January 28, 2009

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Ambassador's Corner

WEEKLY MESSAGE FROM AMBASSADOR JOHN BRUTON

January 28, 2009

Who bears the risks? Sharing the burden of the economic downturn

The current economic crisis is about a lot of things – but one of them is about who should bear the burden of particular risks.

For example, in some European countries, the risk that someone will suffer a long-term illness is borne, wholly or partly, by the Government or the taxpayer. In the United States, unless one is over 65 or below the poverty level, the burden of that risk is borne by the individual himself, his or her employer or his insurance company or by a combination of the three.

A similar situation applies with respect to who bears the risk of bank rescues. If the financial sector’s bad loans and toxic assets are all grouped together and bought by the Government, then the taxpayer is taking on the risk. If, on the other hand, the Government takes ordinary shares in the bank, as a way of boosting the banks capital, then part of the risk will remain with the bank’s existing shareholders. I believe that if the taxpayer takes the risk, the taxpayer should share in the profits when bank shares eventually recover (as they will).

What is the best way to get finance moving again?

There are other choices to be made too. If the goal is to get banks back to solvency quickly and normal credit activity sustainably resumed, than making banks promise to lend money straight away as a price for capital injections may not always make sense. This is because many banks and credit institutions have been seriously “overleveraged,” in other words they relied excessively on borrowed funds to increase their capacity to lend. If they are required to lend even more before they have rebuilt their balance sheets, then one may be prolonging a problem by treating the symptom rather than the disease.

The head of the IMF [International Monetary Fund] Dominque Strauss Kahn was blunt:

“As long as the financial system is not restructured, all the money from stimulus will go into a black hole. One dollar of financial stimulus may be more useful than a dollar of spending on infrastructure.”

This is probably true, but it is not an easy message for politicians to convey to constituents.

There is also the complexity that not all financial institutions are in the same position. The American Bankers Association told me recently that many traditional banks are actually able to increase their lending but are finding no takers because of a general loss of confidence, which has come about because of the complete close-down of a non-traditional form of credit--which had exploded in size in recent years: namely “securitizations” or “originate-to-distribute” mortgages. The fall in house prices undermined securitization, and that has led to a general loss in confidence.

But the number of existing homes for sale in the US fell by 11% last month and new house building has almost stopped. So sooner or later, house prices will start to rise again. Thus, if properly conducted, taxpayer investment in banks could turn out to have an upside in the long run.

It is also really important that we get our act together internationally.

China and the US will, between them, produce stimulus plans worth many trillions of dollars. The effectiveness of both plans would be seriously compromised if trade between them were to be restricted.

While there is a view that China may be undervaluing the renminbi to boost its exports, we should also remember that it is also buying a lot of bonds denominated in dollars; and if it were to revalue the renminbi suddenly, it would be unilaterally and voluntarily reducing the value of its own dollar investments in renminbi terms, something that it is hard to expect anybody to do.

So what we need is a coordinated approach among the US, the EU and China to agree on a measured plan to rebalance all three economies towards a more stable model, whereby those who have been borrowing and consuming too much doing less of both, and those who have been saving too much and spending too little doing a bit less saving and a bit more spending.

While minding Governments own balance sheets

A nagging worry nowadays is that, if governments increase their own debts to rescue financial institutions, they themselves may get into financial difficulties or at least have to pay higher interest rates on their borrowings. That depends very much on how wisely they spend their money and on whether they also have a sound long-term plan to increase the competitiveness of both their public services and of their economies generally.

We cannot build a credible stimulus of our economies in the short-term, if we ignore long-term fiscal liabilities. The retirement of baby boomers will impose heavy burdens on our finances on both sides of the Atlantic. Increased indebtedness of governments could lead to higher interest rates unless we take credible decisions on how we will restrict our longer term liabilities, while increasing borrowing in the shorter term to boost the economy. The International Monetary Fund, which is the lender of last resort for governments, must be strengthened, both institutionally and financially.

It is interesting to note the attention being paid to the downgrades of some euro area Member States’ government debt by credit rating agencies. As spreads between Greek, Portuguese, Irish and Spanish bonds have widened over German bonds (in other words, as these Governments have had to pay more to borrow than Germany does), each of these countries have witnessed a ratings downgrade. Ratings are, of course, no more than opinions and rating agencies’ opinions have not always been right. Does this mean, as some commentators on this side of the Atlantic have speculated, that the euro area is at risk of fragmenting? I think the opposite is true.

The fact that we observe spreads should be seen as a confirmation of the credibility of the institutions of economic and monetary union (EMU): of both of the independence of the European Central Bank and in the no-bailout clause (a provision stipulating that European countries are not liable for one another’s debts). If either of these things was in doubt, there would be no rationale for a spread to develop between any two euro area government bonds.

Not all risks are equal

Another issue is what weight to put on different types of risk. How likely is an event to occur, but how does one measure its severity?

The World Economic Forum published its Global Risks 2009 report recently. It put volatility of food prices, infectious diseases and a global ‘flu pandemic at the very top of the scale in terms of likelihood of happening and of the number of deaths they would cause. Terrorism and most other threats were much farther down the scale in terms of number of lives that would be likely to be lost.

So it is important to keep a sense of proportion. Programs that would build up vaccine capacity against a ‘flu epidemic, strengthen public health systems in poorer countries or increase security food supplies should not be raided to finance plans to mitigate risks that are less severe in their consequences.

Meeting with Europe Sub-Committee of the House of Representatives

Last week the Czech Ambassador, Petr KoláY and I met with the Europe Sub-Committee of the House of Representatives headed by Congressman Robert Wexler [at left, with Ambassador Bruton] of Florida. Petr was there as representative of the Czech Presidency of the European Union. Among the members of the House we met were Elton Gallegly, Bob Inglis, Brad Miller, Shelley Berkley and Michael McMahon [in photos below].

I took the opportunity to stress a few points of importance to the European Union.

• We are very supportive of the Transatlantic Legislators Dialogue between members of Congress and Members of the European Parliament. It is a very good way of minimizing friction and maximizing cooperation between the EU and the US.

• We believe that open markets and easy trans-Atlantic travel remain the best ways to maximize the efficiency of both the EU and the US economies. Protectionism prolonged the economic downturn of the 1930s because it increased inefficiency. Neither the US nor the EU can revive their economies on their own because their problems have global roots. We need to persuade China and other major economies to work together with us on stimulus packages so that will get the maximum boost for each dollar, euro or renminbi we spend. We should avoid protectionist measures like the suggested insertion of a “Buy America” provision in the proposed stimulus package.

• We strongly object to legislation that would require 100% of containers from EU ports destined for US ports to be scanned and subject to radiation detection entirely at the expense of the EU exporters. This 100% requirement will impose a huge burden on European ports, involving large lines of trucks and a big backlog. It is not the best way to devote resources to tracking suspect containers. The EU and the US both already have a more selective risk-based system, which has worked well and is a much better use of resources. Containers leaving US ports for Europe are not to be scanned under the legislation, so the proposal is discriminatory.

• We are unhappy at the initiatives taken by the outgoing USTR [US Trade Representative], Susan Schwab, to impose an unprecedented set of unpredictable and constantly changing tariffs on EU goods in retaliation for EU restrictions on hormone-treated beef imports. EU consumers simply do not want to eat unlabelled hormone-treated beef wherever it comes from, but our main problem with Susan Schwab’s initiative is its unpredictable nature. By arbitrarily changing the goods on which it will charge the penal tariffs, the US is introducing a new element of arbitrariness into tariffs relationships across the Atlantic. When there is so much uncertainty in the business world already, this is a mistake.

Representative Elton Gallegly, Wife Janice & Granddaughter Savannah with Ambassador Bruton

Representative Bob Inglis
Representative Brad Miller

Representative Shelley Berkley
Representative Michael McMahon

The Electronics and Information Technology Industries

Last week, I met with the leaders of two of the associations representing the US Information Technology (IT) sector, Chris Hansen of the Technology Association of America, and Dean Garfield, President of the Information Technology Industry Council.

The IT industry has been one of the great success stories of the US economy. It has taken technological breakthroughs, many of which originated in military research, and turned them into goods and services--like smart phones, laptop computers and the internet--that have changed all of our lives and have connected the whole world together in ways that would have been unthinkable twenty years ago.

We discussed the significance of the proposed US Economic Stimulus package for the world economy and how Information Technology can be used to help economic revival by:

• Making it easier to check medical records remotely so that doctors can treat patients more effectively. Electronic records would avoid unnecessary duplications of diagnostic tests and save costs. They would provide valuable background information and help the selection of the optimum drug or treatment for the particular patient. Of course there are difficult questions about interoperability of computer systems, data ownership and data protection against misuse to be settled.

• Using IT to improve the energy efficiency of buildings and the cost effectiveness of the electricity transmission grid. The advent of the smart grid in which appliances are networked to manage their power consumption and consumers monitor real-time pricing and shift some consumption to off-peak periods, is revolutionizing electricity use. “Intelligent” buildings, equipped with sensors and transmitters, can reduce energy costs and minimize the wear and tear on equipment.

A common EU and US approach to mutually recognizable certification of e-health records (as part of a project being promoted under the Transatlantic Economic Council), would help this development by creating a bigger market for innovations.

And Finally…

There was an excellent article in the Financial Times recently by Javier Solana [right], entitled “Five Lessons in Global Diplomacy.” He sets out some very good principles to guide foreign policy of both the EU and the US in years ahead. It is well worth reading.

Please send me your comments about this or any of my weekly messages or other EU matters. I look forward to hearing from you!