Macroeconomic Issues in Addressing the Crisis
Chair's Summary

1-Besides the immediate causes of the crisis (subprime lending and the dysfunctioning of the global financial markets), there are deeper macroeconomic factors explaining the present turmoil. Hence, the discussion started with a consideration of the underlying macroeconomic issues. Three major macroeconomic sources of the crisis were (a) underlying global imbalances; (c) inequalities in the global economy; and (c) the increased global instability resulting from certain policy choices in recent decades. In most advanced countries, the average wage almost stagnated during a quarter of a century, while inequalities surged. The imbalances and inequalities created a situation of lack of global aggregate effective demand, which was hidden by increased indebtedness by consumers and the private sector. One may even argue that the increase in public debt in OECD countries was partly the consequence of this evolution. In countries were the social protection system is well developed (Europe), it helped compensate for stagnating income in a context of high unemployment but at the price of an increased public deficit. In countries were the social protection system is much weaker (say, the US), fiscal policy was the instrument to avoid increased unemployment, with obviously the same consequence on public debt. This structural lack of global effective demand, even if hidden by mounting debt, was exacerbated by emerging countries building up reserves to avoid for potential instability. The building up of reserves is a natural response to earlier crises (including those of the 90s) and the way they were managed, with high economic and political costs to affected developing countries, including the loss of their economic sovereignty. In addition, many countries which chose a current account surplus strategy (exports as a key source of growth) pushed reserve-building beyond prudential levels. With the exception of the US, most countries were also hewing close to fiscal discipline Finally, soaring oil problems contributed to the problems of global imbalances in the immediately preceding years. To offset the depressing effects of high oil prices on oil-importing countries (like the United States) there was a need for either looser monetary or fiscal policies. A focus on price stabilization precluded extensive use of monetary policy, forcing the burden of adjustment (especially in the U..S.) on fiscal policy.

Economic reforms also led to increased instability, from the dismantling of automatic stabilizers, such as moving toward defined contribution to pension system, greater wage flexibility or the leaning of the welfare state.

The consequences of loose monetary policy and low interest rates (partly reflecting the global imbalances noted earlier) were compounded by loose regulation. It led not only to bad lending, but also to a drive to increase returns through high leverage—at the expense of great risk. There is broad agreement now that financial liberalization on the international and domestic level has not promoted economic development, and exposed countries to high levels of instability. This crisis is only the most recent of many. Financial institutions have repeatedly failed to make appropriate assessments of credit-worthiness and there have been repeated bail-outs. It is not even clear that financial liberalization serves its intended purpose of increased innovation to facilitate better risk management and resource allocation The failure of financial markets to perform their key function has generated massive externalities to the real sector, and capital market liberalization and global financial market integration has meant that failures in one country (in this case, in the U.S.) can adversely affect others.

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The challenge now is to readjust these imbalances and to address the inequality question seriously. We need to address both the current and longer term problem of insufficiency of global aggregate demand and the problem of systemic instability. This would require a new global economic system based on a different economic framework. In order to create a "global public economics", Atkinson (2003) suggested that three conditions be met: "the analysis of national policy in a global context"; "the analysis of policy incidence in an interdependent world"; "the application of principles of cosmopolitan justice to the normative issues of global policy making." These principles should be applied when dealing of the issues concerning our Commission. A key challenge is how to reconcile legitimacy with economic and political power.

2- Measures are needed very quickly to avoid a further deepening of the crisis in emerging and developing countries, including restoring social protection, and reducing the procyclical features of the economic system. Many developing countries face constraints that naturally lead to pro-cyclical policies: in a downturn, they loose access to finance and so must constrain their budgets; to prevent capital flight, they have to raise interest rates. They suffer, in addition, from a lack of automatic stabilizers Many of these countries have been constrained further by International Financial Institutions to adopt restrictive policies in time of slow growth or even recessions. ,. If measures from the international community are not taken quickly, in the current crisis, they will also suffer from the crisis responses of developed countries. The latter have two distinctive advantages – the credibility of their guarantees is obviously greater; and the sheer fact that they are rich which implies that they have the means to engage in massive countercyclical policies and bail-outs. In particular developed countries bailouts of their banks and firms put developing countries at a disadvantage because their resources are more limited and their guarantees do not have the same credibility. In the short-term, policies to enable developing countries to exercise countercyclical policies, social protection schemes, infrastructure development, and credit guarantees are thus indispensable. Subsidies are recognized as a form of protectionism, but are even more unfair than tariffs, since they are an instrument only available to the rich. If developed countries are to engage in such policies (the group did not discuss the wisdom of these policies), they must provide countervailing assistance to developing countries to ensure fair competition. (In light of this experience, it may be necessary to reconsider certain rules of the global trade regime, including those pertaining to subsidies and to financial sector regulation) . Furthermore, developing countries need low-conditionality and compensatory financing to tackle volatility in commodity prices and other external vulnerabilities which do not arise from their domestic policies.

3-During the recovery phase in particular, developing countries need access to new credit and liquidity facilities for social protection, infrastructure investment and environmental interventions. In the longer term, the global system should provide financing for developing countries' countercyclical interventions. The options for achieving this financing are: (a) existing institutions, including IMF and World Bank, but that requires that the problem of conditionality is resolved, (b) special funds in existing institutions with different governance arrangements, and (c) new institutions/credit facilities. The other question is where the new resources will come from. Here different possibilities which are not mutually exclusive exist: (a) new allocations of SDRs, (b) increased contributions from developed countries (discussion emphasize the importance of developed countries not reducing their foreign aid budgets at this time), (c) contributions from countries with large international non-borrowed reserves, (d) regional arrangements such as Bank of the South and swap arrangements like the Chiang Mai initiative.

There was a shared view of the group that the SDR allocation is the most promising and perhaps politically achievable suggestion that the Commission can make at this time. Allocation of SDRs should be seen as a key response to the credit crunch. But the other options underlined should not be forgotten: developed countries would have no excuse for reducing their aid budgets while playing an unfair competition game; international non-borrowed reserves could be profitably used for the advantage of both for the reserve countries and the recipient ones; regional arrangements exists already and their development would bring more stability at the regional level.

4-It is important the crisis response take fully into account the need for transforming the present mode of growth by trying to slow down the overexploitation of natural resources, and the excessive emissions of greenhouse gases contributing to global warming and climate change, which may imply a change in consumer habits. Investment into new technologies of environment and energy to tackle climate change adaptation and mitigation is a timely approach for countercyclical stimulus in developing countries as it is in the U.S.. Through new technologies of environment and energy (NTEE) we design technologies able to lower the energy content of our standard of living, leading to the production of energy from renewable resources, and helping to preserve, repair and ameliorate the environment. Tese investments should be mainly financed by industrialized countries. While developed countries are the biggest global polluters today, in the future, developing and emerging market economies are likely to become the biggest global polluters (though not on a per capita basis) It thus makes good sense to invest massively in the industrialized countries today to develop those technologies and through technological transfer to make them available freely to developing and emerging countries, as reflected in previous international agreements. This is an example of a global public good: all will benefit. Helping developing countries should be seen as part of the solution and not the problem. Almost all recovery programmes being designed by developed countries include measures to address the environment and energy questions..

We should look into the political feasibility of additional and innovative sources of finance (including those derived from auctioning off emission rights, and currency transactions and carbon taxes. We should also consider the creation of stabililization (rainy day) funds, to help developing countries engage in countercyclical fiscal policy.

Tax cooperation, including a global tax compact, needs to be expanded and intensified..

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5-We have to define what macroeconomic stability means. Macroeconomic stability has been overly confined to consumer price stability and has not paid enough attention to business cycle (real) and asset price stability. Policies measures need to be designed to offset the inherent asymmetrical treatment of countries by private markets..

There are long standing criticisms of policy conditionality—including that it has no place in a democratic environment characterized by political accountability and that it undermines the effectiveness of policies—but in the current circumstances, the case against most conditionality is even more compelling— it risks be inconsistent with that developing countries undertake robust recovery programs.

Beyond the short-term, central banks have to rethink their policy objectives in the aftermath of the process in which the explosion of global imbalances was sustained by the excessive creation of global liquidity which was in turn a symptom of the almost exclusive focus on consumer price stability Some monetary authorities seemed to believe that a necessary and almost sufficient condition for economic stability and long term growth was price stability. The apparent paradox is that their policies not only did not prevent one of the gravest episodes of financial turmoil, but may have contributed to it.. The policies were sometimes justified on the grounds that each institution should have one objective (for the central bank—price stability) and focus on one instrument (the interest rate). That Tinbergen view rests on the most simplistic economic models where uncertainty has no role to play. That does not mean that the objective of price stability should be given up but that (a) there needs to be broader coordination among those determining macro-policies; and (b) other instruments should be made use of. On this issue, there was no general agreement at this stage: the pros and cons have to be detailed and alternative views have to be properly dealt with. How to design a system that is able to pursue the goals of employment, growth, reduction of inequality, financial stability, external balance, and so on, is a question the answer to which will require further thinking. Notably, this answer requires a view of the policy mix (in a broad sense) and of the optimal degree of cooperation among institutions.

6-Almost all countries are in the process of launching of a recovery programme. These programmes have been nationally designed with almost no coordination between countries, even in the euro area. The result is that the programmes are probably less effective and less balanced. It is why it is important during the recovery period, to initiate and strengthen macroeconomic coordination. (It is especially important to avoid free riding by the major surplus countries) Moreover macroeconomic coordination would avoid self-defeating strategies aimed at increasing exports while attempting to decrease imports—new versions of beggar-thy-neighbor policies. Such strategies will do no good to international trade and thus to the resolution of the crisis.

Because countries are at different phases of the business cycle, mechanism for coordinating macroeconomic policy could be difficult. Developing countries have a stronger external dependence and vulnerability to external cycles and have a much weaker capacity to undertake countercyclical policy. Their dependence on IMF financing has also constricted their policy space for countercyclical policy.

Global surveillance should have a broader agenda and include employment performance and financial stability.