Special briefing session
7 February 2012

“Interactive dialogue on the current economic and financial situation”

Informal Summary

H.E. Mr. Miloš Kotečec, President of the Economic and Social Council, welcomed participants and speakers and expressed regret that Professor Bhagwati was unable to attend the event due to an emergency. He stated that recovery from the global financial and economic crisis of 2008 and 2009 had been slow. Due to the volatility in financial markets, slow recovery and the debt crisis in a number of countries, the world is now on the brink of another double-dip recession. The ECOSOC President also highlighted the high and growing level of unemployment and underemployment across regions, especially among youth, and its potential negative impacts on medium-term growth prospects. He stated that the economic crisis had caused many more people to fall into or remain trapped in poverty, and stressed the need for a more sustained, inclusive and equitable growth strategy that would address these challenges.

Moderator Rob Vos, Director, Development Policy and Analysis Division, UN DESA, provided the context for the current global economic and financial situation based on the 2012 edition of the World Economic Situation and Prospects (WESP). Growth will continue to be sluggish in the advanced economies in the near future, while developing economies – which buoyed the global recovery in the aftermath of the 2008-09 crisis – were projected to grow at a slower pace. A number of structural fragilities in the global economy persisted: the jobs crisis, sovereign debt problems, and food and commodity price volatility. In addition, domestic political paralysis and social unrest afflicted many countries, in turn challenging efforts to coordinate policy at the international level.

Unresolved structural fragilities in the economy

Peter Diamond, Institute Professor and Professor of Economics at the Massachusetts Institute of Technology and 2010 Nobel Economics Laureate, began by identifying a number of tensions that continued to hamper efforts to overcome the structural fragilities in the global economy: 1) the tension between fiscal austerity and sovereign debt problems; 2) the need for more bank capital versus the need for more bank lending; and 3) the need for private deleveraging and consumer spending. Each of these tensions result from the need to maintain aggregate demand and production on the one hand and, on the other hand, to put economic fundamentals into place so as to avoid another crisis.

Regarding the tension between fiscal austerity and debt, Prof. Diamond stated that with heavily indebted countries, whether the nominal value of outstanding debt is reduced in an orderly or disorderly way would determine how much fragility there is in the system. Conversely, countries that had no imminent need to satisfy the bond market about their ability or willingness to repay their debt should avoid austerity and ensure that austerity did not result from the mere lapse of fiscal stimulus. These countries need to put in place measures that have a significant impact on debt in the long run, without
having negative impacts in the short run. Several options include: 1) reforming pension systems; 2) addressing healthcare costs; and 3) investing in infrastructure. Moreover, countries need to embark on regulatory reform that has an impact on competitiveness – the world needs more “good regulation” and less “bad regulation,” he observed.

As to the second set of tensions, banks should build up capital to avoid the next round of crises. Healthy levels of lending should be maintained, since lending is critical for investment and thus for economic growth. One possible solution to this tension is to stop banks from paying dividends and allocate these funds to build up capital.

Private deleveraging and consumer spending, particularly household debt, is a serious concern, given its impact on private spending and investment. Moderate inflation is a good way to solve this problem, but it is unclear how one generates inflation without incurring negative side effects. An option would be to experiment with various debt modification programs, including restructuring mortgage arrangements for homeowners.

Prof. Diamond also addressed unemployment as a critical issue. In the short run, it will lead to lost output in the economic system as well as financial harm for workers and their families. In the long run, historical records show that those who have been out of work for long periods have difficulty achieving the same level of productivity as the long-term employed, as their skills and capacities decrease over time. This is particularly acute with unemployed youth, who are unable to accumulate experience that will make them more productive. Research has demonstrated that much of the productivity and income gains in an individual’s professional trajectory are rooted in the experience and skills they accumulate prior to the age of 30. High and prolonged unemployment among youth is therefore serious in economic terms, in addition to its social consequences.

Professor Carmen Reinhart, Senior Fellow at the Peterson Institute for International Economics, began her remarks by comparing the severity of the current crisis to that of the Second World War; not since then has there been a simultaneous combination of high debt, low growth, and high unemployment. She noted that some countries are burdened with public and private debts so large that austerity measures alone would not restore sustained growth; for these countries, policy choices to address the crisis were severely limited. As for countries with lower debt levels, there is a need to write-down private debts.

Prof. Reinhart shared that the decade following a severe financial crisis is, historically, one of stubborn unemployment, low growth, and gradual deleveraging, and that economies usually take 7-10 years to recover. Moreover, too often in the run-up to and aftermath of a crisis, policymakers look for solutions that addressed liquidity, rather than solvency, issues.

Prof. Reinhart noted a key difference between the current crisis and that of the 1930s. While during the Great Depression economies worldwide all suffered, the current crisis is characterized by a divide, whereby advanced economies experience low growth and emerging economies are seen as a magnet of opportunity. She cautioned that the seeds of crises are usually sown during the boom years, and emerging economies must learn from the mistakes of the past and avoid the next bubble.

**Alternative development models for sustained growth and job creation**

Focusing on the developing world, Prof. Diamond stated that for these countries now is the time to build the foundations for long-term, sustained growth. The first step is to put in place infrastructure for the effective functioning of markets. Corruption at all levels must be stamped out. Also necessary are good commercial codes, protection of intellectual property rights – which are important for innovation
– and court systems that predictably and consistently enforce such codes. The second important aspect is education, training and retraining. In particular, he argued against focusing solely on increasing the number of university graduates and instead advocated a broader, more comprehensive approach to the variety of skills and training programmes provided. He stressed that retraining is especially important due to the rapid evolution of technology and skills. He recommended a sustained commitment to social protection programmes and policies that promote empowerment. He also advised that governments should approach policy making as an experiment as there are no set rules. There needs to be a process of monitoring and evaluation of policies to determine what works, as well as a willingness to stop programmes that are harmful.

Prof. Reinhart shared her perspective on “what not to do” in addressing alternative models. She said that when economies are growing slowly, there is a tendency for countries to look inward and increase their competitiveness. While it is necessary to build domestic demand to spur growth, countries should avoid engaging in competitive devaluations or currency wars that can lead to protectionism. This happened in the 1930s, when the world economy underwent a series of competitive devaluations, followed by protectionist tariff policies.

Prof. Reinhart warned that every financial crisis in the past was preceded by large capital inflows, widening current account deficits, and booming credit with a tendency towards overheating and overvaluations. Many of the problems that countries find themselves in today could have been avoided, if not mitigated, had they paid more attention to the lessons from the past, particularly the risks of excessive leveraging. Financial crises typically start with a boom in private borrowing, accompanied by a boom in asset prices. Multilateral institutions have a role to play in calming down and acting counter-cyclically when these occur.

Global policy coordination to mitigate uncertainties and reduce risk

Prof. Reinhart addressed this topic by referring to the various cycles of globalization. She observed that the world is currently dealing with the aftermath of a cycle in which financial regulation, at both domestic and international levels, did not keep pace with the growing interdependence of the global economy. She noted that the period 1860s until the First World War was a period of rising globalization, international flows, and high external borrowing. The high level of indebtedness that developed between the First World War and the Depression until the Second World War ended with international policymakers taking a different course of action, namely, financial repression.

In the period ahead, some financial de-globalization would take place as countries attempt to respond to current difficulties. Governments in the advanced economies will increasingly look inward and place their debt domestically – in pension funds and domestic banks, for example. Emerging economies, on the other hand, concerned about the risks of large capital inflows, will be more inclined to use regulatory measures to deter financial bubbles. The wave towards a regulated financial system is in the offering, with restrictions on cross-border activities. The combination of inward-looking advanced economies and emerging markets imposing financial restrictions can be quite dangerous. Prof. Reinhart emphasized the role of multilateral and international organizations in fostering dialogue and improving coordination, and in avoiding piecemeal approaches that can result in poor regulations. Coordinated financial regulation is needed both at domestic and international levels.

Prof. Diamond believed that global attempts at coordination were not progressing, citing climate change negotiations as an example, with important economic implications for emerging economies. The collapse of Lehmann Brothers showed that there were inconsistencies in the laws and regulations of different countries. Moreover, Professor Diamond believed that the ability to shut down large financial firms should be enhanced, as well as global coordination to determine those that should be
rescued. Governments also need to work closer on cooperating on tax matters and dealing with tax havens.

Discussion

Some representative requested further elaboration of the concept of financial de-globalization. The European Union enquired which international organization was best placed to deal with this, while the United States asked whether this was a policy that was actively pursued or merely a natural consequence of private deleveraging. Indonesia also inquired as to the type of international cooperation needed to avoid the risks of financial de-globalization.

Prof. Reinhart responded that financial de-globalization can take many forms, and can also be a response to an overshooting economy. For example, from the early 1980s to 2007, the tendency was towards more laissez-faire international and domestic financial markets, resulting in a build-up in external leverage and an overshooting. There are macro-prudential reasons why a country would want to undertake financial de-globalization. She also commented that it will take a long time before the world economy recovers from the current crisis, noting that the world may end up with a hybrid situation of continued globalization on the trade side and less excesses on the financial side.

Prof. Reinhart also said that there is a common policy concern among advanced economies that diverges from the policy concerns of emerging economies. International cooperation is usually more successful when countries face similar issues. She cautioned that financial or macro-prudential regulation has a better chance of succeeding when implemented across the board rather than unilaterally.

Burkina Faso, Ethiopia and Senegal questioned what specific measures could be taken to minimize the impact of financial crises on developing countries, in particular least developed countries. Prof. Reinhart stated that during periods of buoyant commodity prices, a recurring mistake has been to treat the boom in commodity prices as permanent, when in fact it is transitory. One recommendation is for developing countries to prepare cyclically-adjusted budgets, commodity-price-adjustments.

Several participants enquired about capital flows and currency wars. Brazil asked how efficient were measures of capital control aimed at restricting the inflow of short-term capital, as well as what could be done regarding the effects of competitive devaluation on trade flows. The IMF representative asked if there was a danger that focusing on capital controls will result in a system that is not suited for the “normal world” not in crisis. Senegal also asked whether strengthening monetary cooperation is the best way to avoid currency wars.

Prof. Reinhart stated that the issues of competitiveness, currency wars, and inflation are all correlated. Higher commodity prices and low international interest rates, she advised, can lead to excessive intervention in the foreign exchange market to avoid nominal appreciation. This is a difficult situation especially for countries with less-developed financial markets that could lead to higher inflation. Trade-offs exist, and a real exchange rate appreciation could happen quickly through a nominal appreciation, or gradually through higher inflation.

Prof. Reinhart also stated that establishing practices of currency manipulation and quantifying its extent are very difficult. She expressed her skepticism in establishing regimented rules identifying currency manipulation, and that addressing this issue will most likely take place along bilateral lines.

Prof. Diamond stated that when grappling with a suitable framework for regulation, there is often a trade-off. For example, derivatives are important for getting rid of risk, allowing economies to grow
and globalization to occur, but they have also been one of the main culprits of the financial crisis. Similarly, Pigovian taxation is ideal for addressing negative externalities, but are almost never set correctly, leading to lower efficiency. Thus, any attempt to limit the flow of “hot money” will inevitably have some inefficient side effects.

Participants also questioned about austerity measures and what could be done about the current financial crisis in Europe. The Netherlands stated that markets find it counterintuitive when highly-indebted countries opt for stimulus and asked whether countries were being pressured particularly by such realities, to take the austerity route. Italy asked whether there was a silver bullet that the EU governments could use to reduce the scale of the crisis.

Prof. Diamond responded that the austerity versus stimulus debate was not zero-sum; there are many ways to increase aggregate demand without increasing deficits, such as by cutting taxes for those with high marginal propensity to consume. He then stated that the problem facing Europe is both a stock problem (size of debt) and a flow problem (not being competitive, not being able to devalue). Therefore, there is the need to determine what is required to reinvigorate domestic production.

Prof. Reinhart considered the shift in attitude of the European Central Bank (ECB) very helpful. She believed that the role of a central bank is not limited to inflation targeting, but extends to safeguarding financial stability. The greater willingness of the ECB to be a lender of last resort to banks has been an important step at the European level. Similarly, debt overhangs have a direct bearing on unemployment; solving one helps address the other.

Germany questioned whether developing more public-private partnerships was an optional model. Prof. Diamond responded that such partnerships were good for countries with limited ability to borrow. However, those with the ability to borrow should not use this method, as it involved taking on the private partners’ risk and was often more costly.

Tunisia recounted the High-Level Meeting on Youth (2011) and enquired what would be the components of a global strategy to foster youth employment and the potential stakeholders to be included in this exercise. Prof. Reinhart responded that the problems of unemployment, debt overhang and household spending were all inter-connected.

Closing

The ECOSOC President closed the session by thanking the speakers, moderator, representatives of Member States and other participants. He committed to seek ways to introduce the recommendations arising from the discussion into the ECOSOC decision-making process for follow-up. He also reaffirmed the role of the Council to promote international cooperation on these issues.