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THE GLOBAL ECONOMIC CRISIS: THE CRUCIAL ISSUES

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1. The dramatic recession under way

The financial turmoil erupted in the US in mid-2007 and soon after in some European countries (particularly the UK), speeded up with the collapse of Lehman Brothers in mid-September 2008, and has now become the worst financial crisis since the Great Depression and the worst recession since the Second World War. The crisis is global and systemic in character. The GDP of industrial countries has been falling at annual rates of 7 to 8% during the last quarter of 2008 and the first quarter of 2009. IMF projections for world GDP now indicate that it will fall 2.5% at market prices, and will not recover its 2008 level until 2011. However, a longer recession and even a depression (reduction of GDP for several years) are clear possibilities.

International trade has collapsed since the last quarter of 2008. WTO and IMF projections indicate that it will fall between 9% and 11% in volume terms in 2009. In turn, commodity prices fell by 59% during the second semester of 2008. An implication of this is that countries more open to international trade are hardest hit. This includes Japan and Germany among industrial countries, as well as the first generation of Asian Tigers (Korea, Singapore and Taiwan) and Mexico. Even China experienced a sharp export contraction.

Emerging and developing countries partly "decoupled" during the first phases of the crisis, but are now severely affected, through three major channels: (i) the collapse of international trade and commodity prices; (ii) the paralysis of external financing and outflows of the most volatile capital; (iii) reduced remittances (the World Bank projects a 6% reduction in 2009, but this may turn out to be an underestimation). Central and Eastern Europe have been hardest hit through the financial channel, and the Asian Tigers and Latin America through the trade channel.

As the crisis deepens, its social costs have also been mounting. ILO has estimated that the crisis will increase unemployment in 2009 by 30 to 50 million people, and that there will be a much larger increase in the number of working poor (up to 200 million, based on a two

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dollar a day line). The latter is likely to be the most important outcome for developing countries.

The international and domestic political implications of the crisis are also deep. Nationalism is clearly on the rise, and is leading to a resurgence of protectionism under different guises. The most undesirable outcome of the current crisis would undoubtedly be repeating the beggar-thy-neighbor policies that magnified the effects of the Great Depression. Mounting political tensions within countries will also be the rule rather than the exception, stressing the capacity of democratic regimes to process conflict in an institutional way.

The roots of the crisis will continue to be debated for a long time. The major issue was undoubtedly the excessive confidence in the capacity of financial markets to self-regulate and self-correct in the face of disturbances. By now the regulatory deficit in finance is broadly recognized. It has also become clear that the dominant economic paradigm provided a grossly inadequate lens to analyze reality. Equally important, the Financial Stability Forum and the IMF failed in giving warning of serious problems to come, as did the regulators and supervisors in major industrial countries. Most analysts now agree that the expansionary monetary policy of the first half of the 2000s and global imbalances also contributed to the crisis, though interpretations of how they did differ among analysts.

2. The economic policy response

The magnitude of the financial meltdown and world recession under way has already generated a strong response by economic authorities. The earliest were the measures by central banks to provide liquidity, which were dramatically scaled up after the collapse of Lehman Brothers in mid-September 2008. These measures were effective in overcoming by late October the panic generated by the collapse of Lehman Brothers, but have not been effective in generating a recovery of lending. As a result, central banks have been moving towards even more aggressive policies, generally referred to as "quantitative easing", which may be understood as a shift in emphasis from increasing *liquidity* to reactivating *lending* and reducing the interest rates that borrowers pay. The US Federal Reserve has been the most aggressive in this regard.

A second focus of authorities has been how to manage the collapse of numerous financial institutions, which are now seriously undercapitalized or outright bankrupt. The solutions have so far proved insufficient, particularly in the United States. There is now broad recognition that a temporary nationalization of financial institutions can be the best and least costly instrument in the long-term, as the initial capital injections can be partly or fully recovered when these institutions are re-privatized later on, but the U.S. has been very reluctant to go in this direction. A second ingredient of financial bailouts has been the creation of mechanisms to buy "toxic assets". This has also been an area of limited success, given the technical difficulties in valuing complex and heterogeneous financial assets. The third ingredient has been enhanced deposit insurance. There has been broader success in this regard.

A major effort to stabilize financial institutions is crucial, to avoid the protracted distrust in financial institutions that affected Japan during its "lost decade". An equally important problem is the fiscal cost and the transparency of the associated bailouts, which can result in massive subsidies to bankrupt investors.

A major agreement in the international debate has been the recognition that the deficit in financial regulation must be corrected. It is in this area that the G-20 has been most useful, particularly in agreeing on certain principles. The first principle is that regulations must be comprehensive or at least much broader in scope, and should therefore include hedge funds, credit rating agencies as well as the types of transactions that led to the current crisis, particularly securitization and derivatives. Systemically important financial intermediaries must be subject to particularly harsh supervision, and those with global reach should be subject to truly international supervision (such as the college of supervisors proposed by the G-20). A second principle is that prudential regulations should have a counter-cyclical focus, thus forcing financial institutions to accumulate increasing capital, provisions (reserves) and liquidity cushions during booms. They should also be subject to absolute limits on leverage (the ratio of assets to the capital of institutions). Consumer protection (to avoid their use of complex financial instruments) also figures out prominently in several proposals. Since the current wave of bailouts is likely to result in higher concentration in the financial industry, restricting monopoly power should also figure out prominently in new regulations.

Monetary and credit measures are unlikely to be sufficient to guarantee a strong recovery. The basic reason is that private sector demand - consumption as well as investment - is likely to be weak for some time. This has been the experience of financial crises in many countries. Therefore, although restoring credit is a priority, monetary and credit stimulus is likely to be insufficient. This is why expansionary fiscal policies are essential. Also, and since the objective is to increase aggregate demand, additional public sector spending policies are preferable to tax benefits.

The strong decisions in the fiscal area by the United States have not been followed by most European countries. This may reflect a tendency to underestimate the intensity and likely duration of the crisis. The growing weakness of the eurozone (and eventual costs of a crisis of the monetary union) is undoubtedly behind the reluctance of EU countries to provide more fiscal stimulus, indicating that saving the monetary union is top in their agenda. However, European countries have stronger automatic stabilizers than the United States, particularly more generous unemployment insurance. The improvement in social protection systems and incentives to keep existing jobs and create new ones should be top in the agenda of all countries.

The fact that many developing and emerging countries have accumulated large amounts of foreign exchange reserves in recent years, and have lower external and public sector debts than during previous crises, imply that they have more room to maneuver to adopt expansionary policies than in the past. But there is a consensus that this is insufficient, and that new financing mechanisms have to be available to allow them to play a role in the global recovery. This is behind the initiative of the G-20 to increase the availability of multilateral financing, particularly through the IMF. This requires that countries demand these resources, given the limited and highly conditional financing that the Fund provides. An important step was taken in March 2009, when the IMF created the Flexible Credit Line and doubled the size of other credit lines, eliminated ex-post conditionality for the first and structural benchmarks for all facilities.

3. The broader agenda

The current crisis has shown, finally, how dysfunctional the current international financial architecture is to manage today's global economy. Despite this fact, the focus of international negotiations has been limited. They have concentrated on the coordination of

macroeconomic policy and strengthening financial regulation. In both areas, clear institutional mechanisms should be put in place to manage coordination at the global level. The G-7 and now the G-20 seem to have a strong preference for managing macroeconomic policy coordination in a direct (though rather weak) way, and financial regulation through their own body, the renamed Financial Stability Board. Both mechanisms exclude medium-sized and small countries, and raise serious questions in relation to the nature of global governance.

Furthermore, these issues do not exhaust the agenda of international financial reform, which include four other topics. The first is the need for a new international monetary or global reserve system, less dependent on the use of a *national* currency (the US dollar) as a global currency. It can be based on the broader use of the IMF's Special Drawing Rights. The second is the need for a better mechanism to manage sovereign debt crises and cross border bankruptcies, by creating an International Insolvency Court. The third is reviewing the role of capital account regulations in strengthening financial stability at the global level. The fourth is the need to strengthen international tax cooperation, by avoiding tax competition and increasing information to combat tax evasion.

Institutional issues are equally important. The preference for informal organizations with restricted membership chosen by the major industrial countries is problematic, as is the inadequate representation of developing countries in international economic decision making in general. The world's governance system must be based on *representative institutions*, not on any G, which will always face problems of legitimacy. It is necessary, for the same reason, to involve the United Nations, the most representative global institution, perhaps by taking the step of creating a Global Economic Council in the United Nations, with effective powers of coordination over the system of global economic and social governance.

The institutional design should also take into account the role of regional institutions. Among other virtues, these institutions give stronger voice and sense of ownership to smaller countries, and are therefore more likely to respond to their demands. An institutional design in which regional institutions have an important role is already in place in the system of multilateral development banks. It should be extended to others, such as macroeconomic and monetary cooperation, financial regulation, international debt workouts and tax cooperation.

4. Parliaments' agenda

Based on these considerations, the agenda for national and regional parliaments is broad, and include the following issues:

- Helping governments design better counter-cyclical policies, particularly in the fiscal area.
- Designing better social protection systems and incentives to keep existing jobs and create new ones, to manage the social effects of the crisis.
- Guaranteeing the transparency of financial bailouts.
- Helping avoid the resurgence of protectionism.
- Improving financial regulation.
- Strengthening international cooperation and helping in the design of a better structure of global and regional economic governance.