

EIN, Washington DC meeting

A New Era In World Economics & Finance

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Session Chairman
Pilar del Castillo Vera

Panel speakers:
Juan Jose Daboub
Dr Jean-Marc Coicaud
Peter Jungen
Fred L Smith
+ FAES participant

Rapporteur
Ross Walker

Key Conclusions

A correction of the global macroeconomic and financial imbalances remains the most pressing issue. The global economy appears to have entered a 'Shumpeterian' phase of 'creative destruction', necessary but painful (for the less optimistic this process was depicted as 'destructive destructions'). Either way, this restructuring process is just beginning. Policy – monetary, fiscal, supply-side, regulatory, can cushion this adjustment but cannot of itself deliver the required rebalancing. Economic recovery, at least in the developed world, is expected to be slow and protracted. This, more than previous downturns, is a 'balance sheet recession'. To secure a sustainable recovery what is needed is: a more co-ordinated policy response, better regulation not more regulation and more competition and market-based disciplines.

It is important to understand that this crisis is not confined to Wall St and the City of London. The financial sector implosion of 2008 – culminating with the bankruptcy of Lehman Brothers – has developed into a more conventional, broader economic recession. There is clearer evidence that GDP has bottomed-out, but there is little sense that growth is likely to expand rapidly – at least beyond any initial turnaround in the inventory cycle.

Financial sector reforms need to ensure future regulation is not excessive. Solvency and capital adequacy issues are central. Price stability must remain the core objective of monetary policy but an additional 'macro-prudential' pillar is required to address wider stability issues. Specifically, extra capital requirements should be aligned with where externalities exist and there should be more focus in future on money and credit variables. Caution is needed when considering whether to increase the power of central banks – ironically perhaps, additional responsibilities for central banks could end up threatening their very independence if they are perceived to be too powerful.

The much wider geographic sweep of the crisis is also crucial in terms of the policy response. The major emerging market (EM) economies are central to the rebalancing process – there cannot be a one-sided rebalancing. Whilst there are major monetary and fiscal stimulus programmes underway in the EM economies, there is considerable uncertainty surrounding the extent and speed with which multiplier effects will feed through to higher demand in Western/deficit economies. A major challenge over the next cycle will be to boost consumption in the major 'middle income' countries such as China and Brazil.

It can be dangerous to generalise about EMs as there remain significant differences in terms of structure and performance. The most vulnerable EM economies are those with under-developed capital markets and with non-diversified commodity export bases – more globalisation is part of the

solution, not the problem – but it has become increasingly difficult to persuade these countries of the virtues of the free-market model.

The financial crisis should not undermine the case for market-based solutions – which will continue to provide the most fertile ground for sustained increases in growth and rising prosperity across the world. Regulation needs to be ‘better’ rather than ‘bigger’. We should not lose sight of fundamentals such as the rule of law and property rights, augmented by institutional and political stability.

For many economies – especially debt-laden ones such as the US and UK – a broad policy combination of loose monetary/tight fiscal seems most appropriate. Fiscal tightening is required to varying degrees in different countries, with significant risks in both directions: ie, that policy is tightened prematurely derailing the recovery or that serious reform comes too late and thus stifling recovery. Exit strategies need to be considered more opening, to bolster confidence and certainty.

Reviving global trade is fundamental to sustainable economic recovery. There is no period in modern history where strong, sustained improvements in growth and living standards have not be accompanied by strong increases in global trade. A revival in trade is a prerequisite for improvements in productivity performance. Yet, mercantilist and protectionist thinking still pervades and too many policymakers remain intent on export-led growth. The world cannot run a trade surplus!

On a related issue, political rhetoric in some quarters risks creating misleading impressions about the nature complexity of the financial and economic crisis. The banks and financial sector clearly made mistakes, but governments, companies and individuals all wanted cheap credit. One of the great ironies of this financial crisis has been that its origins, and evidence of the most extreme stress, can be found in one of the most heavily regulated sectors of the economy: housing.

Concerns were expressed about a leadership vacuum with regard to both politicians and key policymakers. Protectionist barriers are increasingly evident in various economies and pose a risk to recovery. From a leadership perspective, several contributors perceived the US to be ‘on the back foot’ and that China was either unable or unwilling to fill this leadership role (domestic economic and social issues dominate Chinese thinking).