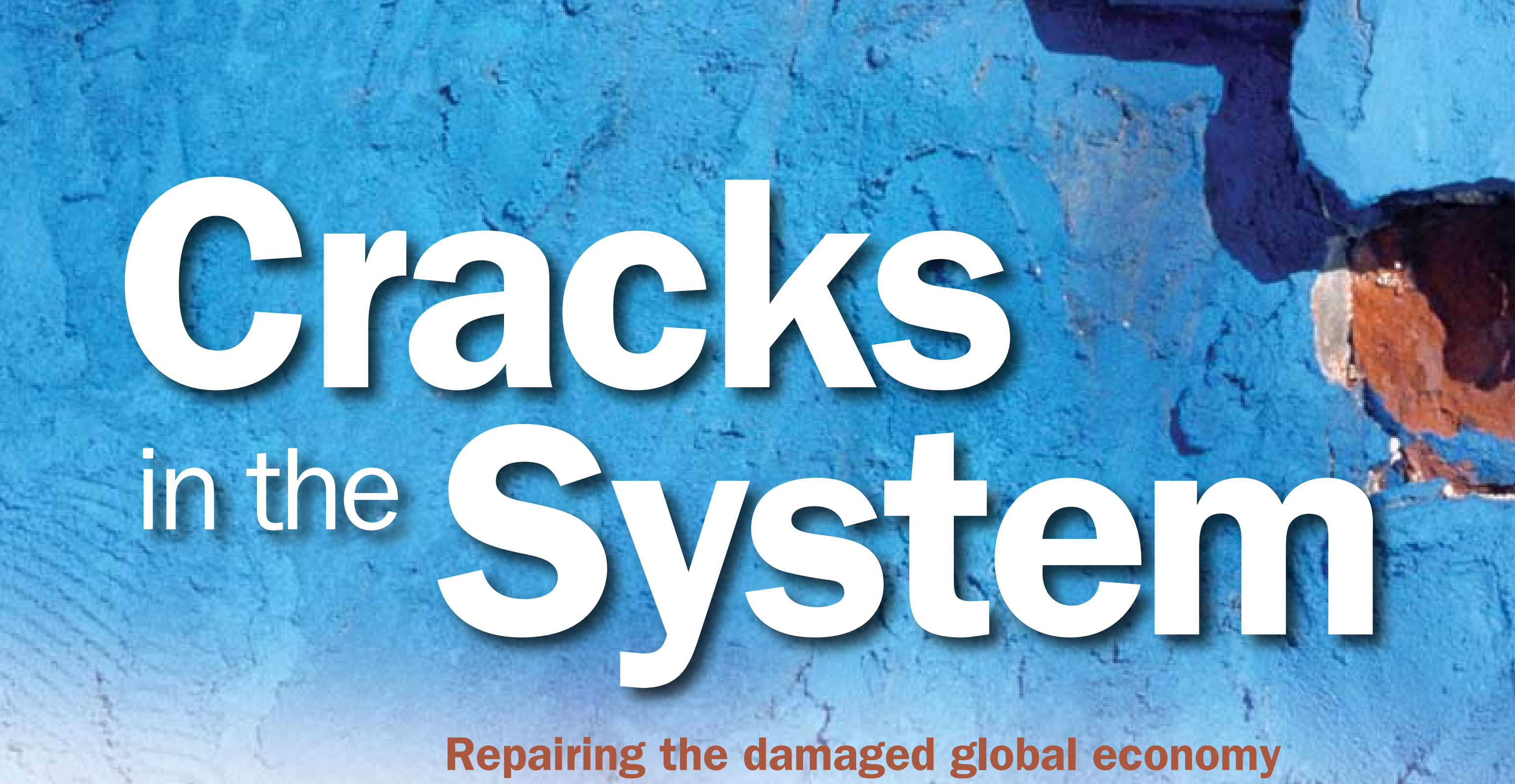

Cracks in the System

Repairing the damaged global economy

Olivier Blanchard

THE global economy is facing its worst crisis in 60 years. In the first half of the 2000s, a benign environment led investors, firms, and consumers to expect a permanently bright future and to underestimate risk. Housing and other asset prices shot up, risky assets were created and sold as being nearly riskless, and leverage increased. So when housing prices turned around, and subprime mortgages and the securities based on them turned sour, the stage was set for the crisis. In the context of rapid global integration and deep and complex interconnections between financial institutions, the crisis quickly moved across assets, markets, and economies. The rest is history, or, more precisely, history in the making.

Looking at where we are today, the good news, if any, is that we have probably stepped back from the brink of financial catastrophe. In October, faced with what looked like an imminent implosion of the financial system, major advanced economies announced a coherent set of measures to deal with the problem. In addition to continuing the provision of liquidity, governments initiated programs to buy bad assets, recapitalize financial institutions, and provide comprehensive guarantees. To be sure, these are extremely complex measures to implement, and implementation has been far from perfect, with governments feeling their way through the right combination of measures as they go along. The message from the financial markets at this point is that progress has been made, but it is much too early to declare victory. Indeed, while the financial crisis has moderated somewhat in advanced economies, it has increasingly engulfed emerging economies. Through no fault of their own, many countries are facing sudden stops, pressure on the exchange rate, and the danger of financial disruptions.

The bad news, however, is that, as policymakers in advanced economies were adopting appropriate measures on the financial front, the financial crisis began to have a sharper and deeper impact on the real economy. Deleveraging by financial institutions has now translated into more expensive credit for households and firms, and difficulties in financing even normal business operations. And, more importantly (at least in terms of its quantitative effects), consumers and firms across the globe have lost confidence. Fears of a long and deep recession, similar to the experience of the 1930s, have triggered worries about job security, savings, and credit. As a result, consumer spending has slumped, business investment has shrunk, and unemployment is rising rapidly.

These developments, notably the collapse of confidence over the past two months, led the IMF to revise its forecast substantially down from the October *World Economic Outlook*. We are now projecting output to decline in advanced economies by ¼ percent

on an annual basis in 2009, marking the first annual contraction in the post-war period for this group of countries. Based on the expectation that house prices will turn around sometime in 2009 and deleveraging will slow going forward, we predict growth in advanced economies to become positive in 2010. We also expect growth in emerging and low-income economies to moderate, because of weakening global growth prospects, plunging commodity prices, and tight financial conditions. Any hope of decoupling is now long gone.

How confident are we about these forecasts? Not very. On the upside, it could be that the decline in spending is not due to pessimism per se, but is a result of uncertainty—consumers and firms may be delaying spending until there is greater clarity concerning economic prospects. A decrease in uncertainty may then lead to greater consumption and investment demand, allowing output to recover faster than projected. On the downside, there is a clear risk that the fall in output could worsen the balance sheets of financial institutions more than expected, leading to a further contraction in credit, causing further bankruptcies and further worsening economic activity.

This is the environment in which the G-20 meeting took place in Washington in November. The agenda for policymakers in general, and for the IMF in particular, is simple: first, extinguish the current fires—identify and adopt policies that will limit economic damage in advanced, emerging, and low-income countries. Second, be proactive in thinking about how best to avoid a repeat of what we are now going through. Let me take both parts in turn.

Policies for now

What needs to be done in the short run is clear, if not easy. Governments must attack the crisis on two fronts. They must implement and refine the policies adopted in the past few months to deal with the financial crisis. And they must take strong measures to sustain demand, limit the fall in output, and restore confidence and private spending.

On the first front, I argued earlier that the policy framework—organized around liquidity provision, asset purchases, recapitalization, and guarantees—was largely in place. The implementation, which is inherently complex, is however proving difficult. Changes in policy and ambiguities about future policy are in some cases making things worse rather than better. Until the programs are clarified, and rules of the game more clearly established, private investors are unlikely to be enthused, worsening the crisis and delaying the adjustment in the financial system.

On the second front, it is clear that the onus will have to be on fiscal policy. While some countries, notably in Europe, still have some room to ease monetary policy further, others—especially the United States and Japan—have already decreased interest rates to very low levels, and real rates are rising as inflation falls.

Fiscal expansion must, therefore, now play the central role. What should be the size of the expansion and which countries should provide the stimulus? We have come to the conclusion that, at this point, the goal should be a fiscal boost of about 2 percent of global GDP. Assuming a multiplier of one—a conservative assumption if the fiscal stimulus is well targeted—this would translate into 2 percent higher global growth, reducing substantially the risk of a deep recession. To avoid spillover effects, however, it is essential that fiscal expansion is, if not explicitly coordinated, undertaken by all countries where low debt and disciplined policies in the past have provided sufficient policy space. A caveat is important here: if the decrease in output turned out to be even worse than we currently forecast, the fiscal expansion would have to be even larger than we currently recommend. The reason: what is essential at this juncture is to eliminate the risk of a full-fledged depression, and its adverse effects on spending today.

Preparing for the after-crisis

Let's now turn to the future. When the crisis abates (if we can imagine such a time), governments will have to tackle two main issues.

First, they will face a dramatically different fiscal position. The fiscal deficits needed to increase demand in the short run will result in higher debt in the long run, often by significant amounts. In most countries, the scale of public interventions in troubled institutions and the purchase of assets will lead to much higher gross debt. However, as the value of the assets they will have acquired may be substantial, the increase in net debt is likely to be much smaller. Still, the fiscal position of the government will be significantly leveraged, and will require the adoption of a more flexible fiscal policy stance.

Second, in several countries, the financial landscape will look dramatically different, comprising a significantly consolidated financial sector, with a large public presence. Governments will face a number of questions about how to manage their presence in the financial sector. The goal here should be to maintain a level playing field with privately owned institutions, and to steadily allow the return of the financial sector to private hands. Experience from many past banking crises provides a useful guide on how best to do this.

Avoiding a repeat through better regulation

The crisis has shown the limits of the current regulatory and supervisory frameworks at both the domestic and international levels. The challenge is, therefore, to design new rules and institutions that reduce systemic risks, without imposing unnecessary burdens and stifling innovation. Implementation will take time; the design has already started, and will be further explored by the working groups created at the G-20 meetings. The contours of reform are however already clear.

Measuring systemic risk will require better information. This implies the need for reviewing transparency, disclosure, and reporting rules, and the collection of information from a much larger set of institutions, including insurance companies, hedge funds, and off-balance-sheet entities, than is currently the case. Limiting systemic risk will also imply a broader perimeter of regulation than what we have now, in exchange for broader access to liquidity provision.

New and better national rules will be necessary, both at the individual institution and at the macroeconomic level. Countercyclical macro-prudential rules appear to be a promising way to reduce the buildup of systemic risk. These measures need to be complemented with improvements in the robustness of the financial infrastructure to counterparty failure—a central element of the current crisis—including through the increased use of centralized clearing houses and organized exchanges, and the development of stronger frameworks for the resolution of individual institutions.

The international dimension and the IMF's potential role

The crisis has made clear that the financial system is a global system, with strong interconnections across countries. What was initially a U.S. crisis is now affecting the entire world. National policymakers cannot do the job alone: what happens to them depends not only on their own regulatory structure, but also on the regulatory structure of other countries; not only on systemic risk at the national level, but also on the buildup of systemic risk elsewhere. Monitoring systemic risk at the global level is essential. The IMF seems best equipped to do the job, in collaboration with central banks and other international organizations. This will imply expanding our global surveillance role, and this is something on which we have to start working right now.

The crisis has also made clear the need for international liquidity provision. In the context of the current crisis, the need for such support has been addressed through ad-hoc bilateral swap arrangements involving a small subset of countries. Going forward, global liquidity provision can be improved either by increasing the resources that backstop the IMF's new Short-Term Liquidity Facility or by establishing a multilateral structure that would enable co-financing of liquidity provision by the IMF by other member countries and official creditors.

Finally, the crisis has made clear that in a world of large and volatile capital flows, countries in crisis will need access to larger pools of funds than in the past, and larger pools than the IMF can currently provide. An increase in the resources available to the Fund will thus be necessary, so that it can fulfill better its key mandate of helping ensure global financial stability. ■

Olivier Blanchard is Economic Counsellor and Chief Economist of the IMF.