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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

An Age of Anxiety in the Financial World

The month of September always produces a sense of anticipation in the international community as the United Nations holds its General Assembly in New York and the International Monetary Fund (IMF) and the World Bank hold their annual meetings in Washington. As Christine Lagarde stepped into the role of IMF Managing Director in July, she did not need a formal briefing to appreciate "it's a fine mess we're in" as Laurel and Hardy would doubtless have proclaimed. Set against an economic background of a stalled recovery with low growth and high unemployment in the United States, and risks to the viability of the Eurozone with a potential sovereign debt default scenario, Ms. Lagarde faces an age of anxiety in the financial world.

A sense of anxiety exists as to how global monetary and fiscal policies should be administered. Keynesian economic policies encourage programs of economic stimulus, but the dangers of global financial instability generate calls for financial discipline and austerity measures. Shakespeare's Hamlet understood the dilemma of choosing between whether to "suffer the slings and arrows of outrageous fortune" or to "take arms against a sea of troubles." It is overly simplistic to view Hamlet's dilemma as a choice between two courses of action rather than as an opportunity to embrace both options sequentially in carefully-measured proportions. In the world of realpolitik, views are more polarized in terms of choosing between the Scylla of economic recovery and the Charybdis of financial rectitude. To her credit, Ms. Lagarde recognizes that a carefully-conceived program embracing both stimulus-now and austerity-later is the optimal prescription for healing the financial afflictions of today's global economy.

In a speech to central bankers at Jackson Hole in August, Ms. Lagarde outlined her prescription for economic policies in the United States, Europe and developing countries. She called for several actions including: rebalancing global trade by stimulating demand in developing countries with large export surpluses; more aggressive mortgage relief in the United States; and giving job creation priority over deficit reduction in both the US and Europe. She also called for substantial injections of public and private capital into European banks. While acknowledging the necessity for long-term deficit reduction, she made clear that near-term policies must give priority to generating jobs, stimulating demand and renewing economic growth. For Europe, Ms. Lagarde recommended more financing for debt bailout plans, a concerted effort to strengthen vulnerable banks, and the need for a common political vision of the euro's long-term future.

Economic historians have taken recent opportunities to remind today's generation of policymakers about the lessons of the year 1937 in the United States. In 1937 an economic recovery from the troubles of the great depression was stalled by a too-early application of policies in response to a clamor for a return to perceived notions of financial rectitude, thus setting the stage for a double-dip recession. The lesson for today's generation of policymakers is that "timing is everything for economic policy."

Another speech on September 15 by Christine Lagarde at the Woodrow Wilson Center in Washington on *Global Economic Challenges and Global Solutions* provided a forum for an appeal to the legacy of Wilson in terms of the cause of multilateralism and the global fraternity of nations. Ms. Lagarde credited the Wilsonian vision with the powerful idea that cooperation on a global scale can bestow economic stability and a better future for all of mankind. She stressed that the role of the IMF is "to see and shine the light when the picture seems so dark." She called for a clear path to sustained recovery that requires strong political will across the world, with leadership over brinkmanship, cooperation over competition, and action over reaction. Ms. Lagarde identified the key components of current global economic problems as a short-run concern over balance sheet pressures in advanced economies with too much debt in the system, together with a longer-term issue of the potential for core instability with the risk of contagion as economic problems in one country can quickly reverberate across the global economy. Her vision for global solutions involves a combination of policies to repair, rebalance, reform, and rebuild various parts of the global economy and financial system. A first step is to mitigate the pressures on the financial condition of the balance sheets of sovereigns, banks, and households. A second step is to strengthen the foundation for future financial stability with a priority objective of implementing financial sector reform. The challenge to rebalance involves shifting demand from the public to the private sector as well as adjusting demand between nations with external deficits and nations with external surpluses. The other dimension to a global solution will require low-income countries to rebuild their economic policy buffers, including fiscal positions, to protect against future adverse scenarios.

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