

A call for leadership

Keynote speech: **New Challenges in a New Cycle**

Tuesday afternoon, 3 June 2008

Moderator: **Agnès Bénassy-Quéré**, Director, CEPPII, France
Rodrigo de Rato, Senior Managing Director, Lazard

The recent financial market crisis has triggered a new economic cycle characterised by weaker growth and higher inflation, including significant upward pressure on commodity prices that could be with us for some time. While weaker economic growth has not affected all economies equally, higher inflation is a global problem.

Rodrigo de Rato opened by noting that the global economy has embarked on a new cycle following several years of strong growth and low inflation. Although some aspects of the new cycle have earlier roots, it was generally speaking triggered by the credit crisis that developed from the summer of 2007 onwards, which has been followed by another surge in commodity prices that has exacerbated earlier price rises for oil and other commodities. Unlike most earlier financial crises, this one is affecting the developed world more than the emerging economies, although even these countries are unlikely to escape unscathed in view of the likely decline in world trade growth from 8.5% in 2006 to an expected 4.5% in 2008. Global imbalances have intensified, with reserves having become increasingly concentrated in emerging economies (which now hold around three quarters of global reserves). The US is suffering a sharp downturn, and may possibly tip into recession. So far, stronger exports have staved off a full-blown recession, but this may not last.

Financial sector problems have eased to some extent since the crisis began, but risk aversion remains substantial, as demonstrated by high interbank interest rates. Investment grade credit spreads have fallen from their peak, but are still high. Recent developments show that financial innovations in recent years have failed the market test. The rise in spreads shows the extent to which risk was mispriced prior to the crisis. Europe has so far suffered less than the US. Spain is suffering a real estate crisis, but bank reserves against bad loans are high. Aside from real estate, the US problem has not really transferred to Europe, despite some signs of a slowdown. Indeed, the IMF has recently revised up its European growth forecast. The increase in inflationary pressures represents a bigger problem for Europe.

Inflationary pressures are likely to be a key feature of the new cycle, for both developed and emerging economies. High global inflation places significant strains on monetary policy, especially for those central banks that are trying to hit both growth and inflation targets. Emerging economies have become more interesting to investors, fuelling capital inflows that are placing additional strains on monetary policy.

Dollar weakness is helping to stave off US recession, but is not without risks for other economies. These risks are asymmetric. European and emerging currencies have risen sharply, posing risks to growth. But for the dollar-bloc countries weaker exchange rates

are adding to inflation risks. In these circumstances, exchange rate flexibility is an important tool. Rising wages represent another inflation risk, as do speculative upward pressures on commodity prices.

High oil prices are partly due to demand pressures, but also reflect the low level of spare capacity and declines in supply in 2007. High prices have not encouraged higher production. Indeed, a surge of economic nationalism in many countries has resulted in less liberal energy sector investment regimes and increased uncertainties over supply.

In conclusion Mr de Rato noted that the world needs real leadership in a number of policy areas, and that this can no longer be just about leadership by industrial countries. Emerging economies must also take responsibility. There is an urgent need to finish the Doha round of trade negotiations. In addition, measures are needed to tackle price stability. Global imbalances have to be dealt with, and financial markets have shown themselves to be poor at financing them and therefore need to be reformed. Liberalisation of investment regimes is also needed, especially in commodity producing countries, where investment restrictions threaten to pose limits to growth.

The moderator, **Agnès Bénassy-Quéré**, posed a number of questions to the speaker, asking whether the emerging economies could remain immune to the financial crisis, in view of their dependence on US demand. The moderator also noted that low inflation in previous years was partly due to globalisation and the sharp increase in supply from low wage countries. With wages now rising in many of these countries and demand putting upward pressure on commodity prices, does that mean that globalisation is now an inflationary rather than a deflationary force? Finally, Ms Bénassy-Quéré questioned whether greater exchange rate flexibility in Asia first required the development of deeper, more liquid financial markets.

In response, Mr de Rato noted that there will be some spill-over to the emerging economies via trade ties, but also noted that rising wages in emerging countries meant that demand in the global economy was becoming less reliant on the US. Inflation is rising because demand driven growth has reduced spare capacity. He also agreed that rising wages would reduce the disinflationary benefits of globalisation, but that the rise in living standards was in any event a good thing. Further, he noted that external shocks are by their nature difficult to predict, and that flexibility is therefore important in dealing with them, and part of that is greater exchange rate flexibility. Moreover, Asia will find it hard to maintain weak fixed exchange rates and to develop its financial markets at the same time.

In questions from the floor, one participant questioned whether significant reforms to the financial system were required in order to stimulate investment in real agricultural and industrial development, rather than merely supporting financial investment. Mr de Rato responded by noting that reforms to the financial architecture were necessary, but that further discussion is required first, taking into account the views of emerging economies.

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