



# **Tackling the World Recession**

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**January 2002**

Published in January 2002 by

**Catalyst**

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# Executive summary

## 1. Introduction

- Events since September 11 have heightened the danger of a serious world recession.
- This threat can only be tackled effectively if the leading industrial countries jettison the neo-liberal economic consensus that emerged in response to the inflationary crises of the 1970s and adopt more expansionary policies.
- The United States shows encouraging signs of doing so, but policy in the EU is still largely dominated by the prevailing orthodoxy, as it is in the UK.

## 2. Monetary and fiscal policy

### *The neo-liberal consensus*

- This is reflected in the remit of the Bank of England Monetary Policy Committee couched solely in terms of reaching the inflation target, and Gordon Brown's Golden Rule which rules out the active use of fiscal policy to influence demand and employment.
- A similar philosophy is evident in the status and remit of the European Central Bank, and the restrictive provisions of the Stability and Growth Pact.

### *Monetary policy*

- Both the Bank of England and the European Central Bank have followed the US Federal Reserve in cutting interest rates. But monetary policy on its own is unlikely to be sufficient to maintain demand.

### *The Pre-Budget Report*

- In his Pre-Budget Report the Chancellor quite rightly proposes no measures to cut expenditure or increase taxes to meet the shortfall in revenue resulting from the slow-down in the economy. To do so would merely depress demand further. But the Report contains no further fiscal measures to expand demand.

### *Contingency planning*

- The future outlook is particularly uncertain, and the UK and other European governments should now be considering what additional contingency measures they would take should the outlook deteriorate further.

### *Fiscal measures*

- Temporary tax cuts such as improved allowances on corporate investment and reductions in social security contributions may be needed to stimulate demand. On the expenditure side increases in social security benefits and increased public investment in transport, health and education should also be considered.

### **3. International cooperation**

#### *Coordinated expansion*

- Coordinated expansion by the leading industrialised countries is not merely desirable for their own sake but also crucial for the developing world.

#### *Financial instability*

- The direct effects of weakening demand may be heavily compounded by the volatility of financial markets.

#### *Stand-by measures*

- The most immediate need is for stand-by measures so that any new financial crisis is met with united action to stabilise the situation. G8 finance ministers should set up a special committee of the IMF to deal with such emergencies.
- It is also essential to agree a procedure for orderly debt work-outs. Measures should be considered to assist countries whose export receipts are hit by falling commodity prices.

#### *A new Bretton Woods*

- More fundamentally, the current situation provides an opportunity for agreement on a new Global Financial Architecture to tackle the three inter-related sources of instability: capital movements, asset price bubbles, and exchange rate volatility.
- Some moves have been made towards more effective regulation of financial institutions, but it must be a priority to reduce the degree of leverage in the system and tightening up the regulation of bank lending for speculative purposes.
- Taxes on financial transactions, such as the Tobin Tax could improve stability by reducing the profitability of short-term speculation, but they can only be levied on an international basis. The Government should aim to harmonise taxes on share transactions not abolish them.
- The present regime of floating exchange rates should give way to a new era of managed, but flexible rates. This would of necessity involve a two tier approach, with a number of (varied) regional systems, and global arrangements to manage the rates between them.

### **4. Summary and conclusions**

- Governments should be making contingency plans for more active domestic expansionary measures if the outlook deteriorates.
- As individual countries become more closely connected it is increasingly vital to strengthen international economic cooperation and its institutions.
- The danger of financial instability exacerbating any recession makes it all the more urgent to press ahead with reforms of the global financial system.

# 1

## Introduction

The events of September 11 have heightened the danger of a serious world recession. The growth of the US economy was already slowing down; the Japanese economy was in serious difficulties, and the economic outlook for the UK and the rest of Europe was deteriorating. The terrorist attacks have hit confidence and loaded the scales against any quick recovery. Unemployment is now starting to rise throughout the industrial world. Uncertainty about economic prospects has increased as psychological factors have become especially important in determining consumer and business behaviour. In particular, there is a strong likelihood that firms will defer investment decisions, and so depress the demand for plant and equipment and new construction. With the future so uncertain, it is important that governments not only adopt more expansionary policies, but prepare contingency measures in case the situation deteriorates more quickly than immediate forecasts might suggest.

So far the United States has shown the most positive reaction to this threat. The Federal Reserve has reduced interest rates and given its backing to the President's package of tax cuts and increases in public expenditure now before Congress. The response on this side of the Atlantic has been more hesitant. Both the Bank of England and the European Central Bank have followed the Fed in cutting interest rates, but neither the Chancellor nor other European financial ministers have announced any expansionary budget measures, ie. tax cuts or increases in public spending. In his Pre-Budget Report Gordon Brown maintains his existing expenditure plans, which are fortuitously somewhat expansionary, but makes no mention of any further changes in fiscal policy. Similarly, in the EU as a whole, budgetary policy remains restricted by the Stability and Growth Pact, which makes it difficult for most countries to take any expansionary measures for fear of taking their budget deficits below the specified limit of 3 per cent of GDP.

The growing threat of world recession can only be tackled effectively if the leading industrial countries are prepared to jettison the neo-liberal economic consensus that has prevailed for the last two decades, and adopt more expansionary policies. The United States shows encouraging signs of doing so, but policy in the EU is still largely dominated by prevailing orthodoxy, as it is in the UK. The following sections discuss some of the key changes in policy needed at national and international level to meet the problems we face today.

# 2

## Monetary and fiscal policy

### The neo-liberal consensus

The existing policy consensus, a sort of modified monetarism, emerged in response to the inflationary crises of the 1970s. At the time it was presented as a replacement for the concept of Keynesian demand management which had successfully maintained full employment for the first 30 years after the Second World War, combined with a variety of prices and incomes policies to contain inflation. But when these failed to contain the inflationary pressures of the 1970s — sparked off by the commodity price boom at the start of the decade and the oil crises which followed — the monetarists sold the politicians the idea that controlling the money supply would magically keep prices in check. In practice what followed was a sharp contraction of demand due to both tighter monetary and fiscal policy which led to major increases in unemployment and kept down wage demands. The Thatcher government did not abandon demand management, but used it in a strongly deflationary way to break the inflationary spiral, weaken the trade unions and change the balance of economic, social and political power. Governments elsewhere behaved in a similar way. Inflation was the main target and full employment was expendable.

The three major tenets of the new orthodoxy were:

1. monetary policy, under the control of an independent central bank, should be used to control inflation;
2. governments should aim to balance their budgets and not use them as an instrument for controlling demand; and
3. unemployment was due to imperfections of the labour market rather than a shortfall in demand.

This doctrine has dominated New Labour thinking and the approach to economic policy in the EU laid down in the Treaty of Maastricht.

In the UK, the New Labour government handed over control of monetary policy to the Monetary Policy Committee within days of taking office, with the sole remit of hitting the inflation target of 2.5 per cent. In addition Gordon Brown laid down the Golden Rule stipulating that the current budget (i.e. excluding public investment) must be balanced over the business cycle and should not be actively used to influence demand. This does leave room for the automatic stabilisers to come into play so that any fall in demand is mitigated by a reduction in taxes paid and higher



expenditure on social security benefits; but the Chancellor specifically ruled out any more positive fiscal measures to control demand.

In the Eurozone, the European Central Bank is totally independent of any political control, and, following in the footsteps of the Bundesbank, shows a heavily monetarist influence. It is thus to some extent surprising that it followed the Fed in cutting interest rates at a time when the case for doing so in terms of its 2 per cent inflation target was still uncertain. This gives hope that when it comes to the crunch, common sense will prevail and they will cut interest rates further to try to stave off recession.

The scope for expansionary budgetary measures, however, is limited by the Stability and Growth Pact. This forbids countries to run budget deficits of more than 3 per cent of GDP, unless GDP is falling at a rate of at least 2 per cent a year — in other words unless a serious recession is already underway. Not only could this rule out expansionary measures in countries which already have budget deficits, but it could also put them under pressure to raise taxes or cut expenditure, thus aggravating any fall in demand. There are some signs, however, that the Pact may be interpreted flexibly in the light of current conditions. But unless the Pact is either renegotiated, or interpreted more flexibly, the use of fiscal measures to stimulate demand in any recession will be severely limited.

## **Monetary policy**

The belief that lower interest rates alone will be sufficient to maintain demand in the face of a severe threat of recession is likely to prove tragically misplaced. As far as consumers are concerned, lower interest rates may increase the disposable incomes of homeowners with variable rate mortgages, but they also reduce the incomes of savers. It seems doubtful whether interest rate cuts will have any significant effect on consumer spending financed by credit cards or bank borrowing.

Most people pay little attention to the precise rate of interest on their credit cards — or indeed even know what it is! In recessionary conditions, banks are likely to be more cautious about the risks of lending to individuals who are in increased danger of losing their jobs.

It would also be unwise to assume that lower interest rates will necessarily have much effect in stimulating new investment in plant and machinery. Firms' investment decisions are much more dependent on the outlook for sales than the cost of

borrowing; and again businesses may find it more difficult to get bank loans in a recession, because branch managers are more sensitive to potential risks. We hear a lot nowadays about the signalling effects of interest rate changes. The main signal that drastic cuts in rates send to business is that the Central Bank think the risks of recession are serious: this is likely to depress, rather than stimulate investment.

We should be beware of assuming that monetary policy has some magic potency for keeping demand and output on an even keel. The expansionary experience of the US and UK economies over the last few years may owe far less to skilful manipulation of interest rates than is often supposed.

## **The Pre-Budget Report**

Budgetary policy may be the key to recovery. In his Pre-Budget Report the Chancellor, quite rightly, proposes no measures to cut expenditure or increase taxes to meet the shortfall in revenue resulting from the slow-down in the economy. To do so would merely depress demand further. But he does not go beyond this and the Report contains no positive measures to expand demand; nor does it discuss what measures might be taken if the economy fails to live up to the Treasury's optimistic forecast that there will only be a slight slowing down in growth in 2002 and a return to trend by the end of the following year: GDP is forecast to grow by 2.25 per cent in 2001 (the lower end of the range forecast in this year's Budget) and by between 2.0 and 2.5 per cent next year.

If the fiscal stance implied by the Chancellor's plans was appropriate in the more buoyant demand situation envisaged when he introduced his last Budget in March, it is arguable whether it is still appropriate in the more deflationary situation today. Certainly if the Treasury's forecasts prove too optimistic, positive fiscal measures to expand demand will need to be taken. The most worrying feature of the Report is its failure to discuss this possibility, and the lack of any signs of contingency planning in case the recession gathers momentum. The Chancellor gives every indication of sticking rigidly to his Golden Rule regardless, even if the situation deteriorates. He seems to be more concerned to convince financial markets and economic commentators of his continued adherence to fiscal respectability than to fight the threat of recession.

## Contingency planning

One of the problems facing government policy makers everywhere at the present time is the exceptional uncertainty of any short-term economic forecasts. All the major economies were showing signs of a slow-down before the terrorists attacks, and these have clearly accentuated the danger of a serious recession. Output is now falling in the US and other major industrial countries; and even where growth is slowing down rather than falling, the failure of output to reach its potential level, means job losses and rising unemployment — as we see in the UK today. In the rest of the EU unemployment was generally higher before the crisis — 8.5 per cent in euroland as opposed to 5 per cent here — and there was already a need for accelerating the growth of demand to bring down unemployment.

Manufacturing industry is being particularly badly hit. Industrial production is falling throughout the industrialised world. The closures of capacity and dispensing of skilled labour will not suddenly be reverse when demand picks up. This then creates the danger that to avoid inflation the industrial economies will tend to operate at a higher level of unemployment after the recession than before.

In this situation it would be wrong for governments to sit tight and hope that the European economy will just flatten out for a time, and then — with the help of lower interest rates — recover. The risks of a serious recession are much more serious, both economically and politically, than that of stoking up renewed inflation. Governments should therefore already be leaning in an expansionary direction — and certainly not increasing taxes or cutting back expenditure to minimise deficits. But further than this, they should be drawing up contingency measures in case things get worse. Here there is a delicate point in timing. Ideally such measures should be taken in advance of any threatened deterioration in order to prevent it happening. In practice governments may feel obliged to wait for the first signs of such a deterioration, before actually putting such measures in place. The first requirement, however, is to prepare contingency plans now, rather than continue to let things drift in the hope that they will not be needed.

In industry, planners frequently construct a number of scenarios about how the future will develop and examine the action they should take in each case. The weakness of Treasury policy-making is that it is so often based on a one point forecast. When variations from this central forecast are discussed, the questioned examined is generally how this will affect revenue and expenditure, rather than whether the implied fiscal stance is appropriate, eg. too tight in a recession.

European governments should now be considering in detail what additional measures they would take in a scenario of growing recession.

## Fiscal measures

In considering possible fiscal measures to stimulate demand if the position worsens, there are three main desiderata.

1. The loss of government revenue or increase in public expenditure should be reflected in as high an increase in private expenditure as possible (as opposed to increased saving).
2. The measures should be capable of being put in place with a short lead-time, and affect demand within a limited period.
3. The measures should be capable of being reversed as the economy recovers.

Possible cuts in different forms of taxation need to be examined in the light of these criteria. In terms of their effectiveness in increasing on consumer spending, the lower paid are likely to spend a higher proportion of any tax concessions than the rich — a crucial point in the argument between the Republicans and Democrats in Congress as to who should benefit from tax cuts. One measure which could have an immediate effect on consumer spending would be a cut in sales taxes, such as VAT, especially if it was known to be only temporary. But reversing such cuts when the economy is picking up is liable to accelerate inflation just at the wrong moment. They are therefore probably best avoided.

Cuts in income tax have to be made on an annual basis, and at first sight are politically difficult to reverse. But this can to some extent be done by stealth — by keeping personal allowances and tax bands steady in money terms when these would otherwise have gone up in line with inflation or the general rise in incomes. Reductions in corporate taxation likewise have to be made on an annual basis. They may boost industrial confidence, but are unlikely to have much direct effect on investment. Experience suggests that the most effective stimulus to investment is a concession on tax allowances on investment expenditure made before a specified date.

Reducing social security contributions has the advantage that this can be done in the middle of the tax year. Reductions in employees contributions should lead directly to extra consumer spending. Reductions in employers contributions might

encourage firms to hold onto labour they might otherwise shed, but would not necessarily be much of a stimulus to demand. Reversing any temporary cuts would be straightforward but transparent.

On the expenditure side, increases in social security benefits are likely to result in almost commensurate increases in consumption, as state pensions, unemployment and sickness benefits disproportionately benefit the least well-off, with the highest propensity to spend the extra income. The fact that benefits tend to be increased annually also means that increases in benefits can be reversed by a process of attrition — that is by having smaller or no increases in subsequent years until their value is back on trend.

The traditional remedy of increasing public works has many advantages. There is a direct increase in employment in the construction industry, which tends to be hard hit by recession. In the UK in fields such as the railways and the London Underground, there is an urgent need for a spurt in investment, which would command widespread public support. Similarly, temporary increases in building of new hospitals, schools, etc. do not necessarily create any pressure to maintain investment at this level when the recession has come to an end. The main problem is that such schemes need to be fully prepared and ready to go ahead when needed. It is doubtful whether this is the case in the UK at the moment. Indeed public investment has been lagging behind schedule partly because of the inordinate complications associated with the introduction of private finance. While uncertainty prevails, one of the most appropriate actions the government could take would be to encourage departments, local authorities and NHS Trusts to prepare investment schemes in advance of their present schedules, with the possibility that they may get approval for an earlier start if we enter a recession.

The scope for immediate increases in planned *current* expenditure on public services depends on the availability of the additional resources required. In at least two fields where the need for increases is most pressing, however — health and education — the possibilities of any short-term boost are limited by the availability of doctors, teachers and nurses.

# 3

## International cooperation

### Co-ordinated expansion

**In formulating fiscal policy, the governments of the major industrial countries may feel no immediate pressure to work together. In the past, one country expanding more rapidly than its trading partners would have been concerned about the likelihood of an accelerating growth of imports leading to an embarrassing balance of payments deficit. But today, when capital movements, rather than current deficits, have become the dominant cause of balance of payments crises, this is of less concern. On the other hand, the growing volume of international trade means that expansion in different countries is increasingly mutually reinforcing. There is therefore an incentive for all the G7 countries, for example, to take expansionary fiscal action together — and this applies even more strongly within the EU, where provision for such co-operation already exists in the Treaty of Maastricht.**

Expansionary action in the industrial countries is not merely desirable for their own sake, but crucial for the developing world. Falling demand in Europe and North America would have serious effects on exports of primary products and industrial goods for less developed countries. In the case of primary products, the danger is not only a loss of revenue from a falling volume of exports but also a sharp decline in prices. For the newly developed countries, like Korea, the decline in markets for their industrial exports is already serious. The most important contribution the West can make to the welfare of the rest of the world over the next year or two is to keep their own economies expanding.

### Financial instability

Expansionary measures alone may not be enough to avoid trouble. The direct effects of weakening demand by consumers or businesses may be heavily compounded by the volatility of financial markets and the emergence of financial crises. This is a particular danger in a situation like today where uncertainty and psychology are major factors. It is, moreover, difficult to tell in advance where such crises may strike. In so far as they tend to go for the weak points, there is a heightened risk that any country in internal economic difficulties may suffer a loss of confidence with a consequent outflow of capital and pressure on the exchange rate. Most of the developing or transitional (ex-Communist) countries could come into this category. The use of controls on capital movements to cope with this danger should

be more readily acknowledged. In addition there is always the danger that some further development could trigger a fall on Wall Street and a loss of confidence in the dollar, thus compounding any US recession and disrupting world financial markets. The possible fall-out from this is difficult to determine.

There is now, however, considerable experience of crises elsewhere: the list includes Mexico, Brazil, Korea, Thailand, Indonesia, Philippines, Malaysia, Russia and Argentina. At one time it seemed as if the 1997 Asian crisis would act as a catalyst for major reforms of the so-called Global Financial Architecture. But once the industrialised countries found they were emerging relatively unscathed, any major impetus for reform seemed to die out. The need to act before disaster strikes has, however, become more pressing than ever. What might have been regarded as possible long term reforms, if taken now, could reduce the danger of fresh financial crises at a time when the global economy is least able to bear them political stability has become increasingly fragile. In this field the agenda for fundamental reform is largely synonymous with that for short-term crisis prevention. But again it necessitates abandoning the current orthodoxy that markets know best and should be left to their own devices.

## **Stand-by measures**

The most immediate need is for additional stand-by measures to ensure that any fresh crisis is met with united action to stabilise the situation. The weakness of the current approach to country crises is that it assumes that such crises are fundamentally a problem for the country concerned to put right with some assistance from the IMF — subject to stringent advice and conditions about how it should conduct its affairs. This misses two points: the need to tackle the volatility of global markets as such, and the fact that if there is a run on currency, the ability to stabilise it depends mainly on speedy action by countries with the strong currencies — the weak currency country has little power to restore the position. We need to think much more in terms of crises as essentially an international problem, and remember that for every rash borrower there is a rash lender. The governments of the major industrialised countries need to be brought into the action from the start, rather than leaving it to bilateral negotiations between the crisis country and the IMF. G8 Finance ministers should take the lead in setting up a special committee of the IMF to deal with such emergencies, on the understanding that this could call on the resources of the leading central banks, as well as the IMF, to take swift action in any major currency or banking crisis. Above all, the IMF should not enforce

deflationary action on countries in difficulty, such as Argentina, and hence heighten their internal problems.

As part of any measures to prevent and deal with crises more effectively, it is high time the seemingly endless discussions on new procedures for dealing with countries defaulting on their debts were brought to a conclusion. The objective must be to provide a means of reaching agreement on sharing the losses, without provoking or accentuating, a financial crisis — in other words so-called orderly debt work-outs.

Another line of attack would be to take special measures to aid countries whose export receipts were hit by falling commodity prices. This could be done by industrialised countries putting part of their saving on their commodity import bills into a special fund which would be distributed to the countries heavily dependent on commodity exports. It would then be the responsibility of the national governments of the recipient governments to the producers involved. These would, of course, vary from small farmers to large mining companies, and differing treatment might be appropriate in each case.

## **A new Bretton Woods**

More fundamentally, the sense of urgency and atmosphere of closer international co-operation engendered by the terrorist crisis could provide the opportunity for agreement on a new Global Financial Architecture — as the Second World War did at Bretton Woods. This would need to tackle the three inter-related sources of instability: the instability of capital movements; asset price bubbles; and exchange rate volatility. In a typical crisis, such as that in East Asia in 1997, funds flow in from abroad, share prices and property prices boom, and there is upward pressure on the currency. Then when some event, which may be quite trivial, serves as a catalyst leading to a change in sentiment, funds flow out, asset prices collapse and the exchange rate crashes. There is not one simple way of combating these changes. Action is needed on a wide front.

### *Financial regulation*

The need for effective regulation of financial institutions, both in lending and borrowing countries, is so far the only field in which the need for action has been agreed. Finance ministers of the leading industrial countries have set up a new



Financial Stability Forum to co-ordinate the activities of the various supervising authorities. It has set up a number of Working Parties, which have produced reports on Hedge Funds and various regulatory issues, such as disclosure; but it has as yet made little significant impact.

The Basel Committee on Banking Supervision have put forward proposals for a new regulatory framework that has yet to be finalised. The proposals envisage that regulators would rely more on rating agencies and large firms' own risk management procedures, rather than (as at present) on standardised rules for the amount of capital required to back different types of loans. The danger is that both would be unduly affected by the waves of market optimism and pessimism that are a key contributor to such crises.

What is lacking is any recognition of the need to tackle the excessive leverage in financial markets — that is the ability to bet on a large gain or loss for a small stake by the use of borrowed money and the ever-growing varieties of derivatives. The need is to tighten up prudential regulation of bank lending for speculative purposes (e.g. by increasing the Basel capital backing requirements) and by the market authorities taking action to limit the speculative instruments available.

#### *Taxing financial transactions*

Another potential means of achieving greater stability in financial markets is the use of taxation on financial transactions to reduce the profitability of short-term speculation. The long-standing proposal to levy a tax on currency transactions (first put forward by James Tobin in 1971) is now receiving increasing attention as a means both of damping down speculation in foreign exchange markets and raising revenue for international purposes, such as development aid, environmental and health purposes. (It has recently been officially approved by the French Parliament.) A tax of 0.1 per cent on all such transactions has been estimated to raise over \$200 billion a year. Such a tax would not appreciably affect the profitability of speculating against changes of say, 10 per cent, in pegged exchange rates, but it would take some of the froth off the market, where currencies are floating, or managed flexibly.

Similar issues are beginning to emerge in the case of other financial transactions. The UK is not alone in levying stamp duty on share transactions, but the London Stock Exchange has been lobbying for its removal on the grounds that as such transactions can increasingly be conducted on the internet irrespective of location, business is in danger of gravitating elsewhere. The answer is not, however, for any

one country to abolish such a tax, but for them to get together and harmonise such taxes at a standard rate.

### *Managing exchange rates*

While the introduction of the Tobin Tax would help to reduce somewhat the volatility of foreign exchange markets, it would not tackle the fundamental weaknesses of the present regime of floating exchange rates. Whilst constantly shifting rates provide a source of profit for financial institutions, they are an essentially destructive force on industry. When a country's exchange rate becomes over-valued, as is the case with sterling at the present time, industries' competitive position deteriorates, plants close and workers are laid off — as we see in the motor, steel and many other industries at the moment. But, if and when, the exchange rate falls to a more competitive level, firms will be reluctant to expand and open new plant, because they have no guarantee that such conditions will continue — the risk is too great. Similarly between countries, the gains of the beneficiaries from under-valued rates are not commensurate with the damage done to the temporary losers. Volatile floating rates are fundamentally inconsistent with the growth of global industry. Multi-national firms cannot rationally plan new investment, or even short-term production, when they cannot tell where the relevant exchange rates will be in three months, let alone three years time.

Trying to re-establish the Bretton Woods regime of fixed rates is no solution. When adjustments were needed they were nearly always delayed and took the form of devaluation under crisis conditions. The flows of capital now are too large to make such a regime sustainable. Developing countries which have pegged rates to a major currency have experienced similar difficulties when they were under pressure. We must move towards a system, or systems, of managed, but flexible rates. In the present crisis, international co-operation on exchange rates should be encouraged. Initially this will tend to be largely informal, but the objective should be to work towards more formal arrangements with stated parities and bands that provide a basis on which industry can plan.

In considering the form these should take, we should learn certain key lessons from the ERM. The first is that the initial rates must be realistic and acceptable to all parties. The pound's entry to ERM at too high a level meant that our membership was inevitably doomed. The second lesson is that to facilitate the changes needed over time (eg. because of differing rates of inflation or the growth of productivity), such changes should be made in small steps and relatively frequently. For example,

rates might be reviewed monthly, and altered in steps of 1 per cent. This would ease the problem of getting agreement and cut down potential speculative gains. With a band of  $\pm 2.5$  per cent, an anticipated change in parity of 1 per cent would not necessarily mean any change in the spot rate the following day. The third lesson is that arrangements need to be made for automatic intervention to keep currencies within their stated bands. Rather than leaving this to *ad hoc* intervention by central banks, there should be a fund established for this purpose. Initially such a model might serve as a basis for a new ERM to manage the rates between the euro and the pound and the currencies of the other Outs .

Any approach to exchange rate management must be on a two-tier basis, with (varying) regional systems and a global system to manage the rates between them. As well as a new ERM, this would initially involve the development of a system in North and South America based on the dollar, but not tied rigidly to it; and a system in South East Asia based on the yen and the currency swap arrangements in the recent Chiang Mai initiative. The IMF should encourage, not as in the past discourage, such developments. The management of the rates between these three key currencies, the dollar, euro and yen (or the baskets of currencies around them) should be the task of an Exchange Rate Management Fund body under the IMF. The future of the IMF should be seen as that of ensuring the smooth running of the global financial system, not just bailing out countries in difficulties.

# 4

## Summary and conclusions

**The world economy is already slowing down and there is a danger that we may be entering a serious recession. It is vital that the major industrial countries should now adopt more expansionary policies and jettison the neo-liberal shibboleths of the last two decades. Inflation is no longer the dominant problem. The re-emergence of mass unemployment is now the major threat to economic and political stability.**

### *Contingency planning*

Economic forecasts are particularly uncertain at the present time. While it may be reasonable to suggest that any slow-down may be moderate, there is also a serious risk that it could be more severe. Governments should therefore be making contingency plans for more active domestic expansionary measures if the outlook deteriorates. At present only the US is showing signs of such action. It is quite wrong to suggest that because the chance of such a deterioration are 1 in 4 or 1 in 10, we should not be ready to cope with such an eventuality. In no field of activity, does the need for safety precautions disappear because it is not certain that an accident will necessarily occur.

### *Monetary policy*

The Federal Reserve has shown no hesitation in cutting interest rates and they have a formal remit including the maintenance of employment as well as price stability. The Bank of England and the European Central Bank have also shown a greater willingness to reduce interest rates than the fact that their remits were solely to maintain price stability might suggest. It would, however, be timely to broaden their objectives to include the maintenance of a high level of output and employment.

### *Budgetary policy*

It is doubtful, however, whether lower interest rates alone will provide an adequate stimulus to demand. Budgetary measures in the form of temporary tax cuts or increases in public expenditure are also likely to be needed. In the US there is already a major fiscal package under discussion in Congress. In the UK the Pre-Budget Report maintained existing revenue and expenditure plans, but contained no further measures to stimulate demand. Nor did it give any indication that the Treasury had any contingency plans to cope with the situation if the economy failed to live up to their optimistic projections. In the EU any expansionary fiscal measures are still being strongly opposed by the European Commission. The Stability and Growth Pact also rules out any action that would lead to increased budget deficits in

most countries. A major change in attitudes is needed if the European Union is not to run the danger of a serious economic crisis.

#### *Developing countries*

Any recession in the industrialised economies will have a major impact on the developing countries. It would reduce the volume of exports of both manufactured and primary products and lead to a fall in commodity prices. There is the added danger that a general lack of confidence in world financial markets would make any country in difficulties more subject to financial crisis. It is vital for the developing world that the industrialised countries take measures to maintain their own levels of activity.

#### *Crisis measures*

G8 finance ministers should take the lead in setting up a special committee of the IMF to deal with financial crises, on the understanding that they could call on the resources of the leading central banks, as well as the IMF, to take swift action in any major currency or banking crisis.

Consideration should be given to devising a commodity stabilisation scheme to help offset the impact of falling commodity prices on developing countries. A new fund might be set up to which industrialised countries would contribute part of the saving in their import bills from any fall in primary product prices. This would then be distributed to the developing countries affected.

#### *A new Bretton Woods*

There is an urgent need to press ahead with major reforms of the global financial system. It is to be hoped that recent events will act as a catalyst for intensified international co-operation in the economic, as well as other fields. The time is ripe for a new Bretton Woods Agreement.

The instability of capital movements, bubbles in share and property prices, and the volatility of exchange rates are all inter-related and need to be tackled on a wide front.

- Developing countries should be permitted to use exchange controls when threatened by an outflow of capital.
- Further consideration should be given to the imposition of small taxes on currency and other financial transactions to reduce short-term speculation.
- The present regime of floating exchange rates should give way to a new era of managed, but flexible rates. This would of necessity involve a two-

tier approach, with a number of (varied) regional systems, and global arrangements to manage the rates between them.

The present crisis will not be the only one in the coming years. As the economies of individual countries become more closely connected it is becoming increasingly vital to strengthen international economic co-operation and institutions working in this field. Now is the time to start.

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