory frameworks, and prevents regulatory arbitrage. It is now important to keep the momentum in the implementation of the ongoing global initiatives.

Effective coordination of all policy initiatives is the key for ensuring global consistency and success; but financial stability ultimately depends on the implementation of global initiatives at the local level. Sound regulation, supervision and governance of financial markets are key parameters on the way towards a financial architecture that will pass the test of time. In this regard, it is now time to build for the future.

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