

Managing the global economy through turbulent times

December 2008



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Executive summary

"Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again¹."

The unexpected scale of the turbulence in international financial markets and its impact on real economies has become a global crisis, as the risk of contagion to emerging markets increases.

The Leaders of the G20 advanced and emerging nations met in November 2008 in Washington to agree a new and decisive systemic international approach to handle the challenges to the world economy and financial markets. As we look forwards to our next Leader's meeting in the UK in April 2009, we need to take this agenda forwards quickly, to start the process of reform so as to manage globalisation as a force for good in the medium-term.

The context is that first, we need coherent and concerted policy action across the world to counter falling demand and fragile confidence. Within this, there will be room for further monetary easing in the advanced economies as commodity prices have fallen and the risk of higher inflation has receded, although countries have different room for manoeuvre on monetary policy.

Fiscal policy has an essential role to play alongside monetary policy in sustaining demand. A well-designed fiscal stimulus is timely, temporary, targeted and sizeable, and part of a concerted international response, tailored to individual country circumstances.

Emerging economies with large accumulated surpluses could also take action to rebalance growth as appropriate, including supporting other countries in their regions directly or through the international financial institutions.

Second, the international community must take action to prevent further contagion and support vulnerable emerging and developing markets, including ensuring the IMF has the resources and instruments it needs.

Third, in order to restore confidence, we need to work together to address the failures in the financial and supervisory architecture the crisis has exposed, guided by the principles of transparency, integrity, sound financial regulation and responsibility of management for the risks they take.

Fourth, we need to move quickly to strengthen cross-border co-ordination of financial regulation including a global early warning system, globally accepted standards of regulation, colleges of supervisors, and cross-border stability groups. We also need to strengthen as a matter of urgency the legitimacy and governance of the Financial Stability Forum and IMF, so that they are able to foster the international cooperation needed to promote global macroeconomic and financial stability.

Fifth, we must boost world trade and reject protectionism, being vigilant to immediate problems over trade finance, and work for more stable and secure global commodities markets.

Finally we must reaffirm our commitment to meeting other global challenges despite the financial turmoil, including maintaining aid flows to meet the Millennium Development Goals, combating climate change, and looking to reform of the resources, mandate and governance of the international financial institutions. And we must start the process of setting out a long-term vision for managing globalisation as a force for good in the global age.

¹ J.M. Keynes "A tract on monetary reform" (1923)

1

Introduction

1.1 The world is witnessing unprecedented turbulence in international financial markets, a financial crisis that has the potential to affect every country and household around the world. That has come against a backdrop of global capital imbalances, and a period of significant volatility in commodities markets, including energy and food, presenting major challenges for policymakers around the world.

1.2 We have already taken action to stabilise financial markets and restore confidence in the international financial system. Central banks and national authorities have already acted to deliver substantial injections of liquidity, taken steps to unfreeze credit and money markets and agreed frameworks for injection of capital to shore up institutions.

1.3 These decisive actions have helped to stabilise and ease pressures in global financial markets. However, there has been a sharp contraction of credit conditions almost everywhere as a result of market corrections. The result is that we are seeing a very sharp slowdown in the real economy in a number of countries, with unemployment rising, continued steep declines in asset prices, and a precipitous decline in business and consumer confidence.

1.4 The Leaders of the G20 major advanced and emerging economies met this month in Washington for the first summit on financial markets and the world economy, to agree a new approach to economic co-operation, a shared strengthening of our regulatory systems, and a vision for the future of our international financial institutions.¹ Leaders will meet again in the UK in April 2009 to review the implementation of the principles and decisions agreed. We need to act decisively to prevent the current downturn from being unnecessarily deep and prolonged and to mitigate the risks of contagion to emerging and developing markets, both through difficulties in accessing finance and as world growth slows. Breaking this spiral will require a new and decisive systemic approach from economic and financial policy makers around the world.

1.5 Enhancing the effectiveness of international financial institutions in dealing with global problems is dependent on reforming their remits for the global age, improving their governance and strengthening their legitimacy, including improving the participation of emerging markets and low income countries.

¹ See declaration from the Summit on Financial Markets and the World Economy, Washington No 15 2008
<http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html>

2

Stabilising the global economy

2.1 The world economy is facing a significant downturn. As set out in the 2008 Pre-Budget Report, against the backdrop of major economic shocks, world growth is forecast to have slowed to 3 ½ per cent in 2008 and to fall to just 2 per cent in 2009. Policies to help stimulate growth can help to guard against a more prolonged and deeper downturn.

Monetary policy

2.2 All advanced countries face a similar challenge of recession. We welcome recent actions by central banks to reduce policy rates. Additional immediate monetary easing could further help ameliorate the downturn, helping restart the flow of credit in the economy. But monetary authorities have different room for manoeuvre.

2.3 Past monetary policy co-ordination has proved effective, helping reduce the risk of excessive exchange rate volatility. This remains a policy option but should not undermine Central Bank independence or constrain those countries with more room for manoeuvre.

2.4 The measures that governments and central banks have taken – including government guarantees of bank borrowing, special measures to provide liquidity to banks, and agreed frameworks for injection of capital to shore up institutions – to restore confidence and improve liquidity in the inter-bank market are now beginning to be effective in reducing interbank lending rates. However, in some countries it may be necessary to take additional measures to ensure the proper functioning of the monetary transmission mechanism – and in particular that reductions in policy rates translate into reductions in the rates charged to companies and households.

Fiscal policy

2.5 On fiscal policy, we agreed together with G20 Leaders in Washington that fiscal policy has an essential role to play alongside monetary policy in sustaining demand, with quick-acting measures to encourage a rapid impact with help for households and businesses.

2.6 In a normal downturn, it would be expected that monetary policy would support demand, with fiscal policy playing a more limited supporting role. But in current circumstances, monetary policy alone will not be sufficient. The nature of the financial crisis, with credit constraints becoming more binding, and the effectiveness of monetary policy becoming more uncertain, also points to more of a fiscal response.

2.7 Overall, a fiscal stimulus will be most effective if it is:

- **timely**, so it delivers a stimulus when it is needed. Discretionary fiscal actions can take time to agree and implement, and can therefore become pro-cyclical, supporting growth when the economy is already recovering. While the likely duration of the current slowdown makes this less of an issue, the rate with which the world economy is slowing down means that rapid action is called for. So measures that can be introduced quickly are at a premium;

- **temporary**, to ensure longer-term sustainability. Any fiscal response needs to be consistent with maintaining sustainable fiscal policies in the medium term. Indeed, if action is not taken to ensure fiscal discipline, there is a risk that higher long-term interest rates will outweigh its stimulus effect. This argues for measures that are (in terms of their aggregate fiscal impact) temporary;
- **targeted**. It is important that the support boosts spending to maximise its impact on economic activity. The impact of changes in direct taxes will depend on whether households choose to adjust their saving or spending. As a general rule, households that have limited access to credit are more likely to alter their spending. Changes to indirect taxes affect households' purchasing power, and their incentive to spend. Pre-announced changes to indirect tax rates may also encourage households to change the timing of their spending, notably on durable goods, such as cars and televisions, and
- **sizeable**. To have the desired impact, fiscal policy actions need to be of sufficient size to impact macroeconomic conditions overall.

2.8 In addition, fiscal policy actions in individual countries will be more effective if they are part of a concerted international response. This is a global crisis, and therefore requires a global solution. The combined effect of coherent actions taken across countries will be more effective than each country acting alone. One reason for this is that part of a fiscal stimulus taken by an individual country will be transmitted abroad through the demand for other countries' exports. A concerted stimulus among major trading partners would increase trade flows in both directions. However, this does not mean that all countries do the same thing; fiscal actions need to be tailored to the situation of each country depending on their budgetary and external positions. Countries that already have high levels of public debt relative to GDP have less scope to undertake fiscal expansion than those with low debt-to-GDP ratios.¹

Emerging markets

2.9 Emerging markets are now experiencing the impact of the global slowdown and global credit shock. Growth in larger emerging economies is expected to slow to below recent strong rates, and the risk of contagion leading to much sharper contraction in smaller emerging economies has increased significantly. Those emerging markets with large current account deficits and external financing are particularly vulnerable. Prospects for 2010 and 2011 are highly uncertain with a broad range of possible outcomes for emerging markets, both individually and as a group.

2.10 As in advanced economies, there is scope for emerging markets with to take action to stimulate and rebalance growth, for example through measures in surplus countries to moderate savings. But countries have different room for manoeuvre according to their budgetary and external positions.

2.11 The scale and mix of macroeconomic policies in advanced economies and emerging markets should be designed in a way that takes account of the impact on global imbalances in the medium term. Countries with high levels of national saving and strong external positions have more scope to sustain fiscal expansion in the longer-term.

¹ The case for an international fiscal response is set out in more detail in the Treasury paper published 24 November 2008 http://www.hm-treasury.gov.uk/d/pbr08_internationalfiscalresponse_853.pdf.

2.12 Other emerging markets with large accumulated reserves may have less scope to stimulate domestic demand as inflationary pressures persist, but may be in a position to support other vulnerable countries in their regions, including through the Regional Development Banks and the IMF.

3

Managing contagion

3.1 The international community agreed at the November Washington summit that it was essential to ensure that the international financial institutions have the resources they need to provide critical support for the global economy. We must take action to manage the contagion spreading to vulnerable emerging and developing markets. We have seen in recent weeks the financial crisis spreading to middle income countries. It is clear that the whole of the international community has an interest in halting this contagion and preventing a worsening of the global economic downturn.

3.2 This means both extending dollar swap lines and new IMF lending to systemically-important countries with fundamentally sound economies; and faster emergency lending with tailored conditionality to countries that need policy adjustment as well as finance. As a precaution, this should be supported by an increase in the resources available through the IMF. The policy prescription for emerging markets must be tailored to their needs and this must be reflected in the form of IMF support.

3.3 We need new instruments to support countries who have a strong track record but who are becoming increasingly vulnerable to capital flight and the damaging effects of the financial crisis on their currencies and stock markets. We welcome the IMF's recent establishment of a new short-term liquidity instrument to channel funds quickly to emerging markets that have sound fundamentals but that need rapid help during the current financial crisis to get them through temporary liquidity problems.

3.4 We also need significant resources to help other emerging markets who require policy adjustments alongside financing to tackle the crisis. The Fund should design a comprehensive programme for these countries, with tailored conditionality – as it has already done in the case of Hungary and Ukraine – and provide rapid support to them through the emergency financing mechanism.

3.5 The EU must stand ready to provide financing to Member States, in support of IMF programmes, as was done for Hungary. Commission proposals to extend the level of financing available under the Medium Term Balance of Payments facility are necessary and sensible.

3.6 The Fund should tailor conditionality, targeting the minimum adjustment necessary to get these countries back on a sustainable path and re-open access to financial markets.

3.7 The IMF currently has \$200 billion in forward financing capacity in its General Resources Account, and can call on an additional \$50 billion through the General and New Arrangements to borrow.

3.8 Given the potential scale of the current economic and financial turbulence, we need to ensure that adequate resources are available to the Fund as a precaution against an increase in financing needs by member countries. We therefore need a new financing agreement, drawing on the resources of those countries best able to contribute, for example those with substantial currency reserves, to bolster the resources available to countries in need of IMF support. We all have an interest in restoring stability to the world economy.

3.9 We also need to be vigilant to the impact on the poorest countries. While many have been insulated from the first round effects, as their financial systems are less connected, reductions in growth will slow or reverse progress on the Millennium Development Goals and hurt the poorest communities the most.

3.10 In the immediate term, the World Bank should frontload assistance to the poorest countries, where appropriate, and look for means to increase the amount of resources available, increase support for trade facilitation and capacity building, move quickly to help recapitalise banks where necessary, and work with sovereign wealth funds to leverage their resources.

4

Reforming financial governance

4.1 We agreed at the Washington summit to implement reform that will strengthen financial markets and regulatory regimes, so as to avoid future crises. Our approach should be guided by five key principles: transparency, integrity, responsibility of management for risk, sound practices in banking regulation, and good cross-border co-ordination.

4.2 Transparency, so that risks can be managed and value-impaired assets cannot be hidden. We must ensure that firms fully disclose the impact on their accounts of recent changes by the IASB on the application of fair value, and that firms continue to improve their risk disclosures in line with best practice agreed by supervisors. We must go further to ensure:

- action to assess steps by market participants to enhance the information available on the assets underlying structured products;
- action by standard setters to strengthen consolidation and disclosure standards for off-balance sheet vehicles;
- stronger coordination between financial institutions and standard setters to ensure transparency is maintained as new products are introduced; and
- strengthened operational infrastructure in Over the Counter (OTC) markets, in particular a robust central clearing facility for OTC credit derivatives, and effective transparency arrangements for these markets.

4.3 We need to strengthen **integrity and responsibility of management** for the risks they take, to discourage excessive risk taking, inappropriate lending, misaligned incentives in risk and reward. We need to be sure firms are taking due care in assessing and managing the risks their institutions face, and are not swayed by conflicts of interest. We must move immediately to implement agreements on managing conflicts of interest at credit rating agencies. We should move forward by, among other things:

- reviewing executive compensation schemes that encourage excessive and irresponsible risk-taking, so as to align reward with long-term value creation and ensure board members manage risks within their firms effectively;
- strengthening firms' risk management and stress testing practices, including the management of exposures to leveraged counterparties, and off balance sheet and securitisation activities; and
- ensuring firms have incentives to properly assess risks in products they originate, through tough disclosure and due diligence requirements on market participants.

4.4 Sound banking, so that all financial firms are run responsibly, and operate within a framework that manages the risks they create for the wider economy. Supervisors and banks must move rapidly to implement the Basel Committee's new liquidity risk management guidelines. We should move forward by:

- strengthening capital requirements for banks' securitisation activities and promoting more robust and internationally consistent liquidity approaches for cross-border banks, through recommendations by the Basel Committee;
- closing gaps in regulatory structures and restricting the scope for the emergence of shadow banking systems; and
- understanding the interaction between the financial system and the economic cycle and taking all necessary steps to address pro-cyclicality.

5

Global financial governance

5.1 Global financial markets present challenges that no one nation can solve in isolation. We need to supplement shared action at national level with stronger **co-ordination across borders**. The current international financial and monetary system is such that each country has pursued policies that made sense from their own point of view but which, taken together, have resulted in a highly unstable outcome as evidenced in the current financial crisis. We must strengthen global cooperation so that all countries see it in their own interests to participate in the management of the international financial system. And we must improve the governance of a new global financial system - a new Bretton Woods which recognises the globalisation of financial risk in the responsibilities of global institutions.

5.2 This new global governance must deliver:

- a **global early warning system** so that future risks to global economic and financial stability are identified and mitigating actions taken early;
- **globally accepted standards of supervision and regulation** applied equally and consistently in all countries; and
- **effective cross-border supervision of global firms**, including through international colleges of supervisors.
- **mechanisms for cooperation and concerted action in a crisis**, through agreeing common principles on how to manage a cross border crisis and establishing international cross-border stability groups.

5.3 To achieve that we need reforms to global governance to ensure we have the right institutions to deliver our needs, with the right expertise, and the legitimacy to fulfil their task effectively.

Immediate action

5.4 At the IMF, we need to move quickly to:

- establish an **early warning system**, with the IMF and Financial Stability Forum (FSF) working closely to together to analyse the risks to global financial stability, and the links between macroeconomic events and prudential regulation. The IMF and the FSF should report jointly to Ministers each year on the key macrofinancial risks and appropriate policy responses and invite Ministers to explain the action they have taken to address identified risks; and
- enhance the IMF's ability to provide **credible and independent macroeconomic surveillance** on the build up of global imbalances, in addition to the macro-prudential surveillance undertaken with the FSF. The new Statement of Surveillance Priorities (SSP) provides a real opportunity to refocus the IMF's surveillance work and improve the accountability of the Fund for its surveillance. The IMF Managing Director should report each year on whether and how these priorities have been achieved.

5.5 We need to strengthen and legitimise the **Financial Stability Forum** by;

- **expanding membership** of the FSF to include key emerging markets, bringing in outside participants to work on specific issues, and strengthening the relationship with the G20;
- giving the FSF a formal role as the **key coordinating body** to provide strategic guidance and focus to regulators, supervisors and standard setting bodies in the main financial centres, and an organising framework for supervisory colleges; and
- strengthening the FSF's role in bringing together key participants in the event of a market wide crisis, and where appropriate facilitating the creation of effective structures to manage problems at individual cross-border financial institutions.

A process for future reform

5.6 We need to put in place a process to equip the IMF to deal with the new world of global capital flows and capital account crises in the future, including;

- reforming IMF governance to enhance its legitimacy and enable it to effectively discharge the new responsibilities of independent macroeconomic and macro-prudential surveillance, recognising the changes in the world economy, the growth of emerging markets, and the risks that have arisen from global imbalances;
- reforming IMF lending instruments to equip it to deal with capital account crises;
- building on the IMF's enhanced macro-economic surveillance with more effective means to strengthen macroeconomic cooperation between the major world economies, including through the G20 process.

6

Maintaining open and stable markets

6.1 International trade has been a major driver of global growth and prosperity over the last fifty years. Open economies have been able to harness the power of trade to boost competitiveness and productivity, helping improve living standards and sustain economic growth. Countries that trade more ultimately grow more.

6.2 In the immediate term, there is evidence of global trade slowing by more than expected. For example the Baltic Dry Index, which measures the global prices of shipping dry raw materials (grain, coal, iron etc), has fallen by 92 per cent since its peak in May. There is also anecdotal evidence that the system of trade finance through letters of credit is slowing. These underpin much of the trade that occurs globally. Without them goods will not be shipped and the global supply chain will become blocked.

6.3 We need to act quickly to address this risk. The World Bank International Finance Corporation plans an increase in its trade-financing programme by \$1.5bn. But we need to remain vigilant and stand ready to act further if necessary. Co-operation between national and multilateral agencies, and with financial institutions that provide trade finance facilities is essential to find a global response to this problem.

6.4 Despite major reductions in trade barriers, protectionism continues to be a major risk to our economies and a barrier to lifting developing countries out of poverty. We should not raise new barriers to investment or trade in goods and services, and we should vigorously promote market access for all businesses. Further economic co-operation will help to boost trade and investment flows that benefit all our economies.

6.5 The strongest signal we can send to counter protectionist policies is to reach urgently a successful conclusion of the Doha Round of world trade talks. That is why Leaders in Washington tasked their trade Ministers to move quickly to agree modalities. We need to demonstrate the political leadership necessary to break the deadlock and agree a framework WTO deal this year. A deal would not only add billions in additional trade to the global economy, but would provide a significant confidence boost to markets.

6.6 Recent commodity prices volatility also calls for a concerted approach to deliver stable and sustainable commodity markets by: encouraging the most efficient level of demand, enabling supply to respond as effectively as possible; and increasing capability to respond to increased volatility and more frequent supply shocks¹. An ambitious deal is an essential part of a sustainable long-term solution to the current global food challenges. A successful agreement is also a critical element of any strategy to reduce global poverty and achieve the Millennium Development Goals.

6.7 More widely a framework for maintaining macroeconomic stability in both developed and developing countries is an essential underpinning element of the international community's strategy for ensuring stable, secure and sustainable commodity markets and maximising resilience to short-term price shocks. This requires sound long-term macroeconomic policies,

¹ As set out in *Global commodities: a long term vision for stable, secure and sustainable global markets* HM Treasury June 2008-11-12

based on transparency and accountability. Central banks have a primary role to play in maintaining low and stable inflation rates through appropriate monetary policy. It is also essential that, in responding to the pressures placed on their economies from high oil prices, countries take forward responsible fiscal policies based on sustainable long-term growth, including, as appropriate, through the removal of fuel price subsidies.

6.8 The IMF must continue its role in helping the international community to form a shared view of the trends, risks and the appropriate policy responses, working closely with other international organisations, central banks, finance ministries and other national authorities. The IMF should integrate its analysis of the impact of rising commodity prices into its surveillance activities, and help its members to respond to these challenges through its policy advice.

6.9 The international institutions should also continue to enhance their capacity to provide financial support to countries facing instability through the provision of adequate, targeted shocks assistance and we welcome the recent reforms to the IMF's Exogenous Shocks Facility which will enable more countries to benefit.

7

Global challenges

7.1 More generally, alongside this agenda, the importance of dealing with immediate crisis should not undermine our commitment to addressing the global challenges that remain crucial for sustaining growth in the medium term.

Meeting the Millennium Development Goals

7.2 Global growth is essential for poverty reduction and achievement of the Millennium Development Goals. Since 1990, over 400m people have been lifted out of poverty. Eighty per cent of this is explained by economic growth. We need to ensure this can continue so that over time developing countries themselves contribute to global growth and to greater stability and security for all of us. Poor countries are already suffering the effects of high and volatile food and fuel prices. According to World Bank estimates, 100m people will have been pushed into poverty by high prices this year.

7.3 The World Bank, other multilateral institutions and bilateral donors (including the EU) should intensify efforts to foster private sector growth in the low income countries, including through the development of effective financial services, investment in health, education, infrastructure, social protection for the poorest and adaptation to the impacts of climate change.

7.4 In September, world leaders came together in New York to take action to accelerate progress towards the Millennium Development Goals. The UN Secretary-General estimated that this generated commitments of over \$17bn. We must work together to increase levels of development financing through the World Bank and other multilateral channels, and individual donors must deliver on their existing aid commitments. Emerging economies should play an enhanced role and take on further responsibilities for the achievement of these global goals.

7.5 The UK remains committed to meeting our ODA targets. Specifically, we remain on track to meet our commitment to spend 0.56 per cent of our national income on ODA in 2010/11, exceeding the EU's commitment to a minimum of 0.51 per cent, and to spend 0.7 per cent of our national income by 2013, two years ahead of the EU target.

7.6 We welcomed the UN follow-up conference on Financing for Development, held in Doha, Qatar, last month. This will be an opportunity to renew the global consensus on development financing. We urge all donors to reaffirm their ODA commitments. We must also make sure aid is more effective, implementing the Paris Declaration on Aid Effectiveness and the Accra Agenda for Action agreed in September.

7.7 We must also ensure that developing countries are equipped to deal with regulatory changes in financial markets, drawing on the expertise of the IMF, World Bank and other institutions.

Combating climate change

7.8 It is also imperative to tackle climate change. It is clear that unchecked climate change will have catastrophic effects on our future prosperity. We cannot allow the current financial turmoil to distract us from this risk to global prosperity. On the contrary, we should be investing now both to hasten the transition to a low carbon economy tomorrow and to create jobs and

economic opportunity today. We must harness this momentum to achieve an ambitious post-2012 Global Climate Change Agreement at the UNFCCC meeting in Copenhagen in December 2009.

Reforming the international financial institutions

7.9 Reactions to the financial crisis have demonstrated our international financial structures were ill-equipped to deal with the unprecedented turbulence in the global financial markets. The next summit in the UK in April 2009 will allow us to advance work to reform the Bretton Woods Institutions comprehensively so that they are better equipped to meet future challenges and reflect changing weights in the world economy to increase their legitimacy, and ensure a greater voice and representation for the emerging and developing countries.

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