DISCUSSION PAPERS

GLOBAL ECONOMIC CRISIS: SOME IDEAS FOR THE G-20 AGENDA

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1
Introduction

The fact that the world has avoided the "meltdown" that some feared a year ago does not mean that the world will soon return to robust growth, nor does it mean that we have adequately addressed the underlying problems which led to the crisis. While the rehabilitation of the financial system may be necessary for a resumption of robust growth, it is not sufficient. In addition, of course, there remain the long festering problems of climate change and global inequality.

A situation where there is global excess supply reflected in high levels of unemployment and excess capacity, and, at the same time, huge unmet global needs should be viewed as unacceptable.

There still remains considerable uncertainty about the evolution of the crisis. There is still the possibility of further calamitous events, such as the failure of a major financial institution. In the United States, foreclosures are continuing, and there are serious potential problems in commercial real estate. The uncertainties in Eastern Europe have not been fully resolved.

In some cases, the full effects of the crisis have been muted, as firms, households and countries have drawn upon reserves (savings). The longer the downturn lasts, the smaller the remaining reserves, and the more fragile the economic system becomes, less able will it be to withstand another jolt, even of a smaller scale.

The withdrawal of the stimulus packages will itself have an adverse effect on growth. If this occurs prior to the restoration of robust growth, it could put the recovery in jeopardy, extending the length of time before the world's growth returns to normal. At the same time, the mounting national debts will put pressure on governments to scale back these government programs. Those countries that began the crisis with high debt to gross domestic product (GDP) ratios and those that had poorly designed bank bailouts, with high long run budgetary costs, may be in particular difficulties.

It is important that governments not give into such deficit fetishism. What matters is the countries' balance sheets; if liabilities are increased, but, at the same time, so are the assets, the country may be in a better position to meet future challenges. The implication is not to reduce spending, but to renew efforts to make sure that the money is spent well, in particular, on high yielding investments.

Even after growth resumes, unemployment (both open and disguised) is likely to persist, and there is therefore a need for continued assistance to these and other innocent victims of the crisis, including small businesses, many of whom are finding it difficult to get access to capital.

2
Recovery

For the economic recovery it is fundamental to address the following topics:

- **Growth Gap.** Global growth prior to the crisis was supported by debt financed consumption in the U.S. That model of growth has now been broken. Savings in the United States are rising markedly, and there are reasons to believe that it will remain at a high level. This means that there is a deficiency in global aggregate demand. This gap will persist even after the banks are fully repaired.

- **Underlying problems in inadequate global aggregate demand.** Little has been done to address other underlying contributors to inadequacy in global aggregate demand, the growth in inequality in most countries around the world and the accumulation of reserves by developing countries.

- **Global reserve system.** That is one of the reasons why a new global reserve system is of the utmost priority. The world is likely to move away from the current dollar-based reserve system, especially as the dollar is seen as a poor global store of value: it yields little return, and yet presents high risks. But, unless the international community works in concert to create a new global reserve system, the movement away from the dollar-based reserve system may contribute to global instability.

- **Developing countries are still in need of assistance.** They do not have the resources to respond effectively to the crisis. While the efforts of the G-20 to provide additional resources are to be commended, there are two problems: there needs to be a variety of channels of disbursement, including channels that have more confidence of the borrowing countries, and more of the money should be in the form of grants. The developing countries do not want to get themselves into another debt trap.

- **New credit facility.** There are deficiencies in all of the current arrangements, from both the perspective of prospective borrowers, and those countries with surpluses that might make their funds available. A new credit facility could be quickly established, seconding personnel from existing institutions. With a twenty-first century governance structure, and committed not to imposing counterproductive pro-cyclical conditionalities, such a credit facility could have enhanced support from both borrowing countries and potential creditor countries.

- **Beggar-thy-neighbor policies.** In spite of the affirmation of the leaders of the world in the G-20 meeting not to engage in protectionist measures, we note with concern the fact that so many of the countries have done so, often in ways that discriminate against developing countries. Yet, we should recognize that, without such affirmations —and without the "rule of law" provided by the World Trade Organization (WTO)—, matters almost surely would have been much worse.

3
Crisis Prevention and Economic Restructuring

As countries work to maintain their economy, they should focus on what kind of economy they want to emerge after the crisis. This crisis was not just an "accident," a once in a hundred year flood. It was man-made, the result of policies that were pursued in several of the advanced industrial countries. Recovery programs should be used to help restructure economies, in line with changes in global comparative advantage and technology. Unfortunately, in some countries, large amounts of money have been spent to preserve the status quo. This will present problems going forward.

Of particular concern are the consequences of bank bailouts, which may have led to banking systems that are less competitive, more concentrated, and with a relative diminution of those parts of the sector which provide capital to medium and small enterprises. In some countries, the problems of too big to fail, too big to be resolved, too intertwined to be resolved, and too big to be managed, and almost too big to be bailed out institutions have worsened. The bailouts have, moreover, increased the problem of moral hazard, especially for the too big to fail, too big to be resolved, and too intertwined to be resolved institutions.

Implicit and explicit subsidies provided to these institutions distort the economic playing field, creating an unhealthy dynamic in which these institutions are favored over smaller institutions that do not represent such a threat to the stability of the economy. It is imperative that governments take actions to limit these distortions, by preventing the growth of these institutions, by restricting the extent of their risk taking, by restricting the products that lead to intertwining, and/or by imposing sufficiently high direct or indirect taxes, e.g. through substantially higher capital adequacy ratios or higher deposit insurance fees. In addition, all such large institutions should have in place and disclose to regulators plans for their orderly unwinding in ways that would not require government assistance either to themselves or to other market participants, and such plans should be updated on a regular basis. There is little evidence suggesting large economies of scale or scope, but ample evidence suggesting large negative externalities by these institutions on others.

The financial sector as a whole became bloated. It is a means to an end, not an end in itself. But in spite of its size, it failed to perform well its essential functions of allocating capital and managing risk. Part of the restructuring of the economy should be a downsizing of the financial sector, doing so in ways that enhance and strengthen those parts of the sector which support new enterprises (venture capital) and small and medium sized businesses.

There is an emerging consensus that there is a need for substantially more and better regulation than before the crisis —and better enforcement; but the devil is in the detail, and statements of principles, even if widely agreed to, are not likely to suffice. Thus, moves to encourage derivatives to be transparent and traded over exchanges are welcome, but proposals to allow the continuation of over-the-counter trades without full disclosure of individual transactions (necessary to assess the nature of counterparty risk) are worrisome, even if such trades are accompanied by higher margin requirements. If the additional margin requirements are too small, then trading in the less-than-fully-transparent over the counter (OTC) may continue little abated, posing large systemic risk.

By the same token, moves to increase transparency are important, but by themselves insufficient. Knowing the address of a financial institution that might pose systemic risk to the global economy is a move in the right direction, but needs to be accompanied by measures that prevent such institution from posing systemic risk. Similarly, it is important for governments to have enhanced powers of "resolution." But if the underlying economics are not changed, governments may be induced to repeat what has happened in this crisis —a bailout of bondholders and shareholders. The alleged reason for these bailouts was that not doing so would impose high economic costs.

There is little doubt that distorted incentive structures contributed to the crisis. There is a need for international cooperation in restricting especially the structure of incentives (ensuring that they focus on long run returns and that there are adequate claw back provisions), and particularly so for institutions that may potentially impose systemic risk to the economy. Countries should consider adopting incentive structures to encourage better compensation systems, e.g. by allowing banks that have such compensation schemes somewhat low capital adequacy requirements, and by diverting government transactions and deposits to such financial institutions. Measures that should be taken into account are:

- **A financial product safety commission.** The financial system created products that exploited uninformed individuals and resulted in their bearing risks that were beyond their capacities. Countries should consider creating a financial products safety commission, to determine the safety and efficacy and suitability for various purposes of various products marketed by the financial sector.

- **New mortgages.** The failure of the markets to devise better mortgages suggests the need for a more active government role, both in restricting products currently sold and in creating new products that might lead to a more stable housing market (e.g. the Danish mortgage bonds).

- **A twenty-first century electronic payments system.** Modern technology has allowed for the creation of an efficient electronic payment system, but in many countries, the financial system has used anti-competitive practices to extract huge rents from its control over the payments mechanism. These anti-competitive practices should be forbidden, and actions should be taken to create a global efficient modern electronic payments system.

- **Bank secrecy.** There is little evidence that hedge funds or transactions in offshore banking centers played a central role in this crisis. Still, tax evasion, corruption, and illegal activities that were supported by the secret bank accounts undermine the functioning of governments and markets. Any conclusion that all countries had met the standards that had been set suggests that the standards may have been set too low. There need to be provisions for the automatic exchange of information. While tax evasion may be of particular concern to certain developed countries, the issue of corruption is of particular concern to many developing countries. Safe haven for funds obtained through corruption is sometimes provided not only by offshore but also by onshore banks. And there is continuing concern about the repatriation of misappropriated funds, once discovered.

The problems that have been revealed by this crisis extend beyond the financial sector. Problems in corporate governance partially account for the flawed incentive structures; deficiencies in competition laws and their enforcement help explain both the growth of too big to fail institutions and the ability of the financial sector to suppress the development of an efficient electronic payments system. Global cooperation in setting regulatory standards is required if there is not to be a race to the bottom. Financial institutions in any jurisdiction that fail to adopt adequate regulatory standards should be prohibited from interacting with financial institutions in well-regulated jurisdictions.

A key test of the adequacy of proposed regulations and regulatory institutional reforms is to ask, were these reforms in place, would they have prevented the occurrence of the current crisis. In this respect, there should be concern about proposals to delegate more responsibility to regulatory institutions which clearly failed to perform their responsibilities in crisis prevention prior to the crisis without substantial reforms in their institutional design.

4
Dealing with the Aftermath

Many countries have taken on large amounts of debt in order to prevent the crisis from becoming worse. Even without such countervailing actions, deficits would have grown, simply because downturns lead to lower tax revenues and greater expenditures. The way that the bailouts were handled in several countries has especially contributed to the size of the long run national debt. While it is natural that governments respond to these mounting deficits by a cutback in expenditures, it is imperative that the services to the poor and basic investments, such as those in infrastructure, education, and technology be maintained. To do otherwise would increase the long run costs of the crisis and impose additional costs on the innocent victims of this crisis. Governments should eschew deficit fetishism: what matters are countries' balance sheets, and if public money is spent on high return investments, then while there has been an increase in liabilities, there can be a more than offsetting increase in assets.

It is also imperative that the financial sector be made to bear the costs of the crisis. To do otherwise would be neither fair nor efficient. The repeated bailouts are, in effect, subsidies to the financial sector, and such subsidies contribute to an over-bloated sector and undermine incentives. Increasing the progressivity of the income tax system will not only increase the sense of social justice, but also help stabilize the economy —such taxes act as automatic stabilizers.

One of the key challenges going forward will be the design of an *exit strategy.* Uncoordinated removal of bank guarantees could lead to unstable movements of capital from countries no longer having such guarantees to countries still offering them. Reducing stimulus packages acts as a "negative shock" to the economy, and unbalanced, sudden, and especially premature reductions in these stimulus packages could lead to an interruption in the recovery.

Before the crisis, there was a concern about global imbalances and the possibility of a disorderly unwinding of these imbalances. Part of the world was consuming far more than it was producing, while another part was doing just the opposite. What was especially peculiar about these patterns was that the country that was consuming beyond its income had a demographic structure that might have led one to expect it to have large savings. There are some reasons to believe that there may be adjustments going forward, but unless the adjustments are well coordinated, there can be further strains on the global economy. For instance, it would make sense for the United States to respond to the crisis by increasing its savings rate, and there is evidence that it is happening. But unless China and the other "surplus" countries increase their spending markedly, this will give rise to a persistence of a global inadequacy of aggregate demand. There is no reason for the two adjustment processes to move in tandem.

One of the reasons why many developing countries have accumulated large surpluses is as a form of insurance against global volatility. The “safety net” provided by the International Monetary Fund (IMF) in recent crises was sufficiently unpalatable so that most countries do not wish to rely upon it, if they can avoid it. Alternative global insurance schemes might reduce the need for reserves, but none of those proposed so far are likely to give developing countries sufficient comfort. The one approach that seems most promising is the expansion of the global reserve system discussed earlier (and in the United Nations [UN] *Commission Report,* Chapter 5).

Oil and other natural resource countries have strong incentives for precautionary savings, which also undermine global aggregate demand. Recent studies suggest that speculation may play some role in this volatility. If so, a coordinated global tax on capital gains may dampen such speculative activity. It would be imprudent, however, for countries with highly volatile incomes not to engage in precautionary savings.

Some developing countries may have used exchange rate policies as instruments to encourage the development of nascent sectors, including industrial sectors, to promote exports and economic growth. Such broad based measures may have advantages over more narrowly based industrial policies, which in any case face restrictions within the WTO framework. The right to development has to be recognized. The question is how to facilitate best such development in a sustainable way. Export led growth may have provided a model which worked for an extended period of time, but it is obvious that not all countries can have exports exceed imports, and with the sum of the deficits equaling the sum of the surpluses, it is not sustainable for a single country to be the “deficit of last resort.”

Whatever the reason why countries have engaged in large accumulations of reserves, the creation of a global reserve system would mitigate the adverse effects on global aggregate demand and contribute to global stability.

5
Global Governance

The G-20 has made important commitments to improve the institutions and arrangements for managing global globalization. It is important that these be effectively implemented, e.g. that the choice of the heads of the international institutions be chosen on the basis of merit. Still, it should be clear that the pace of reform is slow and the reforms on the table, while moving in the right direction, may be insufficient to address the criticisms. For instance, while giving China and other emerging markets more voting rights is desirable, there is little reason to believe that it will result in fundamental changes on the behavior of the International Financial Institutions. More fundamental reforms, e.g. double majority voting, should be considered.

Other ways of increasing accountability of the international institutions need to be explored. While proposals to strengthen "reporting" to a more politically accountable body, such as a Council of Finance Ministers, might seem to do this, such reforms may have the opposite effect; if the Finance Ministers are insufficiently engaged, it would, in effect, give more autonomy to the bureaucracy. Reporting to the Global Economic Coordination Council or the G-20 leaders might, at least on certain key decisions, such as the extent of conditionality in lending or the role of the international institutions in promoting global public goods, be helpful.

At the very least, there should be a commitment that these international institutions accord with the best practices of transparency and governance; this means, for instance, full disclosure consistent with the strongest Freedom of Information Acts and instituting restrictions on revolving doors. On a number of occasions, such as the determination of standards for bank secrecy, the international community has turned to the Organisation for Economic Co-operation and Development (OECD) as an independent "think tank" for the international community. But it remains an institution of the advanced industrial countries. There is need to create an analogous international institution embracing developed and developing countries.

6
Concluding Remarks

- The broad economic and political agenda described above must be addressed within a framework which is consistent with our basic values and principles, which emphasize the importance of social justice and solidarity, both within each country and globally.

- We have noted that financial systems are a means to an end, not an end in themselves, and this confusion of end with means has contributed to the current crisis. But the economy itself should be viewed as a means of enhancing the well-being of our citizens.

- In this respect, we need to recognize the limitations of GDP as a measure of well-being. What we measure affects what we do. Some of the trade-offs between "GDP" and the environment might appear to be false trade-offs, if we have better metrics. Global and national efforts to improve systems of measurement, including by the International Commission on the Measurement of Economic Performance and Social Progress and the OECD, should be encouraged and expanded.

- There will be many innocent victims of this crisis, and there needs to be renewed efforts to protect these. This is especially so because the recovery of the labor market (return to normalcy) is likely to be slow.

- Strengthening automatic stabilizers through the enhancement of social protections and increasing the progressivity of the tax structure would contribute both to the stability of the economic system and to a broader sense of social justice and solidarity.

- This crisis has frayed many critical aspects of our social compact. Ordinary citizens have been asked to bail out wealthy banks, which have used some of the proceeds to pay bonuses to their executives. Workers have been asked to take cutbacks in wages, while the contracts of those highly paid executives of financial institutions have been treated as if they were sacrosanct. In some cases, the profits of the banks have been based on exploitation of the least educated members of society. In some countries, growth has been based on exploitation of the environment; given the pace of climate change, the growth path of the world is clearly unsustainable. The crisis should be an occasion for reflection, for re-establishing the social contract among the members of society today, between the developed and developing countries, and between this generation and future generations.

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