Ignazio Visco: Challenges to international cooperation in the wake of the global crisis

Speech by Mr Ignazio Visco, Deputy Director General of the Bank of Italy, at The Italian Chamber of Commerce and Industry for the UK XXXI Annual Conference "A New Approach for Global Economic and Social Growth", London, 16 October 2009.

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1. The unfolding of the crisis

1.1 Origins

Whether the global crisis that has hit the world economy so severely since August 2007 was rooted in macroeconomic causes is an open question. To be sure, the trigger and proximate causes of the crisis were essentially financial, originating in a specific segment of the US financial system, i.e. the subprime mortgage market. Nevertheless, I believe that financial excesses could not have developed to the extent they did if the macroeconomic environment had not been characterised by large saving-investment imbalances, very low interest rates and asset price misalignments. These factors helped create the conditions in which financial innovations and regulatory failures caused serious dysfunctions in the US and global financial system. The general climate of excessive optimism that those macroeconomic conditions supported certainly contributed, with risk managers and supervisors allowing financial vulnerabilities to grow basically unchecked.

Signals of macroeconomic stress, which interacted with financial system flaws to create very serious fragilities, had been manifest at least since the late 1990s. The most evident were the dramatic fall in the saving rate of American households, from around 7 per cent in the early 1990s to near zero in 2005-2007, and the persistence and significant widening of the US external deficit (from 1.6 per cent of GDP in 1997 to 6 per cent in 2006), against growing surpluses in a number of emerging economies, in particular China (from 1.3 to 11 per cent of GDP between 2002 and 2007) and the oil exporting countries.

Focussing on the role of policies in sustaining this pattern of highly unbalanced growth and on how they reacted to the various shocks – geopolitical, technological and economic – to the global economy, two factors appear to have played a major role.[1] The first was the great increase in US and global liquidity, in part owing to the generally accommodating US monetary policy stance. This accompanied a protracted expansion of consumer spending financed by growing household indebtedness. At the same time, low interest rates triggered a search for yield that squeezed risk premiums on whole classes of assets and so tended to make financial conditions even more favourable for a broad range of borrowers. Abundant liquidity and credit expansion, as well as regulatory failures in some markets, helped feed an uncommonly synchronised global boom in house prices.

The second element was the decision by China and other rapidly growing emerging economies to peg their currencies to the dollar as a way of supporting their essentially export-led growth model. Not only did this imply basically importing the generally easy US monetary stance; most importantly, it produced an enormous accumulation of official reserves (from $168 billion to $1.9 trillion in China between 2000 and 2008, 40 per cent of the increase in the world as a whole), perhaps as a self-insurance response in the wake of the Asian crisis of 1997-98. Largely invested in US financial and monetary instruments, these

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[1] See Visco (2009b).

reserves helped to finance the massive US deficit in the current account of the balance of payments and to maintain very low interest rates along the whole length of the yield curve.

Both of these policies were attractive in the short term but unsustainable in the long run. In fact, when global supply encountered bottlenecks in the form of shortages of primary commodities and as inflationary pressures started to materialize, the Federal Reserve progressively tightened monetary policy, and house prices started to fall. At that point, the serious risk exposures that had been built up within the financial system suddenly became apparent, precipitating the turmoil. The relevance of this broad set of interrelated factors – macroeconomic as well as financial – in creating a crisis of these proportions is evident in the way the crisis was so rapidly propagated across financial markets and then to the real economy, not just in the industrialised world but globally. It was the unbalanced world consumption patterns that transformed what might otherwise have been a very serious but limited episode of financial turmoil into a fully-fledged global economic crisis, with plunging world trade and output. When the United States stopped serving as "consumer of last resort" the whole world suffered from insufficient aggregate demand precisely because of the unbalanced consumption patterns.

1.2 The real economic consequences

The crisis has left deep scars. In the advanced economies the IMF projects the unemployment rate to reach 9.3 per cent in 2010, almost 4 percentage points above the low point registered in 2007; the shortfall in GDP, relative to potential, is projected to reach 4 per cent this year and to remain just slightly below this level in 2010.[2] But predicting the exact dimensions of this slack is complicated, since the crisis is also likely to affect potential output in various ways that are difficult to quantify.

Past experience shows that the repercussions of financial crises in terms of lost output are both significant and sustained: the IMF has estimated that seven years after the start of a major crisis gross domestic product is still, on average, ten percentage points below where it would have been had it continued on the previous trend. However, growth paths after the initial output decline have differed widely in historical experiences: while in some cases output gradually returned toward the pre-crisis trend, in others the gap widened over time. It is probably still too early to tell which type of adjustment pattern will prevail this time.

While there is consensus on the fact that the *level* of potential output in advanced countries is likely to be reduced permanently as a result of lower investment and structural unemployment, estimates of the size of this loss vary widely, around 3 to 5 per cent. What will happen to its future *growth rate* is even more uncertain. Both the IMF and the OECD have assumed so far that, as a first approximation, it should be unaffected. However, one could argue that we may be at the beginning of a major structural change, certainly in the financial sector and perhaps in the economy as a whole: uncertainties over the recovery of demand and the process of deleveraging in the financial sector could hamper not only investment but also the accumulation of human capital and innovation, with likely negative effects on potential output growth.

1.3 Policy responses and the outlook

Policy makers' response was generalized and remarkably well coordinated. Official interest rates were lowered rapidly; in many countries they are still near zero. Central banks injected liquidity in unprecedented quantities, extending the range of their instruments for action. The severity of the crisis has created a vast international consensus on the need to accompany monetary action with fiscal expansion. For the G-20 economies, crisis-related discretionary

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2 IMF (2009).

fiscal measures are estimated at about 2 per cent of GDP in 2009 and 1.5 per cent in 2010, over the 2007 baseline. To this, we should add the substantial cost of various measures – capital injections, guarantees on bank liabilities, relief of impaired assets, liquidity and bank funding support – enacted in most countries to sustain the banking systems.

This powerful response averted the danger of a systemic collapse and helped to restore market confidence and bring back a more "normal" risk appetite. The cost of money market funding has come down considerably and worry over the health of the banking system has been allayed. Corporate risk spreads have narrowed to levels close to those prevailing before the bankruptcy of Lehman Brothers in September 2008.

Recently, the global economy has begun to grow again, but the recovery appears to be sluggish, uneven and highly dependent on policy support. According to the IMF central forecast, after contracting by 1 per cent in 2009 global activity should return to growth of 3 per cent in 2010 thanks to a modest upturn in the advanced economies and more vigorous expansion in the emerging and developing countries. By way of comparison, the average world economic growth rate between 2002 and 2007 was around 5 per cent. It is important to stress that there is considerable uncertainty around this scenario, and forecasters' current views about the strength of the recovery span a wide range. For example, while private forecasters expect US GDP growth to reach around 2½-3 per cent in 2010, the IMF is projecting only 1½ per cent growth.

One may wonder why we are still considering the predictions of economic forecasters after their dismal recent performance, which surprised even Her Majesty the Queen. We should not forget that forecasting activity permits the consistent organisation of our ideas and hypotheses about the most plausible path of the main economic aggregates. This is particularly useful to analysing the effects of policy actions, which usually come with time-lags and through many channels. It goes without saying that economic forecasters are not fortune-tellers, and their projections always come with explicit or implicit probabilistic ranges of possible outcomes. But it is also true – to quote the great social scientist Herbert Simon – that unless the phenomena to be predicted "are sufficiently regular that they can simply be extrapolated … our predictions will generally be only as good as our theories".[3] Some occasions are particularly marked both by the lack of sufficient regularity in the data observed and by difficulty in properly using our theories to anticipate the non-linear consequences of economic and financial decisions. This calls for special care, better discussion of alternatives and greater consideration of the possibly severe consequences of what may be seen, ex ante, as rare events. But modesty in our evaluation of economic projections should only be seen as a call for more transparency and better analysis, not as a refusal to use quantitative assessments based on an informed and probabilistic reading of the available evidence.

Anyway, the general view of the latest official projections is very cautious and correctly postulates that the support deriving from the fiscal stimulus and inventory rebuilding cannot last forever. Beyond the short term, it still remains to be seen how soon and how far private demand – consumption and investment – can take up the slack and give rise to a self-sustaining recovery.

In fact, in much of the industrial world private consumption is still stagnating at best, and its weakness appears even more significant if one excludes the effects of temporary measures, such as the various "cash for clunkers" schemes in the United States and in the major continental European countries, or the reduction of the VAT in the United Kingdom. To the extent that subsidies have merely brought part of households' planned expenditure forward, once these programmes expire consumption may lapse again. With anaemic demand prospects and with banks still curbing credit as they deleverage, investment too is bound to

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3 Simon (1972), p. 170. See also Visco (2009a).

be sluggish at best for some time. And without a pick-up in the pace of investment it is hard to imagine any return to a healthy growth path.

The main risk is that rising unemployment rates will undermine household confidence and depress spending. As long as jobs are still being lost, there is plenty of potential for destabilizing feedbacks. Lower employment can trigger more mortgage defaults and put additional stress on key financial institutions. In other words, as long as the employment picture continues to worsen, the risk that things could deteriorate again remains great.

2. Challenges for international cooperation

2.1 Repairing the financial system

One of the main challenges is to complete the repair of the financial system so that it can support the return to sustained and stable growth. As the financial markets appear to be regaining confidence, it is important that the reform momentum not be lost. The decisions of the G-20 summit in Pittsburgh point to a renewed effort to overcome the deep flaws that affected the financial environment prior to the eruption of the crisis.

Although the question of capital requirements for banks is certainly most prominent, it should be considered only part of the solution. To discourage excessive leverage, the quantity and quality of bank capital should be raised. But it is also of paramount importance that the perimeter of regulation be extended to cover all systemically important institutions. Regulatory systems must be harmonised to limit the potentially disruptive repercussions of regulatory arbitrage. In this context, the prudential framework should be designed to prevent the pro-cyclical accumulation of financial vulnerabilities during booms and sharp deleveraging during crises.

There is also widespread recognition of the need to reform corporate governance in the financial sector, so as to align executive compensation with long-term performance and ensure greater transparency. All these measures should help deal with the threat posed by institutions “too big or too interconnected to fail”. Better mechanisms should be devised to limit the costs of failure, but widely shared solutions are still to be found. Resolution plans and a stronger capitalisation may mitigate but will not eliminate the financial fallout of the bankruptcy of one of these institutions and the related moral hazard.

2.2 Rebalancing the sources of global growth

Whatever shape the future financial system may take, it is urgent to rebalance the sources of global growth. At present, the main priority of monetary and fiscal policies in all the advanced and in many emerging countries is still to support economic recovery by compensating for the weakness of private demand and countering the effects of financial deleveraging. As a result of the crisis and the strong policy response, the public finances have deteriorated notably. Under current policies, budget deficits in the advanced countries are projected to remain very large and gross public debt may rise over the next five years above 110 per cent of GDP, from 80 per cent before the crisis.

If maintained for too long, the substantial fiscal and monetary stimulus enacted during the past year could become a new source of instability. So the most challenging task for economic policy is timing what are now called “exit strategies”, i.e., when and how to phase out these exceptional measures. This involves striking a delicate balance. As the recovery of final demand is likely to be lacklustre for some time, support should not be withdrawn prematurely. At the same time, credible exit strategies are crucial to reassure the markets as to the commitment to price stability and a return to sound and sustainable public finances.

Central banks have already made it clear that they have the tools necessary to withdraw excess liquidity, and are determined to do so as soon as conditions warrant. The most delicate challenge is to choose the appropriate timing and speed for exiting from “unconventional” measures and for raising interest rates. In this process, the strength and durability of the recovery will have to be taken into account, as well as the progress toward financial system repair.

In designing the appropriate fiscal policy response, it is important to take expectations into account. The economic slowdown partly reflects the pessimistic expectations of economic agents. A well-designed and well-targeted fiscal plan can help the recovery by boosting the confidence of households and businesses. Also the financial markets’ reaction to any given level of public debt is powerfully influenced by their expectations on future fiscal behaviour. Accompanying the fiscal stimulus with credible action to right the public finances in the medium term can limit the rise in interest rates stemming from a temporary upsurge in debt. This strategy is particularly important for countries with high debt or a weak reputation for fiscal rectitude.

The problem, particularly at the present juncture, is how to make this commitment to medium-term consolidation credible while preserving the necessary flexibility in the short term. On the one hand, the commitment to a long-term objective may not be credible without an indication of how to get there. On the other hand, because the shape and strength of the economic recovery are so uncertain right now, and because the premature end to fiscal stimulus could easily derail it, governments may find it difficult to stick to pre-announced fiscal targets.

Going forward, the need to move towards more sustainable fiscal positions will require tough policy choices in a number of countries. Although the challenges posed by the projected rise in health and pension costs connected to population ageing have been well known for some time, with substantial comparative assessments produced by the European Commission, the IMF and the OECD,[4] the fiscal costs of the crisis have now sharply reduced the margins for manoeuvre, and addressing those challenges can no longer be postponed. Governments need to commit credibly, now, to curb the future growth of those entitlement programs; this could provide space for a more gradual removal of fiscal support. However, the manner in which the eventual consolidation is carried out will also be important. If the mix of expenditure cuts and (probably unavoidable) tax increases could be engineered so as to minimize the adverse impact on medium-term growth, the consolidation would be less painful. For instance, as much as possible the penalization of growth-enhancing expenditures, such as R&D investment, education and overall human capital formation, should be avoided.

Over the medium term, the crucial factor for sustained growth is a better balance in global demand. The rise in US private-sector saving and the sharp fall in investment, partly offset by a larger public sector deficit, appear to have cut the US current account deficit from 5.3 per cent of GDP in 2007 to 2.6 per cent in 2009, as projected by the IMF. The Chinese surplus has also been reduced, from 11 to about 8 per cent. However, most of these corrections are due to cyclical, not structural, factors.

If the recovery is driven by demand in the surplus countries – not only emerging Asia, but also Japan and some European countries – then some real correction of imbalances is possible. A major rebalancing of world demand from deficit to surplus countries presupposes coherent movements in exchange rates. I do not intend to pinpoint exactly where exchange rates should be. After all, no one knows what is the correct or “fair” value of a currency. But the risk of a disorderly adjustment in exchange rates has to be averted. I think the solution is

[4] See, for the most recent assessment, the report by the European Commission (2009), where on the basis of current policies, the age-related public expenditures (especially for pensions, health and long-term care) to GDP ratio is still projected to increase in the European Union, on average, by about 3 percentage points by 2035 and 5 percentage points by 2060.

unlikely to consist either in asking countries with dollar-peg regimes to shift abruptly to a fully flexible regime or in the quest for the "holy grail" of a single world currency – which would require very high flexibility in the markets for goods and services in all the national economies. As the rebalancing of world demand proceeds, reasonable solutions based on intermediate regimes, such as target zones or bands and currency baskets, should not be dismissed out of hand.

There is now a growing awareness of the importance of rebalancing, as the Pittsburgh summit acknowledged. However, it is still not evident how (and whether) any given country will in fact implement such shared understanding. If the current situation does not change, shifts in saving and investment will not be able to correct global imbalances, thus feeding the expectation of significant exchange rate adjustments and triggering potentially disorderly movements.

2.3 The increasing role of international cooperation

In the last few months several fundamental changes in the IMF's modus operandi have been agreed, as well as an increase in its financial size. First, the Fund's lending framework has been reformed radically. In particular: (a) conditionality has been simplified and tailored to the varying strengths of countries' policies and fundamentals; the IMF will rely more on pre-set qualification criteria (ex-ante conditionality) and less on traditional (ex post) conditionality as the basis for access to its resources; (b) a new Flexible Credit Line (FCL) has been introduced, for countries with very strong fundamentals, policies, and track records of policy implementation. Countries eligible to the FCL are granted large and upfront access to Fund resources, within limits to be assessed on a case-by-case basis and with no ongoing (ex post) conditions; (c) the traditional stand-by lending arrangements have been made more flexible, to enable high access on a precautionary basis for members that do not qualify for the FCL; (d) non-concessional loan access limits for countries have been doubled (to 200 and 600 per cent of quota on an annual and cumulative basis, respectively), in order to bolster countries' confidence that adequate resources would be available to meet their financing needs.

Second, and perhaps more important, the Fund's lending capacity has been trebled from the pre-crisis level, from $250 billion to $750 billion. A number of advanced and emerging countries have volunteered to lend new resources for more than $500 billion, through bilateral loans and IMF notes purchase agreements.

On the whole, the IMF's lending toolkit has been re-oriented from crisis resolution to crisis prevention, and the substantial increase in financial capacity has enhanced its credibility as a multilateral insurance mechanism. The FCL plays a special role in this new framework. Its success so far (as in the cases of Mexico, Poland and Colombia) bears witness of a radical shift in the sentiment of the potential beneficiaries.

Third, a decision has been taken to allocate new Special Drawing Rights (SDRs) equivalent to $250 billion, two fifths of which to emerging and developing countries. SDRs are a means for IMF members to obtain freely usable currencies from other members, and they therefore help to increase countries' international reserves.

One purpose of these reforms is to convince emerging countries to abandon the quest for self-insurance through the massive accumulation of official reserves against potential crises and go over instead to a mutually accepted system of multilateral insurance provided by international financial institutions. In recent years, many emerging market economies have relied upon reserves for their precautionary needs. Some countries, especially those running persistently large current account surpluses, have accumulated reserves far above any reasonable benchmark.

However, large reserve holdings can generate costs both for individual countries and for the world economy as a whole. For an individual country, the issuance of domestic debt aimed at absorbing excess liquidity from abroad carries a fiscal cost if the domestic interest rate is higher than the return on official reserve assets; furthermore, and perhaps more importantly, the country risks large capital losses if, sooner or later, its currency is revalued. More generally, large reserve holdings entail a misallocation of resources that could have been more efficiently invested domestically. From a global standpoint, the accumulation of reserves in some countries has been the counterpart of the external deficits run by others, which have been a key co-driver of the crisis, the global recession, and the collapse of world trade.

Does this imply that the IMF can act as international lender of last resort and provide full coverage of the potential needs of its members? I do not believe that time is ripe for such a bold move. While the IMF is now well-equipped to mitigate the economic disruption from sudden stops in capital flows and from the perceived need for excessive (and expensive) official reserves, I am convinced that sound macro-financial policies at the country level remain essential to strong, sustainable and balanced global growth. In an interdependent world these policies should take into account, as much as possible, the spillovers to the global economy.

Here is where the IMF's surveillance function can play a decisive role. In the recent past the Fund has failed to get major countries to steer their domestic policies towards reducing their large external imbalances. To be sure, this was an extremely difficult task, since the logic of surveillance rests on the postulate that policy makers should cede a measure of sovereignty in the interest of international cooperation. Unfortunately, this happened only in a very small part.

Going forward, the global crisis might have had the beneficial effect of forcing policy makers to think outside the box, i.e. to act cooperatively to rebalance world demand and steer the global financial system. This is a very big challenge, and one should not cultivate exaggerated expectations. However, we should acknowledge that, in this respect, in less than a year the G-20 and the Financial Stability Board have become the new protagonists: the first, as a sort of world economic "steering committee", which availing itself of the IMF's analysis and advice can enhance international cooperation on all fronts and help achieve balanced and sustainable growth; the second – enlarged and institutionalized from its predecessor, the Financial Stability Forum – to make substantive progress in the key task of setting out financial and regulatory standards that will also involve the Basel committees, as well as the Fund.

3. Structural reforms to sustain growth

3.1 Structural reforms in times of crisis

Rebalancing cannot be achieved without sound structural economic policies. The joint statement released at the G-20 summit in Pittsburgh acknowledges that a strong recovery will necessitate "macroeconomic policies that promote adequate and balanced global demand as well as decisive progress on structural reforms that foster private domestic demand, narrow the global development gap, and strengthen long-run growth potential."

In the aftermath of the economic crisis, pro-growth structural reforms may be held back. As the main focus of policy-making during the recession has been demand support, the issue of structural reform may well be downplayed or even set aside. In part this may reflect political reasons: insofar as reforms have short-term costs, the political appetite for them could be low. But this would be a lost opportunity.

The reform action must not be halted by more urgent needs linked to the current crisis. It must continue to remove the obstacles to growth that lie in low levels of competition and several rigidities in product and labour markets. A constant monitoring of the progress in each country should provide an important stimulus for action. This is the aim of the OECD program *Going for Growth*, launched in 2005, which provides a sort of structural surveillance on OECD member countries. A possible extension outside the OECD membership could be a significant step forward.

The nature of the present crisis demands a general review of financial regulation around the world. Specifically, there is a need to broaden the perimeter of regulation and to adopt new rules. After the years in which markets were presumed to be self-regulating and public rules were abolished or greatly relaxed, the financial landscape will now have to be reshaped with more pervasive regulation, both domestically and internationally. This is a necessary step toward ensuring a functioning financial system and fostering the return of confidence to the credit markets.

There is a risk, understandable, that for some time regulation of financial markets might turn out, ex post, to be even too heavy. We should be careful not to extend this pro-regulation attitude to other product and service markets where some regulatory easing is needed. Were not this the case, the outcome would be to weaken competition and increase monopolistic rents, favoured by administrative burdens and inefficiencies. Innovation and the evolution of productivity would be impaired in the long run, with negative consequences for economic growth.

However, policy action must be carefully designed to avoid flawed structural interventions or measures that could jeopardise the benefits of recent reforms. The early retirement schemes introduced in many European countries were intended to foster youth employment, but after a good many years most of them proved to be failures. Similarly, incentive schemes targeted to specific sectors risk creating a dangerous dependence on public support and should accordingly be phased out quickly.

3.2 Support to domestic demand in emerging economies

In most economies with external surpluses, it is crucial to establish the conditions for expanding private consumption and investment. Take China, for instance. In 2008 the Chinese current account surplus of 10 per cent of GDP was equivalent to about a third of the total surplus of Asia (including Japan) and the major oil exporting countries. Gross domestic saving amounted to 50 per cent of GDP. Such high saving (half of it generated by the business sector) together with very low household consumption (35 per cent of GDP, half the ratio for the United States) are striking by international standards. Underlying these figures are very substantial reinvested earnings and the high household propensity to save (on average 25 per cent of disposable income), mainly out of precautionary motives.

Lack of basic social services – health care, education and pension benefits – for a rapidly ageing population, together with credit constraints, has greatly increased the need for self-insurance. At the same time, an output structure intensely skewed towards capital-intensive industries, the underdeveloped state of financial markets and privileged access to bank lending by large state-owned enterprises are all factors inducing firms to finance investment largely out of retained earnings. In this context, demand-side reforms are needed to reduce precautionary saving, while supply-side measures should aim at shifting output composition more towards labour-intensive activities, chiefly in the service sectors.

As for social services, the recent health care reform is a step in the right direction, although the share of the anti-crisis stimulus package allocated to overall social welfare programs is small indeed compared to that going to infrastructure and other public investments (0.5 and 11 per cent of GDP respectively).

The service sector would benefit greatly from financial system reforms to stimulate credit to small and medium-sized enterprises, which until now have been severely constrained.

This could prompt the emergence of a large middle class and lead to a better distribution of income, thereby increasing the overall propensity to consume.

3.3 Reforms to boost growth in the advanced economies

The Chinese case, and that of the emerging countries in Asia generally, differs from other countries running an external surplus or a small deficit. For Japan and some European countries, such as Germany and Italy, where the scope for fiscal manoeuvre is limited, structural reforms should be directed at the sectors where heavy regulation limits competition, hindering innovation and productivity growth. The deregulation of the telecommunications market in the 1980s and 1990s helped to spark the formation of new companies and the introduction of new products, thereby raising demand. Something similar could be done for professional services and retail trade, which are still characterised by relatively pervasive regulation. These are reforms that would not be difficult to implement and would entail potentially very large gains in potential output.

We are probably going to experience what many commentators are already calling a "jobless recovery". In fact, unemployment is rising all over the advanced world: in the United States the rate is expected to hit double digits within the next few months and to stay there throughout much of 2010. The fiscal and monetary stimulus have saved a lot of jobs, but it is widely recognized that extra effort is needed to help employment to recover quickly.

What is particularly disturbing in the current juncture is that jobless workers tend to remain unemployed for longer than in the past, to the detriment of their human capital. This tendency must be countered by a proper reform effort: the evolution of potential output depends on the level of a society's human capital. As the G-20 said, "Each of our countries will need, through its own national policies, to strengthen the ability of our workers to adapt to changing market demands and to benefit from innovation and investment in new technologies, clean energy, environment, health, and infrastructures". Active labour market policies may help workers acquire the skills that will be needed as the economy revives. This has implications not only in the short term – enabling people to find jobs and so increasing their spending power – but in the long term as well – by raising productivity. Both in Britain and Italy there is a growing awareness of the need to improve our education system in order to seize the opportunities offered by innovation and technological progress. This can be achieved by raising the population's level of training and education (in Italy it is the lowest among the advanced economies), so as to boost productivity and assist low-skilled people. Better educational attainment and wider distribution of educational resources should help close socio-economic gaps and promote social mobility, as is described in considerable detail in the British government's "New Opportunities" White Paper.[5]

The severity of the crisis, its pervasiveness across countries and economic sectors, has led a good many commentators and policy makers to question the validity (and predictive capability) of economics as a science. I beg to differ, although of course I do not deny that our knowledge, understanding and predictive ability can be substantially improved. I agree that rapid innovation and globalization, particularly evident in the financial markets, have produced an environment whose implications have not been adequately appreciated. But it should be recognized that the warning signs of the building-up of very serious macroeconomic imbalances were pointed out repeatedly – to be sure, with some dissenting views as to their unsustainability. What has been lacking, along with an adequate response of regulators to the build-up of financial risk, has been the recognition of the need to reduce the misalignments in real and financial asset prices and to cooperate and act collectively to counter the global imbalances.

Further, as suggested above, I still believe that much can be done to improve the working of our economies at the structural level. I think that the analysis and the empirical evidence on the sources of economic growth still support what I wrote introducing, soon after the bursting of the dot-com bubble and in a different capacity than the one I now have, a detailed

[5] HM Government (2009).

summary of research conducted at the OECD. Namely, "contrary to simplistic beliefs, regulatory reforms are not the same as unconstrained deregulation, enhanced competition does not mean uncontrolled laisser-faire, and the reduction of excessive employment protection does not inevitably imply widespread job insecurity. The quest for most appropriate conditions to foster investment opportunities and economic growth needs to focus on enhancing market efficiency and innovation, promoting the accumulation of knowledge and increasing the diffusion of new technologies".[6]

4. Conclusion

The challenges for the international community are formidable, the recovery is still in its infancy, halting. But we must not miss the opportunity to start reforming our economies to make the productive system more efficient and more resilient to shocks.

The G-20 summits here in London last spring and more recently in Pittsburgh have displayed remarkable consensus on analysis and remedies. All the countries agreed to adopt a *Framework for Strong, Sustainable and Balanced Growth*, underlying the need for more systematic international cooperation. Many reform measures have already been taken and others should follow soon. The response of markets and analysts has been generally positive, although a number have questioned the real willingness to apply the reforms. Some recall *Much Ado About Nothing*; others, worse still, cite what Tomasi di Lampedusa has the Prince of Salina say in *The Leopard* at the time of Garibaldi's conquest of Sicily: "Change everything so that nothing changes". Now more than ever, we must reject any such stance and work to strengthen the current recovery and safeguard the future health of our economies. To this end, we need to encourage a pro-reform attitude – in the international monetary system as well as in the advanced and emerging economies – and to make sure it is translated into concrete actions, to maintain the momentum in our collective and cooperative efforts.

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