The London Summit: reviving the world economy and reforming the financial system, two ambitious goals for one Summit

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The agenda of the G-20 summit to be held in London on 2 April 2009 is extremely heavy. The US, supported by the IMF, wishes the meeting to focus on how to revive world economic growth, which is becoming more and more desperately needed as world output growth forecasts are lowered almost every day. On the contrary, the Europeans consider that the G-20 should tackle in priority the issue of improving financial markets regulation, observing that past financial markets deregulation is at origin of the current crisis.

There is probably a need to pursue both objectives: the need for active policy measures should not hide the need for reforms in the financial sector. A substantial fiscal and monetary stimulus is required to bring along economic recovery, but restoring confidence in a sustainable and durable growth requires the design of a new world growth model. Banking and financial systems need to function properly again; although, here also, the implementation of a new functioning of the financial system is a major issue to be addressed.

Short-term stabilisation objectives come sometimes in contradiction with longer term structural objectives. Stabilisation objectives imply that interest rates should be maintained at low levels for a long time and that banks are rescued so that they can resume lending again in the very short term. Reforming the financial system aims at avoiding the emergence of financial bubbles again and hence for a stricter control of credit supply. Similar fiscal actions are desirable as concerns stabilisation policies, while differentiated measures should introduced as concerns structural evolutions. It is not shocking that countries running surpluses implement larger expansionary measures than others; wages should be increased in order to raise domestic consumption in countries like Germany and China. Protectionism would be the worst answer to the crisis. But it would make sense that countries with unsustainable external deficits (US, UK) allow for a depreciation of their exchange rates while countries running external surpluses (like China) let their exchange rate rise significantly. In the future, output growth in emerging countries should rely more on domestic demand than on exports. Last, it is not shocking that countries introduce specific support to industry sectors most affected by the crisis and help these sectors to move towards more environmentally friendly production processes.

It would be optimal that coordinated polices are implemented in order to prevent free-riding (countries benefiting from active policy measures introduced in neighbour countries), to avoid the implementation of harmful strategies for neighbour countries (exchange rate depreciation, protectionism), to design a long-term strategy (especially as concerns the financial system and taxation). But coordination may take time and situations differ from one country to another: coordination does not mean similar policies.

What for a fiscal stimulus?

According to the 3T rule, expansionary policy measures should be timely, temporary and targeted. However the appropriateness of temporary measures is questionable if the crisis has structural roots. For instance, inequalities have risen in Anglo-Saxon countries in the recent past higher social benefits could be durably financed through higher taxation on the

wealthiest; the Chinese economy needs higher households' consumption and this can be obtained through introducing a more satisfactory social protection level.

Housing sectors are especially affected by the crisis and measures aiming at stimulating output in the construction sector may be justified. However the weight of the construction sector needs to be reduced in some countries like Spain. Machinery and equipment goods are also particularly hit by the crisis and fiscal policy alone cannot offset this shock: this is an issue for Germany today. Bolstering activity today (through supporting existing industry sectors) comes in contradiction with longer term goals (production should become less energy intensive and more environmentally friendly).

The world economy needs a huge stimulus because world demand is currently too weak. The IMF had suggested a fiscal package of around 2 percent of GDP, the European Commission of around 1.5 percent of GDP. Each country may give reasons why they should do less than others: European countries may request that the bulk of the effort is done by the US, because the US financial sector is responsible for the emergence of the crisis. But the US may answer that one reason for the crisis it that he was the only country supporting the world economy. Germany may be unwilling to undermine the strong efforts done in recent years to restore its competitiveness but this policy is seen as counter-productive by EU neighbour countries. Hence it would be wise that each country agrees to implement a significant and long-lasting stimulus in 2009 and 2010.

It is difficult to assess effective implemented policy actions: in some countries expansionary fiscal measures are implemented together with consolidation measures (like cuts in public sector jobs in France, tax increases in Italy). Some countries include in their fiscal plans measures only indexing social benefits on prices, transfers between different government levels; some countries aggregate the fiscal impulse (higher government spending or lower tax receipts designed to support activity) and cyclical deficits (rise in government borrowing resulting from lower tax receipts under falling output).

Public deficits will rise substantially between 2007 and 2010 (see Table) but the output gap will have widened so deeply that the rise in deficit will be mainly cyclical. Expansionary fiscal measures announced in existing plans are substantial in the US, the UK, Spain (amounting to 3 percent of GDP), much smaller in Germany (1.6 percent of GDP), and even smaller in Italy, France and Japan. If the depression lasts longer than currently expected, it will be difficult to maintain such deficits in 2011.

Table: Assessing fiscal plans 2007/2010

As a percentage of GDP

	Gov. Balance 2007	Gov. Balance 2010	Output gap	Increase in deficit	Fiscal impulse
USA	-2.9	-10.1	- 8.9	7.2	2.8
Japan	-3.4	-10.1	-12.4	6.7	0.5
UK	-2.7	-11.9	-11.2	9.2	3.6
Germany	-0.2	-6.2	- 8.8	6.0	1.6
France	-2.7	-7.0	-8.4	4.3	0.2
Italy	-1.5	-6.0	-9.0	4.7	0.6
Spain	2.2	-6.6	-11.5	8.8	2.7

Sources: IMF, OFCE, own calculations.

Fiscal stimulus packages: where do we stand?

The crisis has disrupted the functioning of the financial sector and generated a strong uncertainty on future world economic growth. Worldwide equity market value has been cut by $ 28,000 billion, i.e. 42% of annual GDP. It is difficult for fiscal policy alone to counterbalance such a huge shock.

From an economic point of view, the rise in public deficits raises three issues which should not be overstated.

- *The fear of a Barro-Ricardian effect*. Households observe the rise in government debts and may anticipate future tax rises and thus reduce their consumption, which would lead active fiscal policy to be inefficient. Governments need to explain that budgetary positions will be brought back to balance thanks to higher output growth, not higher taxation.
- *The fear for inflation.* An awkward but widespread view is that higher public debts will generate inflationary pressures. This is very unlikely. The world economy suffers today from a substantial lack of demand. It is difficult to see where a strong pressure from higher demand or wages would be able to generate higher inflation. Clearly markets are confident about the absence of inflationary risks: returns on price-indexed bonds currently reflect 10-year ahead expected inflation at 1.1% in the US, 0.9% in France and 0.4% in the euro area.
- *The default risk*. Here also, markets do not anticipate that governments will be in default. Government borrowing will automatically be cut when consumption and investment grow again. Governments have no choice but borrow in the current circumstances since they are the only ones in which markets still have trust. In the future governments will have to choose between reducing their debt (in particular through selling back the financial institutions' shares they are buying today) and maintaining their debt in order to play a more important financial role. Although some voices argue that governments should announce today when budgetary positions will be back to balance in order to reassure markets, it is too early to make such a commitment since no one knows when the recession will be over. Commitments should not be too binding especially within the Stability and Growth Pact. The crisis should not be used as a pretext for introducing huge social spending cuts, especially as concerns pensions.

How to support banks?

It is absolutely necessary to support the banking sector today. Banks' accounts need to be restored, through isolating and valuing toxic assets, recapitalisation and introduction of new operating rules. Here also, the need to revive economic growth – ensuring that the banking sector is able again to lend to companies and households – may come in contradiction with the objective of reforming the financial system – changing deeply the functioning of the system.

Over the last years banks have developed complex and intricate financial products which make it very difficult to measure with accuracy the magnitude of bank losses. The amount of losses has been rising with the deepening of the crisis. A global transparency operation would have been needed although this would have been difficult to implement in practice: how to estimate the probability of individual housing credit re-imbursement and the non-repayment

risk which depends on short-term economic developments? How to assess risky credits covered by a CDS knowing that the insurer may go bankrupt?

In the US, the Geithner Plan suggests to single out banks in difficulty, which need to be recapitalised, in other words almost nationalised, and the more solid ones which would be able to sell their toxic assets. Banks' accounts would be disposed of risky assets and these assets would be sold to private-public investment funds in public auctions, possibly amounting from $ 500 billion up to $ 1,000 billion. The main interest of such a plan is that toxic assets are given a price. Banks will record losses but they will be more transparent. The drawback of the project is that hedge funds are expected to buy toxic assets, which will raise the importance of these funds instead of reducing it. It is not clear that Banks would agree to sell their assets with these conditions. A temporary nationalisation of a significant part of the banking sector would have been a better option to take the time to cleanse their accounts of the toxic assets bequeathed by the madness of the ten last years.

Most countries have recapitalised banks through capital injections in terms of preferred shares (or subordinated debt in France). Conditions have been imposed on banks as a counterpart of this support: commitment on lending levels, restrictions on dividend payments and management pay. But this government intervention is supposed to be temporary; banks will have to reimburse the amounts received rapidly (which means that they will need to make substantial profits and will not provide too much lending which would raise their capital requirements). Should banks recover their autonomy and be allowed to be liable only to their shareholders?

Over the last fifteen years, banks have moved away from their role: offering safe returns on households' assets, lending to companies and households, to play an active role in financial markets, where they have made a rising share of their profits though raising their risk exposure and turning the Basel ratios.

Massive government support raises the issue of the status and role of banks. Banks now benefit from a double guarantee: on their deposits and on the amount of lending they receive. Banks escape too a large extent to competition rules. They have a public service role: providing lending to the economy. The statement of the November 2008 G-20 meeting said that: 'Authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner'. But is it possible to not to draw lessons from the crisis in terms of banking regulation?

The London summit should move further ahead, reassess that banks should refocus on their core banking activity, that new sustainability rules should be a disincentive for banks to lend to hedge funds and should facilitate lending to the productive sectors of the economy. Banks should not be allowed to resume building complex, non transparent assets packages: securitization and financial innovation should be restricted. Countries should be allowed to use recapitalised banks to build a 'public financial service' model, with government guarantees and lending based on output and employment objectives.

How to reform the financial system?

Supporting the world economy should not exclude the achievement of a reform of the world financial systems which was central in the statement of the G20 November 2008 meeting. The

text adopted by the EU on 13 March, like the G20 Finance Ministers' and Central Bank Governors' Communiqué on 14 March and recent speeches by Barack Obama go in the right direction although they remain too shy in our view.

Hedge funds should be regulated and registered, but their indebtedness should also be limited so that they cannot use borrowed funds to speculate.

Credit-rating agencies should be subject to a better surveillance. They should not be allowed to give an assessment on operations they have organised. Too complex products should be forbidden and financial innovation should be placed under strict surveillance.

The Basel rules need to be changed. But as already said, rethinking the role of the banking sector should be the priority.

Strong measures need to be taken against tax and regulatory heavens. The EU has already increased pressure on countries implementing bank secrecy in Europe: Austria, Belgium, Luxemburg, Andorra, Switzerland, Liechtenstein and Channel Islands have committed themselves to change their legislation. It remains to be checked that their reforms go far enough. G20 countries should forbid their banks and companies to work with tax and regulatory heavens (based on a rigorous list of the latter).

Traders and managers pay practices in large companies and financial institutions should be regulated. An agreement should also be reached on a minimum level of tax harmonisation, both for higher income taxation and corporate taxation.

A consensus seems to emerge to give the IMF a surveillance role of macro-financial unbalances. Recent experience has shown that the crisis results both from unsustainable and selfish national macroeconomic strategies and from the instability generated by the functioning of free financial markets. It would thus be wise to follow Angela Merkel and Nicolas Sarkozy who have proposed to: 'come in the end to the setting of a world governance structure'. The G20 London summit will take steps in the right direction but the risk is that it remains too shy both in terms of supporting the world economy and reforming the financial system.