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Gn meeting in Rome, May 2009

The outlook is still bleak

The impact of the crisis is still deepening and widening, and we now need expeditious and determined policy responses to stem the hemorrhaging of global demand, and specific emerging measures for the most vulnerable countries and people. But beyond that, the systemic failures in global finance and in international economic governance call for bold, long term solutions and a profound rethinking about the global framework of financial regulation and multilateral cooperation in macroeconomic management, including about the role of the international financial institutions.

Current responses at the level of the G-20 and the United Nations General Assembly signal that the imperative of multilateral coordination has gained wider recognition in the current circumstances, but it seems there is still no consensus in the international community on the concrete steps to be taken towards a reform of the international monetary and financial system.

The immediate global and regional economic outlook remains grim, and, while being particularly concerned about the impact of the crisis on the developing world and the most vulnerable poor countries, my perception of the course of the world economy at this stage does not differ significantly from that presented by the IMF and others. However, now, as the landing has turned out to be even harder than the greatest pessimists would have predicted, the poorest populations in developing countries, fully innocent of any responsibility for igniting, feeding or otherwise contributing to the financial crisis and the ensuing recession, are likely to feel the burden of adjustment burden in the most painful way, that is by increasing unemployment and poverty, and a setback in the fight against hunger and malnutrition.

Short term policy responses portray something of a mixed bag: most impressive so far has been the United States fiscal stabilization packages, coupled with monetary easing to encourage re-ignition of the credit markets. Governments of many other countries acted in recognition of the need for stabilizing policies, but in many countries, especially in Europe, it seems to be more difficult to overcome fiscal conservativism, and to engage in more consequent expansionary fiscal action. Unfortunately, this pattern of demand-boosting policies is unlikely to help correct global imbalances in sustained manner: it tends to repeat the earlier pattern in the distribution of global demand growth that led to the build-up of the global current account balances.

Meanwhile, emerging surplus economies are resorting to their recently-regained fiscal space to boost demand at their end of the global economy. This may help to contain the negative income and employment effects at home, but, through the trade channel, it also helps generate a demand stimulus for other countries. This shows the importance of an internationally coordinated expansionary action, aiming not only at a stronger overall stimulus for the world economy, but also at avoiding free-riding of countries benefiting from the fiscal packages undertaken in other countries, where debts resulting from current deficit spending will have to be serviced from future public revenue.

Deflation is the imminent threat

Given the sharp contraction in industrial output in the developed countries, the immediate danger is deflation. With many prices like those for commodities falling already, an absolute fall of the price level can no longer be avoided. The critical question, however, is whether this marks only a temporary, one-off corrective drop or whether this may be the beginning of a longer period of deflation. The more households, businesses, banks, and other economic agents directly involved in speculative activities with borrowed funds, the greater the pain of adjusting the level of borrowing to diminished revenues.

The "debt deflation" that sets in fuels further painful adjustment as debtors try to improve their financial situation by selling assets and cutting expenditure, thereby driving asset prices further down, cutting deep into profits of companies and forcing new debt deflation elsewhere. Consequently, the danger of falling into the deflationary trap justifies aggressive and persistent monetary and fiscal policies, including "quantitative easing" and the build-up of new government debt.

Deflation will not cure itself. Debt deflation underpinned by contracting private demand can only be countered by government action. Therefore, the most important task is to break the spiral of falling asset prices and demand and to revive the financial sector's ability to provide credit for productive investment to stimulate real economic growth. Since the market system is not self-correcting with respect to deflation, governments and central banks have to take active measures to boost demand through interest rate cuts and increases in government spending.

But, in such a scenario, voices continue to be heard regarding the danger of an inflationary acceleration later, allegedly through the channel of "too much money chasing too few goods". However, to become inflationary in a market economy, "too much money" has to go either through the channel of "too much demand" or "too high costs", in particular labour costs. Obviously, the situation of the world economy is far from either of these being realistic channels for inflationary acceleration. Capacity utilization is at historic lows and unemployment is rising with dramatic speed, which will clearly prevent wage inflation for a considerable period of time. Once the global economy begins regaining normal capacity utilization and employment levels, possibly in a matter of years, not months, it will be possible for central banks to mop up excess liquidity by selling revalued assets and absorbing excess money supply. Hence, fears that "too much money" or rising government deficits could reignite inflation appear unjustified and could be misleading in the current depressed global economy.

Is the IMF the right fire brigade?

At the multilateral level, replenishment of IMF resources should allow it to begin to act on behalf of international community in fighting fires as they erupt in countries which are increasingly strained to roll-over their external debt as they face strong currency depreciation pressures. But it is not only enlarged access to official finance that matters for developing countries in order to counter the recessionary effects of the global crisis, it is also important that access to these resources allows governments to undertake expansionary, counter-cyclical action. Unfortunately, IMF conditionality still tends to compel countries to tighten monetary policy and to curb public spending. Not only is this precisely the opposite of the new "Keynesian" policies adopted in United States and other developed countries, in most cases, such policy action is also likely to make matters worse. This should be a time when the international community seriously begins to rethink its paradigm of national monetary sovereignty in a globalized economy and opens the door for an approach of financial and monetary cooperation that is better in line with the needs of macroeconomic policy and the international trading system.

Moreover, there is a high risk that developing countries will not only be affected by the crisis through a repatriation of foreign capital, higher cost of, and more difficult access to, external financing from capital markets, a slowdown of foreign direct investment, sharply reduced export earnings and reduced inflows of workers' remittances, but also through reduced inflows of official development assistance. Such reductions would be counter-productive also for donors, as they would finally lead to a reduction of their exports to the aid-receiving countries. Rather than cutting ODA, donor countries should raise aid flows as a part of their stabilization programmes. To go a step further, it may be worthwhile considering a temporary moratorium on official debt: both debtor and creditor countries would probably better served in the current crisis situation if scarcer foreign exchange earnings in the debtor economies can be used for the purchase of imports rather than for debt servicing.

Long-term responses so far remain peripheral to the core systemic failures that this crisis reflects and this stems from the unwillingness to recognize the impact of unfettered financialization and the interaction of unchecked securities, commodity futures and currency speculation. There is lingering concern, both among policy makers and within broad swaths of public opinion, that bank bailouts will socialize private losses, Moreover, measures to date pay inadequate attention to the need to regulate the shadow banking system where opacity, illusion of risk-free profits and perverse incentive systems all contributed to the failure of the "modern" financial system, which in too many respects had begun to resemble a casino economy.

The G20 Summit has confirmed that a new spirit of pragmatism in economic policy prevails and we can see the first "green shoots" of a yearning for multilateral coherence that has been sorely lacking in recent years, indeed decades. The resource commitments already made, including those which entail replenishing IMF resources and new issuance of SDRs are a recognition of the fact that at such a moment, only the IMF has the machinery to channel resources to the next battle front. Certainly, the availability of such resources cannot be held hostage to the still unsettled debate about voice and participation in the Fund. It is also important to encourage the move away from the old attitude that “if a country is in crisis, it must be its fault” and to acknowledge that developing countries are mainly innocent bystanders hit by crises that originate at the center of the world’s financial system. In order to face these external financial shocks, developing countries need to be provided with ample liquidity with no strings attached.

While the increase in the Fund’s ability to lend partly addresses problems’ related to its ability to “supply” funds, it does not address problems on the “demand” side. Countries are reluctant to approach the Fund because they feel that the macroeconomic model which is at the basis of Fund policies is not the right one. The legitimacy problem facing the Fund today is not only due to the fact that several developing countries are underrepresented in its Board, but it is also related to the fact that most potential borrowers have become more skeptical with regard to the Fund’s policy advice.

IMF resources are often conditional upon what amount to restrictive fiscal and monetary policies. But the conventional wisdom that has emerged in this current crisis rightly warns that such conditionality would be pro-cyclical and not conducive to the sort of domestic demand stimuli that export-dependent developing countries will need to deploy if they, too, are to play their part in countering the collapsing, or at best stagnant, global demand. If the Fund continues to insist upon the same sort of policy packages as rolled out during the Asian crisis, the increased money may even end up being counterproductive.

The initial multilateral response must be further strengthened, with coordinated approaches that go beyond simply providing global liquidity at a time of unprecedented recession, however urgent such fire-fighting might be. Better regulation of growth-inducing finance should proceed alongside a frank evaluation of the social costs and benefits and economic risks inherent to more predatory, unproductive forms of shadow finance.

Systemic failures have to be addressed

The crisis is global and systemic in nature. Its dynamics reflect failures in national and international financial regulation, persistent global imbalances, absence of an international monetary system and deep inconsistencies among global trading, financial and monetary policies and arrangements. Market fundamentalist laissez faire of the last twenty years has dramatically failed the test. Financial deregulation within and across nations allowed the build-up of huge risky positions whose unwinding has pushed the global economy into a debt deflation that can only be countered by the inflation of government debt:

The most important task is to break the spiral of falling asset prices and falling demand and to revive the financial sector's ability to provide credit for productive investment, to stimulate economic growth and to avoid deflation of prices. The key objective of regulatory reform has to be the systematic weeding out of financial sophistication with no social return. Blind faith in the efficiency of deregulated financial markets and the absence of a cooperative financial and monetary system created an illusion of risk-free profits and licensed profligacy through speculative finance in many areas:

This systemic failure can only be remedied through comprehensive reform and re-regulation that acknowledges the need for a vigorous role by governments working in unison. Contrary to traditional belief, governments are well positioned to judge price movements in those markets that are driven by financial activities and should not hesitate to intervene directly and indirectly whenever major disequilibria are looming.

The growing role and weight of large-scale financial investors on commodities futures markets has affected commodity prices and their volatility. Speculative bubbles have emerged for some commodities during the boom and have burst after the sub-prime shock: Regulators need access to more comprehensive trading data in order to be able to understand what is moving prices and intervene if certain trades look problematic, while key loopholes in regulation need to be closed to ensure that positions on currently unregulated over-the-counter markets do not lead to 'excessive speculation'.

The absence of a cooperative international system to manage exchange rate fluctuations has facilitated rampant currency speculation and increased the global imbalances. As in Asia ten years ago currency speculation and currency crisis has brought a number of countries to the verge of default and dramatically fuelled the crisis: Countries, in particular developing countries, should not be subject to a "crisis rating" by the same financial markets, which have created their trouble. Multilateral or even global exchange rate arrangements are urgently needed to maintain global monetary and financial stability, to avoid the collapse of the international trading system and pro-cyclical policies by crisis stricken countries.

The crisis has made it all too clear that globalization of trade and finance calls for global cooperation and global regulation. But resolving this crisis and avoiding its recurrence has implications beyond the realm of banking and financial regulation, going to the heart of the question of how to revive and extend multilateralism in a globalising world.
The United Nations must play a central role in guiding this reform process. It is the only institution which has the universality of membership and credibility to ensure the legiti-

macy and viability of a reformed governance system. It has proven capacity to provide impartial analysis and pragmatic policy recommendations in this area.