Think Tank 20:

Beyond Macroeconomic Policy Coordination Discussions in the G-20

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The Interdependence of Macroeconomic Policies and Structural Reforms

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The Cannes G-20 Leaders' Meeting in Context

A year ago, many hoped that the November G-20 Leaders' Summit in Cannes would be an opportunity to state that the worst was over and that the world economy was on a solid growth path again. Leaders were expected to turn to long run issues to implement their vision of "strong, sustainable and balanced" global growth.[1] In April, finance ministers already started a discussion of how to monitor key structural variables as a backdrop to a discussion on rebalancing global growth.

Today, it is clear that a sense of urgency over the short-term prospects of the global economy has returned. In the United States, growth is weak and the fraction of the population employed is at historical lows. The eurozone is facing an existential threat and even the German growth engine is slowing, perhaps even stalling. Japan cannot get out of a now two-decade long stagnation. And the widespread confidence prevailing in emerging markets is giving way to greater anxiety as global trade falters again and advanced country banks are recalling liquidity to their home bases. As has always been the case when anxiety mounts, there is a flight into the U.S. dollar despite America's fiscal problems. The emerging market country currencies that are basically floating have depreciated sharply against the dollar. Brazil, a country that had been very worried about the appreciation of the real, has intervened to slow down a sudden marked depreciation. Turkey's central bank is selling reserves. Equity markets have been down worldwide although there is a great deal of volatility and there have been rallies.

In 2009, the G-20 came together with a coherent package of macroeconomic measures to deal with the crisis. Today, the situation is quite different. First, in some countries, while a considerable amount of fiscal ammunition has been spent, the current slowdown in growth is shifting the balance of opinion against immediate fiscal consolidation. An increasing number of observers are now of the opinion that careful support to the recovery is more important than immediate fiscal retrenchment in those economies that have still preserved some fiscal space, including the U.S. Nonetheless, longer-term debt dynamics are very worrisome so there appears to be a serious fiscal conundrum. Second, today's global economy seems to have entered a new phase characterized by heightened uncertainty over long-term growth prospects. In the current environment, there is greater talk of the need to implement structural reforms to provide an impetus to growth and to link macroeconomic policies, especially fiscal policy, with strategies to address structural weaknesses and to restore long-term business and consumer confidence rather than to discuss macroeconomics purely in terms of short-term aggregate demand. Monetary and aggregate fiscal policy have reached their limits as countries have lost fiscal space and as the conundrum caused by the need for short-term support to the recovery, and the need for long-term consolidation remains unresolved. Therefore, it is the interaction between macroeconomic policy and structural reforms that is the topic of the essays in this volume.

The Unfolding of the Crisis

Three years ago in the fall of 2008, the world economy faced its most threatening crisis since the Great Depression of the 1930s. The crisis followed a period of unprecedented worldwide growth, stretching from 2002 to 2007. Some renowned economists believed that serious business cycles and recessions were a thing of the past. In his presidential address to the American Economic Association in 2003, Robert Lucas proclaimed that "[macroeconomics'] central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades."

Reality turned out very different. The "Great Moderation" of 2002-2007 has been followed by the "Great Turmoil" of 2008-2011 and probably onward.

The first phase of the unfolding crisis from mid-2007 to September 2008 was one of slowing output growth in the U.S. and Europe. Stress in the financial sector was increasing, as manifested in the Bear-Stearns crisis in March 2008. However, market and opinion leaders treated this as a one-off problem and did not grasp the systemic severity of financial sector problems so they continued to drive up prices in commodity and energy markets.

The second phase came with the collapse of Lehman Brothers in September of 2008 and the ensuing "heart attack" in the financial sectors of the U.S. and Europe. The effect of the "heart attack" in the traditional center of the world economy affected most of the periphery but with variable virulence. Trade, capital flows and confidence levels were the channels for contagion. All over the world, private demand collapsed, fear about the future increased and firms reduced their workforce. Eastern Europe with its huge current account deficits and hence exposure to capital shocks was most strongly affected, but even China experienced major employment losses and firm closures. The price of oil fell from $147 a barrel in July of 2008 to below $40 a barrel by the end of the year—a vivid reflection of the dramatic, unpredicted and unprecedented nature of the "heart attack".

The third phase of the crisis saw the effects of a massive globally-coordinated Keynesian policy response, accompanied by extraordinary direct intervention by governments in the financial sector. This allowed the patient to survive. By spring 2009, a partial recovery started and a world depression was successfully avoided. The first signs of a recovery were seen in financial markets but soon extended to the real economy as inventories were rebuilt (or at least stopped falling). Yet, the output recovery did not involve a significant pick-up of private investment, new capacity building or significant new demand for labor. On the contrary, in many advanced economies, notably in the United States, employment and output trends diverged in a way that had seldom been experienced before.

Nonetheless, from the summer of 2009 to the spring of 2011, a moderate recovery seemed to take hold in the U.S. and Northern Europe while the emerging market economies, notably China, regained growth momentum to levels close to their pre-crisis pace. It seemed that world economic growth was reverting to trend; the International Monetary Funds's April 2011 World Economic Outlook (WEO) had 2011-2012 growth predictions of 2.8 percent for the U.S., 1.7 percent for the eurozone and 3.6 percent for the world economy as a whole.

The Fourth Phase of the Crisis

By the summer of 2011, however, the world economy was entering a fourth phase of renewed slowdown. The September 2011 WEO projections have lowered U.S. growth projections for 2012 by 1.1 percent, those of the eurozone by 0.6 percent and those for the world economy as a whole by 0.5 percent. Some economists are now predicting at least a 50 percent chance of actual economic contraction in the U.S. and Europe for the last quarter of 2011 and the beginning of 2012. The confidence crisis in the eurozone triggered by the peripheral economies is now slowing growth throughout the continent, including in Germany. The buoyant growth in many of the emerging market economies is also declining. Even China is affected. There is little doubt that global economic policymakers are back in crisis mode, although more so in the advanced economies than in the developing world so far.

In this fourth phase of the crisis, the policy strategy of gradual fiscal tightening that was developed in the third phase has come under severe attack. The most prevalent recommendation in the fall of 2011 is to loosen fiscal policy for the immediate future, wherever there is fiscal space, while announcing future tightening. From a theoretical point of view, there has always been concern about the feasibility of "provide stimulus now, while announcing retrenchment for the future." One does not have to be a strong "Ricardian" to believe that economic actors look ahead at least to some degree when they make their spending decisions—tax cuts today create expectations of future tax increases. But from a practical point of view, the reverse arguments are also being made—tax cuts today create pessimism over the political ability to raise taxes (reduce deficits) in future. Financial markets are questioning the realism and adequacy of projected fiscal cuts and some politicians in advanced countries are calling for more substantial short-term fiscal contraction as a way of building confidence in the sustainability of public sector debt. In the United States, this option was fueled by Standard & Poor's downgrading of U.S. public debt in the aftermath of the collapse of bipartisan budget negotiations. The signs of weakening in output growth trends have significantly altered public debt dynamics. In an important editorial in the *Financial Times*, Christine Lagarde, the new IMF managing director, noted that markets are even more afraid of slow growth than of high deficits.[2]

It is worth remembering that debt ratios have a numerator (the amounts of public debt) and a denominator (GDP), and that debt dynamics are driven by the interaction of deficits, growth and interest rates. With interest rates already at historical lows, there is not much more favorable news that can be expected on this score. When growth slows, deficits rise because of automatic stabilizers (both on the tax and expenditure sides) and because of the risk of renewed contingent liabilities in banks and public pension funds. If fiscal cuts to reduce deficits also reduce growth, they can become self-defeating in terms of the underlying debt dynamics. When interest rates also adjust to unfavorable debt dynamics because of sovereign risk, as is happening in parts of Europe, the room for maneuver becomes even narrower. Moreover, if uncertain debt dynamics and slow growth policies are synchronized across borders, the system in each individual country becomes even more unstable. That is what is happening now with ongoing fears of currency wars and associated worries of trade wars and additional negative growth shocks. Given this strong interdependence, the danger of simultaneous substantial retrenchment in macroeconomic policies should not be underestimated.

A New Debate on Structural Policies

This fourth phase of the crisis presents policymakers in advanced countries with a huge challenge: how to offset deficient private demand, which is not recovering fast because of balance sheet effects as well as increased income concentration at the very top, while maintaining financial market confidence in the stability of public debt dynamics. Political majorities have to be forged for the packages proposed in the middle of a widespread lack of confidence in policymakers due to the failure of the economic predictions made over the past few years. The lack of confidence in turn curtails the demand for labor and investment in new capacity and deepens the economic gloom.

If aggregate fiscal policy is really constrained because of the potential negative impact on short-term growth prospects and hence on contingent liabilities, as well as a serious danger of social unrest in some countries, then the only way out is to pay more attention to structural policies and that is now the focus of attention in many countries. But structural policies are notoriously difficult to implement in political terms (the balance of winners and losers is hard to manage) and often take time to yield results. In Europe, the extent of progress on implementing the Lisbon agenda has been very slow. In the short term, even having a discussion on the exact nature of structural reform can generate policy uncertainty and further curtail growth.

Structural reforms are easier to take forward when there is fiscal space. For example, bilateral trade agreements in the United States were held up partly because of disagreement over how to fund worker retraining to smooth the adjustment of labor from affected industries.

In most advanced economies, governments are now able to borrow at interest rates that are at historical lows—in fact, close to zero or even negative in real terms. If the public sector can create assets that are useful to the economy, it can actually improve its balance sheet and reduce its degree of indebtedness by spending more today on building productive assets. In most advanced economies, infrastructure spending to lower logistics costs seems to offer obvious opportunities. And fees or tolls can be charged in many cases, generating not only a positive economic rate of return for the economy but a positive financial return for the public sector. Yet, while in theory all public investments where returns exceed the cost of borrowing should improve debt dynamics, in practice there is skepticism in some countries over the government's ability to choose sound projects and implement them without cost overruns. Some of that is pure ideology, but it weakens the ability to combine sufficient public spending and policy reform in packages to achieve structural change.

We believe that further discussion about aggregate fiscal measures will not be sufficient in the current context. Policymakers have to look at the distribution of income and adjust the structure of policy to achieve real impact. For example, tax relief or income support targeted to the poor can be effective, even if it is accompanied by announcements of tax increases for the richest top segment of the population in the medium-term future because of marginal propensities to consume or save differ across income groups. Poorer households facing strong liquidity constraints tend to spend what they earn. The very rich, who have a substantial cushion of wealth, on the other hand, are unlikely to strongly adjust their immediate spending downward in the face of longer-term tax increases announced for the future. The strength of these distributional effects is an empirical question, but policy should be formulated on the basis of the research evidence rather than on the basis of simple ideological beliefs.

Of course, a big distributional issue is intergenerational—managing the costs of long-term social, retirement and health policies. There is again little doubt about the strong upward trend in societal costs thanks to an aging population and an increase in the cost of health care due to the otherwise good news that effective treatment now exists for many diseases. Reforms are needed to reduce that cost, but how this is done has an impact on growth and debt dynamics. For example, a simple increase in the age of entitlement to Medicare in the U.S. might reduce the immediate projected cost of the Medicare program. But if it is done in a way that creates anxiety for older people, leading them to reduce their expenditures, it could actually worsen public debt dynamics. Again these relative effects are subject to empirical analysis and it is on the basis of such empirical analysis that reforms should be designed. A well-designed reform aiming at greater cost sharing by the rich is not just about redistributional goals. It is also likely to be more effective in terms of the impact on aggregate demand than distributionally-neutral reforms. Similar considerations are relevant for pension reforms. Entitlement cuts can be strongly deflationary, even if announced only for the future, unless distributional targeting is included in their design. Hence, both Keynesian and Fisherian insights are needed when analyzing the current set of challenges.

The debate about appropriate structural measures needs to be conducted on an international stage because it is clearly very difficult to insulate oneself in today's world economy. National policies clearly remain the drivers of what is happening and what can happen in each country. However, these policies unfold in an increasingly interdependent world and everyone would benefit from much greater efforts by the leading nations to approach problems in a forward looking, cooperative manner that takes full account of the factors that bind the world economy into an interdependent whole. This is both the challenge and the mission of the G-20. Whereas in the past the burden of global adjustment fell disproportionately on deficit countries that could not attract private capital flows, today surplus countries are also affected by the threat of rapidly appreciating currencies and potential deflation. Thus, no country is immune from problems in the major economies.

Emerging market economies that had seen some evidence over the last two years for "trend decoupling" in growth rates between themselves and advanced economies are starting to realize that there is no clear "cyclical decoupling"; interdependence through trade and finance, as well as through expectations and sentiment (animal spirits) ensures that problems in any important part of the world economy continue to have an impact on the entire world economy. The nature of the fiscal deal that the Obama administration and the U.S. Congress is seeking - and the difficulty they are having in striking such a deal – is having an effect on the entire world economy. The uncertainties surrounding Greek and other peripheral European sovereign debt are also affecting the entire world economy, despite the small size of the peripheral economies.

We believe structural and distributional issues are crucial for the advanced economies. The emerging market economies and developing countries are in a better position, with younger populations, generally much lower debt ratios and often rapid "catch-up" growth. But for them too, structure and distribution matter. As forcefully argued by Dani Rodrik, catch-up growth is much faster in some sectors than others and should not be regarded as an automatic and aggregate mechanism. Developing countries need thoughtful microeconomic and structural policies to maintain rapid growth and indeed in most developing countries the key policy concerns today are about the pace of microeconomic structural reforms. Macroeconomic prudence, while required, is not enough. Moreover, income distribution is becoming more unequal in many developing countries or is still very unequal in others. Inequality can easily become a factor of instability, particularly if the pace of overall growth slackens. So developing countries too must embed and complement their macroeconomic policies in proactive structural and distributional policies.

This fall 2011 collection of the Think Tank 20 (TT-20) essays has been commissioned with these considerations in mind. This collection contains many different perspectives. There is no agreed or "common" policy line which makes the G-20 discussions all the more difficult. Jacques Mistral from France draws attention to the new challenges that the huge income concentration at the top—particularly but not only in the U.S.—poses for both the political economy of reform and the effectiveness of macroeconomic policy. Qiao Yu and Lan Xue from China do not seem to worry about income concentration at the top but about the growing share of income going to the state rather than the private sector. They appeal to as free as possible markets as the solution, thereby providing a striking example of how some emerging market economists have become strong advocates of what used to be views centered in the right-of-center segments of the political spectrum in London and Washington. The specific conditions in different countries vary and the contributions reflect this diversity. There is no doubt, however, that the G-20 will meet in Cannes in early November amidst great worries about the world economy, worries that are reminiscent of the dark days of late 2008. Now, as then, is a time for courageous and coordinated action based on sound and empirically grounded analysis.

If there is one common thread throughout all the essays in this volume, it is that the composition of public expenditure and taxes matters, as well as the aggregate levels. In the contributions by authors from advanced countries, questions abound whether enough attention has been paid to the long-term growth strategy. In Japan, the euro area and the United States, sluggish short-term growth is creating doubt about the path of future output. Those essays call for structural reforms to invest for the future, largely in infrastructure and education, echoing data showing that global investment as a share of global GDP is at a low point due to low investment in the advanced countries.

The contributions by authors from developing countries, where growth performance is still good, emphasize the impact on social stability of a better composition of public spending. Brazil and Turkey have histories of recovering from their own crises with a mix of macroeconomic, structural and social policies that produced "fair" distributional outcomes. It is that sense of social stability that now stands these countries in good stead in dealing with the current global crisis.

Each G-20 nation will pursue policies that reflect its own specific circumstances, historic memories and political constraints. But there is too much interdependence in the world economy to give up on the hope for greater coordination. Common ground can be found to develop policies that can lead to win-win solutions. We hope that the TT-20 network can contribute to such analysis and usefully accompany the official process.

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Endnotes

[1] Pittsburgh Summit Declaration
[2] Lagarde (2011).

Argentina's 2001 Economic and Financial Crisis: Lessons for Europe

Miguel Kiguel

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The 2001 Argentine economic and financial crisis has many parallels with the problems that some European countries are facing today. Prior to the crisis, Argentina was suffering a deep recession, large levels of debt, twin deficits in the fiscal and current accounts, and the country had an overvalued currency but devaluation was not an option.

Argentina tried in vain to restore its competitiveness through domestic deflation and improving its solvency by increasing its fiscal accounts in the midst of a recession. The country also tried to avoid a default first by resorting to a large financial package from the multilateral institutions (the so called shield or *blindaje*) and then by implementing a debt mega-swap that helped to refinance most of the debt with private banks. In the end, none of these efforts worked and Argentina faced its worst economic and financial crisis ever.

There were two issues that complicated the policy response to the crisis in Argentina, which to different degrees are important in Europe today. First, Argentina was unable to devalue its currency—without breaking the convertibility law—to restore competitiveness when the external conditions deteriorated. The strategy of trying to achieve a real depreciation through deflation did not work because there was not enough downward flexibility in nominal prices and wages.

Second, there was a large degree of financial dollarization in the economy, as the banking system functioned mainly in dollars. In this environment, the banking system had short-term liabilities in dollars but lacked a lender of last resort, as the stock of dollar assets—namely liquidity held by banks and international reserves—was not enough to cover the financial liabilities of the consolidated financial system. This was a major source of vulnerability, especially because there is ample evidence that an economy without a lender of last resort is inherently unstable and subject to bank runs. This is not a pressing issue in Europe, where the European Central Bank can provide liquidity to banks.

The trigger for the crisis in Argentina was a run on the banking system as people realized that there were not enough dollars in the system to cover all the deposits. As the run intensified, the Argentine government was forced to introduce a so-called "fence" to control the outflow of deposits. Under this system, people could only transfer funds within the banking system but they were not allowed to get cash, except in small amounts. This measure resulted in a monetary crunch and led to a collapse of economic activity—especially in the informal sector which mainly works on cash—and to widespread social unrest.

In the end, the fixed exchange rate regime collapsed and the country declared what until now has been the largest sovereign default in history ($85 billion). Argentina suffered its worst economic and financial crisis ever. The currency depreciated from one to more than three pesos per U.S. dollar in a matter of weeks, GDP per capita fell by around 20 percent during the whole period, while unemployment increased to 25 percent of the labor force and poverty levels reached 55 percent of the population.

While the crisis was extremely painful, the economy recovered relatively quickly. Since the crisis, Argentina has enjoyed sustained high rates of growth (a median of around 8 percent per year), which only suffered a pause during the 2008 global financial crisis. What factors explain the Argentine recovery? There is certainly no consensus on this issue. Some analysts give most of the credit to the default on the debt, others to the depreciation of the currency combined with policies that reduced macroeconomic vulnerability, while others argue that the key factor was the improvement in the external environment.

Although the default is often seen as the most important policy decision, it is not obvious that Argentina had a solvency problem at that time even though it definitely had a liquidity one. In 2001, the debt-to-GDP ratio was 55 percent, although the figure increased to 150 percent after the depreciation since most of the debt was denominated in foreign currency. The default was helpful in dealing with the refinancing problems because it provided significant relief to the liquidity problems. But in itself it did not help to restore competitiveness or confidence to resume growth.

The depreciation of the currency was probably more important, as it helped to improve competitiveness and to generate the twin surpluses. It was particularly effective in eroding the real value of wages and public sector expenditures (especially pensions), where there had been significant resistance to accept nominal reductions. It provided the flexibility in real wages that was not possible to achieve through reductions in nominal wages. The fact that the economy was suffering a severe recession and high rates of unemployment minimized the inflationary effects of the devaluation, which previously had been a problem.

The devaluation was also critical in reducing government expenditures in real terms and in improving the fiscal accounts. It was also instrumental in allowing the government to run large fiscal surpluses for more than five years.

While the sharp depreciation of the currency succeeded in changing relative prices, it did have substantially negative balance sheet effects, as firms and individuals had most of their debts denominated in dollars. To address this problem, the government adopted a forceful conversion of most financial assets and liabilities that were denominated in dollars into pesos at the old parity—this is now widely known as "pesification".

This policy was very disruptive and was a source of social unrest, especially among small depositors who found that their savings had lost purchasing power. It definitely affected property rights; the exchange rate that was used to convert the assets and liabilities was arbitrary and implied excessively large transfers of wealth from creditors to debtors, but it also avoided widespread bankruptcies.

In the case of the Europe, this would only become a problem if one of the countries were to abandon the euro. This may not have severe balance sheets effects if in the end the euro depreciates against other currencies. The opposite may happen, however. On balance, it would appear that an exit from the euro could be full of huge risks for any country in the eurozone.

The greater competitiveness of the economy in the aftermath of the devaluation was helped by a better external environment, especially the improvement in export prices and the stronger demand from Brazil, China and other emerging markets.

In addition, the de-dollarization of the banking system, while traumatic, did reduce the financial vulnerability of Argentina, as the central bank could again act as lender of last resort. The government also reduced its currency miss-match as a large part of public debt was also "pesified", which implied that it could service the debt using its tax revenues that were mainly in pesos.

Four years after announcing the default, Argentina finally restructured 72 percent of its debt and it managed to negotiate long maturities and a 65 percent haircut in net present value. Most of the outstanding debt that remained in default after the first offer was restructured in 2010—nine years after the default—under similar financial terms.

Is the Argentine default and subsequent restructuring an example to follow for Europe? There is no clear cut answer to this question, as the Argentina case had mixed outcomes. True, Argentina has enjoyed high growth since the crisis, but it could be argued that this took place thanks to the depreciation and the improvement in the external environment, and at the cost of allowing inflation to rise to almost 25 percent per year. Argentina took a large haircut that over time has led to a reduction in the net debt burden to around 25 percent of GDP. However, as this reduction was obtained by what the market perceived as an "excessive" initial haircut and by eroding the peso-indexed debt through the under-reporting of inflation, Argentina has not been able to regain fluid access to financial markets and credit spreads have been the second highest among emerging countries—only surpassed by Venezuela.

With the benefit of hindsight, it seems that Argentina could have done a few things differently. The market understood and accepted a restructuring of its debt and a large haircut as part of the process to restore solvency and access to financial markets. But it penalized the country thereafter mainly because Argentina imposed tougher terms than the market had expected. In addition, once Argentina finished the restructuring, it once again affected the property rights of the creditors, making what some economists have termed a "technical default" on the peso-indexed bonds.

The lessons for Europe are important. A default is doable, the market can accept it and it can work to restore fiscal solvency. However, in and of itself, a default is not enough to restore growth. In Argentina, the real depreciation of the currency and luck—the rise in soybean prices—were critical to sustaining a strong recovery.

Can Asia Keep Growing in the Midst of Global Economic Turmoil?

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Getting the right fix on the interaction between macroeconomic policy and structural reforms is crucial to navigating the world's economic woes in the years immediately ahead. The turmoil in industrial Europe and North America today is centrally about plummeting confidence in the ability of political leadership to establish the right balance between stimulating their flagging economies and dealing with the structural problem of future debt. As private sector demand fails to recover quickly because of serious balance sheet effects, it has been difficult for governments to maintain financial market confidence in their ability to deal with spending that is currently needed and future public debt. Fractious politics hamstrings forging majorities for packages designed to lift confidence and get recovery on track. Corrosion of the authority of political leadership feeds back into weak demand for labor and confidence in investing, and deepens the gloom. Restoring confidence will be a slow and painful process in a period of economic and political turmoil.

Europe has its own mess to deal with. The International Monetary Fund meetings in Washington in September and the political follow up that is now playing out across Europe have done something to staunch the financial bleeding, but the European economy is still in emergency triage. The European experiment is at risk. Over the last decade, unit labor costs in Greece grew by about 30 percent more than in Germany. This implies a 30 percent effective appreciation of Greece's real exchange rate. The validation of a real appreciation of that magnitude required a lot of government spending. That fiscal stance was bound to prove unsustainable. Greece is not the only European country in this pickle. Whether the Greek and European body politic can now wear the fiscal burdens of an adjustment without breaking the euro currency system remains to be seen. Deep down the worry is that the writing is on the wall for the euro itself. There is no doubt at all that, despite all the emergency measures to prop up Greece and keep it in the fold, there is serious risk of a eurozone collapse. Greece is not the only eurozone member trapped in the euro straightjacket. The core problem for southern Europe is its chronic inability to match German productivity growth.

In Asia, in which Australia's economic fortunes are crucially enmeshed, the question is whether there is any chance that strong growth will be knocked off course by the continuing weakness in the developed world. Success in avoiding that depends on whether extensive structural reform is put in place to shape the expansion of the investment so that it continues to roll out in ways that ensure it is productive and that economic growth does not run into the sand. In China, worries about inflation now dominate worries about maintaining employment growth, although growth of 8 percent or so would still continue to propel demand for key materials and a range of industrial inputs and imports.

Based on evidence from the last two years, emerging market economies in Asia and elsewhere might have had some reason to think that there was "decoupling" between their growth rates and those in the old G-7 economies; events of the last few months have significantly dispelled that illusion as interdependence through expectations and market sentiment, as well as more directly through trade and finance, has ensured that problems in the industrial economies wreak their havoc around the rest of the world. The political fragilities that were exposed for all to see in stitching a fiscal deal between the White House and the U.S. Congress and in trying to arrive at a doable deal in the European Union have taken their toll on world markets everywhere. The antics of the Congressional leadership and the cynical, half-baked nature of the deal they put in place, downgraded U.S. economic and political assets around the world.

Decoupling clearly has its limits but the Asian emerging market economies are still in a stronger position with demographic dividends still to reap, much lower debt ratios, and economies that enjoy the benefit of powerful "catch-up" to the industrial country frontier.[1] The potential rate of growth in emerging economies remains high because the "convergence gap," the gap between productivity levels in industrial countries and developing economies, remains large even for economies like China and India. This has not changed because the world has fallen into recession. Dani Rodrik is right that catch-up growth through closing the convergence gap should not be regarded as an automatic mechanism of guaranteeing rapid growth;[2] successful catch-up growth depends on getting policies and institutions right to absorb ideas and knowledge from the technology frontier. But that does not qualify the scope for rapid catch-up growth and the likelihood that it will dominate China and India's economic performance two to three to decades out, given their track record of policy commitment and economic performance thus far. In this context, it is instructive to reflect on the history of Japan's experience in the interwar period, when despite the massive hit that the Japanese economy took through trade and investment shocks as well as policy discrimination, it hardly missed a beat. Japan's economy still recorded in excess of 4 percent real growth (exceptional growth by the standards of that time) through the worst years of the Great Depression.

With these assets, what is to stop emerging economies powering the global economy from its industrial country malaise?

The long-term trajectory that foresaw the emergence of these new economic powers has been both elevated and truncated. Catapulted forward by their economic resilience during the global financial crisis, the BRICS (Brazil, Russia, India, China and South Africa) already have a more prominent place and role in the global system. The prediction less than a decade ago was that they would account for less than 10 percent of global output at the end of the first decade of the 21st century. They already hold twice that share and now global consumption growth in the years ahead is predicated on their continued and rapid growth, with the lackluster outlook for most of the G-7.

The perverse reality is that, even at a time of deficient global demand, the savings of emerging economies—most of which are generated in Asia—are being intermediated chiefly in the financial markets of New York and London. These savings are then invested largely outside Asia with a significant part lent to governments of already heavily-indebted developed (usually western) economies to finance their fiscal deficits. This money can certainly be put to better use. [3]

The "self-imposed crises in the U.S. and the EU have destroyed the capacity of industrial countries to contribute to global growth in the short term".[4] G-20 leaders—understandably consumed by the anxieties in Europe and North America—should not miss a crucial opportunity when they meet in Cannes next month. With Europe and the United States in the mire, this opportunity for medium-term growth is investment in developing economies. That does not mean just another big fiscal stimulus in China—there are risks with that which the Chinese government is justifiably cautious about assuming. But, it means putting the emerging economies of the BRICS at the leading edge of the global recovery strategy.

As growth in the G-7 economies stagnates, the average growth rate in emerging market economies has remained strong at around 6.2 percent. Over the next few decades, the economies of Brazil, China, India, Russia and South Africa can play an even more important global role along with other emerging economies like those of Indonesia, South

Korea, Taiwan and Singapore.[5] Stronger economic growth in these countries will also secure greater bargaining power, creating stronger leverage in international trade and diplomatic negotiations. BRICS should have a bigger say in world financial matters but they should also seek to define a key role in the strategies for a global recovery as they reform global governance.[6]

The potential for productive investment in infrastructure in the emerging economies is enormous.[7] The Organization for Economic Cooperation and Development estimates global infrastructure requirements to 2030 to be in the order of \$50 trillion.[8] Much of this demand is in Asia, which is also the primary source of the savings that are currently sloshing around the global economy. There is almost a trillion dollars worth of infrastructural investments in the region that have been given the once-over by the Asian Development Bank. China's economy may be facing a temporary problem of over-heating, but its stock of capital relative to population and income is low. India and Indonesia offer vast scope for investment infrastructure. The U.S. also needs to make large investments to rehabilitate or extend its economic infrastructure. More generally, global investment is at a historically low share of global output.[9]

An atavistic G-7 mindset has the G-20 focused on a development agenda that largely misses this main point. G-20 leaders have appointed a High-Level Panel on Infrastructure to advise them on improving the institutional and enabling environment for infrastructure investment and ideas for financing infrastructure projects with significant but delayed returns to investors. Yet the panel's brief focuses only on infrastructure in the world's most difficult investment environments, in particular sub-Saharan Africa. This focus is too narrow. The issues of institutional capacity, innovative financing and risk management need attention everywhere. At their next summit in Cannes, G-20 leaders need to grab the panel's terms of reference and widen them, challenging their officials, financial sector managers and international financial institutions to use their expertise to find ways to intermediate more savings into commercially viable investment in infrastructure wherever it is needed, but especially in the BRICS.

The Asian six in the G-20 can take a lead here. On a visit to Jakarta at the end of September, Japanese Economic, Trade and Industry Minister Yukio Edano announced that Japan would support the reconstruction of Jakarta's ramshackle port capacity, including a new airport, and help build a long overdue urban railway system.[10] This is the kind of infrastructure investment that will both boost Indonesian productivity and lift Japan and the G-7's recovery and growth prospects.

It is time for G-20 leaders to look beyond the G-7 funk and focus on the opportunity for sustaining global growth through a development agenda, driven by robust investment and growth in the BRICS.

This strategy for global recovery can succeed only if it is complemented by vigorous structural reform in the emerging economies that must drive it. There cannot be sustained growth through ramping up infrastructure investment if that investment is not productively and efficiently deployed.

Structural reform includes measures that improve institutions, incentivize efficient and sustainable production, investment and employment, and facilitate fundamental, productivity-increasing changes in economic structure. This is a complex task to which the Asian members of G-20 bring a particular and important perspective because of their experience with rapid economic transformation and reform. Structural problems ultimately have to be dealt with by national governments but they will be made more tractable through international cooperation and understanding of what is at stake.

The Asian economies have been growth success stories in the past because of the pro-market, export-oriented reforms that they have undertaken. Openness at the border has delivered high catch-up growth based on the export sector and stimulated by very high rates of investment. This growth path is unsustainable because market reforms that have encouraged it are incomplete. Goods markets have been liberalized but other markets are still heavily distorted, including those for the services that infrastructure investment is designed to deliver.[11]

A central step in achieving this will be through the liberalization of the factor and service markets: markets for labor, capital, land, energy, the environment, and physical and social infrastructure. This requires market institutions to appropriate to settings in national economies that will ensure the efficient and equitable operation of these markets as well as the markets for goods.

Some of the distortions, such as state control of energy prices or monopolies in telecoms, transportation and other services, are the result of deliberate policy decisions. Others, such as restrictions on capital markets and on the movement of labor, result from transitions in the process of reform. But they all share common features. They generally depress factor prices and lower production costs, subsidizing producers in the tradable goods sector. This model has been successful in the past, judging from the rapid rates of economic growth. The producer subsidy equivalents have increased industrial profits, raised investment returns and improved international competitiveness, artificially lifting these economies to income levels that would otherwise not be possible.

But the pre-crisis growth model has not been without costs and it is not sustainable for much longer. The most obvious problems are the structural imbalances, resulting from the overdependence of the economy on exports and the high rates of investment and resource consumption. More fundamentally, expansion of investment without structural reform will lead to waste, diminishing capacity to grow and mounting debt. This model of economic growth cannot be sustained in the longer term because consumption in advanced country markets has to fall. There will not be the same capacity to absorb exports from emerging markets as there was in the past. Industrial countries have to cut their deficits and rely less heavily in the future on external borrowing.

Growth in Asian and other emerging economies against the global tide is not sustainable in the pre-crisis growth model. But the room to grow is there and that presents an opportunity which the world cannot afford to forego.

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Brazil in the Current Environment: Will the Tropical Social Democracy Sustain the Momentum?

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In the last decade or so, an unusual commodity boom took place with interest rates decoupling from commodity prices and more recently commodity prices from the economic cycle of advanced economies. If historically interest rates, prices and global output moved together, the rise of China, India and other Asian commodity-dependant economies seem to be responsible for a new type of commodity super cycle taking place despite the difficulties of advanced economies to regain traction and move toward economic recovery. Although commodity prices are not indifferent to the current crisis, and short-term price movements do respond to spikes of risk aversion as observed during September, a combination of supply constraints and rising incomes in emerging and developing economies is putting sustained pressure on prices and it would take a major recession for a "shift down" in this long-term trend. Clearly a lot will depend on the growth prospects of China and other emerging economies. If trend deceleration becomes a fact and China's long-term growth peters down to 5 percent, the decoupling proposition loses strength. However, the view espoused here is that high commodity prices are here to stay in the foreseeable future.

One major implication of this phenomenon has been the boost to economic growth for low and middle-income countries with significant natural resource endowments—mainly countries in Latin America and sub-Saharan Africa. Those countries with fairly solid economic policies have benefitted the most by ensuring that the shift in the terms of trade and major income gains did not translate into price inflation; and the needed import space was occupied by a combination of consumption and investment goods necessary to sustain the growth momentum. Government finances also gained from the "boom", not only by growth-induced increases in tax receipts but from a change in the power balance between commodity producing firms and governments, with the latter bent on capturing a larger proportion of economic rents and improving their fiscal position. It seems that over the longer term, the consequences of the current commodity super cycle will have greater significance than the economic and political shifts propitiated by the 1973 oil shock and the rise of OPEC, for income gains are now more widespread and do not depend on a cartel arrangement but on structural factors linked to the fundamentals of supply and demand.

Among the large emerging economies, arguably Brazil has benefitted the most from the rise of China and other commodity-importing nations. After decades of facing growth arresting balance-of-payments constraints, Brazil´s external position is now a far cry from the past. Buttressed by $352 billion in international reserves, the external sector as a barrier to growth became an effective non-issue: a total trade flow of $456.5 billion generated a positive trade balance of $28.7 billion (over a 12-month period); a current account deficit of 2.1 percent of GDP is being over-financed by foreign direct investment flows equivalent to 2.4 percent of GDP; and total external debt at $297.1 billion implies a debt service ratio of 2.3 percent of GDP (versus 10.9 percent in 2002, when the reserves-debt ratio was a mere 18 percent). Although credit default swap spreads nearly doubled from December 2010 to end September 2011 (111 to 202 bps), they are still significantly under the average for emerging economies (370 bps), while the last time the country issued a sovereign debt instrument it paid 105 bps over Treasury bonds of same maturity.

The commodity cycle was relevant to the relatively solid fiscal position, by lifting profits and the wages in agribusiness, mining and energy, with positive spillovers across construction, manufacturing and services. The rise in taxation (which now amounts to 35.3 percent of GDP) mostly from an increase in taxable income in the formal economy and a reasonable degree of fiscal discipline (budget surplus before interest payments stands at 3.2 percent of GDP) brought the public sector deficit to 1.9 percent of GDP in July 2011 and net debt to an estimated 38.5 percent at the end 2011 (with gross debt at 60 percent of GDP).

With a little bit of luck, a modicum of prudence and competent macroeconomic management, Brazil avoided the squandering of resources and put them to good use overall.

On the domestic front, a new set of social policies providing cash transfer to the poor, the elderly and the disabled came to maturity. In the last decade, increasingly well targeted programs not only reduced poverty and income inequality but injected a measure of economic dynamism in poor and depressed areas in Brazil. Other growth inducing forces were at work and included an excess demand for labor at the bottom of the pyramid, centered on services, commerce and the housing industry, which sanctioned policy that brought minimum wage in line with perceived minimum consumption requirements. A proactive stance on labor rights also pushed employers to formalize relations, pay taxes and bring the working poor under the social security umbrella that was previously denied.

For Brazil, the numbers speak for themselves: in every single year since 2001 the Gini coefficient has decreased (at 0.53, it is still very high when compared to 0.36 for India and 0.42 for the U.S.); poverty rates have gone down during the period from 35.2 to 21.4 percent of the population by 2009, with extreme poverty being more than halved (15.3 to 7.3 percent)—12 million people have been lifted out of extreme poverty and 19.3 million have been lifted above the poverty line. From 2003 to 2011, 37.5 million people made the transition away from poverty into the middle class, which now makes up 55 percent of the population and 47 percent of purchasing power.

Rising domestic consumption was fueled as well by credit from a conservative, capitalized banking industry. In recent years, leveraged by low nominal and real interest rates (by historical standards), limited family debts and rising real wages, consumer and mortgage credit expanded to match a pent up demand for durables, vehicles and housing. In 2011, the ratio of total credit to GDP will reach 49 percent with a still low mortgage debt/GDP ratio of about 4 percent. This suggests that credit markets will continue to fuel domestic demand and therefore output growth and imports. With the current account deficit checked by the commodity driven export dynamism, Brazil might for the first time in decades be on a path for sustained growth at trend rates of 4 to 5 percent. While modest by Asian standards, this level of growth is high considering the record of the last three decades, that it is supported by a low investment rate (currently at 18.4 percent of GDP), and it is driven by consumption on the demand side and on the supply side by the service industries, which now account for two-thirds of the economy.

Brazil's positive economic record can actually be traced to two decades of reforms, which strengthened the basic institutions of economic management and improved the quality of policies. Helped by a more open economy, and having for reference a number of frustrated stabilization attempts, the 1994 Real Stabilization Plan was implemented in the context of effective institutions, including a highly regarded central bank and a ministry of finance well versed on debt management and the complexity of inflation dynamics. Monetary reform led to a quantum jump away from hyperinflations. And fiscal reform culminated in 2001 with a strict law of fiscal responsibility, which threatened with civil sanctions and criminal penalties public officers unwilling to follow the guidelines of prudent fiscal management. It is worth stressing that denied a generous inflation tax on demand deposits, over-branched and undercapitalized banks had to adjust, restructure and dispose of assets at a fiscal cost of less than 2.5 percent of GDP and thus with limited impact on public debt.

The other side of the silent revolution that Brazil underwent for the last two decades resulted from microeconomic reforms. Privatization, despite some misgivings, was a far cry from anything resembling a giveaway or the transfer of assets to a new economic clique. A competitive process raised resources and a significant chunk of public debt was transferred to the new owners. Initially, the fiscal imperative was dominant. However, following the examples of the United Kingdom, New Zealand and Chile, the promotion of entry and competition, and tracking of contractual obligations required regulatory oversight by newly constituted agencies. Some were more successful than others, but generally privatization and the opening to competitive rivalry injected dynamism, efficiency and promoted the modernization in sectors such as mining and metals, oil and gas, as well as in infrastructure.

Brazil's Workers Party government which took office in 2003 had some misgivings about privatization and doubts about the mandate of the agencies, but a reversal never took place. Moreover, a new agenda of reforms was initiated centered on the enhancement of credit markets which dovetailed with gains in real incomes starting in 2004 and pushed out the consumption envelope. Improvements in family incomes were propitiated by a combination of a rise in labor demand and increases in minimum wages often in excess of inflation and productivity. Yet overall these were consistent with labor market conditions and did not introduce major distortions.

Brazil does not stand out on the basis of its growth record, which since 2003 has been moderate at an annual average rate of 4 percent; nor even in terms of poverty reduction. Other countries have achieved faster economic growth and a number have been able to reduce poverty rates in significant ways—but more often than not at a cost of rising inequality, social tensions and political exclusion. It is the combination of growth, poverty reduction *and* lowering inequality in Brazil that raised eyebrows. It is also the fact that this was achieved in a broadly non-acrimonious atmosphere, with a de facto (implicit) compact expressing a convergence of views on the fundamentals of what constitutes economic and social progress. Political radicalism, religious sectarianism, and social Darwinism find little solace in Brazil. The ethos of moderation prevails in politics and religion, and a sense that the weakest segments of society have to be protected in a Rawlsian perspective on distributive justice —being the government's obligation to extend the umbrella—suggests that Brazil embraced a tropical version of social democracy.

The Brazilian *model* of growth-cum-redistribution and political accommodation is a product of the country's 1988 Constitution, which enshrined the notion of economic rights enforced for the disenfranchised, the elderly, the unemployed (and not only) by the state. It comes with some distortions —mostly in the pensions and unemployment insurance regime—and at a cost. Domestically, its financing requires steep and creeping taxation of economic activities; externally, the country needs a benign environment and a voracious China and other commodity hungry countries. Thus, Brazil is not impervious to the current crisis and authorities are quite concerned to say the least. They join the chorus of voices asking for determined action above all from European leaders, political institutions and the *troika* to act in the coming days and weeks. And they should move before the Greek drama spills over to a banking crisis and pushes the world to revisit the Great Recession, which it may *not* emerge from in the next two to three years.

In fact, Brazil has been a critic of the measures taken by the U.S. and Europe to deal with the recession. In an inversion of roles—denoting how the world has changed in less than two decades —it chastised politicians and policymakers from advanced economies for the fact that not enough has been done on financial reform; that banks "too large to fail" paid a light price for irresponsible behavior and therefore are bound to repeat it; that "quantitative easing" and similar initiatives brought about an exchange rate war, imposing the need for policy reversal in countries which had not actively managed exchange rates and had relatively open capital accounts; and that the larger and more solid European economies should be leading the way in shoring up the finances of the European periphery, even at the expense of political dogmas and conservative economic credo.

The perception of how deep the crisis is has changed in recent days and weeks. The symptoms abound: the divisions within Europe and an apparent absence of political urgency combined with a lack of a clear path out of the financial and fiscal mess; the last actions by the Federal Reserve and a sense that Ben Bernanke's "bag of tricks" is now empty, and political opposition to activism by the Fed is on the rise; and the appearance that President Obama is unable to communicate a strategy, galvanize his people and lead the U.S. out of the crisis, yet continuously surprised by the complexity and magnitude of economic problems the U.S. and the world face.

Brazilian policymakers and many of their counterparts are now pondering what the optimal defensive strategy is in view of the uncertainty clouding the world economy.

There are a number of channels through which low growth in advanced economies, or worse a new recession and a banking crisis, would affect the Brazilian economy. First and foremost, through credit and capital markets, as the last quarter of 2008 clearly demonstrated; second, from diminishing demand and lower prices for Brazilian exports from its major trading partners, with the looming danger posed by beggar-thy-neighbor policies.

The core objective of Brazilian policymakers is to ensure growth in the 3-4 percent range this year and possibly the next, while maintaining inflation in check (that is, below 6.5 percent, the upper band of the central bank´s target). Currently inflation is running at 7.3 percent on an annual basis. The most dramatic action undertaken by the Brazilian government was to change the policy mix: tightening fiscal policy while lowering interest rates from 12.5 to 12 percent on August 31. Nonetheless, with real rates close to 5 percent, it still contrasts with quasi zero real rates in India, China, Russia and Japan, and negative rates in the U.S., the U.K. and the euro area.

For Brazil's central bank, this was a bold move. Historically, real interest rates have been maintained at very high levels to ensure macroeconomic stability in view of the persistence of inflation, with economists unable to agree why that is so and such high rates are indeed needed.

Be as it may, the Brazilian central bank reassessed the balance of the risks, and loosened monetary policy despite inflationary pressures. It is taking a "calculated risk". In this regard it is not alone; on September 26, the Bank of Israel lowered rates to 3 percent despite 12-month inflation running at 3.4 percent (outside the 1-3 percent band). Stanley Fischer and his colleagues seem to be saying that at this juncture the inflation risk has been dominated by that of recession.

If the crisis looms, it has yet to hit the shores of Brazil. So far, credit markets in Brazil are functioning normally and well irrigated with resources; domestic banks are capitalized, not afraid of lending and borrowers are repaying on time; and lower interest rates will be a prop to both consumers and firms in the coming months. At the same time, the government seems to be increasingly bent on protecting industry from the combination of exchange rate appreciation and an import surge which has firms pondering if the most trade exposed manufacturing segments will survive in the coming years. Low-rate financing, tax incentives and more recently a de facto tariff barrier targeted on (basically Asian) automotive imports outside Mercosur, seems to be the wrong response to low savings, investment and productivity.

Indeed the Brazilian redistributive *model* of a consumption-driven economy has so far thrived on the back of a diversified, large and efficient natural resources sector, despite the shortcomings associated with low rates of investment in *collective* goods or those commanding large growth-inducing externalities, such as infrastructure or quality basic education. Therefore, one would not expect the country to significantly alter its economic trajectory in the coming years but to sustain moderate growth rates with reduced inequality levels and extreme poverty becoming a residual phenomenon, through a combination of market forces and government entitlements, and converging toward a middle class society characterized by a reasonable degree of social and economic mobility.

How long will this last? There is an undercurrent of demographic and economic forces that will no doubt challenge the fundamentals of the *model* in the coming years. Brazil is enjoying a demographic bonus that should peak at the beginning of the next decade and rapidly change the age structure of the population thereafter, as fecundity rates collapsed from 2.8 to 1.9 children per woman in 1990-2010. The population will get older, taxing the resources, straining the government´s fiscal position in the face of society's diminishing willingness to continue to pay for an expensive and relatively inefficient public sector. This will also happen at a time that the commodity bounty may be over as China and other emerging economies mature. At the same time, Brazil is not taking advantage of its current generous demographics. At the current exchange rate, and after a 16 percent devaluation in September, unit labor costs are still three times as high in Brazil than in China, while labor productivity in the last decade increased respectively by 0.4 percent and 5.2 percent annually. Large tracts of the Brazilian heterogeneous economy can be characterized by high cost and low productivity.

Both phenomena are intertwined: demographic and economic trends point to the necessity of social security and related reforms in the Brazilian government´s transfer programs, which simultaneously reallocate resources toward investments in infrastructure, human capital and other productivity enhancing factors while establishing the basis for a long-term increase in government and private savings. In this context, major improvements are due in the efficiency and quality of government services, the delivery of which is marred by bureaucracy, waste and corruption. Yet, despite the wish of many in government, the functioning of the political system conspires against significant reform initiatives so long as the sense of accomplishment and self satisfaction prevails.

What is being suggested here is that the imperative of reforms and structural change to enhance productivity—the only guarantee for sustained growth over the longer term—could in the Brazilian case possibly be postponed beyond this decade. For the next few years, Brazil should benefit from a combination of resource abundance on the supply side and a growing middle class with unsatisfied consumption aspirations providing dynamism to the domestic market as long as demand and prices for agricultural, mineral and energy commodities hold firm. Other emerging and developing economies may not have the same choice. But it is unlikely that Brazil will confront its fundamental weaknesses other than through incremental changes, as long as a generous resource endowment can continue to finance private and government consumption and investors continue to bet on the country's future.

Responding to Global Economic Challenges: A View from China

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The world is again on the brink of a global crisis. Major economies are respectively plagued by different woes: the eurozone is confronted with a free-falling of sovereign debt, leading potentially to a full-fledged financial crisis; the United States is suffering from intractably high unemployment that shows no sign of improvements; and major emerging economies are besieged by unexpected high inflation. Largely due to the economic difficulties, social tensions have increased significantly and unrest has occurred sporadically in many countries.

World leaders have been called to take action to stop the global economy from falling into an abyss. But the challenge is how: launch a grand bailout for the broken coffers of Southern Europe? Expand government spending or conduct an austerity campaign? Carry out another round of quantitative easing in the industrial countries while squeezing the money supply in emerging markets? Unlike the situation immediately after 2008 financial collapse, when it was possible to have globally synchronized policies such as a universal fiscal stimulus and simultaneous liquidity provisions, there is no "one-size-fits-all" solution to address the intricate issues currently facing the major economies.

Problems of the Industrial World

The foremost urgent global problem is the emergence of a full-scale financial crisis in the eurozone. This is coming from the interdependency of sovereign debt woes in Southern European countries and bad assets in European banks. Due to the fact that almost all continental European banks, including German ones, are heavily exposed to toxic peripheral country sovereign debts, sovereign debt troubles and bank insolvency will end up exacerbating each other. This creates a vicious cycle which may doom the entire European financial system and the euro itself.

To save European Union from falling into pieces, the eurozone governments are forced to take collective actions to contain the sovereign debt woes and strengthen sick commercial banks before the situation goes beyond control. But the major obstacle is that the monetary union lacks both fiscal authority and a federal will to employ functional tools to address two interactive systemic risks. In addition, each of the eurozone governments is still struggling to win domestic support for the policy actions needed to address the situation.

Yet, no one can guarantee the success of enlarging the capacity of the European Financial Stability Facility (EFSF), expanding the role of the European Central Bank (ECB) and forming closer fiscal integration. The future of Europe is also shadowed by another recession, thanks largely to austerity policies currently being enforced by peripheral countries and France.

The situation on the other side of the Atlantic is anything but promising. A normal economy would have a strong and sustained rebound after a deep recession clears up the muddle. But this has not happened in the U.S. Two years after the economy started to climb again, the recovery is very weak and temporary. Despite the fact that the U.S. government resorted to an unprecedented stimulus campaign accommodated by the Federal Reserve's quantitative easing, job creation is still stagnant; the current U.S. unemployment rate is still hovering over 9 percent. Public spending, on the other hand, will hit a new high of $3.6 trillion this fiscal year, which makes the U.S. the second most heavily indebted nation in the developed world.

The real danger is that such huge government spending has resulted in little economic growth. This implies that the gap between government spending and revenue is more likely to move toward a diverging track. As the U.S. budget deficit and federal debt are mainly driven by the phenomenal rise of entitlement expenditures, especially in health care, it is very uneasy for the rest world to guess when the welfare status quo in the U.S. will grind to a halt and how the U.S. will unwind its debt burden.

The truth is that the redistribution of wealth needs lots of political support but it is unlikely to raise economic productivity. To absorb unduly high unemployment and reduce unbearable public debt, the U.S. must be on a long-term transition from a mass consumption society toward a creative production economy. However, constrained by political reality, the path of a welfare state is not easily altered.

China's Challenges and Policy Responses

Although China is financially better positioned than the major industrial countries, it has its own challenges.

The first challenge is to cope with rising inflation. Similar to its peers in the developing world, China has been experiencing an increase in prices over recent months. This is caused by both internal and external reasons. For over a decade, the People's Bank of China (PBC) has used yuan to buy dollars and then has sterilized the money supply by selling bonds to retire yuan from circulation to maintain stability in prices and exchange rates. As a result, the PBC's balance sheet is plugged with massive foreign reserves, making it the largest central bank in the world. If the sterilization ceased, a glut of yuan would flood the economy. The grand stimulus starting in 2008 ended the sterilized equilibrium. China's stimulus plan is so heavily debt-fueled that bank lending rose by 21.75 trillion yuan ($3.35 trillion) in 2008-10. This is the monetary driver of rising prices. On the other hand, the Federal Reserve's quantitative easing partly contributes to China's inflation. As trillion-sized extra dollars were injected in the global market, the world commodity prices, including petroleum and agricultural products, have been boosted. As the largest importer of commodities, China is inevitably faced with cost-push inflationary pressure.

The second challenge is to tackle the slowdown of economic growth. This is caused by multiple factors. On the demand side, the gloomy perspective of Europe and the U.S. puts downward pressure on China's growth since they are the most important markets for China's exports, directly accounting for one-third of China's total exports and over a half indirectly. In the meantime, domestic household demand in China lags far behind income expansion, due largely to the fact that income distribution is in favor of government and state sectors. On the supply side, big state companies have easy access to credit with the current financial system, but small and medium-sized enterprises are in a pinch, even though the latter provides the majority of jobs and accounts for half of national products in China. As the matter stands, rising prices coupled with a growth slowdown hints at a real danger of stagflation with Chinese characteristics.

Another woe is the property bubble that has been developing in the past three years when the stimulus campaign was launched. While big firms held too much liquidity, especially monopolistic state companies, they rushed to the real estate sector for unduly high profits. Rich households were zealous of property investments as there were very limited venues to park savings, while middle-income families were panicked to get into the real estate market in fear of rapidly rising property prices.

The fourth challenge is the continuous deterioration of income distribution tilted toward government coffers, big state enterprises and urban riches against the backdrop of rising prices, especially property prices. Meanwhile, disparity between low-income earners and high-income earners has significantly widened.

In addition to these short-term challenges, there are some long-term structural problems that China must address. Some of these include: the continued income disparities between rural and urban areas and among different regions; the reliance on exports and resource-intensive manufacturing as major drivers of economic growth; the relatively slow progress in China's innovative capabilities, and the massive air and water pollution throughout the country. China has been trying to address these problems by changing its overall development model to a more balanced and sustainable path since 2003. However, it is still an uphill battle to try to shift the system to the new development path, particularly in the face of a global economic crisis.

Faced with these challenges, the Chinese government has undertaken a series of policies to combat rising inflation and maintain economic stability.

The most striking one is a tight monetary policy to curb liquidity. Since November of 2010, the PBC has raised the required reserve ratio for commercial banks by nine times, driving the ratio from 17.5 percent up to 21.5 percent, significantly squeezing the available liquidity in the credit market. In addition, the PBC has let the nominal exchange rate of yuan against the dollar appreciate by 4.2 percent since beginning of this year in hopes of partially canceling out imported inflation. The China Banking Regulatory Commission (CBRC) has set up a risk capital requirement for trust companies to oversee Chinese shadow banks for possible credit substitution.

Another strong policy combination is restrictions on residential housing purchases coupled with a big low-income rental housing plan. At the beginning of this year, the Chinese government issued property market regulations to cope with the property bubble by raising the down payment requirement and prohibiting speculative purchases. In the meantime, it has also undertaken a large-scale campaign of constructing 10 million units of low-income rental apartments nationwide this year, and totaling of 36 million units in three years. To accommodate this ambitious plan, the central government is permitting the investment firms of local governments to fund projects by issuing company bonds. The central government is also allowing banks to provide debt financing with preferential rates.

Other visible social programs include a free compulsory education plan for all children, and enlargement of both health care coverage for rural residents and social security for urban low-income earners.

However, some of these measures are double-edged swords. For example, raising the required reserve ratio of banks has an immediate impact on the 40 million small and medium-sized enterprises currently facing a serious credit crunch that is forcing many of them to close or borrow money in the gray market with interest rates two to three times higher than official rates. Most recently, the State Council had to roll out a whole new set of policies specifically designed to support small firms.

On the other hand, traditional tools to tighten credit have become more difficult than ever because financial institutions have many ways of circumventing control and regulations. Furthermore, the conduct of monetary policy is in essence based on direct quota rationing, so that it is more likely to lead to severe rent-seeking by banks.

Compared to proactive monetary policy, fiscal policy is rather inactive and inflexible in responding the looming challenges, even though it may play a more important role given China's strong fiscal position. Certain welfare policies, especially a big campaign for low-income housing, may run the risk of piling up significant bad loans in the banking system as these welfare measures have not been carefully studied and debated.

At the same time, China has also started to promote the development of strategic emerging industries. In all, seven major industry clusters were identified—energy saving and protection of the environment, the next generation of information technology, new materials, alternative energies, clean cars, biotech and high value-added manufacturing—in hopes of increasing their share of China's GDP from 3 to 4 percent to 8 percent by 2015 and to 15 percent by 2020.

Suggestions for Global Cooperative Actions

While China and other countries' efforts may help to ease the problem to a certain extent, it is clear that the world is facing some seriously complex global challenges. An additional round of fiscal stimulus and loose quantitative easing will not help lessen the crisis. On the contrary, they may accelerate its burst and exacerbate the macroeconomic environment afterwards. The following are some possible ways to get out of this economic mess.

The world must work together to contain the immediate financial crisis in Europe in order to prevent the international monetary system from permanent damages caused by either the monetization of troubled sovereign debts or the collapse of the euro system. Meanwhile, it is also urgent to formulate local public polices with global considerations to resume the long path of economic growth in the developed world and to cope with inflation in the developing countries.

1. Fix Europe's Financial Woes

In the context of Europe, the political status quo rules out the replication of the U.S. grand bailout. The International Monetary Fund is an ideal institution to provide external aid. But IMF's European preference is severely constrained by the mismatch of its financial ability and global responsibility. As such, it is necessary to find a creative way to solve the European crisis. An alternative model of cooperation between the European authorities and global market investors can address the current financial woes.

This approach creates a division of labor between the united European governments and allied long-term global investors, including Western private investment firms, like Berkshire Hathaway, and Asian public fund institutions, like China's SAFE and CIC, Singapore's GIC and many others, to strengthen the trembling European financial system. That is, European governments should collectively clear up the sovereign debt mess on the foundation of political compromises and global cash-rich long investors would collaboratively invest in European banks as market-based deals. To facilitate this plan, the European authorities should pursue the following steps in advance:

- enlarge the rescue fund, restructure sovereign debts and promote the Eurobond plan to assure investors;
- adopt the model of a resolution trust company (RTC) to separate bad bank assets from good ones for European banks;
- collectively engage with cash-rich long investors, including Asian and Chinese investors for terms and conditions of involvement;
- enhance transparency of bank balances and off-balances; and
- leave prices and clauses of bank investment negotiated by involved parties on a mutually agreed basis.

2. Restart the U.S. Economic Engine

Obviously, massive government spending alone will not create enough jobs nor will unprecedented quantitative easing. On the other hand, persistent negative externalities caused by these measures loom because together they have driven up commodity prices worldwide and undermined the global trust in the dollar. Keynesian stimulus is not panacea, which has done nothing to mobilize internal sources of growth.

It is time to recall Say's law, another essential economic wisdom, which tells us that supply creates demand itself. The American dream is rooted deeply in the provisions of original innovations and risk-taking entrepreneurship, which come from competitive markets and not almighty government. In this regard, the best approach to reignite the American economic engine is to enact policies that create a business-friendly environment, which cultivates innovation, fosters entrepreneurs and supports capital investment. The following measures should be seriously considered:

- promote small business and American entrepreneurship;
- exit the zero rate policy to reflect the price of capital correctly and lift the glut of easy money;
- cultivate predictable expectations for long-term business investment;
- reform the entitlement system to reduce the fiscal burden;
- restructure the tax system to broaden its base and reward capital investment; and
- open up doors for foreign direct investment in businesses and eliminate structural barricades to such investment.

3. Improve China's Macroeconomic Management

To avoid a possible scenario of stagflation, the Chinese government needs to create a set of policy instruments to achieve the dual goals of macroeconomic management: controlling inflation while maintaining growth at an acceptable pace. The core of these tools is to treat small and medium-sized enterprises fairly in terms of bank lending, explicit taxes, implicit fees and surcharges, and other financial burdens. Keeping these firms afloat in a harsh economic climate is crucially important for employment and growth.

There are many ways to formulate these tools. The first is to refine monetary policy in terms of indirect management and gradually move away from direct quantitative control. If the central bank frees deposit rates and lending rates for banks, it will largely solve the dilemma confronted: the PBC has a high degree of freedom to usher interest rates to ward off inflation, while letting banks have autonomy to select efficient clients and manage risks.

Secondly, it is necessary to form a mix of monetary policy and fiscal policy. To date, fiscal policy is mainly a one-way conduct—a coffer-filling practice regardless of what the macroeconomic environment is. In fact, fiscal policy is able to perform active functions to support monetary policy in achieving its goals. For example, fiscal policy may reduce burdens for small and medium-sized enterprises by simplifying tax practices. Another example is to craft a well-designed income tax code with reasonable deductions for households to replace the prevailing primitive conduct. These would provide incentives and fairness for firms and individuals to pursue honest and hard work.

As for the social programs, especially big ones with long-term effects, the recent bankruptcy lessons of welfare statism in many industrial countries should be kept in mind for policymakers. It is an unsustainable model that is not worthwhile to copy. Even though some programs may win political gains in the short term, the society will eventually pay the cost. The clever way of maintaining sustained harmony and durable stability is to give people more economic freedom while constructing a framework of the rule of law, but not create an almighty government.

Conclusion

World leaders are at a crossroads in deciding where to go. Today's problems need to be addressed by local policies with global implications. Each major nation must take on appropriate policies to solve its own troubles, like debt-fueled spending in the United States or exchange rate management in China. But national governments must do so while keeping in mind the potential global repercussions and backlash from their domestic policies. Meanwhile, the problems also need to be resolved by global cooperation with local solutions. In order to tackle these intricate issues, such as Europe's financial woes and climate change, global cooperation is necessary, but it must be based on local political solutions.

On the other hand, increasing the size of government is not the right answer. Thirty years ago, the world faced big challenges in different forms. The Deng-Thatcher-Reagan revolution was the perfect response—to mobilize millions of people's initiatives to overcome economic and social hardship. This great example is very worthy for newcomers to learn.

Wanted: A Strong and Better G-20 for the Global Economy

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The resurgence of turbulence in international financial markets—with epicenter not in the U.S. banking system as in 2008 but in the European sovereign sector—potentially brings the G-20 closer to the center of policy action after a phase of relative eclipse. Many questions arise. Are the European risks relevant from a global perspective? Is the G-20 the right forum to avert threats to financial stability? And if so on both counts, what concretely can and should the G-20 do?

Since its birth, the G-20 has had two souls—one as policy coordinator in fair weather times and one as crisis manager. As a matter of fact, the G-20 was born twice: a first time in 1999 as a new forum of finance ministers in the wake of the Asian crisis and then again in the fall of 2008, when it was upgraded at the level of heads of state and government in the frantic weeks following the Lehman demise. In both cases, the situation called for a crisis manager, not a fair-weather sailor; the first time, to limit the contagion stemming from emerging but unstable economies; the second, to reassure global financial markets in a moment of grave risk. In both cases, the immediate danger was eventually averted and most would agree that the G-20 contributed to the positive outcome. But in both cases, after the risks receded, the G-20 started to be engaged in the more routine task of crisis prevention, mainly through attempts at economic policy coordination. Here its performance has been at best less convincing and criticism of its effectiveness has mounted.

For these reasons, it is perhaps useful at this juncture to revisit some fundamentals: why should the G-20 exist at all? And how has acted so far and with what success? We argue below that, contrary to what critics say, the G-20 is not unnecessary and has not performed poorly overall since the group's reshaping in 2008. It is true that its effectiveness has diminished and that this has happened particularly when it has tried to play a role as policy coordinator in relatively good times. As we approach the Cannes Summit, the only meeting of G-20 heads of state and government planned in 2011, it seems unlikely that the French presidency will bring substantive deliverables in spite of early ambitions and a substantive agenda. Many observers perceive a slow slide into irrelevance and the G-20 has ceased to be a frequent and topical subject in newspapers, blogs and even scholarly publications. All this is particularly unfortunate at a time when a global economic crisis manager is again needed. Starting from these considerations, the final part of this article elaborates on what contributions the G-20 could provide in ensuring sustainable growth and financial stability in the global economy going forward.

The Case for Global Economic Cooperation

The controversy on the value and the limits of economic policy coordination is among the many unsettled controversies in economics. Decades-old discussions have left behind a number of useful insights, elegant models and plenty of ambivalent empirical evidence, but no clear answers or reliable guiding principles for policymakers.

In principle the basic issues seem easy to settle: in an interdependent world, where national economic performance and policies influence others, there should be benefits from coordinating policy actions—in other words, deciding policies not only on the basis of narrow national interests but also in relation to how they affect others. Moreover, since economic interdependence has increased in recent years due to the surge of international financial inter-linkages, it follows that coordination should also have become more valuable and pursued during time.

In practice, economic analysis has never succeeded in detecting and measuring these benefits precisely for several reasons. First, the counterfactual is lacking; it is not possible to observe what the outcome would have been should coordination in any given circumstance have or have not materialized. Second, many analyses date back to the 1980s —prior to the surge of international capital flows and long before today's emerging powers were starting to emerge. In that world interdependence was limited. Third, standard economic models do not account well for the strength of empirically observed spillovers through asset markets.[1] It is not surprising that older research concluded that the benefits from coordination were negligible.

More recently, economists have revisited the subject using more sophisticated modeling tools, but with no more conclusive results. These models are in general quite restrictive, often assuming constant balance of payments equilibrium and no financial frictions. They do not provide rationale for the degree of interdependence observed empirically. Under these assumptions, these models can hardly provide prescription on policy coordination for a world dominated by persistent global imbalances, very large cross-border financial holdings among advanced countries, and large, highly volatile capital flows between advanced and emerging countries. All in all, since research suggested that the gains from coordination are small either because trade and financial linkages are low when in fact then they have increased markedly, or because they assume away important aspect of financial globalization, it would not seem hazardous to assume that coordination is probably worth pursuing in today's economy.

Recently, the financial crisis has provided additional arguments in this direction, bringing to the fore the existence of substantial international spillovers also in the area of financial regulation. Countries or regions with large developed financial sectors, particularly if their money performs an international role (like the U.S. dollar, or to a lesser extent the euro), typically act also as financial intermediaries for the rest of the world. Their financial structures adapt to this role, collecting abroad large volumes of short-term funds (bank deposits or short-term securities traded in liquid markets) and lending abroad, typically long term. It is clear that, in this situation, the financial regulation and supervision of those countries are likely to have a prominent impact across their borders. Since everywhere in the world financial regulation remains predominantly a national responsibility (within some limits determined by the international harmonization of certain standards), and located in the country where the bank is incorporated (so called "home-country control"), it is clear that the supervisory regulatory frameworks prevailing in the major financial centers exert significant international repercussions, affecting financial stability in other countries and even globally.

Effectiveness and Representativeness

These arguments suggest there are likely benefits from cooperation in global economic governance *if* the institutions and modalities through which such cooperation is enacted are effective. This is a big *if*, however. The incentives to cooperate are weak, particularly when they are most needed. Representativeness typically conflicts with efficiency of action, which requires a small number of participants.

The composition of the G-20 strikes a difficult compromise between representation and efficiency. Political and geographical representation are supposedly provided by the presence at the table of the political leaders from the largest economies, with a correction in favor of emerging economies—this is, after all, the distinguishing trait of the G-20 relative to the G-7. At the same time, efficiency of debate and decision-making requires that the number of seats at the table to be limited; the presence of 20 members (19 countries plus the

European Union, not counting invited members and international organizations) has proved to be on the high side of manageability.

Another delicate aspect is that of the working modalities. This includes the internal organization and the links established with other bodies that, at a more or less technical level, are already active in the areas covered by the G-20. The G-20 has established working arrangements with a number of entities—the International Monetary Fund, the Financial Stability Board, the Basel Committee on Bank Supervision, etc.—and is assisted by two orders of substructures (ministers and deputy ministers). If the lack of its own technical expertise does not seem like a serious limitation—the technical input essentially comes from the bodies just mentioned—a more serious problem has been that of ensuring the continuity of action over time. In absence of a permanent secretarial structure, agenda setting completely relies on the annual rotating presidencies, often with very different priorities from one year to the next.

Some improvements in working arrangements in this area could help. Long-term (multi-year) work streams should be agreed with the aim of providing guidance to the rotating chair. Leaders and ministers should also seek the input from independent experts. More ambitiously, a steering group, similar to that set up in the Financial Stability Board with a mandate extending beyond the annual chair, could be established. A more ambitious possibility in the same direction would be to set up a small permanent secretarial structure at the IMF. Its mandate—ensuring continuity to the process and stronger liaison among the rotating chairs—would not require large staffing and bureaucracy, and red tape should be avoided.

How Has the G-20 Performed?

The few meetings that have taken place since 2008 (summarized in the table) allow only a partial answer to the question of how the G-20 has performed. In this period, the G-20 seems to have gone through a cycle. At first, the "new" G-20 Summit constituted a significant novelty, spurred by a crisis situation. The initial agendas, shaped by the crisis, were pragmatic and action-oriented. The initial period, including the Washington and London meetings, resulted in swift action on financial reform. The Pittsburgh Summit—while still effective in terms of institution building with the establishment of a permanent G-20 and the announcement of a new "framework" for macroeconomic policy coordination—marked the transition to the second stage in which, in the context of economic recovery, renewed a divergence of priorities between advanced and emerging countries, and reduced financial market tension. In this second stage, the G-20 has predominantly focused on macroeconomic coordination and progress has stalled.

From Washington to Cannes

Summit	Date	Headline priorities
Washington	November 2008	• Reform of financial regulation
London	April 2009	• Global stimulus • Reform of financial regulation
Pittsburgh	September 2009	• Rebalancing of world economy • Reform of financial regulation
Toronto	June 2010	• Rebalancing of world economy • Reform of financial regulation
Seoul	November 2010	• Rebalancing of world economy • International financial institutions
Cannes	November 2011	• International monetary system • Commodity prices • Weakening of global growth, euro crisis

This evolving pattern emerges clearly from the wording of the final statements following the meetings. The concluding statement of the Washington meeting was short and fully concentrated on the actions needed to stabilize the financial markets, with a detailed action plan and assignment of specific tasks to the IMF and other bodies. The

Washington Communiqué conveyed a sense of urgency and pragmatism and signaled a community of policymakers that wanted to be on top of events and steer them jointly; this helped the subsequent stabilization of financial markets. The London Summit was dominated by the risks of recession and protectionism; observers at the time were wondering if the world was heading toward another Great Depression. Many seriously feared pervasive restrictions to international trade, as in the 1930s. The London Summit not only maintained the momentum launched in Washington and signaled that protectionist pressures would be resisted, but it also decided on a major and historically unprecedented increase of resources for international financial institutions. Importantly, among the public documents produced at the London meeting was a detailed "Progress Report" showing that in the area of financial reform all actions agreed in the Washington Action Plan were making progress.

Five months later, the Pittsburgh Summit marked a watershed. In a number of ways, Pittsburgh achieved important results, particularly considering the low expectations on the eve. A first result concerned institution building. The leaders decided that the G-20 summit would become a regular event, replacing the G-8 as the entity to which the Financial Stability Board and the IMF would report. This amounted to a significant change in the international financial architecture. A "framework" for macroeconomic policies was announced, in which participating countries would try to coordinate economic policies to reduce global balance of payment imbalances. Leaders instructed their finance ministers to start a mutual surveillance process over macroeconomic policies, the "Mutual Assessment Process" (MAP), with the technical support of the IMF. But Pittsburgh also coincided with a marked slowdown in the productivity of the G-20. In subsequent meetings, the progress slowed down considerably as the pressure of economic and financial emergency abated.

In 2010, the calendar included two summits under a joint Canadian-Korean chair: Toronto and Seoul. For a long time, discussions were trapped in semantics regarding how to express in the final statements sensitive concepts about external imbalances and the exchange rate policies of major countries, notably China. The issue was in the end resolved after major difficulty and over a year later at a ministerial meeting of April 2011 under French presidency. In turn, the 2011 French presidency added new elements in the agenda, including a new focus on the reform of the international monetary system as well as discussions on the volatility of commodity prices and how to deal with them. It is not yet clear to what extent these novelties announced by the French presidency will translate into meaningful decisions at the Cannes Summit.

The G-20 at the Present Juncture

To this day, the G-20's agenda focuses on the priorities dictated by the 2008 U.S.-centered banking crisis and the subsequent recession. The two main lines of action—financial regulation and macroeconomic coordination to contain global imbalances—remain important and should be pursued further. But the G-20 would renege on its responsibility if it did not focus also on today's paramount problem, the risk of financial contagion from the sovereign sectors.

The epicenter of these risks is in Europe. Events have accelerated recently; until June this year, one could still hope that the euro debt crisis could remain confined to a handful of small countries, financially distressed but manageable by a united Europe. After all, Greece, Portugal and Ireland represent a mere 6 percent of GDP for the euro area. The European Financial Stability Facility, the euro rescue fund created in May 2010 in response to the Greek crisis, seemed sufficient to provide a backstop even if the crisis spread to Spain. Even some policymakers' hesitations—for example, in deciding the mix between domestic adjustment, official support and private sector involvement —did not seem excessively threatening given the small amounts involved.

With two large countries (Italy and Spain) under fire, the risks have taken a globally relevant proportion. There are at least three transmission channels: First, distressed sovereigns are implementing harsh and growth-adverse adjustment packages with negative demand as well as supply impacts. Uncertainty and precautionary spending behavior will likely extend to more stable countries. In Germany, in spite of the recent export-driven expansion, the public is concerned and hesitant to endorse large external transfers.

Second, financial institutions are under renewed stress. The euro-area interbank market is again experiencing strains, as during the 2007 liquidity crisis. Banks have suffered from large stock market declines. As a consequence, policymakers are requiring banks to post more capital, which may result in credit restrictions.

Third, confidence in Europe has been severely dented by euro-area developments.

On August 8, when the euro crisis suddenly worsened, the G-20 issued a statement expressing its "commitment to take all necessary initiatives in a coordinated way to support financial stability" and its readiness to "take action to ensure financial stability and liquidity in financial markets". What will this mean in practice?

A first priority is to promptly finalize the macroeconomic coordination framework still under construction and strengthen it by bringing intraregional imbalances explicitly to the fore. They should be treated as global imbalances under the G-20's responsibility if they have global implications—the euro crisis certainly does. So far, there has been ambiguity in this respect; on the one hand, Europe has insisted that its currency zone be treated as a single entity; on the other, the G-20 surveillance mechanism remains organized on a country-by-country basis. For example, the group of "systemic" countries singled out for in-depth examination in the MAP includes, Germany and France and not the eurozone or the EU. Taken literally, this selection excludes all countries whose sovereign bonds have come under severe pressure in recent times.

A second important issue is whether and how the emerging market countries bloc represented in the G-20 could contribute in providing financial market support in conditions of stress. This follows from the wording of the August communiqué and would be consistent with the G-20 self-assigned mandate. Unilateral approaches have been made very recently by some advanced and emerging countries without success. Even if successful, however, the unilateral approach risks being divisive and ultimately may exacerbate tensions, not resolve them. It is in the interest of all G-20 members, particularly the large debtors and exporters, that global bond markets remain stable. An agreement by the large G-20 creditors to support sovereign debt markets, preferably under an IMF facility, as proposed by the former managing director Johannes Witteveen, would convey a strong and possibly decisive signal to market participants. Support should be accompanied by adequate conditionality, consistent with IMF and EU practices.

The G-20 was created in 1998 and reshaped in 2008 with a crisis management imprint. As global financial instability risks reappear, it will have no choice but to revert to crisis mode after some time of tranquil sailing. The more pre-emptive its action the better. Though at present is looks unlikely that Cannes could offer such an opportunity.

Endnotes

[1] See in this respect the Spillover Reports published by the IMF in June 2011.

Wages and Productivity: The Missing Link

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For more than two decades, increasing the return on equity has been the supposed recipe for achieving successful growth. During this time, income inequality disappeared from the radar screens of economists. Yet, one of the most unexpected effects of the global financial crisis has been the resurgence of the issue of income inequality not only as a social concern but as a significant cause of the 2008 crisis. This tentative connection is an opportunity to think deeper about: the origins of the crisis; its similarities and differences with the Great Depression; the addition of the European sovereign debt crisis to the American private sector debt problem; and the avenues we should explore to find an exit to the intractable difficulties we continue to face three years after the crisis.

This essay first examines the literature on U.S. inequality and the 2008 crisis. It looks at inequality from an international perspective and takes the inequality paradigm one step further. Inequality is actually the social result of economic forces at work in the labor or goods market and of redistribution policies. Increasing inequality is a symptom of income distribution, not redistribution, and is a primary economic issue. This essay argues that the wage-productivity relationship is the major force shaping the present global economic outlook with its deflationary dangers and huge external imbalances. The essay concludes with a few policy observations regarding the economic variables the G-20 should consider when trying to achieve more stable and sustainable global growth.

Income Inequality and the Financial Crisis

The United States experienced two major financial crises over the past century, the Great Depression of 1929 and the Great Recession of 2008. Both were preceded by a spectacular acceleration in the distribution of credit and a sharp increase in the debt-to-GDP ratio.[2] This explosion of credit has been rightly associated with the excesses of monetary policy—too lax for too long—and with the effects of financial innovation and deregulation, which allowed the accumulation of hidden risks.[3] Part of the literature further explored the underlying forces which have created the roots of this policy mismanagement. Most striking is the suggested link between household indebtedness and income inequality—"let them eat credit"—as summarized by Rajan.[4] Statistical data by Piketty and Saez on the concentration of income gains at the very top level (1 percent or even 0.1 percent) of the income distribution in the U.S. are truly striking and became the foundation of a new conventional wisdom on the role of increasing inequality in the run-up to the 2008 crisis.[5] The story goes like this: wealth was being captured at the top of the ladder, median wages stagnated, the middle class had to borrow to keep spending despite stagnant income, increasing poverty at the bottom pushed politicians into maneuvering the financial incentives to lend to insolvent households. For a time, rising asset prices masked the unsustainability of the household debt but after home prices reached their peak in 2006, the inevitable consequence was the financial bust. Kumhof and Rancière offer an elegant model of this argument.[6] Their model not only captures very important stylized facts of the run-up to the crisis, but it also offers a coherent vision of their connections: wage moderation and debt increase for the middle class (95 percent of households), savings and accumulation of newly packaged financial assets by the wealthy. The first question that this raises is if inequality is the *ultima* *ratio* of a globalized economy. International comparisons are seemingly supporting this hypothesis but they also raise a different question.

Worldwide Income Inequality

A recent report by the Organization for Economic Cooperation and Development notes that, during the two decades prior to the onset of the global financial crisis, the gap between the rich and the poor widened in most nations.[7] The report's findings show that across OECD countries the average income of the richest 10 percent of the population is nine times that of the poorest 10 percent. Additionally, with the exceptions of France, Japan and Spain, the wages of the 10 percent highest paid workers have risen relative to those of the 10 percent lowest paid workers. Increases in household income inequality have been largely driven by changes in the distribution of wages and salaries, which account for 75 percent of household income for working age adults as well as capital income for the wealthiest. In short, practically everywhere the highest 10 percent of earners have been leaving the middle earners behind more rapidly than the lowest earners have been drifting away from the middle. Did similar inequality increases produce similar political and financial answers?

The Gini coefficient, for example, similarly increased from 0.33 to 0.38 in the U.S. and from 0.30 to 0.35 in Germany, but there is nothing similar in the way these two countries behaved and performed in the decade before the crisis. It is hard to believe that "liberal America" was the only country aggressively fighting increasing inequality while "social democratic" Germany let inequality develop without reaction. A story based on inequality clearly does not capture the whole picture. Before exploring this question, let us note that this recent OECD report confirms previous findings by the International Labour Organisation which studied the evolution of global employment through the prism of inequality.[8] The main finding of the study was that, despite a substantial economic development across most regions, globalization had resulted in the widening of income inequality across and within countries. The rich-poor gap has widened post-globalization as nearly two-thirds of the countries studied have experienced an increase in income inequality between 1990 and 2005. This means that workers gained less from economic growth. The research also found that in 51 out of 73 countries, the share of wages in national income declined over the past two decades; this is confirmed by OECD statistics that show a decline of the share of wages from 63 to 58 percent for 15 major OECD countries.[9] Let us now focus on considering the link between income distribution and economic cycles.

Income Distribution and the Business Cycle

For more than two decades, the success of the real business cycle theory has made all other approaches of the cycle a thing of the past. But we now face an unexpected situation. We have witnessed the reality of an XXL cyclical instability. The real business cycle theory does not provide any help if we want to assess the role of income distribution in the run-up to the crisis and more importantly in the search for an exit. As far as the income distribution is concerned, it remains natural to refer to the fascinating model offered in 1967 by Richard Goodwin that elegantly relies on the Volterra equations governing the reproduction of two predator-and-prey species.[10] When the second is abundant, the first prospers and grows, progressively exhausting its resources and conversely. These interdependencies are properly modeled through differential equations where the variation of a variable depends on the level of the other. Goodwin worked on the interaction between long-run growth and business cycles; he applied the Volterra methodology to the wage-profit relationship. It is easy to see why the *variations* of both wages and profits depend on the *levels* of the other variable. For example, when the profit share is high, investment and employment are high so that strong wage increases will depress profits and ultimately employment thus reversing the initial situation. This suggestively makes fluctuations endogenous to the economic system. At the root of such cycles is the wage-earners' bargaining power, which drives the change in income distribution. In the Kumhof-Rancière model, the real wage equals the marginal product of labor times a "bargaining power" coefficient. This coefficient is modeled trough an auto-regressive stochastic process, which makes the model simple and tractable. The bargaining power initially declines—a hypothesis in line with what we know about previous decades: erosion of the power of unions, competition from low-wage countries, and a possible technological bias against unskilled workers. Why does this coefficient start to rise again after 10 years (in the baseline scenario) remains unclear. This leaves open the question we are facing now, what forces will push the economy durably upwards after a severe recession? Appropriate price signals, investment opportunities, expectations? Reflecting on the fact that those factors could be blocked, Martin Wolf recently exposed the risk of the present "great contraction" extending over time.[11] Anyway, we have now good reasons to confirm that income distribution matters.

The Disrupted Wage-Productivity Nexus

The disconnection between productivity gains and real wage increases is a common feature among major economies since the 1990s. In the U.S., this disruption has been extensively documented. Similarly, according to data collected by Patrick Artus, the real wage per capita in Germany and Japan remained flat between 2000 and 2008 while productivity increased by 10 percent during the same period.[12] Productivity was severely hit in 2009 and strongly recovered in 2010 while real wages remained flat, significantly increasing the wage-productivity gap. In other words, the share of wages in the national income of major industrialized economies has significantly declined. This is also a well-known characteristic of China's development; the share of household income in the GDP of China could have fallen from 52 percent in the mid-1990s to 45 percent in 2010.[13] However, due to the increasing share of profits in national incomes, the world is fundamentally facing a situation characterized years ago by Ben Bernanke as a savings glut (amplified for different reasons by the high savings rate of major oil-exporting countries).[14] We lack at this stage a precise and coherent set of data to summarize the discrepancy between the two sides –production and absorption- of the world GDP and filling this gap should clearly be an important addition to the G-20 indicators.[15] Anyway, according to Artus' approximate but striking calculations, the savings rate of the global private sector could actually have increased from 25 percent in 2000 to as much as 32 percent 10 years later. In short, the disconnection between wages and productivity is at the root of a durable global excess savings which is a major source of the increasing difficulties of the world economy.

Wage Formation, Final Demand

An era of a declining wage-share in world GDP is a typically Keynesian situation, the realm of insufficient final demand. Certainly, adjustments are supposed to operate on other sides; one can, for example, argue that capital markets flooded with profits will adjust at lower interest rates at which we expect other elements of demand take the relay of wage consumption. Recent experience shows both the validity and the limits of those substitutes. As we previously analyzed, this sort of adjustment played a very unexpected role in the U.S. It would be foolish in this case to link the wage-share compression to a situation of under-consumption.[16] But what made the U.S. so far away from under-consumption is precisely anything but the product of a natural market adjustment. The transformation of the U.S. wage-restrained consumer into the world consumer of last resort over the past decade relied on Promethean financial artifacts, which proved unsustainable. It is plausible to analyze 2001-2007 as a period of hidden deflation (remember the actual threat of deflation from 2002-2003[17]), successfully avoided by an extraordinary fiscal and monetary activism. The accumulation of private debt of declining quality eventually triggered the crisis. At that stage, the depression of final demand called for direct public support to household incomes leading to the unsustainable public deficits and debt governments are now trying to control. The reality beyond both the financial crisis and increased income inequality is a distorted income distribution and the way the flow of final demand was artificially sustained in order to push back the inevitably coming downside of the cycle. In short, the Bush-Greenspan policies of the past decade linked up two successive upwards phases of the business cycle; it should come as no surprise that, in a figurative sense, we are now paying the price with a twofold contraction.

How to Exit a Severe Depression?

Economic policies have been battling for three years to exit this crisis. The 2009-2010 recovery was brilliant but common sense suggests that the global economy at the end of 2011 is not out of the woods. A reference to U.S. economic history before and after World War II can be instructive. The experience of the 1930s demonstrates how difficult it is to manage the economy out of a depression or even of a "great contraction". The main lesson is that there is no evident market reaction restarting private final demand. This is what Keynes more forcefully introduced in economic thinking: in a depression, when the economy is far below its potential, expectations are clouded by the levels of underutilization of resources, labor and capital; economic agents have left the comfortable world of quantifiable risk and entered in an era of radical uncertainty.[18] Activity is paralyzed and remains narrowly dependent from public support. The episode of the aborted recovery in 1937 recalls how dangerous it is to prematurely try to balance the budget when the private sector is still fighting with the legacy of a depression.[19] It is sometimes asserted that the U.S. economy did not really escape from the depression before the war. But the war itself did not eliminate the question of productivity gains and income distribution, on the contrary. Huge productivity gains had been made in the manufacturing sector during the war, wages had remained strictly controlled and purchasing power had declined. This is the contradiction which had to be solved to base on solid foundations the long-term post-war phase of growth. How did this start? After the war, president Truman faced social demands calling for wage increases restoring prewar living standards. Walter Heller, at that time a young economist promised to play a prominent role in the Kennedy and Johnson administrations, produced the figures demonstrating the reality and the magnitude of these discrepancies. Wages were actually lagging by more than 15 percent. Following massive strikes, Truman decided that the federal government would recommend to businesses to increase wages by 33 percent which would prove beneficial by raising capacity utilization and investment opportunities.[20] Businesses unwillingly agreed and thus launched the post-war growth period. What businesses, economists and the rest of the world discovered at that moment was the deep truth of a well-known Ford catchphrase: "pay your workers well, they will buy your products". Not true for a company but powerful at the macroeconomic level. Are we facing this sort of "Ford moment" again? Definitely, but the problem today is made more complex by the fact that it is not domestic but international in nature.

Global Imbalances, Regional Imbalances

We now turn to the world of today, a world composed, to simplify of China, Germany, the U.S. and Greece, a world with countries garnering huge surpluses inevitably facing countries digging into huge deficits. What does the previous analysis teach us regarding this situation? The two countries where the disconnection between wages and productivity has taken the purest form are China and Germany. With wages lagging beyond productivity, these countries have low geared domestic demand that could easily have engineered deflationary pressures. They successfully avoided them thanks to aggressive export strategies that require adequately growing markets. In a world of generalized competition toward decoupling wages and productivity, this condition has been met under precarious conditions, demand in deficit countries being more and more propelled by external financing. It is striking to observe the similarities of those two situations. China and Germany for years produced both the goods and the financing of their major clients, the U.S. and Greece or more broadly speaking European deficit-countries including France; about France, one will interestingly observe that this is practically the only OECD country with no income inequality increase or wage-share decline. Lately discovering that the situation they so directly contributed to creating was unsustainable, the surplus countries expressed alarm and criticism. For example, the Chinese premier as well as the German chancellor called the American and Greek governments to repentance. But Jeff Frieden precociously and rightfully explained that there had never been a solution to this sort of contradictions without the surplus country taking part of a painful adjustment.[21] Surplus countries have a natural tendency to emphasize the virtues that produced their spectacular results. On the other side, it is difficult to defend those who went into unlimited profligacy through financial artifacts (the U.S.), tax and spending disorder (Greece) or lack of structural reforms (France). The hard truth of this sort of tango is finally that those who were the two to practice virtue and vice need to be the two to find the exit. The summer of 2011 has provided a vivid illustration of these contradictions with the debt ceiling debate and the downgrade of the U.S. debt on the one side and the failed European agreement to rescue Greece and the spillover of the sovereign crisis onto the European banks on the other. The epicenter of the financial turmoil has been reached and this will be the main challenge facing the G-20 Cannes Summit.

Conclusion

This essay started from the recent literature connecting the financial crisis with increased inequality in the U.S. We extended the survey to the major economies and focused attention on the more fundamental relationship between real wages and productivity. One of the major consequences of globalization has been to disconnect these two variables and this has consequences going much further than the subprime crisis. Wages significantly lagging beyond productivity explains three major features of the world economy today: first, the underlying threat of excess-savings fueling deflationary pressures; second, an increased dualism between countries with either massive surpluses or deficits; third, a fragile and temporary solution to deflationary pressures in the surplus countries by their continuous but more and more problematic financing of their clients' deficits. Would this summary offer a reasonable picture of the world economy today, this would naturally have important consequences for the coordination of economic policies within the G-20 framework. But recommendations are not easy to formulate; there is no "one-size-fits-all" solution— a difficulty that makes the G-20 framework particularly appropriate.

Three suggestions could be formulated like this:

1. *Principle*. The G-20 should recognize that the question of income distribution is a major part of the policy debate. We made clear that this conclusion was neither the fruit of social considerations nor an attempt at finger pointing surplus or deficit countries nor an unnecessary infringement of national preferences. Willing to improve stability and sustainability worldwide, governments and central banks should not be concerned exclusively by public finance, monetary policies or balance of payments. They should place the two aspects, production and absorption, of global GDP into a common framework.

2. *Methodology*. Would a political agreement be reached on the previous question, Treasuries and the International Monetary Fund should be asked to develop appropriate indicators and models focusing on the wage-productivity nexus with a view to offering a precise assessment of the situation and suggesting where, how and how much each country could introduce correcting forces oriented toward a more stable outlook. As far as wages and productivity are concerned, a connection between the IMF and the ILO should be established.

3. *Tactic*. As a first step, the G-20 Cannes Summit could renew its traditional call in favor of a more balanced growth trajectory in the different regions by injecting part of the previous considerations into the communiqué and launching the search for another set of indicators under the Mexican presidency.

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Structural Policies for Sustainable Growth

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The 2009 G-20 Pittsburgh Summit declared "strong, sustainable and balanced growth" as the overarching goal of its coordinated efforts to steer the global economy out of the crisis. Two years later, we know that growth in the advanced countries has been sluggish at best and global imbalances persist. Particularly, Europe is probably facing a prolonged period of low growth, since all possible solutions to the European debt crisis will require a downward adjustment of wages, prices and public spending in Southern Europe. For Europe, there is no way of spending itself out of this crisis. The effectiveness of pushing up aggregate spending, as it has been recommended by a wide range of U.S. scholars and policymakers to those European countries which still dispose of some fiscal headroom, can be questioned. If the decline in growth is structural in nature, short-term fiscal stimulus will not have a lasting effect on growth, but will instead drive public debt to an even higher level and thus limit growth potential in the long run for the aging societies in Europe.

The traditional pattern of wealth generation is overstepping the boundaries of the global ecosystem. The depletion of the stocks of natural capital is beginning to impinge on productivity and adversely affecting the potential for present and future growth. The loss of aggregate productivity is not fully visible in national accounts since part of the implicit cost is externalized and shifted in time and space. Macroeconomic indicators would look much different if these costs would have been adequately monetized and integrated.

Against this background, we have to concentrate on long-term reforms, resolving the imbalances within Europe and on a global scale, while at the same time addressing the sustainability of growth by initiating structural reforms. Advanced countries and rising powers need to face up to the long-term challenge of structural transformation if they want to properly manage the systemic risks inherent in the present model of wealth creation and global governance. Sustainable growth dynamics can only be secured if countries of all income levels switch to a trajectory of a green economy. In this, the G-20 must lead the way and, in addition to domestic adjustment, provide resources and technologies to low-income countries which depend on external support. Stability and shared prosperity will prove to be elusive goals for the G-20 unless it begins to address key destructive factors which threaten the very foundation of the world economy, namely growing social disparities and excessive pressure on global ecosystems. Thus, the G-20 needs to move quickly and simultaneously on two issues: overcoming the instabilities of financial markets and global imbalances while laying the ground for sustainable growth through building a low-carbon, resource-light world economy. Global leadership in this regard is not just a cause of enlightened self-interest but also an expression of moral responsibility. According to the value judgment of the respected German Advisory Council on Global Change, the protection of natural life support systems for the benefit of future generations is as much an ethical imperative as the abolition of slavery and the condemnation of child labor.

The dominant model of industrialization over the past 250 years has been geared toward the use of fossil energy. This particular mode of economic development has fundamentally shaped social relations and public policies on issues, such as regulation, infrastructure, transport, research, innovation, foreign affairs and security.[1] As a consequence, resource-intensive industrial civilization has significantly overstepped planetary boundaries. According to an internationally recognized metric, "ecological footprint", the world presently consumes the resources of 1.5 planets, which means that the present generation is drawing down the existing stock of natural capital at the expense of future generations. By 2030, aggregate global demand is expected to reach a consumption level of two planets.[2] It is estimated that the global middle class will more than double in the coming two decades, from 1.8 billion people to almost 5 billion in 2030[3] due to rapid income growth in rising powers. This will lead to further pressure on global ecosystems. Social inequities and human deprivation are other dimensions of systemic risks in the world economy. Some observers see globalization itself threatened by the erosion of trust as explosive popular discontent could lead to further protectionism and economic nationalism.

In order to safeguard the social and environmental prerequisites of stable growth and prosperity, the G-20 needs to mobilize political will in support of a new global social contract for a low-carbon, sustainable world economy. In order to meet the 2°C climate protection guard rail agreed upon by the global community at the 2010 Cancún climate change meeting, the G-20 must promote radical increases in energy and resource efficiency and initiate the decarbonization of energy systems and production processes. The German Advisory Council on Global Change has suggested focusing on three pivotal areas of transformation: energy/transport, urbanization and land use. It estimates that the costs of transition to a low-carbon world economy would be $200 billion to up to $1 trillion per year by 2030 and significantly higher between 2030 and 2050. However, these outlays amount to just a few percentage points of global GDP and would be offset by savings of similar magnitude later. Presently, the energy sector causes around two-thirds of greenhouse gas emissions. Urban spaces are responsible for three-quarters of global final energy demand. Their population will double to six billion by 2050, implying a concomitant expansion of energy needs. The land-use systems in agriculture and forestry, including deforestation, generate almost a quarter of global greenhouse gas emissions. Future developments in this sector will be shaped by the need to provide enough food for a world population of over 9 billion in 2050 and by the growth in demand due to the increasing use of bio-energy and bio-based raw materials. Pressures in the energy sector are compounded by the ethical imperative of providing 3 billion people access to essential modern energy services who continue to be excluded from such amenities of modern life.

The G-20 has repeatedly expressed its intent to "move toward greener, more sustainable growth". It had, for example, committed itself to "rationalize and phase out over the medium term inefficient fossil fuel subsidies that encourage wasteful consumption….and have our energy and finance ministers, based on their national circumstances, develop implementation strategies and timeframes, and report back to leaders at the next summit".[4] The result of this process was disappointing. Reports on their policies for phasing out fossil fuel subsidies have been delivered by the members to the next G-20 summit, but the process has stalled at the point where no consensus could be reached as to which subsidies could be called "inefficient".

Due to their weight in the global economy and their political clout, G-20 countries must play a stronger role in the "Great Transformation" toward a low-carbon society. This does not imply that the governments alone will have to provide all the solutions and all the action. The paradigm shift from fossil to post-fossil models can only succeed if it is organized as an open societal search process, which includes low-income countries and responds to their specific needs for poverty eradication and broad-based social development. The normative foundations for the design of transformative trajectories can be found in universally accepted standards, such as the United Nations conventions for human rights and labor rights, and the Millennium Declaration. The principle of common but differentiated responsibilities as enshrined in the Rio Declaration and the U.N. Framework Convention on Climate Change allows for individual paths according to a country's capabilities. It also means that industrialized countries will have to carry the main burden of radical shifts in emissions and resource use. Still, they should not shy away from the task since technological solutions and effective instruments for comprehensive decarbonization as well as solid business and financing models for the transition are readily available. These elements, however, need to be brought into play through new modalities of interaction between politics, society, science and the economy.

European countries seem to experience a shift in popular attitudes toward sustainability which could indicate widespread societal support for a new global social contract. A survey conducted in July 2011 on behalf of the Bertelsmann Foundation[5] found that 91 percent of Germans espouse international rules for the use of natural resources and environmental goods and 61 percent endorse the view that the government should promote global public goods rather than narrow national interests. Similar results in other countries could signal a global trend toward post-materialistic values with an increasing emphasis on autonomy, self-expression and quality of life. The growing relevance of the paradigm shift toward sustainability in the political process is demonstrated by the recent decision of the German Parliament to establish a Study Commission on Growth, Wellbeing and Quality of Life which is expected to organize an ambitious work program with numerous studies by external experts and will come up with a comprehensive report of analysis and policy proposals.

The report of the *Commission on the Measurement of Economic Performance and Social Progress* led by Joseph Stiglitz and advised by Amartya Sen provides an implicit critique of the narrow focus on aggregate GDP growth rates. The report argues that in the run-up to the financial crisis "…neither the private nor the public accounting systems were able to deliver an early warning, and did not alert us that the *seemingly* bright growth performance of the world economy between 2004 and 2007 may have been achieved at the expense of future growth".[6] The sole focus on aggregate growth without considering qualitative factors, distributional aspects, and environmental degradation can mislead policymakers and the public with regard to the long-term effects of policies. Structural policies need to look behind the growth figures and ask for the effects of policies on long-term development. The effort of some of the G-20 countries to include "green" policies into their 2009 stimulus packages was a promising start, but only 14 percent of the stimulus packages could be regarded as "green" according to a study by HSBC.[7] Unfortunately, there was no follow-up to this effort, aiming at a mainstreaming of sustainability considerations in macroeconomic policies.

In their efforts for balanced and sustainable growth, the G-20 would be well advised to provide a platform for dialogue and exchange of experience on the ongoing work in member countries and their transformation toward a low-carbon, sustainable economy. One possible option in this regard could be the establishment of a high-level panel on systemic risks in the global economy as suggested in the 2009 report of the Stiglitz Commission to the President of the U.N. General Assembly. The panel would consist of scholars and practitioners from all regions and follow the successful model of the Intergovernmental Panel on Climate Change. The panel would not be charged with writing its own reports but rather systematically compiling and assessing the existing body of knowledge and policy recommendations ("report of reports"). The thematic mandate of the panel should be broadly defined to encompass all relevant dimensions of global change and resulting risks.

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Macroeconomic Policy and Structural Reform The Indian Case

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The Global Economy and India

In their introductory chapter, Kemal Derviş and Homi Kharas discuss the limited political and policy space available to the advanced countries in dealing with continued sluggishness in the global recovery. As Martin Wolf has observed, in many ways it is incorrect even to talk of a double-dip recession for the U.S. or Europe. While the mix between overstretched households, undercapitalized banks and over-indebted sovereigns differs across countries, slow growth is both a consequence and a cause of the attempts to repair balance sheets in each sector. The synchronization of these stresses across the major advanced countries has further retarded the global recovery, in a way that was last seen in the 1930s. Even the crisis of the euro can be seen as a manifestation of the relentless interconnection between the overextension of bank credit (in this case to sovereigns), the bursting of a valuation bubble, and the resulting effects on economic growth and bank solvency.

The only silver lining is that corporate balance sheets remain robust in most advanced countries, although weak prospective demand inhibits fixed investment domestically. The ensuing diversion of investment to faster-growing emerging markets by advanced country multinational corporations, while supporting global growth, has become a divisive and controversial issue in home countries, notably the United States. And if history teaches us that balance sheet recessions linger on for a long time, the experience of the U.S. in the late 1930s and Japan in the 1990s also teaches us that intense political and market pressures for fiscal consolidation build up even when demand is weak. It can be persuasively argued that premature fiscal tightening in both those cases aborted a nascent recovery. Indeed, for a given current account deficit, attempts to increase savings by households (and, as appropriate, to boost net worth by financial institutions) implies an offsetting deterioration in the net worth of the public sector. With monetary policy constrained, there are concerns today that simultaneous fiscal tightening in the United States, United Kingdom, Japan and Europe, although justified from a medium-run fiscal sustainability perspective, may be too harsh in the current environment of weak global demand.

Given these pressures in the major advanced economies, the rapid recovery and strong growth in the major developing countries have been a few bright spots in an otherwise gloomy global economy. Given the size of its economy, the contribution of China to global growth has been overwhelming. Its policy choices attract the most attention and rightly so. Despite the common practice of bracketing China and India together, the much smaller scale of the Indian economy (about one-third the size of China's) and the somewhat lower trade openness of India both imply that the significance of India to the global economy is much less than that of China. Nonetheless, India does currently add to aggregate global demand by running a significant current account deficit. More importantly, both for India's standing in the G-20 and for investment expectations globally, belief in India's longer-term growth prospects has provided a source of comfort. According to press reports, India is one of the "systemically important" G-20 countries being subjected to peer review under the Mutual Assessment Process (MAP) agreed to by the G-20 at Pittsburgh. Together with Canada, India is a co-chair of the so-called Framework Working Group set up at that meeting.

In this essay, I reflect on the dilemmas and tensions facing the Indian authorities as they prepare for the G-20 Summit in Cannes. I see these in many ways as analogous to those facing the advanced countries. I believe the situation is analogous for at least three reasons. First, for India too, a financially sustainable growth path requires a judicious mixture of demand management and structural or supply-side measures. Second, the parlous state of the global economy creates a confusing and difficult decision-making environment for the authorities. This makes it hard both to define the nature of the problem as well as to create a domestic consensus for the kinds of reforms that might be required. Third, the global financial crisis has sharpened the need for politically inconvenient decisions.

Indian Commercial Banking

A useful point of entry into some of these complexities was a recent decision by Moody's Investor Services to downgrade the so-called "standalone" rating of the country's largest commercial bank, the State Bank of India (SBI)[1], which the government is the majority shareholder. Such "standalone" assessments are separate from, but provide the basis for ratings of specific debt obligations issued by the institution concerned. In the case of SBI, the "standalone" rating (also referred to as the financial strength rating) was downgraded to D+ from C-, equivalent to a so-called Baseline Credit Assessment for the institution of Baa3. Consequently SBI, despite the support of the full faith and credit of the Indian government, is judged a weaker credit than its major private sector peers. SBI's current Tier I capital ratio is at 7.6 percent and is currently below the 8 percent that the government of India has committed to maintaining for public sector banks and well below that of the private sector banks listed above.[2]

SBI is the largest of the so-called "public sector scheduled commercial banks". It is India's oldest bank and, as the Imperial Bank of India, performed quasi-central bank functions until the Reserve Bank of India was set up in 1935. The government, acting through the Reserve Bank of India, became the majority shareholder soon after India's independence in 1947 in order to provide direct policy guidance to the bank. SBI, together with its affiliates remained the only publicly-owned banks until Indira Gandhi nationalized the 20 largest privately-owned banks between 1969 and 1980 in order to pursue her socialist agenda. Following liberalization in 1991, a handful of new privately-owned banks were licensed and one of them has grown to be the second largest bank by assets in India. However, publicly-owned banks still account for about 70 percent of the banking business in India. Even after nationalization, SBI retained a substantial number of shareholders and has been a pillar of the portfolio of foreign institutional investors (FIIs), subject to an overall foreign ownership cap. There are a number of foreign banks in India who are important in foreign exchange and corporate business, but whose branch expansion has been tightly controlled.

In justifying its downgrade, Moody's observed that notwithstanding their expectations that SBI's capital ratios will soon be restored, "SBI's efforts to secure this capital for the better part of the year demonstrates the bank's limited ability to manage its capital". This refers to the reality that, for the government to maintain its majority stake, it has to subscribe *pari passu* with other shareholders and finds it inconvenient to do so given its announced path of fiscal adjustment and the impact of a slowing domestic economy. Moody's argues given "that a bank's ability to freely access the capital markets is an important rating criterion globally", a downgrade in the financial strength rating is justified. Looking ahead, Moody's believes that SBI will find itself capital constrained again in a relatively short period of time.

It goes without saying that the ratings agencies have not covered themselves with glory during the recent global financial crisis. They were deeply complicit in providing the highest credit ratings to synthetic instruments put together by clever investment bankers and their business models are shot through with conflicts of interest. At the same time, it is important to try to understand carefully what signals this rating downgrade conveys in the present global environment, not just in the case of SBI but for the structure of the Indian banking system more broadly.

Fiscal Flexibility and Public Ownership

In exploring these wider ramifications, I would like to acknowledge the work of Viral Acharya of the Stern School of Business at New York University. Professor Acharya has been engaged in two parallel programs of work over the past year: one examining the evolution of regulatory reform in the advanced countries in response to the financial crisis; and the second examining market and regulatory responses to the crisis in the Indian banking system. His work is helpful in drawing parallels between the circumstances of the advanced countries and the case of India. These two streams of thinking have come together in a draft paper prepared for the International Growth Centre, which will soon be published by the centre.[3] The paper examines the mechanisms by which the global financial crisis spread in the advanced countries, the appropriateness of the regulatory response as represented by the revision of the Basel III rules for regulatory capital and leverage for banks, and by the Dodd-Frank Act in the United States. While the paper has been designed primarily to be of interest to financial sector regulators, there are some important messages for a wider audience.

One key message from both the work on the U.S. and Europe for India is that there are significant, empirically substantiated links between government deposit guarantees and what finance professionals call "moral hazard": the propensity of institutions which enjoy government indemnity to take risky bets in the expectation of a bailout. In the United States, elaborate regulatory machinery was set up in the 1930s to prevent commercial banks from gambling with insured deposits. The erosion of these boundaries in the mid-1990s is one widely cited explanation for the buildup of leverage that took place thereafter. The U.K. proposal to ring-fence the guaranteed activities of commercial banks and the so-called Volcker rule in the United States are examples of initiatives designed to once again separate the protected and speculative aspects of banking.

What is the relevance of any of this for India? Acharya draws two implications, both of which I agree with. The first is that the natural tendency of a government-guaranteed institution will be to take on risky behavior and strong supervision is needed to counteract these tendencies. Here we have to deal with the ambiguity of the Indian deposit insurance system. In principle, a government guarantee of deposits is limited to small value deposits, supported by an insurance premium, and the same regime applies to both the public and private sector. In practice, it is widely assumed that the government will stand by all depositors in public sector banks, while its *de facto* stance where private sector banks are concerned has not been tested.

Given that 70 percent of banking assets enjoy *de facto* deposit guarantees, the government's response has been twofold: intensive supervision and strong asset controls (primarily in the form of obligatory holdings of "riskless" government debt under the so-called Statutory Liquidity Ratio or SLR). While these strictures apply to all banks, on the basis of market reactions at the time of the Lehman crisis, Acharya argues that the private banks have so far been disadvantaged by the perceived superior safety of public sector bank liabilities.

However, it is Acharya's second point based on the U.S. experience with the so-called government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac that is even more important in the Indian context. He argues that sooner or later the contingent liabilities represented by guaranteed deposits do get called and the country's fiscal position needs to be strong enough to absorb these liabilities.

Moody's rating action accordingly draws notice to two inconvenient truths about India's current banking system. The first is that the largest public sector bank lacks the capital it needs to support the credit growth that the economy requires. Second, the government is poorly placed to provide the additional capital needed or indeed to make good on the implicit guarantee offered to all depositors. The problem is now being aggravated by stubborn inflation that has required considerable monetary tightening, which is predictably putting stress on corporate balance sheets and hence the quality of bank assets, and by the overall reappraisal of the safety of sovereign debt that the European crisis has provoked. As Acharya argues:

"While the Reserve Bank of India has historically done a prudent job of containing the banking sector's potential excesses, and the well-developed equity market counter-balances to some extent the lack of thriving fixed-income markets, it is clear nevertheless that there is a great deal of 'fat' in the government's fiscal condition. There are excessive subsidies to farming and fuel, there are explicit and implicit government guarantees to state-owned banks, and a number of state-owned enterprises and sectors are poorly run and managed. A tidying up of the government balance-sheet on pretty much all of its dimensions may be India's best preparation for any risks that it is exposed to, internally or externally".

For India too then the continuation of the global crisis is likely to force fiscal adjustment to reassure the markets even as monetary tightening addresses stagflation. Ultimately, the government may be faced with the choice of allowing the public sector banks to shrink as a share of the banking system or to give up majority government control.

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[1] I served as an independent elected director (shareholders' representative) on the central board of the SBI between 2002 and 2008.

[2] Tier I capital represents the highest quality equity and reserves available to a bank to absorb losses on its asset portfolio, resulting from changes in market valuations, credit losses, or operational causes such as fraud or technology failures.

[3] Acharya (2012 forthcoming).

The Risk of Prolonged Stagnation and the Need for International Concerted Action

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A Worrisome Scenario for the Global Economy: A Massive Growth Slowdown

The prospects for the global economy have been significantly downgraded since the summer of 2011, especially for advanced economies. International organizations such as the International Monetary Fund and Organization for Economic Cooperation and Development now forecast gloomier outlooks for the world economy and anticipate a baseline scenario of renewed slowdown in the U.S. and Europe for the end of 2011 and beginning of 2012. In the best scenario for the global economy, the growth rate is so below potential that there is a significant increase in the unemployment rate. The other scenario, which has a 50 percent probability, is much worse; it is one of recession with an economic contraction in all advanced economies in the next two quarters.

Another reliable indicator also points to the very high risk of a global recession: the 10-year German Bund and the U.S. 10-year Treasury bond yields have fallen significantly due to a sudden rush to move investments into what are considered "safe" assets.

For emerging market economies, the gloomy economic outlook for advanced economies implies an economic slowdown and a partial recoupling of their growth rate with those of the U.S. and Europe. However, it is going to be more problematic in some economies, like emerging Europe, than in others, such as East Asia and notably China.

How did we get here? By spring 2009, thanks to a massive global monetary and fiscal stimulus coordinated by the G-20, a partial recovery started and a global depression was successfully avoided. The first signs of recovery were seen in financial markets, but soon extended to the real economy as inventories were rebuilt. As the dynamics of recovery acquired greater strength, many were confident in a relay race between public expenditure and private spending so to strengthen and consolidate the ongoing global recovery. According to the OECD and IMF, this scenario already materialized in the first part of 2011.

But this was not the case. Once the fiscal stimulus slowed down in many advanced economies, growth started slowing down as well. The anemic output recovery did not involve any significant pick-up of private expenditure in the most advanced areas, notably in the United States. Companies and households remained cautious about spending. Growth in U.S. consumer spending over the two last years has been lower than those in all previous recoveries since World War II. With consumer demand still accounting for 71 percent of real U.S. GDP, a protracted slowdown in consumption has hurt overall U.S. economic growth. In addition, there was no significant increase of private investment with American firms preferring to hoard cash.

The Weak Recovery: Both a Result and Cause of Ongoing Depressed Aggregate Demand

It is quite clear that the effects of the global economic crisis are far from over and that the world economy still faces serious uncertainty in its short- and medium-term growth prospects. The reasons for this are found in both demand and supply factors. Since no other economy is capable of compensating for a protracted shortfall in U.S. consumption, the global economic slowdown is being felt across the board. Countries end up reinforcing each other, notably export-led growth Europe and Japan. Domestic consumption in emerging economies is still too modest so the enduring weakness in U.S. consumption, and thus the ongoing weakness of global aggregate demand, has been stifling global economic growth.

The Great Recession was not a typical recession, where economies do often grow much faster than usual during the first 12 months of the recovery. This recession is first of all defined by a financial crisis and excess of debt at all levels, including households, banks and governments. Almost all advanced economies are badly overleveraged and in such conditions traditional policy tools used to sustain aggregate demand through expansionary fiscal or monetary policy are only able to make limited positive impacts.

Previous massive fiscal stimulus has largely failed not because it was not large enough but because it crashed against too much debt at all levels. Over-indebted households in advanced countries, most notably in the U.S., have been forced to cut back and rebuild their damaged balance sheets by paying down outsize debt burdens and rebuilding depleted savings. This balance sheet repair has only just begun and everything suggests that it will continue for many years to come. The painful ongoing process of deleveraging implies that economic growth could remain below trend for many years until the deleverage has occurred. It follows that the depth of contraction and the weakness of the recovery are a both result and cause of the ongoing depressed aggregate demand at the domestic and international level.

Problems in the Supply Side

But there are problems at the supply side level as well. OECD estimates indicate that potential output level in the advanced economies may have decreased by as much as 3 percent as a consequence of the Great Recession. While potential growth is more difficult to pin down, it is likely that it has also been affected. The same OECD estimates indicate that average potential growth in the OECD areas may have been cut down by as much as 0.5 to 1 percent.

This is a result of a number of factors. First, the recession has significantly increased structural unemployment (or, in some cases, it has significantly increased the duration of unemployment) and has generated destruction of capital stock in several countries. In these cases, there may be loss in embodied knowledge and consequent negative impact on productivity. Second, total factor productivity may have been affected as a result of, for example, the closure of several companies and the loss of their stock of knowledge. Third, the rapid growth of the new emerging market economies, like China, has led to the loss of low-skilled manufacturing jobs in advanced economies and new investments in large industrial sectors were only temporarily replaced by housing construction, which was sustained by low interest rates and huge deregulation.

Therefore to sustain and consolidate a recovery, it is not enough to just produce more of what used to be profitable pre-crisis. Firms should instead anticipate what will be profitable to produce in the future. Potential output levels will be lower but its composition is bound to be different as a number of companies will have been thrown out of business. Taking potential output back to its pre-crisis levels, and even more importantly boosting the rate of growth of output, will require not just supporting household consumption and business investment but producing an effort in reallocating resources toward new products and sectors. In other words, in order to leave behind the consequences of the Great Recession, all advanced economies will have to pursue "new sources of growth".

A Combination of Keynesian and Schumpeterian Policies to Reduce the Risks of a Severe Economic Downturn

If the diagnosis above is correct, it means that to avoid a severe contraction that could turn into a

Japanese style long-term depression, advanced economies need to implement a new growth strategy that is able to tackle both the lack of demand and supply deficit. They should implement policies to offset deficient aggregate demand and supply since the reasons for high unemployment and low growth are not only short term but structural as well. All that by fulfilling the new and more stringent constraints arising from the needed consolidation of public debt. The traditional demand management policies and pure supply-side economics are both inadequate and there is a need for a policy somewhere between the two. In other words, the huge challenge is how to implement simultaneously a sort of mix of Keynesian demand and Schumpeterian supply side policies.

As for the issue of ongoing depressed aggregate demand, there is no doubt that policymakers should avert generalized fiscal austerity and provide additional short-term stimulus since quantitative easing could help but is not enough. The present fiscal austerity measures applied on a large scale are determining recessionary effects on output in the advanced economies. This is even more so the case with the lack of aggregate demand at the global level given the deleveraging of households and governments and the glut of capacity due to the massive overcapacity in China and in other Asian countries. This is particularly true in the eurozone where the ongoing austerity measures will ultimately hinder growth, especially in in the most distressed economies like Greece. In turn, low growth in Europe will hurt tax revenues, which undermines the proclaimed goal of fiscal consolidation.

Although highly indebted countries, such as those in the eurozone's periphery, should continue to undertake fiscal austerity, there are other countries—such as the U.S., Germany, the U.K., China and Japan—that can provide fiscal stimulus in the short run by postponing their own fiscal discipline adjustments. In addition, it is vital to continue to provide liquidity to illiquid but solvent sovereigns and restructure unsustainable private and public debts in an orderly manner.

In this regard, one should note that the coordination of macroeconomic policies at the G-20 level has a crucial role to play. In a new multipolar world economy, support for aggregate effective demand assumes all the contours of a public good in the sense that macroeconomic cooperation is not only desirable but somehow necessary for producing expansionary global demand and for avoiding countries' free riding in the system.

The Key Role for International Macroeconomic Policy Coordination

The path to recovery and stable growth today lies not in a new consumer bubble but in new infrastructure, upgraded skills and low-carbon energy (structural policies). It follows that fiscal stimulus measures should not be wasted by simply increasing current public expenditure and/or by tax cuts to revive debt-burdened consumers in advanced countries, notably in the U.S. Countercyclical fiscal interventions should be targeted to new areas of growth, such as tangible and intangible infrastructures, education, job-training and human capital improvements, and alternative and renewable energies. To justify these interventions one could emphasize not only the traditional Keynesian argument, emphasizing short run demand effects but also long run Schumpeterian growth effects working primarily through the supply side of the economy. Besides, most of these productive government investments need not add to net financial liabilities if they are repaid through future revenues, especially if they are able to stimulate additional private investments through new incentives. In a sovereign debt crisis, the key issue is how to raise new resources for medium- and long-term investment for growth as well as enhancing a new legal framework for project bonds, debt instruments and more generally credit-enhancing initiatives. Currently, budget accounting in the U.S. and Europe fails to distinguish between self-financing capital projects and those financed by general revenues. If successful, new financial instruments will be an interesting long-term investment opportunity for private institutional investors, such as pension funds, insurance companies and households.

These supply side measures depend more closely on domestic structures and national policies autonomously formulated by individual countries, but in the present highly interdependent oligopolistic system their implementation is also more closely dependent on the international coordination to avoid any collective action problems mentioned above.

The Very Narrow Path to Global Growth and the Risk of Prolonged Stagnation

One should recognize that the single most important driver of fiscal consolidation in countries is strong tax revenues, owing to their good economic performances. The appropriate response for advanced economies would be to put their economies back toward growth.

However, in the current phase, markets cannot generate a fast demand recovery by themselves, since the weaker the expected growth in demand is, the smaller the desire of companies to invest; while they cannot generate structural adjustment as well until a demand recovery is going to consolidate. Therefore, the ongoing slowdown and simultaneous collapse of market confidence in the U.S. and eurozone is sort of a trap. We are stuck in this trap today and we need to find a way out. It will not be easy because there are so far no signs of economic policies in the direction of the ones advocated above.

Neither the U.S. nor Europe has even properly diagnosed the core problem. Obama's disappointing strategy was to try to revive America's over-consumption through a series of tax cuts, increases in government spending and a flood of liquidity from the Federal Reserve Board. The eurozone—with its sovereign debt problems spreading beyond Greece, Ireland and Portugal to Italy, Spain and others, and with significant problems in its banking system—keeps pursuing a self-defeating austerity package without a vision for medium- and long-term investments. It is no wonder that the eurozone is causing major turbulence in the global economy today.

The face that the U.S. and the eurozone have no growth strategy is a great cause for worry. The recent turmoil in financial markets and the stalled recovery in the U.S. and Europe reflect these fundamental shortcomings. The path to recovery and stable growth lies in investing in workers and long-term productivity growth by implementing new policies in advanced economies that deal with the lack of demand and supply deficit at national and international levels. The need for concerted action at the G-20 and international level is greater than ever. A key feature of the new multipolar global economy is that no single country can on its own assure the stability of the international economic system and therefore the advantages of cooperation have been greatly enhanced. This public good characteristic of solutions in a multipolar global economy is applicable to many areas, including trade and finance. However, it is particularly important and relevant to the macroeconomic policies of major countries and the growth of the world economy. A strong coordinated response among G-20 countries is therefore necessary in order to minimize the risk of a mild global economic slowdown or worse another severe prolonged recession. But time is running out so the time for action is now.

A Needed G-20 Consensus: A New Structural Reform Agenda for Developing Countries

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What a wonderful world we lived in before the 2008 collapse of Lehman Brothers and the global financial crisis that followed. Economists and financial market analysts had coined many phrases to describe the period of prosperity before the crisis. Some of these include: the Goldilocks economy, the new economy, the Great Moderation and the second wave of globalization. During this period, the developing world as a whole also enjoyed significant growth acceleration and poverty reduction. Also during this period, international policymakers built up an elegant macroeconomic policy framework, comprised of inflation targeting, the fiscal rules of the Maastricht Treaty for fiscal sustainability and a flexible exchange rate regime. This global economic framework also encouraged regional and international economic integration and private finance initiatives for infrastructure investment. It seemed as if this prevailing global economic framework would ensure the continuation of prosperity in the world economy well into the future.

However, all this was shattered by the global financial crisis and the Great Recession that followed. We are probably still in the process of learning all the lessons from the 2008-09 crisis, but it is becoming clear now that we have to leave the prevailing macroeconomic policy framework behind. We must wade into uncharted waters, where familiar macroeconomic policy tools are no longer sufficient in ensuring global economic stability and growth. We may have to use unconventional or unorthodox structural policy tools and mix these with the conventional macroeconomic policies. The International Monetary Fund under the leadership of its former Managing Director Dominique Strauss-Kahn had ventured into this area, when it began discussing the resuscitation of Keynesian fiscal policy, once regarded as defunct, the controlling of volatile international capital movements, once regarded as a taboo, and the creation of "fiscal space". But we need to go further if we are going to maintain the growth dynamics of developing economies in the medium term.

It would be highly useful to economic policymakers as well as politicians around the world if we could come up with a new G-20 Consensus, with a view of focusing their minds on the much needed policy reforms. This consensus should not be a one-size-fits-all formula, like the much maligned Washington Consensus, but should be flexible and helpful to economic and development policymakers in the developing world, who are struggling to formulate policies appropriate for their countries and their circumstances.

The IMF and World Bank, as well as regional development banks should be called upon to initiate the formulation of a G-20 Consensus for the group's consideration. This work will surely require quite a bit of rethinking in terms of the traditional policy positions that have been promoted by these international institutions in the past. While a new G-20 Consensus should be up for discussion, its ultimate framework should include the following elements:

First, there is enormous underinvestment in infrastructure, including energy supply. Infrastructure deficits are not only limited to sub-Saharan Africa. In fact, they are also prevalent in Asia and Latin America. From a decade's experience of working toward fulfilling the Millennium Development Goals, we have learned that a most effective method of achieving the MDGs is economic growth and yet we have not focused on necessary infrastructure for promoting economic growth. How can we build manufacturing industries if we are to suffer all kinds of power shedding, brownouts and blackouts almost on a daily basis? We have been discussing global climate change with a particular focus on emissions mitigation. But we have hardly begun planning adaptation measures against high waters, typhoons and other climate-related natural disasters that would require substantial infrastructure investment. Many developing country governments have attempted to co-opt the private sector into infrastructure investment in the form of private finance initiatives with rather meager successes. The World Bank and regional development banks often have hid behind the concepts of private sector development and private investment initiatives, and avoided the difficult task of assisting large-scale infrastructure investment—no doubt out of fear of possible environmental damages and corruptive practices. There needs to be a wholesale rethinking of how to do infrastructure investment in the developing countries, which should be part of the structural reform agenda for the G-20.

Second, the recent experience shows that we need to strengthen fiscal institutions in more purposeful ways. Fiscal policy is the crucial nexus between macro and microeconomic policy. While we all recognize the need for improving governance, it seems that many of the efforts to improve governance are too diffuse to yield concrete results. The improvement of what we now call public financial management would go a long way in suppressing corruptive practices in the public sector. It would also help the governments of natural resource rich countries deal with the "natural resource curse", not only in terms of fighting corruption but also in responding to demand and price volatility.

Third, thanks to globalization and the integration of the world economy, small, open economies have, for all practical purposes, lost "tax sovereignty" in setting tax rates. They often have to follow their larger neighboring country in harmonizing their tax environment to keep multinational corporations and investors from leaving. For this reason, the revenue functions of governments are becoming increasingly important.

Fourth, as more countries move to become middle-income countries, social security systems, national health care systems and pension programs must be expanded. Fiscal institutions, both in the form of revenue functions as well as resource transfer mechanisms, will be essential and crucially important foundations for these systems.

Fifth, in the medium-run, an expansion of fiscal space is an imperative. The national budgets of many developing country governments still include a variety of subsidies which are the vestiges of previous policies. While we have learned that direct subsidies to the poor and needy are more effective and preferable to subsidies to inputs or outputs across the board, many national budgets still include substantial subsidies for energy, food and agricultural inputs. Although this is a politically sensitive area, the G-20 Consensus may suggest subsidy rationalization as a first step of fiscal reform.

Lastly, as part of the G-20 Consensus, there should be a rebuilding of policy planning functions for developing country governments. In the past quarter century or so, with few exceptions (e.g. China's Development and Reform Commission and India's National Planning Commission), policy planning functions of these governments had gradually lost their power and leadership in policy formulation and resource allocation. However, most of the structural reform agenda suggested above requires long-term planning, be it infrastructure investment or the expansion of social security institutions and social safety-nets. The rebuilding of planning functions should be made on the basis of a thorough review of their past performance, as there must have been good reasons for their waning power, authority and effectiveness.

A Case for Macroeconomic Expansion with Structural Reform

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Dismissing Keynes Again

In his preface to *The General Theory of Employment, Interest and Money*, John Maynard Keynes wrote: "The ideas which are here expressed so laboriously are extremely simple and should be obvious. The difficulty lies, not in the new ideas, but in escaping from the old ones…"[1] Believing in the power of ideas, Keynes thought that rational policy discourse would follow once his new theory was understood. In "Political Aspects of Full Employment," however, Michael Kalecki[2] pointed out that even if the new principles were understood, business leaders would be opposed to full employment achieved by government spending, for it would weaken their bargaining position by making the threat of an investment downturn or a layoff less credible than otherwise. Thus, adopting Keynesian policy would be a political as well as intellectual challenge.

The evolution of policy discourse since the onset of the 2008 global financial crisis has reaffirmed this dual concern. In the immediate wake of the crisis, what James K. Galbraith[3] calls "False Keynesianism" prevailed and all major economies around the world instinctively adopted a stimulus. This bastardized version of Keynesianism treated the global financial crisis as if it were just a severe recession, to be cured in a couple of years through a large dose of easy money and "shovel-ready" projects. This was an intellectual failure for the Great Depression, and more recent financial crises in Japan and other countries suggested that it would take a long time for highly indebted economic agents on their own to repair their balance sheets after a deleveraging shock. Faced with the zero lower bound on the nominal interest rate, conventional monetary policy would have a limited effect and fiscal policy would have to step in to facilitate debt restructuring and to reduce the risks of mass unemployment and deflation.

Furthermore, "False Keynesianism" paid no attention to the structural causes of financial fraud and instability that had precipitated the crisis. This stood in stark contrast to policy responses to previous financial crises and served as a testament to the political domination of the financial sector. As is well known, the Great Depression triggered off massive investigations into dealings in the financial industry and brought about dramatic institutional changes in financial disclosure, regulation and supervision. More recently, the savings and loans crisis of the 1980s led the U.S. government to allocate a budget of $50 million to uncover any unlawful acts or practices that had contributed to the collapse of these financial institutions. The Justice Department sent 367 FBI agents to the Resolution Trust Corporation (RTC) to support its investigations and subsequently 2,168 persons were found guilty and ordered to pay damages in excess of $600 million. Although the global financial crisis was far greater in magnitude than the savings and loans crisis, no comparable effort was made in terms of criminal investigations and institutional reforms. Clearly, bringing culpable parties to justice would make them consider the *personal* costs of malfeasance and enhance the credibility of institutional reforms.

As soon as the danger of systemic collapse had passed in 2009, even the bastardized version of Keynesianism came under attack. Intellectually, the old-fashioned notion of "sound finance" stormed back and called for fiscal consolidation, even though the bond market was signaling with its extremely low interest rates that the U.S. and other major advanced economies undertake aggressive fiscal expansion. Despite its lack of empirical evidence, the idea of "expansionary contraction"—that is, gaining market confidence through fiscal consolidation to produce an expansionary effect on output—won policy support, especially among European countries. Politically, small government advocates saw a chance to "starve the beast" and dismantle what was left of the New Deal institutions. They could care less about high unemployment as long as social unrest was contained.

This intellectual and political shift away from Keynesianism is not only deflating the global economic recovery but also increasing the risk of another crisis down the road. Conspicuously missing from the current policy package is structural reform to reduce moral hazard and boost productivity. The eurozone is making matters worse by continuing to perpetuate uncertainty about the magnitude of potential investment losses instead of agreeing on a clear debt restructuring strategy with a credible stress test for residual risks. It is no surprise that popular frustration with the lack of accountability and high unemployment is beginning to boil over, as evidenced by the Occupy Wall Street movement.

Korea's Experience with Macroeconomic Expansion and Structural Reform

Combining macroeconomic expansion with structural reform to reduce moral hazard and boost productivity is not an impossible proposition. Korea's experience after the 1997 Asian financial crisis provides a clear example that it can be done, even though it involved some factors that might not be easily replicated in other countries. Due to some fortuitous timing with an election, the outbreak of the crisis was followed by a change of government within a month, allowing Korea to manage the crisis with a relatively clean slate. The severity of the crisis strengthened the position of entrepreneurial reformers, at least in the early post-crisis period, and led the government to tackle the nonperforming loans problem head-on. Although Korea was forced to adopt a high interest rate policy under the terms of its agreement with the International Monetary Fund, its prior fiscal discipline provided space for deficit spending, which the government used not only to strengthen social safety nets but also to improve productivity-enhancing infrastructure, such as information technology networks. Also, Korea's established industrial base could quickly generate a current account turnaround once the exchange rate was adjusted. In fact, Korea's current account balance went from negative 5 percent of GDP in 1996 to positive 14 percent of GDP in 1998. Last but not least, small government advocates were a minority in Korea.

In the wake of the Asian financial crisis, Korea faced two major challenges. First, "legacy costs" or problems resulting from mistaken or unlawful decisions of the past had to be addressed. Foremost among these problems were massive nonperforming loans (NPLs) that had resulted from unprofitable investments. Public funds had to be injected to clean up NPLs and to rehabilitate the financial sector. Also, any unlawful acts or practices that had contributed to corporate failures had to be investigated and rectified. Second, to avoid a repeat of this kind of disaster, institutional reforms had to be implemented. The pre-crisis distortions in financial resource allocation and corporate governance had to be fixed. Reducing moral hazard, improving corporate governance, and promoting competition constituted the central pillars of Korea's structural reform program.

The government had to step in with public funds and urge financial institutions to take proactive measures against insolvent firms. Although the injection of public funds was likely to generate political controversy, the Korean government decided to bite the bullet and stabilize the financial system. Estimated to be around 28 percent of the country's GDP in March 1998, the magnitude of NPLs was too large for financial institutions to resolve the problem on their own. Executives and shareholders did not have the political clout to block financial sector restructuring, which basically involved the injection of public funds in return for equity write-downs and managerial changes. The government injected public funds to recapitalize financial institutions, to settle deposit insurance obligations, and to purchase NPLs and other assets. Overall, 787 insolvent financial institutions (or 37.5 percent) had been either closed or merged by June 2003.

Korea also made concerted efforts to investigate malfeasance on the part of managers whose firms or financial institutions had become insolvent. In 2001, an amendment to the Depositor Protection Act made it possible for the Korea Deposit Insurance Corporation (KDIC) to investigate managers of failed firms for malfeasance. Public prosecutors also launched major investigations in 2001 and arrested more than 100 executives.

In addition to resolving "legacy costs," the government had to terminate implicit guarantees against bankruptcy, improve corporate governance, and strengthen competitive pressure so that firms and financial institutions would make their investment decisions under the discipline of market forces. Massive corporate failures served as credible signals that the government's implicit guarantee regime had indeed changed. Through both court-led corporate reorganizations and out-of-court workouts, the management of many leading *chaebol* was displaced and controlling shareholders saw their holdings either written down or altogether wiped out. In fact, of the 30 largest business groups in 1996, 14 had gone bankrupt or entered workout programs by the end of 1999. The government from very early on focused its corporate restructuring efforts on improving the governance of the *chaebol*. In January 1998, then-President-elect Kim Dae-jung announced the five principles of corporate restructuring: (1) enhancing the transparency of corporate management; (2) eliminating in-group inter-subsidiary loan guarantees; (3) improving capital structure; (4) focusing on core competence; and (5) enhancing the accountability of controlling shareholders and managers.

Starting in 1998, a number of measures were introduced to improve financial disclosure and accounting standards, including a requirement for consolidated financial statements covering all companies under the effective control of the same business group regardless of the level of shareholdings. To strengthen minority shareholder rights, the government lowered shareholding requirements for bringing derivative actions, requesting termination of directors and auditors, and convening a special shareholders' meeting. To enhance the independence of corporate boards, listed companies were required to include at least one outside director in the board membership. The National Assembly also passed a securities class action bill. In addition, amendments to the Monopoly Regulation and Fair Trade Act (MRFTA) sought to regulate inter-subsidiary transactions that controlling families had frequently used to advance their interests at the expense of other shareholders. The principal means of preventing "tunneling" and facilitating corporate restructuring was to impose controls on various in-group inter-subsidiary transactions, particularly loan guarantees and share and bond purchases at above-market prices. In a landmark case at the end of 2001, a district court in Suwon ruled in favor of shareholder activists and ordered the chairman and nine past and present executives of Samsung Electronics to pay compensation of nearly 100 billion Korean won for misuse of company funds and undue resource transfers to other subsidiaries.

In addition to addressing the problems of moral hazard and corporate governance, the Korean government made efforts to strengthen market competition. The most important and extensive policy reforms in this area occurred in the rules governing foreign investment. In the wake of the crisis, the government completely eliminated the ceiling on foreign equity ownership in the stock market. A new Foreign Investment Promotion Act enacted in November 1998 streamlined investment procedures, strengthened incentives, and created innovative new mechanisms for regional governments to play a role in attracting foreign investment. In addition to encouraging new entry by domestic and foreign firms alike, the government also made efforts to remove exit barriers that had impeded corporate restructuring. Bankruptcy reforms in the post-crisis period expedited the bankruptcy procedure and introduced a major change in principle: to qualify for court-led bankruptcy procedures required an assessment of whether the value of the firm as a going-concern did in fact exceed its liquidation value. The courts were required to rule in favor of liquidation when the returns from doing so exceeded the firm's value as a going-concern. This principle was actually tested when Dong-Ah Construction was liquidated in 2001.

Attacking moral hazard in the middle of a crisis, as Korea did, was a difficult proposition, but it had to be done to prevent recurring crises. By comparison, enhancing productivity through infrastructure investment and structural reform was relatively straightforward, but here too care had to be taken in order to make the best use of fiscal resources and to overcome resistance from vested interests. The combined policy package of macroeconomic expansion and structural reform made Korea a more resilient and efficient economy today.

From Contractionary Contraction to Expansion and Reform

Although conventional wisdom holds that macroeconomic expansion in the U.S. and other advanced industrial nations is unlikely due to domestic politics, both the bond market and protesters on the street are increasingly demanding a decisive shift away from contractionary contraction. While small government advocates and moralizers may continue to prescribe pain for the masses, their intellectual case is weak and their political position is fundamentally shaky in a democracy. While business leaders may value the disciplinary effect of unemployment on workers to a certain extent, they also know that persistently high unemployment can create serious social unrest. As a result, macroeconomic expansion is not a lost cause. To be effective both economically and politically, it should be combined with structural reform to reduce moral hazard and boost productivity. Such reform would not only help to mitigate financial instability but also enhance growth prospects to prevent recurring crises.

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Austerity Measures without Growth? Greece, Ireland and Latin America

Guillermo Ortiz

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For several years before the global financial crisis, many advanced economies let government expenditures run well ahead of revenues. Moreover, after the crisis, fiscal policy provided major support in response to the deep downturn. Yet, countercyclical policies were not without a cost. The combination of a slump in economic activity and stimulus measures pushed fiscal deficits in advanced economies to about 10 percent of GDP. And debt-to-GDP ratios in some of these economies are expected to exceed 100 percent in 2011, some 40 percentage points of GDP higher than before the crisis.[2]

While the outlook for economic activity remains uncertain and the room for monetary policy maneuvers in many advanced economies has either been exhausted or has become much more limited, developed countries must return to a sustainable path in their fiscal stance. In Europe, the situation is more complex than in the U.S. because many sovereign governments are involved and policymakers have to deal with more immediate concerns: Greece and contagion to other economies.

However, even if fiscal consolidation is necessary, austerity without structural reforms is likely to slow growth further and will not suffice to bring down debt-to-GDP ratios. Although monetary and exchange rate policies are clearly beyond the control of individual European governments, the latter could focus on removing bottlenecks to growth, enhancing competitiveness and increasing efficiency. It is evident that authorities have reached the limits of macroeconomic policy tools and that in order to increase growth and return to sustainable fiscal paths they have to concentrate now on implementing structural policies.

Lessons from other countries strengthen this statement. Structural reforms were a crucial component of the Latin American strategy to exit the debt crisis of the 1980s. Furthermore, Ireland's reforms to improve productivity and restore growth are starting to deliver tangible benefits as it returned to positive growth in the first half of 2011.

The European fiscal crisis has been a serious source of concern for almost two years now. The initial causes of the fiscal crisis were narrowly focused on the issue of funding pressures for some countries, particularly Greece. However, contagion to other countries in the periphery spread swiftly and began to contaminate even core countries due to links between the sovereign debt crisis and the region's banking sector.

Three things are clear from this process:

1. In the case of Greece, the problem was initially characterized as one of liquidity rather than solvency both by the International Monetary Fund and the European authorities. This made sense in order to buy time, ring-fence other countries (especially Spain) and avoid widespread contagion.

2. The strategy failed mostly due to the perception that the authorities have consistently been "behind the curve." Policy implementation has been reactive to market stress and the dynamics between the political and economic dimensions of the problem seems to have further deteriorated. Recession fears in Europe have risen, exacerbated by widespread austerity

measures and the perception of an increasingly complex political decision-making process. It is becoming clear that the final problem is one of loss absorption—i.e., who pays for the losses accumulated so far and the losses that will be added until the problem is finally restored. The longer it takes to restore market confidence, the larger the losses and spillover effects to the rest of the world.

3. Additionally, growth-enhancing reforms that are so badly needed are virtually absent. Although the European leadership has rhetorically emphasized the issues of growth and competitiveness, in practice the programs put together so far have mostly focused on austerity measures and fiscal consolidation. Achieving competitiveness and growth in the context of a fixed exchange rate system requires more drastic structural measures and in most cases a painful "internal devaluation" process. The flip side to this is that austerity with no foreign exchange devaluation is almost always doomed to fail.

This last point is particularly important and can be illustrated with the two examples previously mentioned: the Latin American debt crises of the 1980s and Ireland.

Like developed countries today, Latin America also had to face public sector over-indebtedness. In the late 1970s, Latin American economies, like peripheral Europe in the 2000s, let government expenditures run well ahead of revenues. This situation, along with a rigid exchange rate regime, resulted in large fiscal and current account deficits. At that time, financial markets were buoyed by excess liquidity due to an influx of petro-dollars.

Initially in the late 1970s, while the global economy expanded and interest rates were relatively low, debt dynamics seemed to be sustainable. Latin America's growth rates exceeded interest rates. But much was explained by cyclical factors. Latin America's growth was mainly driven by public spending and debt resources were not being used for productive activities. While both private and public sector spending were rising, productivity was not. Once excess liquidity dried up, interest rates rose as anti-inflationary policies were put in place and the global economy decelerated. As a consequence, the unsustainability of Latin America's debt became evident. Growth stalled and Latin American countries had to endure a sudden reversal of capital flows.

In 1982, falling international oil prices, rising world interest rates, and massive capital outflows pushed external creditors to refuse to roll over Mexico's short-term debt, leading to the subsequent suspension of Mexican interest payments. Explosive inflationary and balance-of-payment difficulties ensued.[3]

In light of the current European debt problems, it is revealing to analyze how Latin American authorities faced the debt crises of the 1980s. They basically took three steps:

1. They engaged in fiscal adjustment through IMF Stand-by Programs;
2. They stimulated growth through structural reforms; and
3. They sought debt relief through the Brady Plan.

Fiscal Adjustment

In the 1980s, the first response to the debt crisis was the implementation of IMF-sponsored stabilization programs—the so-called IMF Stand-By Programs. These conditioned additional access to international finance—loans from official institutions and refinancing of existing international bank lending—on a significant level of fiscal adjustment, tighter monetary policy and slimmer public sectors, including the privatization of state-owned enterprises. In my view, there was a clear understanding between the IMF, the U.S. Treasury and commercial banks that Latin America had to adjust without new money or debt restructuring.

The claim was that banks were in no position to recognize losses on sovereign lending.

The adjustment resulted in higher primary surpluses. But this response was not enough. Debt-to-GDP ratios continued to rise and creditworthiness deteriorated even further. Deep recessions were triggered by fiscal adjustments, while lower creditworthiness led to higher interest rates. Lasting primary surpluses were not sufficient to offset the negative effects on economic growth of continued capital outflows, deteriorating terms of trade and the upward pressure of higher default risks on interest rates. Large current account surpluses were needed to service debt. This led to exchange rate policies geared to promote exports, undermining the recovery of domestic markets and boosting inflation even with fiscal adjustment taking place. Indeed, it was through the devaluation-inflation policies that external transfers were realized. This is obviously not an option in the European case.

In order to contain the effects of its debt crisis, Greece is following today the same path Latin American countries did in the 1980s. The first step was fiscal adjustment. However, although Greece has already put in place a program for fiscal adjustment, it seems that it may not be able to accomplish such consolidation. The draft budget plan approved for 2012 shows that because, the Greek economy is expected to contract by 5.5 percent this year, the deficit is now seen at 8.5 percent of GDP (compared to a target of 7.6 percent in the EU/FMI program). Achieving a successful domestic adjustment without devaluating and going through a recession in the middle of a negative global environment is definitely a challenging task. Still, further adjustment is required.

Growth Stimulus

Another important ingredient for solving the Latin American debt crisis was growth stimulus. Apart from fiscal and monetary adjustments, several countries initiated a far-reaching process of structural reforms that would eventually enhance growth. Throughout this period of macroeconomic turmoil, Mexico, for instance, transformed itself into a much more open economy through extensive trade reforms, the privatization of most public sector enterprises and financial market liberalization. In a few years, Mexico went from being mainly an oil exporter to a country focused primarily on manufacturing exports. Clearly, the real exchange rate depreciation helped, which is not an avenue open today to European countries. In addition, external demand conditions were favorable for export growth; this is also not the case today. Concentrating on the fundamental issues of economic policy underpinning a sustainable development process was as important as solving the debt overhang itself.

In the case of Europe, although policymakers are generally aware that debt sustainability is not achievable in the absence of economic growth, only timid steps in the direction of growth-enhancing policies have been taken so far. It is true that implementing structural reforms and austerity measures simultaneously may have been politically easier in the Latin America of the 1980s, where mostly authoritarian regimes were in place.[4]

Debt Relief

The third step taken in Latin America was debt relief. Even with fiscal adjustment and reforms, by the mid-1980s it was apparent for several countries that their strategies had failed. Growth was absent and debt-to-GDP ratios were still increasing. In addition, international capital markets were not providing the resources needed to mitigate running reform program costs, despite the expected future benefits. Growth was barely enough to cover the transfer of resources to creditors, which itself was becoming a drag on growth.

In the late 1980s, U.S. Treasury Secretary Nicholas Brady sponsored a concerted debt reduction program—the Brady Plan. Countries that agreed to a new stabilization program sponsored by the IMF would become eligible for voluntary reduction of international bank debt. The U.S. Treasury allowed banks to offset future tax liabilities with loan write-offs. Countries could then exchange existing loans for so-called Brady Bonds and negotiate the menu that best suited their needs—a reduction in the principal of the loan, a lower interest rate or an extension of the average loan maturity.

In 1988, Mexico was the first country to negotiate. In net-present-value terms, it obtained a 35 percent reduction on its external public sector bank debt.[5] At the time Mexico announced its Brady Plan, the secondary market yield on its external debt plunged and the exchange rate stabilized thanks to lower default risk. The combination of fiscal adjustment and debt reduction allowed the country to regain creditworthiness. In addition, these policies enabled the government to anchor inflation, which had been running above 100 percent, and to resume economic growth.

Debt relief in a context where fiscal adjustment was already undertaken was what provided the possibility of success to the disinflation program that was put in place at the time and what, in combination with a credible structural reform program, set the stage for higher growth in the ensuing years.

The so-called "Brady Plan" for Greece is, in my view, premature and misplaced. As explained, the Brady Plan worked in Latin America because fiscal adjustment and structural reforms had already been put in place, which is certainly not the case in Greece. Substantial debt write-offs may be needed, (which is not the case in the current version of the so called "Brady Plan") but they will not by themselves restore growth and competitiveness.[6]

In this respect, it is worth analyzing the Irish case. In Ireland, reforms to improve efficiency and enhance growth are starting to deliver tangible benefits. Even if there are downside risks to growth due to the stress in European sovereign debt markets, recent data are consistent with a return to positive growth in 2011.[7] Actually, while strong implementation of the IMF program has continued with fiscal consolidation on track to meet the 2011 target, the economy is growing at an annualized pace of 7 percent in the first half of the year. The main stimulus comes from exports; however there are also encouraging developments on the domestic side: fixed investment spending and consumption are both growing.[8]

There are two underlying advantages that the Irish economy has compared to the other periphery countries. The first one is strong productivity growth, which the economy's growth ultimately depends on. From 1990 to 2010, Ireland has managed to maintain an average annual growth rate of 3.2 percent on its labor productivity; much higher than the 1.6 percent observed in Greece, the 0.7 percent of Italy, the 2.3 percent of Portugal or the 1.3 percent of Spain. As a result of this, GDP per hour worked in Ireland was almost twice (1.8x) the GDP per hour worked in Greece in 2010.

Also, competitiveness in Ireland is improving. Since 2000, rising labor costs eroded competitiveness. However, unit labor costs have fallen (reflecting efficiency gains) by around 8 percent since the peak observed in 2007 and by 11 percent relative to the euro area average in that time.[9]

The second advantage for Ireland is its rapid foreign direct investment (FDI) growth. From 1990 to 2010, FDI inflows to Ireland registered an average annual growth rate of 20.6 percent, more than three times the average annual growth rate of the European Union[10] (5.6 percent), and more than 10 times the growth rate of the GIPS (Greece, 1.3 percent; Italy, 2.0 percent; Portugal, -2.2 percent and Spain, 2.1 percent). In addition, as a percentage of GDP, in 2010, FDI inflows in Ireland were 12.9 percent compared to 0.7 percent in Greece, 0.5 percent in Italy, 0.6 percent in Portugal and 1.5 percent in Spain.[11]

Ireland's success in attracting FDI has required an increasing focus on research and development support, and on improving workers skills. Furthermore, Ireland became more attractive for investors within the EU by establishing a low corporate tax rate. This encouraged multinational companies to establish their European offices in Ireland and thus book their profits there.

What is missing in the European periphery? Apart from the fundamental issue of policy coordination on the fiscal front and persistent fiscal consolidation, the Latin American and Irish cases prove that growth enhancing reforms are crucial for solving the European debt crisis.

Fiscal adjustment is a clear necessity, but just as important is setting the stage for renewed economic growth. Today like in the 1980s, reforms to reduce uncertainties and stimulate growth are of the essence. The package approved on July 21 has bought Greece some time, but the key problem remains unsolved: how will Greece reduce its debt burden without being able to engage in faster economic growth?[12]

There is an urgent need to transform the Greek economy into a more productive and competitive one, especially by reducing the high tax burden on labor which discourages hiring, making the judicial system more efficient and removing barriers to growth in specific sectors.[13]

In the short term, Europe has to deal with a host of issues that include: the Greek program; the issue of contagion, particularly in Italy—a country that is clearly too big to deal with if it loses market access; and the problems of the banking system, which range from signs of systemic funding strains in the interbank market to questions about the capitalization needs if inter-European claims are valued at market prices. Then again, there are also medium-term fundamental issues to solve, like reshaping the institutional framework to foster further integration with a coordinated fiscal approach and a push for structural measures that could enhance Greece and Europe's growth potential. Room for policy maneuvers has either been exhausted or is much more limited than before the crisis and fiscal sustainability cannot be achieved in the absence of renewed economic growth. Macroeconomic policy tools have their limits. It is now the time to focus on implementing structural policies.

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[1] This paper is based on the material prepared for the conference "What Can the Developed World Learn from the Latin American Debt and Mexican Peso Crisis?" presented in the 53rd annual meeting of the National Association for Business Economics on September 12, 2011. I am grateful to Dolores Palacios for her expert assistance.

[2] According to Cecchetti, Mohanty and Zampolini (2010), if governments do not make substantial fiscal policy changes, debts worldwide will soar by 2020, going above 300 percent in Japan, 200 percent in the U.K. and 150 percent in Belgium, France, Ireland, Greece, Italy and the U.S.

[3] See Wijnbergen, King and Portes (1991).

[4] Even so, not all growth policies were implemented in a timely manner or with enough depth.

[5] See Wijnbergen, King and Portes (1991).

[6] The PSI initiative was clearly a political mistake, the NVP obtained by Greece (nominally 21%) was clearly insufficient, to the point that just a few months later it is being reopened. Debt relief may

be essential, but it should be conditioned to the undertaken of structural measures.

[7] See IMF (2011b).

[8] See Global Data Watch, September 23rd 2011.

[9] See IMF (2011a).

[10] EU15 until end 2003, EU25 in 2004-2006, EU27 as from 2007. European Union includes data reported to Eurostat. Source: Most recent FDI Statistics for OECD and G20 countries, updated on 13 July 2011.

[11] Most recent FDI Statistics for OECD and G20 countries, updated on 13 July 2011.

[12] The last Troika report on Greek debt revised down growth prospects; a longer and more severe recession is now assumed for 2011 and 2012, with positive growth returning until 2013.

[13] See IMF (2011c).

The Fiscal Crisis as an Opportunity for Structural Reforms

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Politicians, newspapers and commentators have a natural tendency to focus on the current problems. The word "crisis" is probably the most used word in the ongoing economic policy debate. While handling the current crisis is certainly a priority, a longer-term view is ultimately more important for the world economy. After all, a crisis in which a country's economy falls by 10 percent of GDP—a very large crisis, indeed—is half as important as a "lost decade" of growth, where an economy grows at 2 percent per year less than it could. Japan is one example of this. At the end of the 1980s, Japan was an envied example of an economy with fast growth, a potential challenge to the economic status quo and the dominance of the Western developed economies, and the economic powerhouse. Twenty years of the anemic growth has now made Japan a lackluster heavyweight slugging along.

Austerity Is Unavoidable

The massive fiscal expansion used to fight the crisis substantially increased the debt burden in the world economy, especially in the OECD countries. The level of debt in many developed countries exceeded the 90 percent debt-to-GDP ratio—the "red line" after which, according to Reinhart and Rogoff, a significant slowdown of growth is very likely.[1] This "red line" is even more important because it reduces the hopes of growing out of the debt problems. The mutually reinforcing high-debt/low-growth trap is a dangerous reality for developed economies that foreshadows a decade or more of lost growth.

Another dangerous sign is that the likely size of the debt problem of the main developed economies is significantly underestimated. The key problem is the value of the implicitly guaranteed off-balance-sheet liabilities. Consider as an example the United States. While the official estimates state that the U.S. debt is in the range of $15 trillion, the number is likely higher. For example, adding up the obligations of Fannie Mae and Freddie Mac and capitalizing the pension and health care obligations results in an astounding 600 percent of GDP or $100 trillion.[2] Certainly, this number is misleading. The $100 trillion amount does not have to be repaid all at once; it is being paid every year from the current budget. Still, the official estimates are to be adjusted upwards. For example, the official estimates do not take into account the potential bailout of the state budgets. As the states will surely face a debt crisis, the federal government will have to take its debt on the balance sheet. Robert Novy-Marx and Joshua Rauh estimate that this will increase the net liability of the U.S. federal budget by about $2 trillion.[3]

But even the official forecasts are not rosy in the long run. The Congressional Budget Office estimates the incremental costs related to the aging population (pension and healthcare expenses) to increase by 5 percent of GDP by 2035. Eichengreen et al. estimate that in Europe such costs will raise the fiscal expenditures by 2.7 percent of GDP by 2035.[4]

The sheer size of the debt problem is so large that the austerity measures are unavoidable—both in the U.S. and in Europe. Europe is already under the pressures of financial markets, but the U.S.—as suggested by the Standard and Poors' recent downgrade of the U.S. sovereign rating—is also going to face this challenge in the near future.

The Rich World's Fiscal Problems Matter for All

Many emerging market economies worry that fiscal problems in the developed countries will be dangerous for them as well. The argument is that the growth in the U.S., Europe and Japan will slow down and the emerging markets will be inevitably hurt. This is why correcting the current situation in the OECD economies is in the long-term interest of the developing countries. Even if (and we argue later that this is a big "if") fiscal consolidation in the developed world slows growth, such reform will still have tangible benefits for the developing markets. Three key reasons for this are as follows:

First, the developing world's "safety cushion" relies on the quality of the long-term financial instruments in the developed world.

The hard lessons of the previous crises and the fast growth led many emerging market economies in the last decade to accumulate a sizeable amount of reserves. These reserves are a crucial safety cushion for growth in the developed world. Much like how the deposit insurance for banks prevents panic and runs on banks, the accumulated reserves significantly decrease the probability of serious problems with the emerging markets. At the same time, the developed world possesses a unique export product—high quality long-term assets. These assets are difficult or impossible to replicate and are therefore essential to "park" the excess precautionary reserves of the emerging world. The decrease in the quality of the long-term assets—which is inevitable if the developed world does not resolve its structural issues—will lead to a significant de facto reduction of the ability of the emerging markets to shield themselves from serious crises.

Second, capital flows to the emerging markets can be significantly curtailed if the uncertainty in the developed markets remains high.

A significant amount of economic research shows that an important determinant of the flow of capital to emerging markets is volatility in the world economy. When uncertainty is high, investors "fly to safety" and so capital flows out of the emerging markets. The "risk-off" mode of the world economy is significantly affecting the ability of emerging markets to finance their capital needs—which, in turn, is important for sustaining high growth rates. The current situation in the developed world is unsustainable in the long run. The ensuing uncertainty about the resolution of the current problems is detrimental for emerging markets—flight to safety reduces inflow of capital to emerging economies.

Third, failure to resolve the current economic crisis will doom the idea of global governance.

The world needs global governance, both in politics and in economics. But in order to build functioning global institutions, developing markets need the rich countries to have credibility. Rich countries still control the global institutions and will control the international organizations regardless of the resolution of the current crisis—by the very virtue of their large share in the global economy, and their technological and military power. Loss of credibility for the developed world will entail a loss of credibility for international institutions. Another related issue is that eurozone itself is a key experiment in multilateral governance. If it fails, it will be a major blow for building the institutions of global governance.

Fiscal Discipline Can Be Enforced

The failure of the Maastricht agreements to maintain fiscal discipline in the eurozone and the current turbulence in European markets have raised a new wave of skepticism in the ability to enforce limits on deficit and debt. By now, we know that domestic political institutions are not sufficient to impose fiscal discipline. Indeed, 2035 is too far away for cutting pensions and the promise of pensions. Therefore, it is not surprising that almost every eurozone country—and all large countries —now violates the Maastricht criteria on the debt-to-GDP ratio.

However, one should not interpret the recent events as a death sentence to fiscal discipline. On the one hand, it is clear the unprecedented level of financial globalization has made almost all countries "systemically important". Therefore, many governments count on bailouts by international financial institutions. And for every politician or political party, such soft budget constraints always create a temptation to gain more political support through lower taxes or higher spending. In the longer run, however, this scenario leads to a dead end; eventually excessive borrowing will result in a default.

On the other hand, the current debt crisis is likely to build a consensus that the international community should change its approach to bailouts—very much like how the 2008 global economic crisis resulted in a serious rethinking on regulating the bailouts of "systemically important financial institutions". New approaches to enforcing fiscal discipline for sovereigns should benefit from the debates (and the resulting solutions) on imposing budget constraints on systemically important banks. The simplest approach is to use the framework of bank deposit insurance for redefining sovereign bailouts.[5] For example, the countries should agree on debt limits (e.g. 60 percent of GDP) and should only allow bailing out the debt that it is within these limits. The "junior" debt in excess of these limits can still be issued but should never be bailed out by international financial organizations. If such an agreement is publically announced, it will be relatively easy to enforce. Voters in one country will be very upset if its government uses their tax money to bail out another—clearly irresponsible—country and its equally irresponsible creditors. Indeed, if the country being bailed out violates its public promise to keep the debt within the limits, the aiding government will be unlikely to win a domestic debate on bailing out the other country's debt.

This will work as a global deposit insurance fund: for the "senior" debt (i.e. debt within the limits), there will be a promise of an international bailout; therefore the run on such debt is highly unlikely. For the "junior" debt, there will be no guarantee; hence, the junior debt will automatically become a high risk/high return asset—where runs and defaults will be possible but will not be considered as threatening to the global financial order, given that they will be almost expected.

Austerity as an Opportunity

There is debate and considerable uncertainty over whether austerity is necessarily detrimental for growth in the short run.[6] However, there is no doubt that responsible fiscal policy is certainly beneficial in the long run—especially if austerity is accompanied by structural reform. Rooting out inefficient subsidies, deregulating the business environment, introducing flexible labor markets, and most importantly radically reforming pension systems and health care will lay the foundations for long-term economic growth. Failure to implement structural reforms will certainly lead to a growth slowdown.

The silver lining of the current crisis is that it creates an opportunity to implement big ideas, which would be politically infeasible during a time of the relative prosperity and slow decline. One example is overhauling the tax system by moving to consumption taxes. Economists have long argued that in order to avoid distortions, taxes should be imposed on what people maximize—hence a consumption tax is optimal in the static sense. In the dynamic sense, it is even more important as it provides additional incentives for saving, which lowers the cost of capital for investment and growth.

Another crucial reform agenda item is pension systems. This will have important implications for the financial system and growth. As the young generation will have to save for retirement, there will be an inflow of savings—again, providing long-term funds to companies and fueling growth. This of course will only work in countries with developed financial markets. But the financial market is already virtually global so savers everywhere will have access to good financial services. This will also increase incentives to develop financial systems in other countries.

Russia Faces the Same Problems

On the surface, it seems that Russia is doing much better than U.S., Europe and Japan. The country has more than half a trillion dollars in foreign exchange reserves, low debt (10 percent of GDP) and a deficit which is close to zero. But Russia is facing a daunting long-term fiscal issue and more broadly a long-term growth problem. The fiscal situation only looks rosy while oil prices are high. In 2007, Russia's national budget would have been balanced if oil prices were at $55 per barrel. Now the balance can only be achieved at $125 per barrel. The non-oil deficit is now above 10 percent of GDP. Russia's pension system is not sustainable. It is true that Russia can borrow, but the need to borrow will be the highest when the oil prices fall as a result of a global slowdown or recession. Consequently, markets will not want to lend to a country like Russia if this is the case.

Therefore, Russia also has the need for both fiscal restructuring and structural reforms in the economy. The good news is that the reform agenda is clear and inefficiencies are many—so there is a huge potential for accelerating growth. The bad news is that the reforms are not necessarily in the interest of the current political elite. This of course is not unique to Russia. As Bueno de Mesquita et al. put in their seminal book, *The Logic of Political Survival*, good policy is not necessarily good politics.[7] In order to improve its competitiveness and accelerate economic growth, Russia needs to build modern institutions of private property rights and rule of law, fight corruption and protect competition. However, the political elites rely on interest groups that control state-owned companies, including many state-owned monopolies. And fiscal expenditures—even if they are not sustainable—are politically important as they help to finance the support base of the regime. This is why as long as oil prices are high, Russian elites will most likely hold off on fiscal restructuring, privatization and structural reforms.

Conclusion

The world has come to a line where fiscal restructuring in the developed countries is unavoidable. The challenge now is to make sure this fiscal adjustment is accompanied by structural reforms. It is also important to draw lessons on rethinking future sovereign bailouts by international organizations—in order to reduce incentives for irresponsible borrowing in the future. The sovereign debt crisis offers an opportunity for such rethinking and it will be in the interest of both developed and developing countries. The fiscal problems of the developed countries hurt emerging markets in several ways: the emerging markets suffer from global economic instability, from an inability to find reliable instruments for investing their sovereign wealth, and from weak credibility of the international institutions led by the developed countries.

Russia has a special role in this context. As long as oil prices remain high, Russia looks like other emerging markets with responsible fiscal policy, low debt and a sovereign wealth fund. However, once oil prices come down, Russia will face all the challenges that the developed countries are facing today: fiscal problems and the urgent need for structural reforms. Therefore, like the developed countries, Russia can and should use fiscal restructuring to build the key foundations for the long-term economic growth.

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[1] Reinhart and Rogoff (2010).
[2] According to Bill Gross from the asset manager PIMCO. See Cox (2011).
[3] Novy-Marx and Rauh (2010).
[4] Eichengreen et al. (2011).
[5] Along the lines of Wyplosz (2011).
[6] See, for example, Trichet (2010), Alesina and Ardagna (2010), and IMF (2010).
[7] Bueno de Mesquita et al. (2003).

South Africa-New Opportunities for Structural Policies And Growth

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Introduction

Global economic and financial developments since 2008 have forced closer attention on the role of national structural policy interventions, both as potential sources of growth but also as necessary policy initiatives to achieve and maintain macroeconomic stability. The standard fare for stabilization policy has included fiscal, macroeconomic and exchange rate policies. Yet, significantly worsening prospects for global growth and the absence of coordinated global remedies to reverse weakening growth prospects in the advanced economies are now forcing a re-examination of the potential for both national and internationally coordinated structural policy interventions. At the Seoul Summit and more recently, G-20 leaders have increased their emphasis on coordinated short-term and longer-term policies to reverse declining growth. They have also raised attention to the contribution of structural policies in this collective quest. The forthcoming G-20 Cannes Summit is likely to give further momentum to this approach.

For several reasons, South Africa is well placed to contribute to this new focus on structural policy as a key driver of growth. First, South Africa is an emerging market economy with a remarkable track record of fiscal, financial and macroeconomic management. The country reversed the macroeconomic decline, which characterized the closing years of apartheid. Yet with a substantial uncompleted structural reform agenda since the fall of apartheid, the balance of policy efforts for the foreseeable future in South Africa will be focused on addressing several longer-term structural impediments to growth, while maintaining what has been an effective macroeconomic stabilization policy.

Second, South Africa is the leading driver of regional economic growth and development in a continent that requires massive transport, environmental, energy and other economic and social infrastructure.

Third, South Africa is well placed to take advantage of a new global focus on structural policy precisely because of its extensive pre- and post-apartheid, experience and experimentation with conceptualizing and implementing structural policies.

Fourth, South Africa has positioned itself effectively, both in the global discourse on structural policies for development as well as in its outward strategy for development. South Africa is co-chair of the G-20's Development Working Group and has been an active contributor to bringing a wide range of G-20 voices to bear in understanding both the sources of growth, their long-term sustainability, and the interplay between fiscal, monetary and structural policies. The country is also now formally a member of the India-Brazil-China-Russia emerging markets group and is increasingly positioning itself, through several bilateral trade and investment agreements, to take advantage of these relationships in the quest for higher and more sustainable growth.

The remainder of this paper briefly traces South Africa's background and track record in pursuing structural reform programs; the paper highlights several structural challenges for the country and identifies a number of structural policy measures likely to be pursued in the next few years, as the country repositions its economy, takes advantage of emerging opportunities and seeks to address its structural challenges.

Background and Recent Developments

The apartheid economy—a closed and deeply flawed economic system—when it collapsed in 1994 left policymakers with large fiscal deficits, substantial net negative external reserves, a poorly-skilled and uneducated workforce, extreme levels of inequality and a profoundly uncompetitive economy. In its collapse, apartheid also left some of the seeds for renewal. Four in particular warrant emphasis. Firstly, South Africa had a diversified, albeit uncompetitive manufacturing sector, which had been built from the mid-20th century utilizing surpluses from deep-level gold mining discoveries in the mid-1950s and new mineral discoveries since then. The post-apartheid policymakers have taken advantage of this to forge major sources of competitive advantage. These include the nurturing of a globally competitive motor vehicle manufacturing capacity without state support and the development of several globally competitive manufacturing sub-sectors, such as chemicals, and the food and beverage sector.

Secondly, South Africa embedded an industrial policy strategy focused on identifying new industries and new sources of growth. It was originally intended in the apartheid era to isolate and make the apartheid economy self sustaining, but it later served as a key inheritance in enabling the country's economy to achieve global competitiveness in some niche industrial policies.

Thirdly, the country had an extensive minerals and extractive industry, albeit insufficiently downstreamed to exploit opportunities for domestic value-added.

Fourthly, South Africa established several institutions and institutional tools for development. These included: a well-capitalized Industrial Development Corporation that initially drove the large-scale acquisition of colonial mineral, financial and manufacturing capital, but later drove small and medium-sized enterprise incubation and development; the Development Bank of Southern Africa, which was initially designed and resourced to perpetuate spatial separation under apartheid, but would later provide the capacity and opportunity for significant infrastructure financing within South Africa and within the region; a military, industrial and scientific complex, spawned to promote long-term isolation and defense against the majority population, which would later serve to promote opportunities for high-value-added new sources of growth, diversification and new industrial development in the post-apartheid economy.

A Macroeconomic Foundation to Pursue Structural Policy

Since democracy, there has also been remarkable progress in macroeconomic management. As global attention shifts to the value of structural policy interventions as a source for global growth, the success of South Africa provides an important foundation for the country's future efforts to more effectively integrate and pursue structural policies.

Success in stabilization policy has been remarkable and multifaceted. Macroeconomic stability has been achieved and maintained, despite persistent exogenous shocks. There has been an extraordinary, managed process of trade opening from an altogether closed and uncompetitive system. Economic growth has accelerated in comparison to the decade prior to the end of apartheid. Inflation has been reduced significantly and an inflation-targeting framework has been introduced. Fiscal policy has proved robust and consistent, quickly correcting an extraordinary tangle of excess and inefficient inter-governmental transfers to support apartheid. The country has set in place a constitutionally binding system of inter-governmental transfers and a mechanism for equitable distribution of fiscal resources to sub-national tiers of government. It has progressively reoriented the direction of spending to address structural legacies and promoted the competitiveness of the economy. In the past decade, the exchange rate system has been unified and made open; and an apartheid-era legacy of net negative international reserves has been transformed, with the country now running substantial net foreign exchange surpluses. South

Africa's financial system and its regulation have strengthened, allowing it to adequately weather recent global financial crises and maintain levels of capital and liquidity well above new international standards for prudential regulation. Some progress has also been achieved in improving growth and addressing unemployment with growth expanding to almost 4 percent in per capita terms from 2004 to 2007, until the recent global economic crisis.

Yet, these gains have come at some cost. The global crisis has reversed several gains in employment and growth. It has also highlighted several structural obstacles, particularly challenges to higher growth. Export performance has been relatively slow to adjust to sector-specific and other incentives. The impact of the crisis has emphasized the shallowness of recent economic gains, with a substantial part of labor creation in the period since 2004 occurring in low-wage sectors and those particularly susceptible to cyclical factors and reliant on domestic consumption.

A Track Record of Structural Reform Initiatives

South Africa has had a long experience in structural policy reform. Since the demise of apartheid, several structural policy initiatives have been promoted, all focusing on the nexus between development and macroeconomic policies. The Reconstruction and Development Program launched immediately after post-apartheid elections targeted the realignment of the structure and direction of national budgetary resources toward the provision of social infrastructure. It addressed the immediate social and economic legacies of apartheid and made a first attempt at addressing extraordinary disparities in income and wealth.

The early post-apartheid years also necessitated a strong program of macroeconomic stabilization with policymakers confronted with addressing an inheritance of large scale poverty, very large fiscal deficits, significant sub-regional discrepancies in income and employment, a dual exchange rate with large negative foreign exchange reserves, high inflation and high real interest rates. The government's response was a further macroeconomic and structural intervention—the Growth, Employment and Reconstruction Program launched in 1996. The program sought to address the acute lack of economic competitiveness after decades of closed an inward-looking development while building macroeconomic stability. In 2005, a further approach was launched, the Accelerated and Shared Growth Initiative for South Africa. The program sought to address inequality, shift the economy away from low-skilled employment and achieve higher levels of growth. More recently, a New Growth Path strategy has been proposed and is being pursued. The strategy is particularly important in the context of the current global discourse on the role of structural policy. It recognizes the monetary, fiscal and other facets of previous experience in structural policy reform and seeks to make these more consistent with a stronger focus on structural policy measures in order to strengthen South Africa's global competitiveness and to address the labor, inequity and other legacies of apartheid.

Key Structural Challenges for South Africa

The global crisis has highlighted several constraints in pursuing structural policies in South Africa. The crisis had acute impacts on disposable income, resulting in the large-scale shedding of employment in several sectors and exposing the persistence of many structural challenges, which have not been addressed in the decade and a half since apartheid. The experience has shown that at least six major structural challenges need to be addressed.

First, South Africa must address its high levels of unemployment. In the first quarter of 2010, unemployment among 16 to 30 year-olds was 40 percent, with most receiving poorly paid and insecure employment. New strategies are needed to absorb and retain employment for a large pool of unskilled labor, while creating new higher income employment in sectors able to achieve and maintain global competitiveness. Several new initiatives are being pursued by the government, including substantial public investment in energy, water, transportation and communications infrastructure. There needs to be a stronger focus on labor-absorbing activity in agriculture through smallholder farming programs and a new focus on employment opportunities in pursuing sustainable development, which includes expanding public employment programs to protect the environment and promoting biofuels production and other renewable energy opportunities.

A second structural challenge is to build sustainable workforce skills. A major intergenerational legacy of apartheid was its failure to train successive generations of the workforce. Post-apartheid policy has focused on bringing large swathes of the school-aged population into formal education. However, it has not succeeded in training labor to compete internationally, it has failed to produce a new generation of technicians and engineers, and it has failed to provide workers with the skills to tap into new knowledge-based service sectors and other sectors, such as health care, education and tourism. A new, significantly strengthened focus on skills development is required to promote a more versatile, adaptable workforce that is capable of attaining high levels of productivity in emerging new industries.

A third major structural impediment comprises very high levels of inequality in income and wealth. The emergence of a substantial middle class, through a deliberate policy of Black Economic Empowerment has been pursued to help address historical inequalities in economic participation and to lay a foundation for broader-based growth. However several challenges in the implementation of this policy have emerged, which will require closer calibration of the policy.

A fourth challenge is that South Africa suffers from a lack of infrastructure to sustain higher levels of growth. The capital stock has aged and the opportunity of pre-crisis growth was not used to modernize and realign the stock of infrastructure. While the share of fixed investment to GDP increased for a period during the first decade of this century, it has fallen back since the global crisis. As a result, significant domestic and regional deficits have emerged in energy, transport, logistics, social and rural infrastructure. The prioritization of infrastructure will catalyze employment, help identify new sustainable sources of green growth, consolidate regional infrastructure, lower unit transport costs and increase the competitiveness of both the domestic and regional economy. Reducing inputs costs, particularly in energy remains crucial if South Africa is to become globally competitive in several key energy-intensive sectors, such as mining, minerals extraction and processing, and chemicals. This will also require strengthening logistics and supply chains both domestically and within the Southern African region, which will require significant new infrastructure expenditure in transport. With ongoing prudence in fiscal and monetary policy, how will these investments be financed? South Africa is likely to utilize a combination of private-sector led commercial finance, regional industrial and development financing, and a recently proposed new African infrastructure financing mechanism to achieve a part of this ambition.

A fifth structural challenge comprises more effective identification and pursuit of new sources of growth and diversification through; increased business incubation, enhanced financing for small and medium-sized enterprises; and stronger export promotion and export diversification initiatives; and developing and deepening value-chains in agriculture, manufacturing and services. South Africa's extensive industrial, developmental, scientific and industrial research capacity will provide a strong foundation for this effort. A part of this strategy will engender taking advantage of opportunities to expand and build international and regional competitiveness in several sectors where South Africa has developed a comparative advantage. Another part of this strategy will require specific initiatives to expand and increase the dynamism of the tradable sector, prioritizing the expansion of exports, including through government-led sectoral prioritization. South Africa should take advantage of its recently expanded collaboration with other large emerging markets, including Brazil, India, China and Russia, and several emerging markets in East Asia. Here, initiatives to take advantage of several recently established bilateral agreements with these countries offer potential to expand the export of higher value-added products.[1]

Sixth, South Africa has the opportunity to take advantage of green infrastructure and growth. Extensive policy planning has taken place and several initiatives are now being launched to shift the economy toward a low-carbon economy. South Africa will enjoy some advantages in this process, benefitting from the experience of other comparable emerging markets which have taken quicker and more trenchant steps to begin their adjustment. But if the country is to benefit from and utilize its domestic comparative advantages, policy implementation will need to be accelerated.

The country's key structural challenges are immense and the above provides an illustration of only a few of these. Many of the following challenges can be considered equally important: a more explicit strategy to address poverty; a stronger focus on rural development; increased attention to competition policy; a specific focus on regional and African integration and development; more explicit enterprise and private sector development strategies; and more directed policies to address labor market rigidities and to adopt technologies that can catalyze new sources of sustainable growth.

These challenges are of course known and well understood by the government. In fact, in recent years, the government of South Africa has continuously and extensively consulted international partners to identify challenges and consider strategies to address them. Recently, contributions have been made inter alia by the OECD, in its assessment of structural challenges in emerging market economies and by a group of Harvard-based economists, who contributed a series of views and recommendations to the South African National Treasury in 2009.

A detailed strategy to address structural challenges in a manner which better integrates macroeconomic, fiscal, monetary and structural policy goals has been set out by the government in its most recent structural reform policy initiative. The strategy seeks to combine both micro and macroeconomic interventions focused on improving labor absorption, together with the composition and rate of growth. The approach integrates a specific set of industrial policy initiatives with new policies and programs in rural development, agriculture, science and technology, mining and beneficiation, tourism education, and skills and social development.

The G-20 consensus to look beyond fiscal and monetary policy as drivers of national and global growth will assist South Africa's pursuits of these initiatives. It will give South Africa a greater sense of confidence that these measures are consistent with the thrust of globally accepted policy practice.

Interplay between Macroeconomic and Structural Policies

How will fiscal, monetary and structural policies coexist and complement each other, as South Africa pursues its new approach to structural policy reform? South Africa's macroeconomic experience with the global crisis has revealed the need for a new and clearer set of policies to better address the inter-linkages between fiscal, monetary and structural policies as the latter are pursued in coming years.

In the decade prior to the global economic crisis, South Africa achieved higher levels of growth by tapping into traditional comparative advantages and utilizing existing sources of surplus. Surpluses from the commodities-based economy, coupled with ready access to international capital, precipitated an appreciation of the nominal value of the rand. The opportunity to rebuild and renew the capital stock in mining and manufacturing and to invest in the capital needed to diversify into high-end services was not taken. Instead surpluses were channeled into the expansion of the retail, financial and telecommunications sectors. Labor absorption occurred only in low-level business services and the construction sector.[2] A rising nominal exchange rate prompted increasing imports of consumption goods, enabled a reduction in interest rates, reduced the competitiveness of the tradable sector, and precipitated widening income inequality.

A new approach to structural policy in South Africa is likely to see a new, more focused and consistent interaction between monetary, exchange rate and structural policy development. It is likely to engender: continued accommodative monetary policy, particularly as global economic uncertainty persists; the maintenance of current fiscal policy, including maintenance of current spending objectives, which envisage real growth in expenditure of approximately 2 percent per year in coming years; a gradual weakening of the external value of the currency, enabling a stronger focus on building competitiveness in high-value manufacturing exports.

A new approach is also likely to embrace a more explicit strategy to increase minerals beneficiation, taking advantage of the country's long-established comparative advantage in this sector.

An environment of low global interest rates can be expected to be utilized to help finance the rebuilding and modernizing of economic and social infrastructure, including financing initiatives to address key impediments to higher levels of sustainable growth, including transport, energy and environmental infrastructure. The governments' new approach to addressing structural constraints to growth is also likely to elicit a more targeted approach to picking winners.

Addressing prospects for continued short-term capital inflows will need innovation. The government's recent proposals to develop a regional infrastructure facility will help address a part of the exchange rate impact of likely continued capital inflows, as will the stronger and more focused national strategies which are being developed for external investment in several emerging markets. These markets are increasingly new sources for South African exports, employment and growth.

Conclusions

The recent focus within the G-20 on structural policies to address global growth augurs well for South Africa and offers important policy space for other emerging markets. It puts a stronger focus on a range of opportunities to place structural change at the center of South Africa's efforts to address its vulnerabilities and challenges. Several key pillars will support South Africa's structural policy initiatives—extensive experience in structural reform over many years; several key successes; a platform of sound fiscal and monetary policy management; and an institutional capacity to affect the adjustments needed to reposition the economy. As with most countries—advanced, emerging and developing—the challenge will not be to identify the key structural priorities but to isolate those for which political will and resources can be devoted to their achievement. For South Africa, the list is substantial, yet many among them are readily achievable.

Endnotes

[1] See opportunities highlighted in the governments' recent paper on the New Growth Path.

[2] New Growth Path Framework, 2010. Available at: http://www.info.gov.za/view/DownloadFileAction?id=135748.

The Political Dimension of Global Economic Challenges: Lessons from Turkey

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Challenges and Paradoxes

The intense debate surrounding the upcoming G-20 meeting, with the European debt crisis taking center stage, reflects deep historical shifts and dilemmas facing the political process as the 21st century unfolds.

The size of governments in most nations has increased in the 20th century. Rodrik[1] provides quite compelling evidence that the size of government in a large sample of countries is positively associated with trade openness and further notes that the most likely interpretation of this association is that government expenditure provides insurance against external risk. Indeed, the objectives of social cohesion, preventing exclusion, eliminating poverty and reducing inequality have been among the primary objectives of the welfare state in rich countries. The important point here is that especially in the second half of the 20th century the objective of social cohesion had become a norm shared by most citizens of the rich countries.

At the political level, this meant that political power was *limited and shared* in a fundamental way in the sense that those in power unilaterally refrained from using this power to the fullest in pursuit of their own political and economic gains. Yes, there was always criticism of the "excesses" of the welfare state by the political right, but this never meant challenging the fundamental notion, for example, that the state is an ultimate provider of social insurance. Politically speaking, having access to this kind of insurance became a basic right for most citizens.

The welfare state is now faced with formidable challenges and paradoxes. On the one hand, with enhanced globalization, geographical distances between nations have narrowed down, resulting in massive migration toward countries with more institutionalized welfare states. This has posed a challenge to welfare states by bringing about a dilemma: welfare economies needed migration flows for economic dynamism, but politically and culturally this led to discourses of xenophobia and fear toward the newcomers. In addition, globalization made it more difficult for individual states to develop policies of stability and protection in a unilateral manner, both generating a need for more global cooperation or else pushing individual countries to roll back aspects of the welfare state to cope with increased global competition. Demographic trends in the advanced capitalist societies posed further challenges to welfare policies by threatening their financial viability. At the same time, enhanced globalization increased the fragility of national economies toward global swings, increasing the degree of risk and uncertainty faced by individual citizens. The need for protection and social cohesion has transcended national borders.

Hence while globalization increased the degree of risk and uncertainty faced by citizens, it simultaneously weakened the hands of nation states in dealing with these challenges. These trends increased distributional conflicts within countries and increased the stakes. It seems these developments transformed the nature of politics in most countries. Politics has become more partisan, predatory and less collaborative. Economic policy has never been a technical issue but it seems we have entered a period where technical issues regarding the aims, design and conduct of economic policy have become irrelevant with partisan, populist and predatory politics completely taking over. A disconnect between politics and economics has occurred. It is now not only the norms of social cohesion that have governed Western societies in the post-World War II era that are under attack, it is the norms of political conduct—norms about what costs one is ready to impose on society in pursuit of partisan politics. This is no longer pure distributional conflict either. The existence of strong distributional conflict is tough enough for the political process but under pure distributional conflict reaching agreements is relatively easy. Under ideological conflict, gaining political power at whatever cost becomes the primary aim and the collective rules of rationality may no longer apply. It is this evolution of the norms of politics that helps us better understand the tea party in the United States, the increasing power of extreme right wing political parties in Europe, or even the human tragedy in Norway in the name of protecting the essentialist cultural values of European modernity.

It is no wonder that the media is full of stories and commentary about the lack of honesty, vision and leadership in rich countries. It is the changing norms of politics rather than the personal qualities and capacities of current leaders that explain the inability of rich countries to find lasting solutions to the current crisis. Recently the *Economist* commented that there is a failure of honesty and that "too many rich-world politicians have failed to tell the voters the scale of the problem".[2] The problem is that politics is carried out under imperfect information. Everyone would find it more difficult to be honest when everyone believes that political opponents are more likely to manipulate the environment of imperfect information to further their political power compared to two decades ago. In the case of an extreme example, it becomes difficult to converse about possible structural measures to resolve the tradeoff between a potential double dip and the need to institute fiscal sustainability over the medium term when political opponents threaten that they may be willing to actually use their power to shut down the government.

Therefore, economic problems facing the world have become politicized. This is a distressing view to watch especially from the seat of an emerging market economy. Advanced capitalist societies were the carriers of these norms of consultation and moderation, and whatever negative shock occurred in the short term, there was confidence that these norms would be durable and solutions would eventually be found. With politics becoming partisan and predatory, we are no longer so sure. One is tempted to see some common thread between tolerance of the extreme right, complacence when the dynamics leading to Greece's debt problems were developing and lack of compassion in the face of steep income declines that Greek citizens will have to face. In all cases, we see politics becoming reactive rather than constructive and collaborative. We suggest that in order to effectively tackle the world's economic problems, it is necessary to alter the existing mode of politics in order to reinstitute a more collaborative dialogical mode of political conduct. In order to make this point, it may be instructive to take a short look at what appears to be a success story in the last decade, namely the Turkish case with which we are most familiar. As will become apparent, the key to institutionalizing stability in Turkey has been a strong and even dominant party government, which demonstrates enduring commitment to an economic program anchored in macroeconomic and financial stability.

The Turkish Experience

Turkey went through a severe crisis in 2000-01. The crisis was homegrown and resulted from dismal macroeconomic management in the 1990s, which included years of populism, patronage and corruption. Turkey was ultimately not only able to respond decisively to the crisis, but after the lost decade of 1990s, the 2000s were by and large years of success. While the recovery from the crisis started under the preceding coalition government, Turkey was governed by a single party majority government of the Justice and Development Party (AKP) from the end of 2002 onward.

Since the AKP first came to power in late 2002, there have been significant political changes in

Turkey. During this time, Turkey began its accession talks with the European Union, adopted a series of extensive political reform packages, restructured civil-military relations, took serious steps in addressing the Kurdish question and followed a proactive foreign policy. This was coupled with impressive economic development in the country, which has become the 16th largest economy with an annual growth rate of around 8 percent. Turkey's increased visibility in international politics and in international institutions has gone hand in hand with its impressive economic growth and its path toward democratic consolidation. The political and economic developments in Turkey have increased its power in international politics and enabled it to play a leadership role in the region.

All of these developments occurred in a broader global context. In fact, Turkey's domestic transformation has gone hand in hand with the crisis-prone transformation of our globalizing world since 2001. First 9/11 and the global war on terrorism, then the 2008 global economic crisis, as well as serious problems of global poverty, disparity, and climate change have created global turmoil with a high degree of uncertainty and risk in international political and economic affairs. Turkey's transformation has been embedded in globalization and in fact constituted an "effective response" to these unprecedented global challenges. It is in here that lies the significance of the AKP experience in Turkey. Since the end of 2002, Turkey has been governed by the AKP majority government and during this period the AKP has been one of the most influential actors in the country's transformation and increasing global visibility. It is both the continuous and gradual power of the AKP government and its serious commitment to a strong economic program that has played a crucial role in Turkey's performance during the global economic crisis. The AKP's strong commitment to macroeconomic stability and financial discipline has contributed to its consecutive electoral victories and the country's effective response to global economic challenges. Unlike the extremely partisan and reactive modes of politics, the AKP has demonstrated that proactive and constructive politics can be the key to success. The AKP has done it through its dominant party position and electoral hegemony.

Yet, the AKP experience in Turkey has also created legitimate concerns about the nature of democracy and democratic consolidation. Is it possible to bring into existence a similar proactive and constructive politics with emphasis on democracy? Is it possible to effectively tackle the global economic crisis and the severe economic crises in certain developed economies, such as Greece, with collaborative and democratic politics? Before we turn to these questions, let us focus on the AKP experience in this context.

The AKP: Dominant Party/Electoral Hegemony

There is no doubt that the consecutive electoral successes of the AKP since 2002 have generated earthquake-like impacts on Turkish politics and modernity. In the November 3, 2002 national election, the three governing parties that had previously formed the coalition government after the 1999 election as well as the two opposition parties failed to pass the 10 percent national threshold. Thrown outside the parliament, they all found themselves as the complete losers of the election. The sole winner of the election was the AKP. By receiving 34.2 percent of the popular votes and with the aid of the undemocratic 10 percent national threshold, the party gained 66 percent of the parliamentary seats and constituted a strong majority government. The AKP's electoral success, leading to its majority government, was welcomed by a large part of Turkish society longing for political stability and effective governing. On the evening of July 22, 2007, the election results created another political earthquake. This time, the ruling AKP won "a landslide victory, receiving 47 percent of the vote, the largest share for a single party since the elections of 1957, and it was only the second occasion since 1954, in which the incumbent party significantly increased its vote share in a subsequent election."[3] The July 22, 2007 election resulted not only with the fortification of the power of the AKP government, but also the election in August 2007 of Abdullah Gül as the new president of Turkey.

Similar developments have occurred in March 2004 and March 2009 municipal elections. In both elections, despite the decline of its votes to 38.8 percent in March 2009, not only did AKP win most of the provincial or greater city mayorships, "the opposition gained little and divided across many modest to smaller size parties and no single opposition party…gathered the electoral momentum" with which to present itself a strong candidate to end the AKP majority government in the coming 2011 general elections.[4] In fact, this has proven true, as in the June 12, 2011 election. On June 12, 2011, the AKP received 50 percent of the national vote in the general elections. This was not only a record level of popular support, but also the third consecutive electoral victory for the AKP with a continuous and gradual increase in its votes. No other political party has achieved this in the history of Turkey's parliamentary democracy. The 2011 elections demonstrated that the AKP is a clear winner in Turkish politics with one in two voters in Turkey supporting its rule. It is also important to note that the Turkish voters' level of participation in the 2011 elections was 87 percent, the highest level of participation so far. The 2011 general election is also a milestone in Turkish politics as the path of democratization underway in Turkey since 2002 seems to have finally culminated in a highly representative parliament.

The electoral success of the AKP has been so strong that it has given them "dominant party status" and "electoral hegemony" in Turkish politics and in the eyes of the Turkish people. The concept of "dominant party/electoral hegemony" refers to a situation in which the dominance of one party in the electoral process becomes so strong that other parties no longer have a claim to win the elections in a convincing way and the supporters of these parties lose faith in their own parties' electoral success. As the 2002, 2004, 2007, 2009, and 2011 general and municipal election results indicate, the dominance of the AKP constitutes a kind of dominant party/electoral hegemony in which it acts and governs Turkey without a strong opposition. At the same time, it brings about the harmonization rather than separation of power among the governing institutions and between the government and state bureaucracy. Therefore, the AKP's dominant party/electoral hegemony allows the government to govern Turkey with strong central power and without strong institutional and societal resistance.

If the AKP remains a powerful, dominant and even a hegemonic actor in Turkish politics, the question is in what way has the AKP created its electoral hegemony in a time when globalization faces severe economic crises, unemployment, and poverty as well as serious challenges in social unity. We suggest that the strategy that has brought about the electoral hegemony of the AKP has been on the party's claim that it can carry on "the transformation of Turkey in a globalizing world" better than the opposition parties. In substantiating this claim, the AKP has been quite successful in differentiating itself both from its past and from the other political parties by defining itself as a "center-right party with a conservative-democrat identity". By defining itself as a center-right party whose reform-based proactive politics can carry out Turkey's transformation process rather than an Islamic party, the AKP has widened and deepened its societal support and global legitimacy. Moreover, the AKP fortified its claim to be a center-right party by articulating liberal market values with traditional community-based norms.[5] The AKP accepted the synthesis of liberal markets and traditional community-based norms, and defined itself as a center-right party operating in the parliamentary democracy and secular constitutional structure.[6]

The strategy of the AKP in presenting itself as a center-right party with conservative-democrat identity has operated on the basis of four principles:

1. Market-oriented and reform-based politics;
2. Philanthropic and regulated neoliberalism;
3. Service-based politics; and
4. Proactive foreign policy

Working on the basis of these principles, the conservative-democrat synthesis allowed the AKP to claim that it could govern the transformation process of Turkey better than others and make the country strong and stable in the globalizing world. However, it should be pointed out that all of these strategies are founded on the AKP's strong commitment to macroeconomic stability and financial discipline, which was first established by the strong economic program of Kemal Derviş and his team as a way of overcoming Turkey's 2001 financial crisis. The AKP continued this strong economic program, paid special attention to economic governance, never applied populist strategies and used the above strategies to strengthen the performance of Turkish economy against the backdrop of global challenges. One can say that the AKP government has been able to establish a strong link between political conduct and economic management.

However, it should be recognized that the enduring dominance of the AKP has not been without problems, confrontations, tensions and even calls for non-political and undemocratic interventions into politics. In fact, the more dominant the AKP has become in Turkey's recent transformation, the more it has been subjected to criticism and skepticism, particularly in regard to the Kurdish question, the instrumentalization of democracy and social polarization along secular lines. In the face of such criticisms, the AKP's electoral hegemony has not paved the way for a solution to the social cohesion problem. The problem of a democratic deficit has also remained. In addition, the AKP has not furthered Turkish democracy. Instead, the AKP experience has involved both the centralization of political power and the instrumentalization of democracy, both of which have been at the benefit of economic performance and effective decision making.[7]

Back to the Global Scene

The Turkish experience suggests that governments ruled by single dominant parties can carry out effective policies that can respond to the challenges posed by globalization but not without raising concerns about checks and balances and the consolidation of democracy.[8] Of course, the degree of relevance of the Turkish experience to the current global situation is limited. After all, there is no possibility of a dominant political actor on a global level that can deploy global power for the purposes of economic management.

But this limitation of resemblance further reinforces the main point: at the global level, resolution of the current economic difficulties requires a fundamental change in political conduct toward more collaborative, constructive and cohesive politics. The politics of partisanship and fragmentation has not only been detrimental to social cohesion in many countries but it has created an environment that prevents effective collaboration in the face of global economic challenges. Politics will have to become less partisan and more cognizant of common objectives. Politics will have to allow for a discourse about what is good economic policy on the basis of reasonably shared views about what is rational and feasible. If it does not, there could be a tendency toward politics or leaders that occupy dominant positions to "get things done". The balance between the need for action and the need for democratic debate is a delicate one.

The world is far from establishing effective global governance of economic management, given the predominance of the nation state as the locus of political activity.[9] But the global crisis is desperately in need of effective economic policy designed and implemented with at least some minimum level of coordination. Perhaps the best way to constrain extreme partisanship in politics is to strive to establish or re-establish norms that will protect common goals and objectives against predatory behavior. Strengthening social cohesion and preventing social exclusion on a global scale may be such a norm.

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[1] Rodrik (1998).
[2] October 1, 2011.
[3] Karakaya Polat (2008).
[4] Çarkoğlu (2009).
[5] For details, see Keyman and Oniş (2003), and Keyman and Oniş (2007) chapters 6and 7.
[6] A detailed analysis of MUSIAD and SIADs can be found in Keyman and Koyuncu (2005).
[7] As it turns out, these concerns about democratic consolidation appear in the draft of the latest Progress Report prepared by the European Commission due October 12 (see Çongar 2011). While on the whole celebratory, draft Report expresses concerns and warnings regarding the degree of participation in the constitutional reform process, representation in the parliament by women and minorities, the conduct of the judicial process during the cases brought against former military personnel accused of plotting against the government as well as journalists and freedom of the press.
[8] A similar concern was recently raised by Ian Bremmer (2011) for Hungary, whose economic outlook has improved since fiscal reforms announced in March 2011, but where "consolidation of power at the expense of democratic institutions exposes a fundamental challenge for the EU as a whole."
[9] Dani Rodrik (2011) draws attention to the "fundamental trilemma of the world economy," namely the tension between globalization, democracy and national self-determination.

A Structural Agenda for the United States

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The global economy is struggling to generate sufficient growth to re-employ capital and labor resources idled in the recent recession in the advanced economies, despite extremely low or even negative real interest rates resulting from highly accommodative monetary policies. The natural resilience of market economies has been restrained by a variety of forces, including the need to work through the overhang of debt and of houses, and consumer durables purchased with that debt in the previous sharp upswing in the credit cycle. Relieving these restraints and overcoming these forces will require a variety of structural as well as cyclical policy initiatives. Businesses and households need to have the incentives, as well as the means, to invest in physical and human capital and to expand their operations and spending. Pessimism about future employment and demand has been the major damper on the expansion, but both the feasibility and effectiveness of countercyclical policies are being impeded by deep structural problems and uncertainties that our political systems seem unable to deal with effectively.

In this essay, I will concentrate on a structural agenda for the United States, but a globally integrated U.S. economy is being held back by two notable structural issues that must be addressed by policymakers in other jurisdictions. The first is the necessity of shifting current account surplus countries toward more domestic demand and less reliance on exports, especially in those countries that have artificially held down exchange rate appreciation. We have seen the destabilizing effects of a reliance on U.S. consumers to drive global growth through much of the 2000s. A more sustainable configuration for global growth will have less consumption and residential housing, more exports and investment in the U.S., stronger domestic demand and fewer exports in current account surplus countries. To a considerable extent, the reorientation toward higher private domestic saving has already been underway in the United States and a number of other advanced economies. To support global growth, the complementary adjustment must also occur in the surplus countries. That shift in turn requires changes in relative prices in deficit and surplus countries, as well as in policies that directly affect the structure of demand; the necessary real appreciation of surplus countries will be much less disruptive if it occurs through exchange rate appreciation than if it is the result of higher inflation.

The second critical area requiring policy action abroad is in the euro area. Concerns about developments there—fiscal sustainability, bank resilience and persistent current account imbalances—have weighed on global financial markets, causing increasing volatility, reductions in the valuation of business capital in equity markets, and a decline in credit availability everywhere. Tighter financial conditions in turn threaten recovery broadly and the euro area governments must take actions to get the required fiscal and competitive adjustments, and to sustain the provision of banking and other financial services while that is going on. These actions must be of sufficient scale and targeted well enough to be credible in financial markets.

A Structural Agenda for the United States

At the same time, U.S. authorities have a long list of structural issues they should deal with to foster near-term recovery and longer-term growth. The problems the U.S. economy is facing are multifaceted and a broad range of policies will be required to restore its vitality. Some necessary changes are underway, but many are not. In addition, the lack of attention to a number of structural issues is reducing the feasibility and effectiveness of countercyclical policies.

1. Devise and commit to a medium-term path for fiscal policy that results in a sustainable level and path for government debt.

   The current inability or unwillingness of U.S. politicians to tackle the very tough medium-term issues for debt sustainability is harming the recovery in several ways: First, it is adding to uncertainty about the structure and level of taxation, and the structure and level of government support for retirement and for meeting health care costs as the population ages. A number of temporary fiscal actions have been taken to boost demand; whether they will be extended adds to uncertainty. A natural response to this policy uncertainty is to do more saving as a household, and for households and businesses to hold back on investment until future government policies become clearer. Planning and investing will be easier when the parameters of government action are clearer. Second, the inability of elected officials to make substantive progress on these issues, and the tendency to play them for short-term political gain, is undermining confidence. It likely is no coincidence that the sharp drop in consumer and business confidence in August coincided with the spectacle of the debt-ceiling negotiations. Third, while the combination of longer-term cutbacks with short-term stimulus probably decreases the effects of short-term stimulus, it is also the case that in the absence of a medium or longer-term credible commitment to fiscal sustainability, the only way politicians have to signal that they take the longer-term problem seriously is to engage in fiscal austerity in the short run. A credible, committed medium-term plan would enable much more flexibility for shorter-term fiscal policy to avoid ill-timed austerity.

2. Reform the tax system to reduce marginal rates, raise more revenue and encourage saving.

   Since the last major overhaul of the federal tax structure in 1986, the U.S. system has become much more complex and inefficient. The bi-partisan Simpson-Bowles commission pointed to a way to raise revenue while lowering marginal tax rates—tackling "tax expenditures", the tax credits that encourage certain types of spending. These include the deduction for mortgage interest costs and the tax-free character of business spending for health care insurance for their employees. Moreover, these types of tax deductions are more valuable for higher income individuals and families facing higher marginal tax rates. Marginal tax rates could be lowered, revenue raised and income redistributed to lower income taxpayers if these deductions were reduced and changed to tax credits in those cases in which the Congress decided certain types of spending still should be encouraged. In addition, consideration should be given to moving toward a more consumption-based tax system over time with a national sales tax or value-added tax. As the U.S. returns to full employment, it should do so with less consumption and more domestically financed investment and less reliance on foreign capital flows. Encouraging domestic saving would contribute to the necessary rebalancing.

3. Clean up the system of housing finance in the United States.

   The U.S. is facing difficult structural problems in housing finance in both the short and long term. In the short run, the inability to make good progress on cleaning up the debt mess left by the housing price bubble burst is hobbling the recovery. Housing usually is one of the sectors to lead the economy out of recession. It is not surprising that it is not filling this role in the current circumstances—we entered the recession with an overhang of debt and houses. But it is disappointing how weak housing remains five years after the peak in house prices, and a good part of the continuing weakness owes to the slowness of the process of dealing with loans that are underwater or are in arrears because borrowers are facing difficulties or simply chose to default. We seem unable to move forward on either refinancing into more sustainable affordable loans or foreclosing where that is not possible. The resulting overhang of "shadow inventory" of homes that are likely to come onto the market at some point is putting downward pressure on home prices and creating uncertainty about future movements in prices. The concern about further depreciation of houses quite naturally is making lenders very cautious and is constraining the availability of credit for refinancing or the purchase of new and existing homes. Devising workable plans for restructuring loans with principle write-downs without encouraging further defaults is very difficult and new efforts seem always to be under consideration. If there is a plan, it should be announced soon or the effort abandoned. In addition, banks need to fix their foreclosure procedures to enable them to move forward quickly when restructuring does not work. State attorneys general, others suing the banks, and the banks themselves should settle expeditiously or figure out a way for foreclosures to proceed while the lawsuits are underway.

The second structural issue with housing finance is the role of the government or government agencies over the longer term. The behavior of Fannie Mae and Freddie Mac likely contributed to the housing bubble and the erosion of lending standards. All agree that these types of institutions in which gains are private but losses are picked up by taxpayers should not be revived. In addition, goals and financing for affordable housing need to be considered separately by the Congress and not piggy backed onto government or government-like agencies in ways that obscure the costs. The revival of the housing market as the detritus of the bubble is dealt with will be facilitated by much greater clarity on the extent of government involvement in housing finance. Such clarity would enable the private sector to get a better fix on the problem and design its role.

4. Build a more stable financial sector.

The transition from the highly leveraged and risk-prone financial system of five years ago to a more robust and resilient system that can absorb major shocks without greatly restricting the availability of credit is inherently difficult and time consuming. Under present circumstances when bank credit is still tight, it could well be slowing the pace of credit easing, thereby reducing the effectiveness of countercyclical monetary policy. Nonetheless, financial institutions and lenders must build capital and liquidity along with better systems to understand and monitor risks if we are to avoid another systemic event. Regulators must put more constraints on risk taking and work to have more transparent and less complex financial instruments that can be evaluated by market participants. Credit needs to be rechanneled—some that was inappropriately priced and distributed in the "shadow banking system" will find its way back into banks. Some credit that was in banks will no longer be profitable once banks hold higher capital and liquidity, and will be intermediated in markets.

The needed structural and regulatory adjustments are underway. The challenge is to have them made with as little negative effect on bank lending as possible. One way to contribute to this objective is to get the regulations promulgated as quickly as possible so as to give market participants more certainty about the rules of the road. A second, and potentially contradictory imperative, however, is to subject those regulations to as rigorous a cost-benefit calculation as is possible within the parameters given by the law. A third is to encourage the buildup of capital buffers and the increase in capital ratios through restraint on payouts of earnings—share repurchase, dividends and compensation—rather than through the reduction of risk assets. Finally, institutions should be allowed long transition periods to the higher requirements—provided that is consistent with the stability of the financial system—as the authorities are already doing in their plan for implementation.

5. Educate our young people for better jobs.

Perhaps the most important longer-term structural reform the United States is already undertaking is the improvement of its primary and secondary education systems. Legitimate concern has been focused on the effects of long-term unemployment and on the stagnation of median incomes even before the current economic cycle. As jobs return, it will be critical that the unemployed have the skills necessary to meet the demands for an increasingly technical and high-skilled labor force. Investment in training beyond the high school level has continued to pay off over recent decades, but that type of training is predicated on a strong foundation and the U.S. is just getting started on the necessary reforms to make that happen. Future increases in living standards will depend on how well the education system provides the right learning opportunities and prepares its students to take advantage of them.

6. Carefully weigh costs and benefits for regulations; rely on market-based solutions where possible.

Externalities and systemic effects justify government intervention in many areas of economic life. But regulations should be subject to rigorous and objective cost-benefit analysis. They should be changed only when absolutely necessary so households and businesses can plan. And to the extent possible, they should rely on adjustments to market-based prices to take account of externalities, rather than potentially arbitrary decisions by regulators so as to minimize the costs of regulatory interventions. Although the administration has moved in these directions, there is a widespread perception that regulatory changes have become considerably more numerous and less subject to rigorous analysis. A sustained effort to improve processes will help reduce uncertainty and concerns about unnecessary and intrusive regulation that may be adding to the uncertainty that is holding back investment and hiring.

7. Preserve free markets internationally.

Free and open markets in capital, goods and services, and foreign exchange can be volatile and prone to overshooting. But in general they are less distortive to resource allocation and more supportive of growth over long periods of time than markets subject to heavy government intervention. Moreover, free and open markets are a powerful signal to households and businesses that they will be able to reap the rewards for their saving and investments, for the risks they might take. To date, a protectionist response to the recession in the forms of tariffs or other restraints on trade or on capital flows have been relatively muted. But pressures are building as weak growth persists and in response to capital inflows, some emerging market economies trying to protect export industries have moved toward capital controls rather than adjustments to exchange rates or to monetary policy. In addition, as already noted, some surplus countries are resisting the natural and needed appreciation of their exchange rates. The response of spending to the incentive effects of countercyclical policies and allowing the adjustments needed to promote global growth will be enhanced by adhering—in the United States and elsewhere—to the principles of minimally intrusive interventions into free and open global markets.

This is a formidable structural agenda for the United States. Progress has been made in some dimensions, but not in many others. As is already evident, even very aggressive countercyclical fiscal and monetary policies have not proven sufficient by themselves to pull the United States or the global economy out of the slump that followed the systemic financial crisis of 2008 and its aftermath. That crisis and period of economic weakness also have highlighted the cost of neglecting critically important structural issues for many years. Breaking out of the current economic morass will require action on many fronts at the same time.

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