Chapter V

Towards a coherent effort to overcome the systemic crisis

A. More and better coordinated countercyclical action is needed

Despite the desperate attempts of a number of Governments to contain the fallout of the crisis, it has spread to many regions and sectors. In fact, the global deleveraging process cannot be easily stopped as the speculative positions of millions of independent entities in a number of important markets unwind and the brutal logic of debt deflation brings new shocks every day. In addition, the near meltdown of the United States financial system and beyond has deeply shaken the belief that business as usual will soon return to the markets. Instead, fundamentally diminished expectations have emerged concerning the yields that can be achieved without engaging in overly risky investments.

At the beginning of 2009 the world economy is in a deep recession. The uncertainty about financial conditions in the near future and about the dramatic changes in relative prices of stocks and flows all around the world has impacted on investment in fixed capital and the demand for manufactured goods in a manner not seen in living memory: indeed, the world seems to face "the crisis of a century" (UNCTAD *Policy Brief*, 2008a).

Global GDP is expected to fall in 2009. This is a dramatic setback from recent global growth rates, which were consistently above 3 per cent for several years. Although this is mainly owing to deep contractions in the developed world (-2 per cent), a considerable slowdown in growth rates in developing countries and transition economies (to 3 per cent) contributes to the dismal outcome. In Africa in particular, the consequences of the fall of commodity prices hit the real economy, whereas countries with a large manufacturing export sector like those in the populous East Asian region suffer from sluggish demand. Eastern Europe economies are trapped by their exposure to debt in foreign currencies and the devaluation of their own currencies. With inflation rates sharply down in most countries of the world and sustained downward pressure on wages, deflation, not inflation, is the main economic policy challenge for the years to come. Fears that "too much money" or rising government deficits could soon spark a new round of inflation are unjustified, misleading and could be dangerous in the current depressed economy.

The decline in economic activity is unusually strong and parallel across economies. Obviously, the world is not witnessing the kind of cyclical decline as occurs once every few years. This time the downturn is driven by an unprecedented rapid deleveraging on a global scale, which means that billions of creditors and debtors have to adjust to fundamentally changed circumstances compared to their expectations. Additionally, changes in relative prices occur at a breathtaking speed. As many markets were overvalued at the same time, the correction is sweeping. It started with house prices, stocks followed, commodity prices were next and foreign exchange markets turned around in the unwinding of carry trade operations.

In addition to the financial strain, the loss of a solid foundation for expectations and planning paralyzes investors. While from a microeconomic point of view it is useful to wait and see in such volatile markets, these individual holding strategies worsen macroeconomic situations by the day. To be sure, the deleveraging and the normalization of prices are necessary and unavoidable. In most cases prices will be better in line with the underlying fundamentals of supply and demand after the unwinding. However, the short-term effects of the gyrations in prices and exchange rates are dramatic. The exposure of households and enterprises to risky assets and liabilities in many cases is big enough to justify immediate default.

Current public fire-fighting thus entails the difficult balancing act of letting the fire consume what is in any case unsalvageable, while also protecting those parts of the edifice that are most vital and that can eventually be rebuilt (UNCTAD *Policy Brief*, 2008b). Therein the task of Governments is of a threefold nature: *First*, they have to restore confidence on the national and international financial markets to ease the flow of liquidity and credit and re-ignite global demand. This is a time-consuming process. It started early on in the crisis, but neither can highly unsettled credit markets be expected to recover overnight, nor can generous liquidity alone ensure recovery. *Second*, they have to apply pragmatic and strong countercyclical macroeconomic measures to fight the resulting global downturn. *Third*, they have to undertake the most urgent regulatory measures now to stabilize relative prices in the global economy by preventing new rounds of destabilizing speculation.

In fact, in developing countries and some emerging economies, central banks have acted swiftly and in a rather coordinated fashion to tackle the crisis. From the start the FED did not only provide liquidity into the interbank market, but also slashed interest rates dramatically to provide monetary stimulus for the real economy. The Bank of England followed suit, in line with many other important central banks. Only the ECB hesitated to cut interest rates, although it provided additional liquidity to the system.

As a result, the United States have no room for further interest rate cuts with virtually zero interest rates after the latest cut on 16 December 2008 to 0.125 per cent. The same is true for Japan with an interest rate of 0.1 per cent. But Europe, both the euro area and the United Kingdom, still have some room for manoeuvre left even as interest rates nudge downwards. By contrast, China's scope for further expansionary monetary policy with a current benchmark-lending rate of 5.31 per cent is still substantial. Much more, China's monetary policy draws heavily on non-interest rate based monetary tools such as window guidance, which can be employed in addition to further interest rate cuts.

With the limits for further monetary easing approaching, massive fiscal stimuli are inescapable if global demand is to be boosted. The United States has followed up on its first fiscal stimulus of early-2008 with a package worth up to $800 billion in 2009 and 2010 (which amounts to 2.5 to 3 per cent of GDP per year). Of this amount some two-thirds will go directly into public investment and one-third into tax cuts. Such a mixture is reasonable as tax cuts are generally less efficient than investment programs for companies because private households tend to save more in the crisis for precautionary motives.

Countries with large current account surpluses and sluggish domestic demand must act more aggressively than countries with external deficits. This is particularly true for a number of economies in Western Europe and for Japan. In the euro area Germany is in an excellent position to use fiscal policies due to low deficits, low interest rates and one of the largest current account surpluses in the world. Recently, the Government announced a second fiscal package of up to euro 50 billion for 2009 and 2010 (reaching a planned combined stimulus for 2009 of around 1 per cent of GDP). But more is needed and with a greater focus on public investment rather than tax cuts and other indirect measures that are likely to be saved and not spent. China, with the second largest current account surplus seems to be ready to capitalize on its favourable external and budgetary position by realizing a large-scale plan for fiscal stimuli. These plans could add up to 10 per cent of China's GDP during the two-year period of 2009 and 2010. At this size it would also help to support global demand (UN-DESA/UNCTAD, 2009).

The scope for counter-cyclical policies among smaller developing countries and countries in transition varies greatly. Many countries with current account deficits and a weak currency are pushed by their creditors to lean towards pro-cyclical macroeconomic policies with high interest rates and fiscal conservatism. However, a departure from the traditional policy practices and policy rules is warranted, indeed indispensable.

As the pro-cyclical policy stance is the result of concerns over the threat of further currency depreciation the international community must allow these countries the room of manoeuvre to stabilize their real economies. This can be done best by way of creating unconditioned international assistance to stabilize devaluing currencies at a certain point by direct intervention of the countries with revaluing currencies. To enhance their scope for counter-cyclical responses further, compensatory financing, reserve swaps and additional and reliable foreign aid flows should be made available immediately. Only if all countries can cope with declining export earnings and reduced access to private capital flows the world as a whole be able to quickly overcome the global crisis.

International coordination is indispensable to fighting the onset of global depression as well as to dealing with the root causes of the slump. If some countries or regions start to "free ride" on the attempts of other Governments to lean against the winds of recession and depression by deficit spending a global depression cannot be ruled out. Any kind of competitive devaluation of currencies, wage cuts and/or protectionist measures would be disastrous at this juncture.

B. The State is back but national action is not sufficient

1. Preventing the competition of nations

The involvement of many markets and of many countries shows that blaming greed and irresponsible behaviour of individuals is a road to nowhere. The global community has erred in the belief that in a highly interdependent world with financial markets closely linked by modern computer technologies each country can go it alone and find its way despite many pitfalls and "fallacies of composition". But not all countries can improve their competitiveness, generate a current account surplus and gain market shares: one's advance is another's retreat. Competitiveness in a global economy is a zero sum game.

For rising economic welfare to be sustainable, it has to be shared without altering the relative competitive positions of countries. Companies that gain market shares at the expense of other companies form an essential ingredient of the market system. If the overall efficiency of production rises in this process, workers who are negatively affected by corporate competition can find jobs elsewhere in the economy due to higher demand and higher growth. But if nations gain at the expense of other nations, dilemmas can hardly be avoided. If the "winning" nations are not willing to give up their superior position and to allow a full rebalancing of competitive positions over the long run they force the "loser" nations into default. This is the phenomenon that J. M. Keynes called the "Transfer Problem" some 80 years ago. Its logic is still valid. If it were better understood it would provide a reasonable path through the coming jungle of open protectionist tendencies and hidden attacks on "the other", who tries to defend what he perceives as his national interest.

Globalization of trade and finance calls for global cooperation and global regulation. To hold that even in the midst of the crisis, free international trade in goods and services must be preserved and the liberalized rules-based multilateral system must be protected while denying that is the right approach for global finance is incoherent and threatens to further destabilize fragile global imbalances. It is the failure of Governments to deliver effective global governance that is to blame foremost for the current global predicament. Resolving this crisis 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 globalizing world.

At the national level new concepts for economic development have to be designed that can better balance spending excesses in deficit countries and export excesses and long-lasting under-consumption in surplus countries. The most important rule to be followed is to use domestically generated productivity increases for domestic purposes through the full participation of all economic agents in the productivity gains. Moreover, all countries that want to share the potential benefits of trade and foreign direct investment have to understand that the creation of level playing fields for the competition of companies is a desirable target but that competition of nations is a useless and dangerous concept. As UNCTAD pointed out in 2007 (UNCTAD, 2007d): all countries can simultaneously raise productivity and wages and the level of trade to improve their overall economic welfare if they follow consistent rules.

To avoid the fight for market shares through manipulation of the exchange rate, wage rates, taxes or subsidies and to prevent financial markets from driving the competitive positions of nations into the wrong direction, a new *code of conduct* is needed regarding the overall competitiveness of nations. Such a code of conduct would have to balance the advantages of one country against the disadvantages of other directly or indirectly affected countries. For example, the effect of changes in the nominal exchange rate deviating from the fundamentals (inflation differentials) on trade balances is not much different from that of tariffs and export bounties. Consequently, such real exchange rate changes have to be subject of multilateral oversight, negotiations and decision-making. Only if such rules apply, can all trading parties avoid unjustified overall loss or gains of competitiveness and developing countries can systematically prevent the trap of overvaluation that has been one of the most important impediments to prosperity in the past.

2. Intervention in financial markets is indispensable

In financial markets that are in full speculative swing, nearly all participants follow the same pattern of expectations based on similar information. This uniformity creates manias and panics and huge systemic risks. In a boom phase, there are too few short sellers; and in a bust phase, too many (UNCTAD *Policy Brief*, 2008a).[17] But the similarity of the behaviour of many financial market participants and the limited amount of information that steers them opens a gate for fully justified and non-distorting government intervention. Contrary to atomistic goods and services markets and the colossal quantity of independent data that help to form the market price there, financial markets are characterized by what could be called oligopolistic information sharing. Most of the information that determines the behaviour of speculators and hedgers is publicly accessible and the interpretation of these data follows some rather simple explanatory patterns.

There has long been a debate in economics concerning the “equilibrium price” in these markets and the incompetence of Governments in identifying it and guiding the market to reach it. But that argument misses the point: Even if well-informed Governments and central banks do not exactly know the equilibrium price they usually do know when prices are in disequilibrium (Williamson and Subramanian, 2009). In other words, the fact that Governments have only a very rough idea about the equilibrium price is not a convincing argument against intervention, as we have learnt now that markets do not only have no idea, in fact they are systematically driving the price away from equilibrium. Take commodity prices: If the oil price doubles in a couple of months Governments and international organizations urge the oil producers to increase supply and in this way intervene in these markets, obviously, that means they know that the price is far beyond equilibrium.

The same is true for many other markets. Take currencies and exchange rates: Some Governments criticize other Governments for intervention to keep the rate at an undervalued level; obviously they pretend to know a price that is closer to equilibrium. Moreover, if exchange rates move in the opposite direction of what is needed to restore the international competitiveness of the overall economy, alarm bells should ring and urge government action in both affected countries to stop this kind of speculation. Take housing: If for most mortgage contracts in a country to be serviceable house prices must rise for the next 20 years or so, Governments should know that something has gone wrong and will go wrong if they do not stop this speculative bubble. Take stocks: If the valuation of companies goes far beyond traditional valuation measures like the price earnings-ratio or implies exploding earnings in an environment of a cooling overall economy, Governments and central banks know that by intervention through interest rate increases they do less harm than good. Take mergers and acquisitions through private equity funds: As the business model of these funds is built on short-termism, namely the leveraging of returns through “equity debt swaps”,

[17] Schumpeter (1939: 51) put the phenomenon of the necessary “friction” in the following way: “Just as the physical world would be an uninhabitable chaos if the slightest difference in temperature sufficed to transfer *all* heat instantaneously to the region of the minimum, so the economic world could not function if, for example, the slightest variation in a rate of exchange sufficed to set *all* gold flowing at once”.

Governments should know that this business model - if used on a large scale - may dramatically increase the systemic vulnerability of the economy in times of stress and downturn.

C. No "crisis solution" by markets

The events of recent months have revealed a huge misallocation of resources and a destruction of enormous values driven by financial markets. The lesson is simple: macroeconomic prices are too important to be left to the vagaries of these markets. However, if the failure has shattered the naïve belief that unfettered financial liberalization and deliberate non-intervention of Governments will maximize welfare, or functional efficiency, the crisis offers an opportunity for a new start. Governments, supervisory bodies and international institutions have a vital role to play to allow society at large to reap the potential benefits of a system of decentralized decision makers. Only consistent and forceful interventions in financial markets by institutions with knowledge about systemic risk can transform a system of atomistic markets for goods and for services into an efficiently functioning entity. Market fundamentalist *laissez faire* of the last twenty years has dramatically failed the test.

Interventions in financial markets that are part of the global economy call for cooperation and coordination of national institutions and for specialized institutions with a multilateral mandate to oversee national action. In the midst of the crisis this is even more important than in normal times. The tendency of many Governments to entrust to financial markets again the role of judge or jury over the coming process of reform and indeed over the fate of whole nations would seem inappropriate. For example, as we shown in the previous chapter, it is indispensable to stabilize exchange rates by direct and coordinated government intervention instead of letting the market find the bottom line and trying to "convince" financial markets about the credibility of the Government of the depreciating currency through pro-cyclical policies like public expenditure cuts or interest rate hikes.

Once this is done, the problem of newly issued government bonds at "penalty" rates that are demanded by the "markets" can be tackled. The paradox that the same market participants that have driven Governments of many countries into a disastrous budgetary and current account situation now ask for "risk premia" because they do not trust these Governments any more and fear government default, has to be answered by the global community of Governments in a strong and clear manner. It is very rare that the Governments of the adversely affected countries alone are responsible for financial failure, while Governments of the unaffected countries are very rarely blameless in this regard. As Keynes (1919: 142) once put it: "In the great events of man's history, in the unwinding of the complex fates of nations, justice is not so simple".

A global answer should follow the same principle: If everybody defaults nobody defaults. Only if some countries try to avail themselves of the opportunity to get cheaper credit at the expense of others, the "markets" have a choice and can demand a "risk premium" from the more vulnerable ones. If every country and every Government acknowledges that the global crisis is foremost a systemic crisis, i. e., due to the failure of the global community to govern the globalized economy properly, a truly global solution like a *global bond* that can be used by all countries at fixed exchange rates is less utopian than it sounds.

In the same vein, a cooperative effort is needed to address all the different sorts of predatory speculative activities that have been responsible for the distortion in national and international price relations have to be tackled at the same time to avoid speculative arbitrage. The tragedy of the modern forms of speculation is their very short half-life: the more people on the globe concentrate on speculation in certain markets and the more effective they are, the quicker the results will be contradicted by economic reality because the real economic system can no longer bear the burden of largely distorted prices and exchange rates.

That is why all the weaknesses in speculative activity have to be tackled at the same time. For example, dealing only with the national aspects of re-regulation to prevent housing bubbles and the creation of risky assets related to this area would only intensify in other areas like stocks. Preventing currency speculation through a new global monetary system with automatically adjusted exchange rates might redirect the short-term games towards commodities and increase volatility there. The same is true for regional success in fighting speculation, which might put other regions in the spotlight of speculators. Nothing short of closing down the big casino will provide a lasting solution.

It is obvious, a coherent and effective approach can only be found at the international level and with the inclusion of as many countries as possible. A broad international agreement about the distortional effects of large-scale speculation in different areas on growth and employment is absolutely crucial to create the framework for a globalization that has the potential to deliver rising living standards for all.