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« The Ways Out of the Crisis and the Building of a More Cohesive World »

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THE SHADOW GN*:

THE WAYS OUT OF THE CRISIS AND

THE BUILDING OF A MORE COHESIVE WORLD

Chair's Summary
Jean-Paul Fitoussi and Joseph Stiglitz

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This year the G's are meeting at a critical moment in history, at least economic and social history. They will confront the gravest economic and social crisis in almost 80 years. To paraphrase Keynes, the ***destiny*** *of the world is in the hands of the members of the G's. They could act in such a way that would allow us to get out of this situation, creating a future where growth is more sustainable, friendlier to the environment, and where its fruits would be distributed in a more equitable way, both within and among countries. Otherwise, they will bear an enormous responsibility before history, that of not having done the duty which has been delegated to them by their people, despite having been in exceptional circumstances that gave them much more room for manoeuvre than they would have had in 'normal' times.*
That is why a group of 'experts', with no commitments other that of being citizens of the world, decided to meet to reflect on what could be done, hoping that from their reflection some useful recommendations to the powerful of this world would emerge. This group, which christened itself the Shadow GN, has been constituted under the leadership of Joseph Stiglitz and Jean-Paul Fitoussi, thanks to a partnership between Luiss and Columbia University.
The group has met twice, once in New York at Columbia University on 4-5 February 2009 and once in Rome on 6-7 May 2009.

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INTRODUCTION: THE MAKING OF A GLOBAL CRISIS

The crisis that began in 2007 in a small segment of the US credit market (subprime mortgages) is today a global recession. The crisis has four distinguishing features. The *first* is that it is truly global in nature, as it started right at the centre of the system. The *second* is that, more than was the case with past crises, the present one is dominated by a widespread sense of unfairness. The *third* peculiarity is that its roots lie as much in structural causes as in the loose regulatory framework of the financial sector. The *fourth* is that it is 'doctrine made'. The belief in the self-regulating properties of markets led to deregulation and a widespread mistrust of government intervention.

The financial crisis, triggered by a modest number of defaults on subprime mortgages, has evolved into a systemic crisis because of the chain of financial innovations prompted by lax monetary policy and loose regulatory framework, which multiplied the effects of the initial shock. Contagion to the real economy mainly happens through tightening credit constraints for households and firms. In an attempt to recover more reasonable ratios, banks either hoard liquidity or lend at high rates. On the other hand, firms tend to use their own cash flow to restore more prudential ratios of debt to capital, thus postponing investment. Households suffer from a negative wealth effect. The result is a generalized decrease of aggregate demand that has led the majority of economists to forecast a recession well into the year 2010, with exceptionally strong effects on unemployment and poverty all over the world. It now appears likely that the ILO's 'worst-case' scenario of unemployment increasing by 50 million worldwide in 2009 will turn out to be over-optimistic. Over 200 million workers could be pushed into extreme poverty, mostly in developing and emerging countries where there are no social safety nets, meaning that the number of working poor - earning below 2 USD per day for each family member - may rise to 1.4 billion. 60 per cent of the world's poor are women.

The crisis has structural roots. The aggregate demand deficiency preceded the financial crisis and was due to structural changes in income distribution. Since 1980, in most advanced countries the median wage has stagnated and inequalities have surged in favour of high incomes. This is part of a broader process which has also affected several parts of the developing world. This trend has many causes, including asymmetric globalization (with greater liberalization of capital than of labour markets), deficiencies in corporate governance and a breakdown of the egalitarian social conventions that had emerged after WWII. As the propensity to consume out of low incomes is generally larger, this long-term trend in income redistribution by itself would have had the macroeconomic effect of depressing aggregate demand.

In the US the compression of low incomes was compensated by the reduction of household savings and by mounting indebtedness that allowed spending patterns to be kept virtually unchanged. At the same time, the limited safety nets forced the government to pursue active macroeconomic policies to fight unemployment, increasing government debt as well. Thus, growth was maintained at the price of increasing public and private indebtedness.

Most European countries tread a different path. The redistribution to higher incomes resulted in an increase in national savings and depressed growth. In the past fifteen years the institutional setting, notably the deficit constraints embedded in the Maastricht criteria and in the Stability and Growth Pact, resulted in low reactivity of fiscal policies and restrictive monetary policy. Together with a financial sector less prone to innovation, this limited consumer borrowing. The shift in distribution resulted in soft growth.

These two paths were mutually reinforcing because the savings from the EU zone contributed to the financing of US borrowing, along with surpluses of other regions which for different reasons – essentially to insure themselves against macroeconomic instability caused by Balance of Payments crises and the subsequent loss of sovereignty due to the intervention of IFIs – also experienced high savings rates (notably East Asia and Middle Eastern oil producing countries). Thus, the combination of structural disequilibria that goes by the name of global imbalances resulted in a fragile equilibrium that temporarily solved the aggregate demand problem on a global scale at the expense of future growth. An important component of this fragile equilibrium was *lax* monetary policy. In effect without a continuously expansionary monetary policy aggregate demand deficiency would have affected economic activity. In a way monetary policy was endogenous to the structural disequilibrium in income distribution.

RECOMMENDATIONS

I- *Proposed Recommendations to deal with the structural causes of the crisis*

To reverse the trend in distribution, and hence to contribute to sustaining aggregate demand in the medium-to-long term, it is proposed as follows.

1- To increase the progressivity of the tax system, in particular for high and very high incomes. This should happen in a coordinated way to avoid excessive movement of highly-skilled workers.

2- Fight against tax heavens – in distinguishing between low tax cooperative jurisdictions and others – and, in general, increase the resources devoted to fighting tax evasion and lack of information sharing.

3- Introduce some sort of cooperation among countries to avoid tax competition, wage deflation and social dumping, the modern versions of beggar-thy-neighbour policies which were common in the 1930s.

4- Return to a more important role for automatic stabilizers, and more generally to an enhanced social protection role for the government to help maintain sustained growth and high levels of employment.

5- Implement a general redesign of the welfare system, aimed at redistribution and human capital formation. This would imply in particular:

a. the generalization of universal health care and education provision;

b. the reversal of the trend from defined benefit to defined contribution pension schemes, that in the past greatly reduced the redistributive role of social security.

II- *Fiscal Stimulus*

1- The crisis is global in nature and countries should put in place a response that is as coordinated as possible to avoid mass unemployment and the risk of increasing social tensions. Sheer prudence requires more stimulus. The world economy needs a more global stimulus and should not tolerate free riding by some countries. This implies a fair sharing of the burden of the stimulus among countries, and a particular effort to help those countries that don't have the resources to lead a counter-cyclical fiscal policy. To our knowledge, a state of fair sharing has not yet been reached: the efforts made by the EU, in particular, appear to be well below what should have been done in view of the size of its GDP and high savings rate.

2- Developing countries and economies in transition have been badly hit by the crisis. According to most projections, Central and Eastern Europe is the region which is suffering the most, but Latin America, Sub-Saharan Africa and some East Asian countries will experience a slowdown of economic growth similar to or stronger than industrial countries. The most aggressive actions proposed by the G20 in its April meeting in London have concentrated on additional liquidity provided through new IMF facilities, particularly the Flexible Credit Line for emerging economies. This needs to be complemented by an important increase in Official Development Assistance and additional development financing, especially for low income countries, in order to increase investment. Infrastructure investment, social spending in the areas of nutrition, basic education and health should be the focus of fiscal policies in developing countries. Targeted programs for the poor, such as conditional cash transfers, are more effective in middle-income countries while in poorer countries, where poverty is widespread, universal programs are preferable.

3- The collapse of international trade is one of the most dramatic effects of the current crisis. This reflects both an expected reduction of 11% in the volume of trade and a sharp reduction in commodity prices. This is why protectionist reactions by industrial countries would be dangerous and why international cooperation should specifically target low-income commodity dependent economies.

4- The availability of external financing to developing countries will be critical. Most of the IMF loans in response to the financial crisis have been linked too much to the "old" conditionality criteria. What is required is a new facility without conditionality, within or outside the IMF. One of the quickest and more efficient way of financing this new facility could be a new allocation of SDRs. A distinct advantage of an immediate SDR allocation is that the institutional structures are already in place. Most of this new financing should be earmarked for investments in the green economy or in human capital related expenditure (health, education). Financing from the facility should, in other words, be the element that guarantees the compatibility between the short-term stimulus plans and the long-term development strategies of the concerned countries

5- The fear of an unsustainable increase in public debt and the concern about inflation to which it leads are in present circumstances much exaggerated. In effect, the stimulus should increase as much as possible the assets owned by the government to compensate for the deficit and debt in order to minimize the burden on taxpayers and boost potential growth. Infrastructure spending, for example, when compatible with reasonable delays (shovel-ready projects) should be preferred to current spending. Investment in building renovation to decrease the energy consumed by households and public administration could be quickly implemented. Assets should, in a broad sense, be considered as indicators of "development", not just GDP. Investment in new environment and energy technologies would thus be desirable, but also expenditures aimed at reducing inequality, or at increasing human capital (education and health reform).

6- It follows from the preceding recommendations that the greater the aid provided to developing and emerging countries, the more efficient the global stimulus will be, as these countries are likely to spend all the financing received.

III- *Monetary Policy*

1- The concern about inflation due to an excess of liquidity injected into the system through monetary policies seems also to be more imaginary than real. Deflation, not inflation, is for the moment the more likely threat. Wage deflation seems to have begun even in industrialized countries. If it continues, it will further depress aggregate demand. Asset price inflation has been the destabilizing factor at the immediate origin of the crisis.

2- One of the lessons emerging from this crisis is that we have to redefine what financial and global macroeconomic stability means. Macroeconomic and financial stability is a much wider concept than price stability, and sometimes the two are conflicting. Controlling inflation at the price of increasing real and financial instability proved short-sighted and led to today's crisis. Macroeconomic stability is a multidimensional concept that embeds price stability but goes beyond it. As such, it needs a multiplicity of instruments and a meaningful coordination with other policy measures. Targeting asset prices, regulatory measures and quantitative easing (or restricting) may all be instruments to be used alongside (or instead of) interest rates to pursue multiple objectives.

IV- *Bailouts*

1- Most of the governments are bailing out firms, especially in the banking sector. In doing so, governments need to pay attention to fiscal impact and fairness, and above all the effect that bail-outs have on lending. In particular, we have learnt that recapitalization may not lead to more lending.

2- Bailouts have become one of the central pillars of policy interventions in an attempt to avoid the collapse of the financial system. In responding to a financial crisis, a distinction needs to be drawn between (a) maintaining credit flows to the real economy; (b) keeping financial institutions afloat; and (c) saving shareholders, bank officers, and particular other claimants to a bank's resources. The primary concern of bailouts should of course be the first, and that should be done at minimum cost for the tax payer. Otherwise the redistribution effected by the bailout between the long term bond holder and the shareholder, on one side, and, on the other, the taxpayer will be detrimental to the latter.

3- Unfortunately such a concern has not always been the case in the current crisis, and the rescue plan seem most of the time designed to fulfil the objective of saving banks and minimizing costs for the shareholders.

4- In most cases nationalization of failing financial institutions associated with debt-equity conversion represents a better option than bailouts. In many countries, governments have become owners of many institutions, while exerting little if any control over them. Taking control along with ownership could have a number of positive consequences. First and most importantly, public management could restart lending immediately, serving the general interest rather than those of the shareholders or creditors. Second, the costs to the taxpayer should in principle be minimized if not actually transformed into gains because ownership strategies more oriented to medium-to-long-term profitability are likely to benefit from the current undervaluation of many assets. The public sector is more able to absorb risk in the short term and can gain in the medium-to-long term from holding illiquid assets while reducing the systemic real sector costs that would have otherwise occurred. Further, private ownership has hindered financial protection of banks and provides perverse incentives with respect to the resolution of the mortgages problem.

V- *Regulation*

1- The regulatory system should focus on identifying and regulating financial institutions that pose systemic risk, including those currently outside the scope of prudential regulation, like hedge funds. Such institutions are more likely to be found in developed countries than in developing ones. A new agency or interagency task force is required to regulate systemic risk on an ongoing basis. Indeed, regulation has to be recognized as being an inherently dynamic process.

2- Regulatory requirements should be heightened to reduce the risk of financial crises, taking into account potential endogenous correlations of risks. It should limit excessive leverage in financial institutions, for example using objective-based capital requirements, leverage requirements and countercyclical capital requirements or forward looking provisions.

3- The shadow financial system has to be supervised to ensure consistency of regulation for instruments currently operating in the shadow financial system. Moreover, it is necessary to increase transparency in OTC derivatives markets. Several options can be considered: regulated clearinghouses, exchange-traded derivatives and public reporting requirements.

4- An important task of the regulatory framework is to create the right incentives. It should propose, for example, executive pay structures that discourage excessive risk taking. One proposed action consists of encouraging financial regulators to guard against asymmetric pay packages in financial institutions, such as options combined with large severance packages.

5- The credit rating system should be reformed in order to limit conflict of interest. Credit rating agencies should comply with a set of norms and be authorized by a public entity.

6- Most proposals on regulation leave aside foreign exchange risk, which in fact is one of the most important risks faced by developing countries in such turmoil. These risks could be better managed through capital account regulations. Regulatory reforms should therefore take this issue into consideration, particularly in trying to avoid very volatile flows and in prohibiting lending to agents that do not have revenues in foreign currency.

7- There is the risk of cosmetic reforms, and that banks will continue to be "too big to fail" and too big to regulate.

8- A Financial Product Safety Commission should also be formed.

VI- *Global Governance*

A new international architecture should focus on four main points.

1- The establishment of a credible and effective mechanism for international policy coordination. The participation not only of major developing countries but also of more representative institutions of global governance is required. This will imply a fundamental revision of the governance structure and functions of the IMF and the World Bank.

2- Reform of the international reserve system, to move towards a multilaterally-backed global reserve currency.

3- Reforms of liquidity provisioning mechanisms backed, among other things, by better multilateral and regional pooling of national foreign-exchange reserves and avoiding the onerous policy conditionality attached to existing mechanisms.

4- Existing institutions have to be reformed because, as the crisis proves, they have failed. And/or they were ill adapted to the world as it is.

5- Fundamental reforms of existing systems of financial regulation and supervision to prevent the re-emergence of excesses. It is not enough to give new names to those existing institutions that did not prove effective in preventing the crises.

6- Given the urgency of action, and with much action already underway while other is being prepared, it is important to immediately establish some mechanism to overcome some of the deficiencies of global governance. This is made all the more compelling by the fact that the devil so often lies in the details (e.g. the review of the debt sustainability framework used by the IMF). Thus the G-8 should establish an "interim committee" as a forum to examine the details of proposals being prepared or in initial stages of implementation. This could consist of an adequately representative group, including in particular African and other low-income countries, which would back follow up and details of measures agreed at the level of heads of governments and reflected in communiqués of the G-20 and G-8.

VII- *Climate Change*

1- In the context of the current economic crisis, it is crucial to make clear not only that climate change policies will not be jeopardized but that on the contrary they can play an important role in overcoming the collapse of economic growth. Indeed, action on climate change can have both a short-term and long-term economic impact. The G-8 and associated meetings offer a unique and crucial opportunity for the leaders of developed countries to demonstrate leadership that can change the tone of international climate change negotiations and increase the prospects for success in Copenhagen.

2- The economy, environment and society are linked and interdependent. The current economic crisis is a significant challenge – and also a potential opportunity – for policymakers to simultaneously address economic stability, job creation and investments in energy sources and economic activities that will also reduce greenhouse gas emissions. The G-N leaders should commit to making climate change an important criterion in prioritizing stimulus spending — with investments in clean energy and adaptation given prominence and GHG intensive investments avoided.

3- Recent studies have reaffirmed the danger of continued emissions of greenhouse gases. Among the disturbing signs documented in recent research are a sudden drop in the extent of Arctic summer sea ice, increased methane releases related to thawing permafrost, increasing intensity of precipitation and storms, increased forest fires, sharp reductions in mountain snow pack/glaciers, reductions in the uptake of carbon by the oceans, incidence of diseases and pests in new areas, and accelerating sea level rise. Many scientists and governments have identified an increase of 2°C in global average surface temperature relative to preindustrial conditions as a threshold of climate change that is dangerous or unmanageable. Even this level of change threatens the existence of small island nations. To achieve a 2°C target with reasonable probability, G-8 leaders should commit to cutting Annex 1 emissions by 25-40% relative to 1990 by 2020 and by at least 80% by 2050. They should publicly recognize that there remains a limited atmospheric carbon budget and that in support of global equity most of it must be allocated to the developing world based on the principles of past responsibility (i.e. polluter pays) and current capacity for action to reduce emissions and finance mitigation

4- Developed countries have a special moral responsibility with respect to adaptation measures in vulnerable countries because they have emitted most of the atmospheric burden of greenhouse gases. Adaptation measures must include strategies designed to enhance the resilience of economic, social and environmental systems to climate change and insurance-like mechanisms to cover costs of recovery from climate-change related disasters. G-N leaders should announce that they will provide approximately $2 billion through the 5th GEF replenishment in immediate funding for the National Adaptation Plans of Action (NAPAs) that have been completed by the most vulnerable developing countries. They should commit to long-term funding for adaptation in the order of $9-86 billion/year (current range of estimates) in addition to current ODA and specific mechanisms for generating this funding in a way that produces sustained, predictable flows. Negotiations over the management of these funds should proceed in the UNFCCC with the full participation of developing countries.

5- Technology action programs can accelerate research, development and diffusion of key mitigation technologies. These programs should focus on technologies of strategic importance to clean development in developing countries. They should explore options for dealing with issues around intellectual property rights to protect and share new technology and providing incentives for future innovation. Energy efficiency is an area that seems to be especially promising for collaborative action. G-N leaders should develop a pledge and review process for improving energy efficiency performance in transportation, buildings, industry and energy supply through an existing mechanism such as the International Energy Agency. They should also commit to technology action plans for renewable energy, carbon capture and storage, electrification of transport, and technologies for sharply reducing emissions of black carbon. Black carbon is often overlooked but is a major contributor to climate change that has a short atmospheric residence time and thus can quickly slow climate change. Reducing these emissions would have major health and other co-benefits.

6- Many low-emitting technologies are more expensive than the current fossil fuel technologies. Financing for low-carbon development will need to be provided to developing countries in a "measurable, reportable, and verifiable" manner, as stipulated by the UNFCCC Bali Action Plan. A key issue to explore is the mobilization of public and private sector funding and investment. The G-8 leaders should identify the features of an effective climate finance architecture including mechanisms for generating needed financial flows on a sustainable basis, thus signalling to developing countries that their efforts to reduce their emissions will be supported**.**

7- An important issue is thus the agreement on the schemes to be adopted for emissions reduction. Indeed, market based solutions entail pricing at levels that would lead to huge transfers from developed to developing countries. Moreover, there is the risk of distortions due to speculation and the related problem of uncertainty about prices that would harm business activity. A carbon tax focuses on the correction of an externality, as it makes sense to tax bad things not good things. A cap-and-trade mechanism with floor and ceilings might actually work as a hybrid system between a pure market one and a tax.

8- Not only could a green stimulus create an asset corresponding to a liability, but could also stimulate private investment at a moment where the awareness of people may lead to a creation of a large market.

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