The Importance of Collective Action
and Sound Policy Frameworks

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Introduction

Let me begin by thanking John and Tiff for the opportunity to address this G20 Workshop. As many of you know, I worked at the Bank of Canada for many years and was frequently involved with G7 issues. Then I moved to the Bank for International Settlements in Basel where the central group for work and discussions was the G10. During much of the time, and certainly in later years, I worried that the shifting balance of economic importance in the world was not being reflected in the membership of these small groupings of Advanced Market Economies.

At the BIS, the management (including myself) tried all sorts of stratagems to get the larger Emerging Market Economies around the table, both at meetings organized by the BIS and meetings organized by the national experts who used Basel as a meeting place; not least the Basel Committee and the Financial Stability Forum. While these stratagems (both at the BIS and elsewhere) achieved a significant degree of success, they were often resisted by countries who felt their power and influence would be reduced accordingly. Against this background, I welcomed enthusiastically the recent acceptance of the view that global leadership had to move to a broader and more representative group; namely, the G20.

As in so many other cases in history, this progress was catalyzed by a crisis. However, since it was a crisis that struck at the heart of the Advanced Market Economies, this raises the puzzle of why they felt it desirable to bring in other countries that were not affected in the same direct way. I think the answer involved an instinctive understanding on their part that, recovering from the crisis and achieving "strong sustainable and balanced growth" in the global economy afterwards, would involve cooperative actions involving countries far beyond the G7. The fact that so many Advanced Market Economies now have massive debt overhangs to deal with, mostly internal but also external, gave further impetus to cooperative action. For every debtor there is a creditor, and in particularly bad times when the debtor cannot pay, it is the creditor who suffers along with the debtor. In a nutshell, we are all in this together and the G20 framework is a recognition of that awkward fact.

As much as I welcome this new framework for discussion and decision making, it is no panacea. Neither for recovering from the crisis nor for achieving the longer term objective of “strong, sustainable and balanced growth” that is the principal concern of this Workshop. I have been asked today to emphasize the importance of a "sound policy framework" and "collective action" in achieving these objectives. Without questioning the ultimate destination (the objectives), or the chosen road to get there (a sound policy framework and the importance of collective action), I want to point out a few potholes along the way. Evidently, the first purpose of identifying potholes (akin to crisis management) is to help travellers to avoid them where necessary. But a second and even more important purpose (akin to crisis prevention), is to help you fill them in wherever possible. Since there are a lot of potholes, and some are quite deep, I will conclude that this G20 grouping still has a lot of work to do to get to its destination.

The Objective of "Strong, Sustainable and Balanced Growth"

A number of years ago, Tom Peters the management consultant got off a few good lines about the crucial importance of objectives.

> *"If you don't know where you are going, you're going to wind up somewhere else."*

And the equally worrisome

> *"If you don't know where you are going, it doesn't matter how you get there."*

While open to a number of interpretations, I would like to believe that the G20 objective implies seeking strong long term growth, but only subject to the constraints that growth be both sustainable and balanced. I would welcome such an objective, since the "sustainable" and "balanced" aspect of it implies a longer term, or multi period focus for policy.

Personally, I believe that a longer term orientation for policy is crucial to offset the short-termism and procyclicality which drives virtually every aspect of private sector behaviour. Looking back over the last ten years or so, we see all too clearly the excessive focus of lenders on short term gains, and the equally excessive focus of borrowers on getting cash through credit to satisfy today's desires. In the process of course, the leverage of creditors grew pari passu with the rising debts of borrowers, exposing us to the economic and financial crisis we are still living through.

One aspect of "sustainability" has been recognized for a long time. In the 1950's and 1960's, it was commonly believed that there was an exploitable long run Philips curve. Thus, you could get faster growth through demand stimulus if you were prepared to accept only a **little** more inflation. Through a combination of the insights of academics (Freidman and Phelps) and rapidly rising inflation in the 1970's, this belief was overturned. It came to be accepted that growth faster than "potential" was not possible without ever **accelerating** inflation. Evidently, this was not sustainable, and led in many countries to a much increased focus on keeping inflation under control. This was an historic change since it implied a recognition that demand side policies with positive near term effects could have negative longer term consequences.

If by "sustainable" growth we mean "growth consist with non-accelerating inflation", I am less sure what is meant by "balanced growth". This is particularly so since unbalanced growth might also be deemed unsustainable, rendering "balanced growth" redundant. I presume one aspect of this has to do with **external** trade imbalances which could lead to exchange rate crises and could thus threaten global growth. What is less clear is whether balanced growth also implies the absence of **internal** imbalances which could threaten growth as well.

In recent years we have seen a number of "imbalances" begin to unwind. Reflecting a rapid growth in credit and monetary aggregates, asset prices rose to inexplicable levels. Reflecting the same influences, household saving rates fell in many English speaking countries, and investment levels rose in China, both to absolutely unprecedented levels. Financial institutions lowered credit standards and increased leverage, thus becoming ever more exposed to different kinds of risk. Following demand, supply expanded in many industries (which are now too big) and manufacturing industries became concentrated in Asia (which is now all geared up to sell to people who have no more money to buy). These imbalances have begun to unwind with all of the negative effects we have been reading about in the papers for the last three years. Moreover, it is likely not over yet, since these internal imbalances (to say nothing of the external imbalances) have by no means disappeared.

So does the objective of balanced growth imply policy action to lean against the build up of internal imbalances as well? I think it should, since I am inclined to believe that internal imbalances have contributed more to external imbalances than the latter have contributed to the former (though both in fact are true). Moreover, it could also be argued that there is another dimension to balanced growth; we need more balance between upswings and downswings. In recent years, it has been popular to believe that resistance to credit booms was useless and that policy could clean up easily after the subsequent bust. Evidently that belief is now in tatters. But should one go even further and say balanced growth **requires** periodic downswings both to clear out the underbrush of debt and to encourage more prudent behaviour going forward? Again, I think it should and that this should be explicitly recognized in the definition used of “balanced growth”.

I do not deny that such definitions would not be easy to sell politically. Is the public ready for policymakers that say a little pain recurrently is better than a massive amount of pain on rare occasions? The success in selling price stability as a longer term objective of policy is encouraging. So too is the fact that private sector behaviour changed, in a more stabilizing way, once the authorities demonstrated their commitment to price stability. Clearly, if the current crisis takes another downturn, or it generates a significant degree of social and political disruption, the public mood for change will increase significantly. However, against the background of the 1920’s and 1930’s, this would have to be thought the silver lining on a particularly black cloud.

Let me make two final points about objectives, one negative and one positive.

The negative one, from my perspective, is that policymakers themselves do not seem to share my concerns about the dangers associated with the build up of internal imbalances. I make this assertion on the basis of observing that virtually every policy action taken since the crisis broke will make such imbalances worse, not better, over time. This is true of expansionary monetary and fiscal policies, policies to support the financial sector, and policies to preserve individual jobs and industries. I will return in a few moments to the important issue of how we balance off the benefits of short term support against its longer term costs.

The positive aspect of the stated G20 objective is that it is clearly intended to include supply side as well as demand side considerations. Indeed, if the scope for demand side stimulus is constrained by concerns about “sustainability” and "balance", supply side measures to provide strong growth gain in relative importance. I know I run the risk of sounding like a party political broadcast, since I am currently the Chairman of the EDRC at the OECD (which oversees the country review process). Nevertheless, I have to note, as an outsider until quite recently, that the breadth and depth of the OECD’s supply side work is extraordinary. While it might have been possible when times were good to downplay work on increasing potential growth, this luxury can no longer be afforded.

The Importance of a "Sound Policy Framework"

As in the previous section, let me begin with some quotes. The first is from Mark Twain

> *"It ain’t the things you don’t know what gets you. It’s the things you know for sure that ain’t so".*

Or as Cromwell put it even more forcefully before the Scottish Parliament:

> *"Brothers. I beg you in the bowels of Christ. Think it possible that you might be in error".*

Intuitively, we would all like to think we know what is meant by a "Sound Policy Framework". However, closer analysis indicates that this knowledge might be less securely based than we suppose. Indeed, it might be wrong.

A "Sound Policy Framework" must be based on a sound analytical framework. The unfortunate fact is that the macroeconomic analytical frameworks currently in widest use simply do not allow for crises of the sort that we are now experiencing. Being essentially one period flow models without a developed financial sector, a credit driven accumulation of stock imbalances leading to crisis is ruled out by assumption. This has led to a variety of policy errors, and these errors will likely be repeated in the future unless the analytical framework is substantially revised.

Because standard models have no room for crises, the recent downturn was not generally forecast, nor were efforts made to respond to the build up of imbalances that led to it. Moreover, absent any fear of crisis, few ex ante attempts were made to put in place reforms that would make crisis management easier (like deposit insurance schemes, bank insolvency regimes etc.). Further, when the crisis hit, its ultimate severity was completely discounted and "denial" characterized policy almost every step of the way. Even today, I do not think there is a full appreciation by policymakers of the need to repair the supply side of the global economy, and how this might have significant effects on the level of potential growth going forward. Finally, given their single period character, these models discount completely the idea that policies that might help today could prove hurtful tomorrow. Put another way, the idea of serial bubbles that are created by the policy makers themselves is analytically inconceivable using today's models.

To be even more specific, the models preferred by academics (though increasingly used by central banks) include the so called New Classical, New Keynesian and DSGE models. In addition to assuming that the economy is self-equilibrating, characterized by rational expectations, and peopled by "representative agents", the financial sector and credit generally play no role. In short, these models make such extreme assumptions as to be useless for practical purposes. As Charles Goodhart said at a 2008 conference at the Bank of England, there is simply nothing in these models that is of the slightest interest to a central banker".

As for the Applied Keynesian models, traditionally preferred by policymakers, they suffer from their own shortcomings. They also ignore credit, stocks, and the existence of the financial system. Moreover, in their practical form, they are estimated on the assumption of parametric stability, which seems unlikely given the massive transformations which have recently characterized the real economy (globalisation?), the financial sector (securitisation and globalisation?) and the conduct of monetary policy (inflation targeting and the Lucas critique).

So, recognizing these shortcomings, where do we go from here? If we cannot trust "established" theory, where can we turn. I would contend there is a lot to learn from economic history, and a lot to learn from the history of economic thought. Sadly, neither topic is covered in the most highly acclaimed graduate schools today.

Turning first to economic history, it is extraordinary to me that modern theory rules out crises and severe economic slumps by assumption. In fact, we have observed such events from time immemorial. The recent book by Ken Rogoff and Carmen Reinhardt is a “must read” in that regard, and I would note in addition that such crises seem to have become more rather than less common in recent years. Moreover the larger crises generally have the same basic nature; sparked by some good news optimism rises, credit expands, spending pushes up both the economy and asset prices, collateral increases and so does credit, rational exuberance turns to irrational exuberance and the bubble turns to bust. Finally a reading of history shows that the bust was hardly ever widely anticipated in advance (“This time it’s different”) and, most important for policymakers, was rarely preceded by a significant degree of inflation. Note that there was no inflation in the United States in the 1920’s and no inflation in Japan in the 1990’s. And yet, very bad things still happened.

As for the history of economic thought, the pre World War ll literature is worth revisiting. Both Keynes and Hayek focussed on deep slumps, but I think it is fair to say that Hayek was more concerned with their underlying causes. The Austrians put their emphasis on easy credit, associated "malinvestments (ie a growing stock of capital investments that would finally prove unprofitable), and eventual crisis. More recently, economists at the BIS have tried to generalize this line of thinking by stressing the dangers of credit driven "imbalances" in the economy, as I noted earlier in my presentation. Finally, we need to go back and look again at the work of Hyman Minsky on the role of the financial sector in a modern economy. Minsky felt that stability in the economy (the “Great Moderation”?) would inevitably lead to worsening credit standards, eventually Ponzi financing, and final collapse. Does any of this sound familiar?

These insights from economic history and the history of thought have practical implications. At a general level, they indicate that we should be much more sceptical than we tend to be about economic forecasts. We know far less than many think. As well, we must recognize the fundamental endogeneity of everything. Developments in the financial sector profoundly influence the real side of the economy and vice versa. Thus, focussing on "financial stability" as a separate issue is to misunderstand profoundly the macroeconomic character of the underlying problem. If corporations or households have over extended balance sheets (too high debt levels), even the healthiest of banks will find there is no demand for their credit. Put otherwise, financial stability is very important but it is not a cure all.

To be still more specific, this way of thinking indicates that policies designed to support the economy after a crisis also have downsides over time. Finance ministries know instinctively (even if models without stocks do not) that markets will punish them if debt stocks rise high enough to be judged "unsustainable". Look what is going on in Greece. There seems less instinctive recognition that very low interest rates for extended periods can have similar downsides. In particular, low rates could encourage another and even larger bubble, as well foster inefficiencies in the economy through misallocations of credit and sustenance for both "zombie" companies and "zombie" banks. On this latter point, look what happened in Japan in the 1990’s and beyond.

As for support for the financial system, the result of recent measures is that we now have more banks that are too big/complex/interconnected to fail/save than ever before. Finally, measures to support jobs and whole industries also have their downsides. "Cars for clunkers" makes little long term sense given 40 percent excess global production capacity, and makes no sense whatever when domestic consumption is already 70 percent of GDP.

Recognizing these downsides has at least two negative practical implications for global policymakers. First, we should strive to "exit" from stimulative demand side policies earlier than would be the case were there no medium term effects. More fundamentally, as implied above, we should be thinking about ways to exit from the longer term strategy of leaning primarily against downturns (beginning with the Greenspan "put" in 1987 and repeatedly thereafter) since this encouraged imbalances to cumulate to truly dangerous levels. Second, we should rely as little as possible on stimulating demand in sectors that already have major debt problems. This applies to the household sector in many advanced industrial countries and the governments in most of them.

Recognizing these constraints, there still remains room for global demand side stimulus. In many emerging market economies, the burden of household and government debt is much less. Moreover, in many countries there is no external debt burden to constrain expansionary policies either. A similar point applies to a number of important advanced industrial economies as well. And, while it might seem natural for high saving countries not to wish to emulate the behaviour of their less prudent trading partners, to lend out savings that will not be repaid (or repaid only in a depreciated currency) is hardly an attractive alternative.

It also seems to me that an increase in fixed investment in many countries would have many benefits, and that governments could have an important role to play. Public infrastructure is clearly inadequate in many emerging market economies. It has also been allowed to depreciate badly in many of the advanced market economies. While public spending would increase already high government debts, there would at least be an asset on the balance sheet to soothe the concerns of financial markets. Finally, governments exert a very important influence on some of the most important prices in the global economy; exchange rates, interest rates and energy prices (especially through subsidies). If governments were to let these prices revert towards more "natural" levels, this would induce a significant amount of private investment as economies tried to adapt. "Green" investments and investment in the production of tradeables in the United States would be two obvious beneficiaries.

If high debt levels seem likely to constrain demand in some sectors going forward, this raise the issue of how those debt levels might be made more tolerable. Two solutions, albeit more slow acting, seem sensible.

The first possibility is to encourage structural reforms to increase potential growth such that the burden of the debt falls in consequence. There is certainly great scope for reform in both labour and product markets in many countries. Such reforms might also encourage investment, and demand more generally, as entrepreneurs seek to exploit new possibilities for profit. Needless to say, a positive political climate for business enterprise would help a lot in this regard. Recent research on the Great Depression in the United States indicates that the anti-business atmosphere surrounding the “New Deal” played an important explanatory role.

The second possibility is enhanced recourse to bankruptcy and debt workouts. While distasteful to many, it can be to the mutual advantage of creditors and debtors, and can be done in such a way as to minimize moral hazard and the risks of encouraging further crises. Debt alleviation frees up productive resources for other uses, and it reduces the debt (and also the uncertainty about debt servicing) which inhibits spending. Evidently, if carried far enough, confronting the debt problem of borrowers requires the restructuring and possible bankruptcy (or nationalisation) of lenders as well. While challenging, such a process would seem better than the alternative of refusing to face up to reality: if the money is already gone, the only relevant question is how the losses are to be distributed. Many, including myself, would contend that this type of policy error was the real cause of stagnation in Japan through much of the 1990's and even beyond.

Finally, and for the record, it must be noted that there is another traditional way of reducing nominal debt burdens: namely, inflate it away. My own feeling is that this could be a very costly and very risky strategy. Costly, since we saw in the 1970's the dangers posed by high and accelerating inflation. Risky, since the process could all too easily get out of hand. Latin America provides many examples of how government intervention to help deal with the buildup of private sector debt eventually resulted in recourse to the printing press. Should we not then try the other alternatives first?

The Importance of "Collective Action"

Benjamin Franklin, around the beginning of the American War of Independence, said to the others who signed the Declaration

> "Gentlemen, we must hang together or we shall all certainly hang separately"

Why the need for collective action? Let me begin with the obvious. The global economy, both real and financial, has not been so integrated since the end of the 19^{th} century. Moreover, the speed with which things flow through international channels (particularly information and capital flows) has never been higher. Virtually all domestic policies now have important international spillovers, and some of these can be quite harmful. At the least we should be mindful of these externalities. Let me give a few examples, going from the more general to the more specific.

Let me begin with the biggest issue of all - the international monetary system. Ben Bernanke has explained global trade imbalances in terms of "excess saving", particularly in Asia. It is the creditor's fault. In contrast, many Asians point to excess consumer spending in the Unites States, and Germans are prone to denigrate imprudent Greeks. It is the debtor's fault. The reality is that everyone bears part of the blame. Debtors overspent, but creditors willingly gave them the money to do so. For many countries, external debts are now so high that there is serious doubt they can be serviced. This threatens crisis, as we can see in Greece today. And, as I said earlier, if the end result is that the value of the creditor's paper is devalued then everybody loses.

The fundamental problem is that we have no international monetary system to prevent such massive imbalances from building up. Under the gold standard, there was an automatic mechanism to prevent this from happening. Under the Bretton Woods system, the IMF was supposed to impose similar discipline. But today we have nothing of the sort.

Looking back over the last decade or so, relatively low interest rates in advanced market economies (especially the United States and Japan) were acting to push their currencies down. By definition, however, this was pushing up the value of other currencies, particularly in the emerging market economies. In spite of rising trade surpluses, they resisted appreciation, sometimes through sterilized intervention and sometimes through easier monetary policies.

The former gave rise to reserve accumulation, largely in US dollars, which both kept up the value of the US dollar and lowered long bond rates. Thus, both the elasticity and absorption channels of trade adjustment were blocked at the same time. Low bond rates also contributed to the growth of "imbalances" in the United States and elsewhere. The latter, easy monetary conditions in the emerging markets, contributed to inflationary pressures and “imbalances” at home as well. Property prices in China are a good example of this process at work.

In short, we have all contributed to global economic mess in which we find ourselves today. By neglecting the global externalities of our policies we have wound up, not only hurting others, but in the end hurting ourselves. We must collectively find a better way to run the international monetary system going ahead. Nor will this be easy. Given the failure of uncovered interest parity to hold over quite long time periods, simply letting exchange rates float upwards can itself pose problems. Countries like New Zealand, on the receiving end of carry trade inflows, found that higher policy rates actually eased overall monetary conditions and contributed to domestic "imbalances". Such phenomena raise fundamental regime questions about capital controls, and even the desirability of having one's own currency.

But there is also need for collective action in less grand but still important ways. Given internationally active banks, and globalized financial markets, collective action is also required when it comes to **crisis prevention** through regulatory actions. How can we together ensure level playing fields? How should we deal with attempts to avoid regulatory rules through international arbitrage? How can home country supervisors, in association with host country supervisors, moderate the actions of their banks in other countries where they are dominant lenders. This is a real issue in Central and Eastern Europe as well as large parts of Latin America. And, finally, how can we better share information about international counterparty exposures to better identify pressure points as they are building up

When it comes to **crisis management**, there is also need for collective action. I noted earlier the need to put in place ex ante procedures for facilitating crisis management, since a failure to do so invites still more extreme extensions of safety nets during the crisis itself. These procedures must have an international dimension. By way of example of current shortcomings, consider how the Irish decision to guarantee all of the liabilities of Irish banks led to similar extensions of guarantees in virtually all the large countries in Europe. Consider too how the absence of agreement (and appropriate legislation) on winding down large and complex international banks has contributed to the "too big to fail problem" And, as an aside, the absence of international agreements on burden sharing (when the state must absorb losses) has not been helpful either.

It is true that there has been a remarkable degree of international cooperation in managing this last crisis. However, this should not blind us to how much more remains to be done, not least with respect to crisis prevention. If ex ante measures of crisis management are better than ex post measures, it would be still better to have avoided the crisis in the first place.

Conclusion

If collective action is important, how likely is it to happen? Here I am not so optimistic about the near term, in spite of the good intentions of everyone here today. Nevertheless, I am certainly more optimistic about the longer term . A number of years ago, a political scientist called Nathan Kapstein asked what attributes explained the relatively successful international processes used by the Basel Committee. He noted shared values (a kind of cultural affinity), a shared model of how the world worked, and shared objectives. It will clearly take time to establish these three attributes in the framework of the G20. It is, after all, the "whole world" we want to act in a cooperative manner.

Shared values imply a trust in others and confidence in the integrity of the process of decision making. Given the wide variety of the cultural and historical backgrounds represented by the members of the G20, there will initially be hesitations on both counts. Moreover, given the fact that some countries have, historically, been leaders and others followers, it will take time before full equality of membership is both assumed and realized. As for shared models, the thrust of my presentation earlier was that there is, in fact, no currently accepted macroeconomic paradigm towards which all will eventually gravitate. An analytical and intellectual consensus is required and this will take time. Recall, as Neils Bohr the physicist is reputed to have said, "Science advances, funeral by funeral".

As for shared objectives, two forms of divergence suggest themselves. This is the case even if all the members of the G20 agree that the ultimate aim is to increase the living standards of their people. The first possibility, perhaps reflecting the analytical divisions noted above, is that some countries may have a bias towards policies that deliver quick results while others may have a longer term focus. There is already a Trans Atlantic divide in this regard, which might get more profound on a Trans Pacific basis. The second reason for expecting diversity in objectives has to do with different levels of willingness to accept the importance of externalities in setting domestic policy objectives. Some may be more willing to say "we are all in this together". For others, in contrast, the pursuit of purely national (short term) objectives and a philosophy of "sauve qui peut" might be the normal order of the day.

It is only realistic to accept that we have short term challenges. It is only human to suggest that we have longer term opportunities. My only personal hope is that the G20 framework will prove capable of mastering both.