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CPB Newsletter 2008 December 4

CPB Netherlands Bureau for Economic Policy Analysis

Don't throw out the baby with the bathwater

Coen Teulings

The world is in quite a state. Financial markets have been distressed for the last year and a half. It started in the United States. The All American Dream – everybody owning his own home – should become achievable also for low-income families. Betting on a further surge in house prices, banks were prepared to grant them loans, and with the benefit of hindsight we have seen that few bankers and intermediaries seemed to observe the rules for prudence and decency in pursuit of profit. In the end, the dream vanished under the collapse of house prices.

What started as a small fire evolved into in worldwide firestorm. The 'firemen' that worked overtime until the 15th of September (when Lehman Brothers announced bankruptcy) have since then simply been unable to supply the hours. Banks failed, stock markets collapsed. And European banks turned out to be all but immune to these problems. The flammable materials that needed only a sparkle to ignite this fire are known: faulty incentives for rating agencies and bank managers, the originate-and-distribute model, overly complex financial products traded on over-the-counter derivative markets, and unregulated hedge funds. Their precise interaction in the spread of the fire will remain subject to debate for some time.

In meantime, however, the world is desperately seeking somebody to bear the blame for this disaster. The prime suspect is obvious: markets, in general – and the financial market, in particular. They weren't popular, anyway, in major parts of the world, which makes things easy. Let there be no misunderstanding: financial markets are the source of this crisis. Banks have an inherent tendency toward excessive risk taking, a tendency that must be curbed by supervision. This supervision hasn't delivered what it was supposed to do – either in the United States or in Europe. Improvement is urgently needed.

However, this does not mean that we can do without financial markets. The market may currently be closed, but after a while we'll be looking for some new investment projects. Otherwise, technological innovation will come to a complete standstill. These projects require capital for take-off – capital that somebody has to provide. Cross-country research clearly shows the importance of capital markets for innovation and growth. Projects can get funding on various segments of this market: bank lending, venture capital, stock markets, or private equity. All of these have their pro's and con's. If our recent experience leads us to distrust one segment, we can to some extent substitute another. For example, if de-leveraging is needed, as many observers claim, then the role of bank lending must decline. But then, inevitably, stock markets and perhaps private equity will become more important – and they don't seem to be very popular today, either.

Sooner or later, the worst of the dust will settle and capital markets will slowly begin once again to fund new projects. But first we've got to repair the damage, develop some new rules and improve international supervision of financial markets. Financial markets, with all of their unpleasant, even negative, aspects, will always be with us. We can't do without them. In the midst of all of our zeal for reform, let's take care that we don't throw the baby out with the bathwater. □

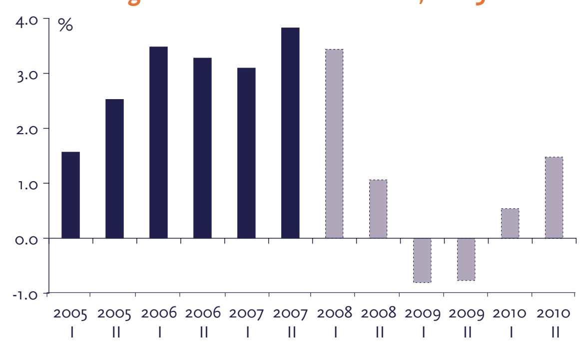
Coen Teulings, director

CPB's short-term forecasts December 2008

- The expected growth of the Dutch economy in 2008 is unaltered, at 2¼%. The projection for next year is adjusted to a decrease of ¾%. 2010 can show a mild recovery, to a growth of 1% GDP.
- This year, the unemployment rate will remain low (4%), but it will rise steeply in the years to come, to 6½% in 2010.
- Inflation will show an increase to 2½% in 2008, falling back to 1% in 2010. Contractual wage growth will be 3½% in 2008, slowing down subsequently to 1½% in 2010.
- The government budget is deteriorating quickly, from a surplus of 1.3% GDP in 2008 to a projected deficit of 2.4% GDP in 2010.

For the main economic indicators for the Dutch economy, see the back page, or www.cpb.nl.

Economic growth in the Netherlands, 2005-2010 a)



a) GDP volume growth rate compared to corresponding period in the previous year.

Recent Publications

September – December 2008

The following list provides an overview of recent CPB publications that have appeared in English between September and December 2008. All publications can be downloaded at www.cpb.nl. An English press release on these publications is sometimes available at the website.

CPB Documents

170. Cross your border and look around

Henry van der Wiel, Harold Creusen, George van Leeuwen and Eugene van der Pijll, September 2008
henry.van.der.wiel@cpb.nl

This document focuses on innovation, human capital, technology transfers and competition as potential sources of productivity growth for firms. It integrates the views of existing literature. The authors provide econometric evidence that technology transfers do matter, predominantly from the national frontier.

171. Border tax adjustment and the EU-ETS, a quantitative assessment

Paul Veenendaal and Ton Manders, October 2008
paul.veenendaal@cpb.nl

If the EU stands alone in adopting climate policy and imposes a strict emissions ceiling, competitiveness of EU energy-intensive sectors will be affected negatively. Relocation of EU energy-intensive firms to countries with a lax regime may also lead to carbon leakage. However, if EU-countries use the opportunities of the Clean Development Mechanism, these impacts will be modest.

172. Evaluating CPB's published GDP growth forecasts; a comparison with individual and pooled VAR based forecasts

Adam Elbourne, Henk Kranendonk, Rob Luginbuhl, Bert Smid and Martin Vromans, October 2008
adam.elbourne@cpb.nl

The authors compare the accuracy of published GDP growth forecasts from CPB's large macro model SAFFIER, to those produced by VAR based models. They employ a data driven methodology for selecting variables to include in our VAR models and find that a randomly selected classical VAR model performs worse in most cases than the Bayesian equivalent.

CPB Discussion Papers

111. Gravity with Gravitas: Comment

Bas Straathof, September 2008
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Anderson and Van Wincoop have estimated what trade between US states and Canadian provinces would have been if the border between Canada and the United States had never existed. This Comment shows that the non-linear system can be solved analytically. The author finds that the border effect for Canada is half as large as reported by Anderson and Van Wincoop.

112. Investigating uncertainty in macroeconomic forecasts by stochastic simulation

Debby Lanser and Henk Kranendonk, September 2008
debby.lanser@cpb.nl

Uncertainty is an inherent attribute of any forecast. The authors investigate four sources of uncertainty with CPB's macroeconomic model SAFFIER: provisional data, exogenous variables, model parameters and residuals of behavioural equations. The total variance of a medium-term forecast emanates mainly from the uncertainty in exogenous variables. For short-term forecasts, both exogenous variables and provisional data are most relevant.

113. The effect of childhood conduct disorder on human capital

Suncica Vujic, Pierre Koning, Dinand Webbink and Nick Martin, November 2008
pierre.koning@cpb.nl

This paper estimates the longer-term effects of childhood conduct disorder on human capital accumulation and violent and criminal behaviour later in life, using data on Australian twins. The authors measure conduct disorder with a set of indicators based on diagnostic criteria from psychiatry. They find that early (pre-18) conduct disorder problems significantly affect both human capital accumulation and violent and criminal behaviour over the life course.

114. Why are criminals less educated than non-criminals? Evidence from a cohort of young Australian twins

Dinand Webbink, Pierre Koning, Suncica Vujic and Nick Martin, November 2008
dinand.webbink@cpb.nl

Does crime reduces investment in human capital or does education reduce criminal activity? This study, which uses data of Australian twins, shows that early arrests (pre-18) have a strong, negative effect on human capital accumulation and a strong, positive effect on participation in crime later on. This suggests that programs which succeed in preventing early criminal behaviour might yield high social and private returns.

CPB Memoranda

209. December 2008 forecast: Tough times ahead

December 2008
jasper.de.jong@cpb.nl

210. The credit crisis and the Dutch economy in eight Frequently Asked Questions

December 2008
michiel.bijlsma@cpb.nl

211. Pension savings up in smoke

December 2008
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The credit crisis and the Dutch economy
... in some frequently asked questions

Why did credit grow steadily preceding the crisis?
The current global financial crisis follows a familiar pattern of financial innovations, a sharp increase in outstanding credit and rising house- and stock market prices. One explanation for this increase in credit can be found in financial innovation. Banks bundled together outstanding loans, sliced them up and sold the resulting products. In this way, banks lowered their overall risk. In addition, market risk also seemed to recede. The (overestimated) reduction in risk stimulated banks to increase their amount of outstanding credit. Worldwide imbalances of payment provide another possible explanation for the strong growth of credit in the US and in Europe.

Why did regulation fail?
As a consequence of loopholes in financial regulation, a non-regulated shadow banking system of hedge funds, investment banks, special purpose vehicles, securitized loans and complex derivatives evolved in the 1990s. This allowed banks to evade regulation by optimally using regulatory loopholes, and created important risks for the financial system.
Banks' ability to manage own risk proved insufficient. Monitoring of clients was lax. Buyers of securitized assets relied too much on complex models that underestimated these products' risks, and credit-rating agencies that miscalculated the risks involved. Although some international organisations did identify, based on several indicators, the danger posed by unrestrained credit growth and rising asset prices, authorities did not intervene.

How did the crisis spread?
Reselling securitized loans should have lowered the risks on the banks' balance sheets. This turned out to be an illusion. When off-balance-sheet vehicles ran into difficulties banks had to step in (due to legal issues or in order to prevent reputation damage) and account for the losses. Due to leverage, the 600 billion dollars loss on sub-prime mortgages diminishes worldwide credit capacity by about 7200 billion dollars.
The market for securitized mortgages dried up because banks could no longer distinguish between good and bad products. After the failure of Lehman Brothers, the inter-bank market also dried up. Central banks had to step in and provide liquidity. At some banks (Fortis, Northern Rock), depositors collectively withdrew their funds. These banks were nationalised.

What are the consequences for the Dutch financial sector?
Halfway through the year, losses and write-offs for Dutch banks totalled over 15 billion euros and consumers and firms withdrew their money from banks. Government intervention became unavoidable. Deposit insurance was extended, new bank loans were guaranteed, capital was made available to banks, and for Fortis/ABN-Amro nationalisation followed.

Is government intervention justified?
Absolutely. If a big bank fails, then other banks are contaminated. The financial sector plays a crucial role in our economy by facilitating investments and providing liquidity. If these functions fail, then substantial problems arise in other parts of the economy.

What will happen with the financial sector worldwide?
First, the shadow banking system will be regulated and oversight will focus more on the stability of the financial system as a whole. Second, the risks that banks face will have to be regulated more effectively, and banks will have to strengthen their internal risk management. Third, managerial pay will be under scrutiny. Finally, international coordination of supervision, regulation and government intervention is important.

What should the Dutch government do?
To minimize these risks involved with government intervention, it would be wise for the Dutch government to privatise ABN-Amro/Fortis as soon as possible.

Final remarks
It is important not to throw out the baby with the bathwater. Efficient financial markets increase welfare. If banks become overly prudent as a consequence of strict regulation, this may be costly as well.

This article is a considerably shortened version of CPB Memorandum 210, available at www.cpb.nl

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Main Economic Indicators for the Netherlands, 2007-2010

	2007	2008	2009	2010
	annual growth rate			
International items				
Relevant world trade (volume)	6.6	2¾	– 2¾	3
Import price goods	1.7	4	– 6½	– 1¼
Export price competitors	1.5	2¼	– 1¾	– 1½
Crude oil price (Brent, level in $ per barrel)	72.5	98	50	50
Exchange rate (dollar per euro)	1.37	1.46	1.26	1.26
Long-term interest rate (level in %)	4.3	4¼	4	4
Demand and foreign trade (volume)				
Gross domestic product (GDP)	3.5	2¼	– ¾	1
Private consumption	2.1	2	0	1½
Public demand	3.3	1½	2¼	1
Gross fixed investment, private non-residential	4.8	8½	– 6	– 5½
Exports of goods (non-energy)	7.3	2¾	– 2¼	3
of which domestically produced	5.0	½	– 1¼	1¾
re-exports	9.5	5	– 3	4¼
Imports of goods	6.8	5¾	– 2½	1½
Wages, prices and purchasing power				
Export price goods (excluding energy)	1.5	1½	– 1½	– 1¼
Price competitiveness [a)]	– 1.9	– ¼	1¼	– ¼
Consumer price index (CPI)	1.6	2½	1½	1
Contractual wages market sector	1.8	3½	3	1½
Compensation per employee market sector	3.4	4¼	3¾	2½
Purchasing power	1.5	0	1¾	¼
Labour market				
Labour force (persons)	1.6	1½	½	0
Employment (persons > 12 hours/week)	2.6	2	0	– 2
Unemployment rate (level in % of labour force)	4.5	4	4½	6½
Unemployment (level in 1000 persons)	344	300	350	495
Market sector [b)]				
Production	4.4	2¼	– 1¾	1¼
Labour productivity	1.8	¾	– ¾	4¼
Employment (labour years)	2.6	1½	– ¾	– 3
Price gross value added	0.6	1	3¼	1¼
Real labour costs	2.8	3¼	¼	1¼
	level in %			
Labour share in enterprise income	78.5	80½	81½	79
Profit share (of domestic production) c)	15.2	14¾	14	16
Public sector				
General government financial balance (% GDP)	0.3	1.3	– 1.2	– 2.4
Gross debt general government (% GDP)	44.7	56.7	52.0	53.9
Taxes and social security contributions (% GDP)	38.9	39.5	39.0	39.3

a) Export price competitors minus export price domestically produced goods.

b) Private sector excluding health care, mining and quarrying, and real estate.

c) Market sector excluding banking and insurance companies.