

# POST FINANCIAL CRISIS: Options for SIDS & emerging economies

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A decorative graphic consisting of several horizontal lines of varying lengths and colors (teal, white, and light blue) extending from the right side of the slide towards the center.

# A Brief Review of the Global Economic Landscape

- We've pulled back from the brink on which we were poised in the fall of 2008
- But we are not out of the woods
- *On average*, the global economy is doing well
- But it's a divided world
  - Asia is growing rapidly
  - Pulling along others with them—especially commodity exporters
  - But Europe and America are doing poorly
  - 2011 is likely to be worse than 2010

# Negative Prognosis for Europe and America

- Stimulus measures taken in early 2009 are coming to an end
  - Before a robust recovery has really set in
- Austerity measures will make things worse
  - Already in evidence in U.K., Greece, Ireland
  - Some countries have little choice
  - But others are voluntarily inflicting pain on themselves
  - And in an interconnected world, on others as well

# Failure to address underlying problems

- Before the crisis economy was supported by an unsustainable bubble that led to unsustainable consumption fueled by debt
  - Bubble has broken, and there is nothing to replace it
  - Finance accounted for 40% of corporate profits
  - Real estate accounted for 40% of all investment
  - Crisis left a legacy of excess real estate
- Crisis left a legacy of debt
  - Little restructuring
  - Almost a quarter of all mortgages in US underwater
  - Foreclosures are continuing apace
    - 2 million more foreclosures expected in 2011, in addition to nearly 7 million that have already occurred

# Weaknesses most clear in labor market

- One out of six who would like full time jobs can't get them
- Unemployment rate in certain demographic groups (youth) much worse
- For first time, more than 40% of unemployed long term
  - US poorly equipped—unemployment insurance designed for short term unemployment, no good safety net
  - Will be increasingly difficult to bring down unemployment
  - Social, economic, and political problems
  - Massive waste of resources

# Financial sector still dysfunctional

- Lending to small and medium sized enterprise still very constrained
  - Source of job creation
  - Lack collateral for borrowing because of loss of real estate values
  - Banking sector still ill
    - 150 banks went bankrupt in 2010
    - Efforts were directed at large banks
    - Than were disproportionately engaged in speculating
    - New regulations only partially successful in redirecting them back to banking
    - And design of bailouts led to more concentrated banking sector
    - Exacerbating problem of too-big-to fail banks

# Global Financial Instability Likely to Exacerbate Problems

- America had hoped to export its way out of crisis
  - Entire world can't export way to recovery
  - Asia has strong enough domestic market to sustain their recovery even with weak US and Europe
  - But Asia is still too small to be engine of recovery for US and Europe
  - Besides, even if China expands domestic consumption and investment, little of it will spill over to US and Europe
    - Health and Education
    - Investments in housing, urbanization, infrastructure

- European problems present additional challenge to US
  - Led to stronger dollar
  - Weaker export market
- Exchange rates are like negative beauty contests
  - Which country is in weakest shape, worst economic policies
  - US had been winning
  - But Euro seems to be winning now
  - Markets are shortsighted—focus on one problem at a time
    - US has many problems ahead (debt ceiling, state finances)
    - But so does Europe (Irish and Greece problems have not been solved; problems will reappear—joined by other countries.)

# QE 2 is changing global financial landscape

- Motivation understandable
  - Fed largely responsible for crisis, wants to do something about the problems it created
  - Wants to show it is still relevant
- But what the US needs is fiscal expansion
- QE 2 is likely to be of little benefit to US—and could even backfire:
  - Little impact on interest rates (actually have increased)
  - Little impact on lending (banks are still broken)
  - Main effect through competitive devaluation
    - Twenty -first century version of beggar thy neighbor policy
    - But as in Great Depression, these policies don't work
      - Other countries respond

# Failure to understand monetary policy in global economy

- In old world, creating liquidity in a country led to increased spending in that country
  - Though even then one has to be careful
  - In 2001 spending took form of unsustainable real estate bubble and a consumption binge—not more real investment
    - Similar to what has happened in many other countries
- In globalized world, money looks around for highest return *in the world*
  - And finding it in dynamic emerging markets, not in US
  - US monetary authorities provide neither incentives nor constraints
  - Worse, have done little to repair banking system
  - Hence, money is going where it's not need, not going where it's needed

# QE2 threatens exacerbating bubbles and inflation in emerging markets

- Higher commodity prices may exacerbate problems for advanced industrial countries
  - Risk of stagflation—inflation sets in before unemployment returns to normal
  - Europe more likely to respond by raising interest rates, dampening recovery
- Mixed effects on other countries
  - Inflation worse, because of larger role of food and energy in market basket
  - Food importers especially hard hit
  - Some commodity exporters benefit

# Responses to QE2

- Countries realize they don't have to passively accept capital inflows
  - Direct intervention in exchange rates
  - Taxes on capital inflows, capital gains
    - Unremunerated reserve requirements
  - Tougher prudential regulations
  - Consequence is a more fragmented global capital market—just the opposite of what the US has been advocating for years
- Some countries realize that traditional responses (raising interest rates to dampen economy) are likely to fail
  - Higher interest rates attract even more capital
  - Trying novel approaches—lowering interest rates and raising reserve requirements and using other administrative measures

# Global Consequences

- New global geo-economics
  - China has just become second largest economy
  - China is already largest source of savings
  - Savings are being redeployed around the world
    - Before the crisis, they were not used well (in effect, to finance US real estate bubble, tax cuts for millionaire Americans, and wars in Asia)
    - Question is: can they be used better?
  - US is having a difficult time adjusting to the new reality

# G 20

- The moment of global cooperation is gone
  - Divided interests, perspectives
  - Evident so clearly in disputes about QE2 and China's currency
    - US/China exchange rate not likely to much affect either US multilateral trade deficit or broader global imbalances
    - Change in exchange rate could benefit other developing and emerging markets—likely to come directly or indirectly (real appreciation through inflation)
    - Win-win path through a global growth strategy
      - Focusing on green investments and investments in emerging markets and developing countries
      - Focusing on redistribution in both China and US

# Other elements of a global growth strategy

- A new global reserve currency
  - Makes little sense in 21<sup>st</sup> century for the world's financial system to be so dependent on the currency of a single country
    - Especially when that country has evidenced such economic volatility
  - Current system is deflationary, unstable, and unfair
    - Developing countries lend to the rich at low (now close to zero) interest rates, and borrow back at much higher interest rates
    - “Foreign aid” to US greater than aid it gives to developing country

# A New Global Economic Order

- UN Commission recommendations:
  - New credit facilities to help redeploy savings
  - High price of carbon, to incentivize green investment
  - A global economic coordination council
    - G 20 lacks representatives and legitimacy
      - 172 countries not represented
  - A new global reserve system
    - Could take on many forms, including expansion of current SDR system (\$250 billion expansion in March, 2009)
- If G20 fails again, its relevance will be questioned

# Special Problems of SIDS

- Lack of economic diversification
  - Both sectors
  - And trade partners
- Trade dependence—so exchange rate is vital
  - But for some, location implies high transportation costs
- Fragile environment
  - With many likely to be strongly affected by global warming

# Some economic lessons from the crisis

- Forced re-examination of Washington consensus policies based on market fundamentalism
- Markets, on their own, may be neither efficient nor stable

# Policy lessons

- Excessive focus on inflation by monetary authorities
  - They thought that ensuring low and stable inflation was necessary and almost sufficient for high and stable growth: belief was wrong; ignored far more important problem of financial stability
  - They were reluctant to use full range of instruments at their disposal (could have dampened bubble by requiring higher downpayments, imposing other regulations)
  - Especially important lesson for trade-dependent countries
    - Confronting imported inflation
    - Can do little about the price of imported goods
    - Distorts the economy to force down prices of other goods, to achieve arbitrary goal of an “average” inflation rate
    - Inflicts triple pain: high prices, high unemployment, and, with high unemployment, downward pressure on wages.

# Industrial Policies: Creating Dynamic Learning Economies

- Key lesson: need a balanced view of role of government and market
  - Not just size of each, but what each does and how they interact
  - Many models of market economy, some perform better than others
    - Scandinavian model has performed better than others
    - On a broad range of indicators
    - Key has been a larger role of government, more social cohesion, low levels of inequality
- Markets on their own also do not “solve” other problems
  - Role of government in education, technology, infrastructure, social protection and promoting environment

# Measuring Success

- GDP is not a good measure of success
- Objective of economic policies should be sustainable, equitable, democratic development
  - Trickle down economics doesn't work: *most* Americans are worse off today than they were a decade ago
  - Need to look at how benefits of growth are being shared

# Sustainability

- Especially important for small island states
- Many dimensions: economic, political, social, and environmental sustainability
- US economic policies before the crisis were not economically sustainable—true for many other countries around the world
- Current patterns of growth are not environmentally sustainable
  - The planet will not survive if everyone aspires to America's profligate lifestyle
- Countries that adapt to the new reality sooner are more likely to prosper

# Concluding Remarks

- For the world, increasing sustainable investments is key to addressing the world's short-run and long-run problems
  - Could help US and Europe emerge from the malaise into which they seem to be sliding
- US, Europe, and the world are not likely to take the policy actions that would ensure greater stability going forward—or even a quick recovery for US and Europe
- Smaller trade-dependent countries around the world have to adapt to this unfortunate turn of events

# Concluding Remarks

- This makes it all the more imperative that they design policies to buffer themselves against this volatility and which promote growth, even when there is limited scope for expansion of exports to traditional markets
  - Monetary and exchange policies
  - Fiscal policies
  - Industrial policies
  - Education and infrastructure
  - Social protection
- In doing so, they can achieve equitable and inclusive, stable and sustainable growth