International Conference on the Impacts of and Lessons Learned from the Global Economic Crisis in 2008

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The great Russian writer Leo Tolstoy wrote in the first lines of his major work, *Anna Karenina*: "*Happy families* are all alike; every *unhappy family* is *unhappy* in its own way."

We can say almost the same about economic business cycles. Every upswing looks like the preceding one, with rising investment and higher productivity keeping prices in check until the upswing gets into a more mature stage.

But every downturn, every recession and certainly every depression is, if I may say so, unhappy in its own way. They were all predictable when looking at events in the mirror. But before the downturn very few people blew the whistle. For the current crisis, it was clear for several years that over-consumption in the US running up high deficits on the public budget and the balance of payments accompanied by dis-saving among households were not sustainable. But so long as China was willing to produce and sell its exports to the US for greenbacks, which it was happy to accumulate, the model looked as if it would come to a standstill – the economists talked about a soft landing – in an orderly and managed way. We know now that this proved to be a false assumption. It was wishful thinking.

Many economists are analyzing the current downturn and comparing it with the Great Depression from 1929 but, fortunately, the differences seem to outweigh the similarities. This is so not least because every downturn has its own characteristics.

We are still in the early stages of the economic downturn and it remains to be seen how households and the business sector react to what is labelled the credit crunch and falling demand accompanying turmoil on the financial market. It also remains to be seen how effective will be the national and international measures put in place. We know from earlier cases that the economy works with a time lag and that economic statistics are not a good guide to how the economy is responding.

For a non-economist, it is a bit worrying to read the newspapers and websites and observe that economists disagree about almost everything. There is little agreement on how we came into this situation, there is not much agreement on how and when we will get out of it, and there is strong disagreement about what economic policies should be applied. Some economists think that the big imbalances must be addressed first, thus establishing a solid basis for later expansion, while other economists take the view that now is the time to push the throttle for full speed ahead to get the economy going and then rebalance the economy.

My first observation is therefore to congratulate the organizers for having convened this conference to shed more light on what can be done and how to extricate ourselves from the financial mess and the unpleasant economic downturn in which we have so unfortunately placed ourselves. It may be a bit early to reach final and definitive conclusions, but it is high time to start digging into our intellectual arsenal to deliver inputs to economic policy-makers.

My second observation is that the financial system is so preoccupied with saving itself with the help of governments that it cannot any longer fulfil the role of providing loans and credits to oil the economy. Financial institutions, primarily in the US but also in some parts of Europe, have participated in the drive for cheap profit encouraged by asset inflation. Now, when asset prices are falling almost like a stone, which is seen in the property markets in the US and Europe, their balance sheet is turning into a millstone around their neck. Even if some banks recently reported profits – one of them, Citigroup, for the first time over recent quarters – they are still in difficulties because the profits do not help where it matters: improving the balance sheet and freeing funds for loan operations. Instead, they channel whatever cash they have into balance-sheet recovery, holding back on normal bank operations. This is what we saw in Japan after 1990 and, although we cannot or should not compare the Japanese crisis with the present one, this is one of the lessons to be learned: policy-makers must force the financial institutions out of balance-sheet recovery and back into banking operations. The banks must lend to industry and they must restart lending among themselves. So long as this does not occur, the economic recovery will be very difficult to get underway.

It looks as if much of the social network built over the years with a strong economy does not really deliver in a time of economic downturn. A large amount of liquidity has been pumped into the economy, but still without visible effect on the real economy. The demand is low in spite of stimulatory packages.

The social network is not promoting the trust and confidence in what policy-makers are doing and how the economy will respond. There is still uncertainty about whether the economy has turned around or will turn around, and so long as people are not convinced that we have turned the corner, they will opt for a cautious attitude that, translated into economic vocabulary, means savings instead of consumption.

My third observation is that the East Asian financial crisis in 1997/98 was prevented from going global – except for Russia being brought down by hedge funds and repercussion in parts of Latin America. Not even all of East Asia was hit: Some countries managed to get through without contraction. There are several reasons that it did not turn into a global crisis.

One of them is that ten years ago, East Asia weighed less in the global economy than it does today. Another and more important one was good global economic policy-making, in particular the Fed relaxing monetary policy, which not only helped East Asia to recover but also inspired confidence in the management of the global economy. The US actually lived up to its role as global leader and stepped in as the "lender of last resort", as economic textbooks might say, even if the crisis had nothing to do with the American economy. After a few years, East Asia was back on the growth track and, although some countries still feel some negative effects, the region as such came reasonably well through the test.

Unfortunately, the current crisis is not confined to one region but has hit the whole world. Only a few countries – China, India, Indonesia and a few countries in the Middle East and Africa – can count upon tangible economic growth in 2009. The fact that we are dealing with a crisis of this nature nullifies any attempt at solving it by simple or isolated policy measures. A global effort is called for.

The G-20 meeting has got mixed reviews. It is possible to say that it did not pull a rabbit out of the hat to launch the world into a phase of economic recovery. However, the political will to contain the crisis and maintain the momentum for stimulatory measures, combined with statements on rejecting protectionism, is not so bad. It all depends on the level of ambition, but we live in a world governed by realities and, judged by that yardstick, the meeting did not do badly.

What worries me is that the G-20 meeting should be seen as the first of a chain of meetings to coordinate national steps. It is not yet certain that this is the case. We are dealing with demand stimulus primarily of a fiscal nature, and monetary policies aiming at pumping money into the system keeping interest rates at an historical low level; on top of that, currency rates and trade policies must be addressed. All students of history will know that this is a heavy agenda for any country and even more so for the international community.

We live in an open and globalized economy, with the result that demand stimulus in one country spills over into the global economy. The implication of this fact is that unless the major countries succeed in coordinating their policies, some countries may feel that their stimulus is allowed to spill over to other economies where policy-makers have held themselves back to reap the benefits of their neighbours' efforts. As the expanding countries paid for the stimulus by running up domestic budget deficits, to be rebalanced by higher taxes later on, animosities could easily arise, souring the economic climate. In the 1930s, we learned that efforts to transfer the burden of adjustment to other countries, called beggar-they-neighbour policies, would result in retaliation, making all worse off. The same reaction may follow from lack of coordination of economic polices among major countries. Mutual recriminations over which country is shirking its duties, followed by a modern version of retaliation by keeping purchasing power at home, are definitely not what we need.

This is why I sincerely hope that the G-20 meeting is the start of a process towards coordination and not just a single meeting, however useful that might have been.

My fourth observation is that the international steering system seems to be a little out of touch with realities, which makes it more difficult to tackle the crisis. The countries needing help, such as the US and Britain, are over-represented and countries in possession of financial strength to provide help, such as China, are under-represented. This is the case with the World Bank (WB), the International Monetary Fund (IMF), and the World Trade Organization (WTO).

There are actually two questions here. The first one is how to deal with the current crisis. The second one is how to reshape the system to avoid similar crises from erupting again.

With regard to the first challenge, we need interaction between the WB, the IMF and the WTO. The World Bank must make sure that the poorer countries are not forgotten in the big game. We all read about the major economies, but some of the weaker countries risk gliding backwards into poverty; years of strenuous efforts to eradicate or diminish poverty may be lost. World Bank President Robert Zoellick said that an estimated 53 million more people would be trapped in poverty this year, subsisting on less than US$1.25 a day, because of the crisis. I think that his statement was timely and to the point. It is up to the member-states to respond. I hope they do so.

The IMF must, as it is doing, step up efforts to help countries survive foreign exchange crises and keep the economy going. It is encouraging to note the willingness to put more funds at the disposal of the IMF.

The sore point is that although world leaders have rejected protectionism, they have been holding back on the point where genuine leadership is needed, and that is re-launching the Doha Round. I shall come back to that in a moment.

In a longer-term perspective, there is definitely a need for stronger supervision of the global financial system. We have all enjoyed the benefits of globalized finance, with financial institutions undertaking operations to stimulate economic activities outside their own borders. That worked well for a while but, as has been seen, irresponsible transaction made the system crash. What are needed now are rules and regulations maintaining the good sides of the system while at the same time stepping in to prevent reckless behaviour. It is an open question how much of this supervision should be left to national authorities with enhanced powers cooperating with each other, and how much should be left to fix the IMF or whatever institution is found suitable for that task.

We must look beyond the horizon and prepare a more balanced and better global economic system anchored in existing institutions to serve as the foundation of sustainable growth in the decades to come. That can only be achieved by adjusting decision-making in the institutions that better reflects the economic weight of member-states in the global economy. This is conventional wisdom, so let me add one thing, which is not always said in the same breath. If this works, the rising economic powers must be ready to shoulder responsibility and exercise leadership and that means willingness to downgrade their own priorities in the interest of global solutions. A better-balanced decision-making process will only help if we know what kind of system we want, with countries willing and ready to act as drivers. More influence in global decision-making is not a ticket to helping yourself, but to serving the global community.

My fifth observation is the state of world trade. The WTO recently announced a 9% contraction of world trade for 2009. This is not only a substantial figure; it augurs a potential risk of protectionism.

I do not think that countries will reintroduce custom duties and similar instruments, as was the case in the 1930s, but I fear that they may be tempted to implement other instruments to the same effect.

One risk is non-tariff barriers in form of technical standards, which looks innocent on paper but in reality is tailor-made to keep imports out and favour domestically produced goods and services even if they are not competitive.

Another risk is to condition state subsidies to the purchase of domestically produced goods. We have seen that in the US with the financial assistance, among other things, to the car industry, even if the "Buy American clause" was toned down before its final adoption. The risk is still there. Similarly, we have heard from Europe that some countries condition assistance on closing factories abroad to keep production up at home. We know that in the coming months, countries will spend billions of USD or Euros on bailing out industries that otherwise would have faltered. If policy-makers do not follow suit and declare that such assistance will not be linked to any particular purchasing policy, some kind of protectionism may arrive through the back door. Experience tells us that if adopted, protectionism is very difficult to get rid of.

A third risk is the threat to international investment, in the sense that countries try to prevent mergers and acquisitions where stronger foreign companies buy weaker domestic companies. We know the risk because such noises have already been heard in the US, Europe, China and Australia. The large multinational companies may not look attractive and some people may feel that they have got too much power, but fundamentally they are among the drivers of globalization and cost-effective production. If we allow present circumstances to put spanners in their wheels, the result will be a less efficient global economy that undermines the global division of labour.

The free and open global trade system is a remarkable achievement of more than 60 years of hard labour. We must close ranks and defend the results while at the same time continuing the liberalization process, adjusted to new circumstances.

Let me conclude in the following way. I am not a pessimist. The current global economic crisis is the worst we have seen since the Great Depression. We are not out of the woods; actually we are closer to be lost in the middle of the forest. However bad the situation may look, experience tells us that there is a way out and the right policy answer to the challenges may lead us back to more normal economic conditions with a growing global economy.