Suggestions for the new version of the "Astana Consensus"

By Domingo Felipe Cavallo[1] , May 7, 2012

This paper analyses in detail the first two of the five main priorities of the Mexican Presidency in G20 ("Economic stabilization and structural reforms as foundations for growth and employment"; and "Strengthening the financial system and fostering financial inclusion to promote economic growth") and suggests a change in one of the recommendations of the "Astana Consensus" 2011 that should be considered for the rewriting of the third priority ("Improving the international financial architecture in an interconnected world")

1. Economic stabilization and structural reforms as foundations for growth and employment

Macroeconomic stability within each country and in the global economy is a necessary condition for growth and employment. Structural reforms that create the incentives and remove obstacles to efficient investment in research, in physical capital and in human capital, thus encouraging an efficient allocation of resources worldwide, are also needed for sustainable growth and full employment.

Worldwide economic growth comes from applied scientific research that pushes up the technological frontier of humanity as well as from investment that applies across sectors and countries the available technology to produce goods and services. Growth creates employment opportunities for those workers that have the skills required by the most efficient available technologies. Investing in Human Capital to develop worker's skills is the key to maximizing the quantity and quality of employment.

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[1] as a proposal to update (not to replace) the "Astana Consensus" 2011

First recommendation**: Stabilize each national economy minimizing the negative spill-over effects of the national macroeconomic policies on the rest of the world.**

The stabilization policies implemented by national governments in small emerging economies, to the extent that are able to keep a low and stable inflation rate and facilitate sustainable growth generally do not produce any negative spillover effect on the rest of the world.

But in the case of reserve currency countries or regions, like the US, the Eurozone, Japan and the UK and also in the case or large emerging economies like China and India, the fiscal and monetary policies designed to tackle domestic problems may produce large spillover effects on the rest of the world, especially via large variations in nominal exchange rates and carry trade. To reduce the risk of transforming national stabilization attempts into "beggar thy neighbor" policies, monetary and fiscal authorities must take into consideration the impact of those policies on the exchange rate and try to keep the nominal exchange rate within some pre-established range of variation.

Second recommendation: **Countries with persistent current account surpluses should implement expansionary macro policies in order to increase domestic demand.**

The only way global imbalances will adjust without generating a global recession is if those countries with large and persistent current account surpluses implement expansionary macro policies that compensate for the recessionary effects of the unavoidable downward adjustments that the countries in deficit will have to undertake. Coordinated efforts in this direction are the best mechanisms to minimize the cost of correcting the global imbalances.

Third recommendation: **Countries with persistent current account deficits should reduce demand without affecting efficient investment in research, in physical and in human capital.**

The downward adjustment of aggregate demand in countries suffering large and persistent current account deficits are inevitable, but they should concentrate in consumption but should not affect investment in sectors that are crucial for preserving a rapid pace of growth. In the case of advanced economies it is crucial that investment in Research and Development is not reduced.

Forth recommendation: **Fiscal policy and structural reforms should be the main instruments used to try to shift the composition of expenditure in order to minimize the need to introduce wild swings in nominal exchange rates across national economies.**

Expenditure shifts from non-tradable to tradable goods and services do not necessarily come from nominal exchange rate changes. Alternatively, for example, unit labor costs can be reduced via lower taxes on the wage bill of firms combined with labor reforms that introduce greater flexibility in labor markets.

Fifth recommendation: **Advanced economies should emphasize investment in research and development of efficiency-improving technologies**.

The responsibility of the nations that have the scientific and technological networks to expand the technological frontier of humanity is to invest in research and development and to supply the technological services and capital goods that will make the new techniques available to the whole world. It is precisely in the production of these technological goods and services that advanced economies have a comparative advantage.

Sixth recommendation: **Every national economy should encourage the investment necessary to implement available technologies at the highest possible speed.**

Every nation of the world has the responsibility to invest in its human resources and in its infrastructure as to unleash the entrepreneurial skills of its people and to create the investment opportunities that will help to implement the most efficient available technologies in the production of the goods and services demanded by their population.

Seventh recommendation: **National trade policies and trade negotiations should target complete free trade of capital goods and technologies and, at the same time, each nation should reassure enforcement of Intellectual Property Rights Protection as already negotiated in the WTO.**

The institutions that try to provide global governance have the responsibility to identify and negotiate the removal of the obstacles to the free flow across national borders of technological knowledge, capital goods and financial capital therefore making investment for growth a continuously expanding process.

2. Strengthening the financial system and fostering financial inclusion to promote economic growth

Financial intermediation is needed because it provides payments services that are very necessary in modern monetary economies and arbitrages between savers that generate financial surpluses and investors that incur in financial deficits. However, during the last two decades financial intermediation evolved in a way that encouraged excessive leverage of families, firms and the financial intermediaries themselves.

The tax system, by discriminating against equity financing relative to debt financing for firms and by encouraging home ownership through mortgage financing has aggravated the trend towards generalized excessive leverage.

Although excessive leverage was in the origin of the global financial crisis of 2008, deleveraging has been one of the explanations for the slow pace of the post crisis recovery. In the future a strengthened financial system has to offer opportunities for financial inclusion of low income families and small and medium size enterprises on a sounder base and, at the same time, workout a generalized debt/equity adjustment to more sustainable and less risky levels. This will require improved financial regulation, recapitalization and restructuring of financial intermediaries and elimination of tax incentives to leverage.

First recommendation: **Reinforce the provision of payment services by the banking system in every country targeting complete inclusion of every family and business, no matter how poor, small or geographically remote they are.**

Payments through bank accounts and electronic means are the necessary first step for expanding financial inclusion and increased transparency and efficiency in the tax and transfers system that will allow governments to implement policies that aim at improving both, the allocation of resources and the distribution of income witin the national economies. For this reason the provision of a payments system has to be seen as a public good and justifies using fiscal resources the same way as government guarantees are used to protect people's savings when they are deposited in the banks.

The technological advances of the last quarter of a century in information technology have drastically reduced the costs of the provision of these public goods. Also, the other financial intermediation of depository banks should not compromise the effective extension of payments services and protection of savings of the people.

Second recommendation: **Promote lending based on prudent risk appraisal.**

The second most important role of depository banking should be the channeling of savings to the financing of households and firms based on a prudent risk appraisal. Increasingly efficient and inclusive electronic payments system provides valuable information on transactions, incomes and wealth of borrowers that should allow for an ever improving appraisal of risks and a more efficient intermediation between depositors and borrowers, particularly as additional services (deposits and loans) are offered to new client bases.

Third recommendation: **Reinforce the separation of the two main roles of depository banks from brokerage and intermediation in the capital markets.**

Financial intermediation between savers that are willing to purchase bonds or stocks and the firms that demand financing through the capital markets should be an activity separated from the other two basic activities of depository banks. This separation avoids risking the ability of the depository banks to perform their role of suppliers of payment services and financial intermediation between depositors and borrowers. Investment banks, the investment departments of depository banks, hedge and investment funds should be subjected to same regulatory requirements and have resolution procedures that protect tax payer's money.

Forth recommendation: **The Eurozone should have common regulation and supervision of financial institutions and national and regional regulatory and supervisory systems should be based in similar principles and concepts in order to facilitate the coordination and avoid regulatory arbitrage.**

Legislation on financial regulation and supervision should have the same territorial scope as that of the Central Bank and should be similar enough as to prevent regulatory arbitrage. The BIS and the Financial Stability Board should continue working to propose principles and concepts that will help to make national legislation compatible with that of other nations, very open to capital movement and well-integrated into global financial markets.

Fifth recommendation: **Tax treatment of interest payments and dividends by corporations should be similar as to avoid inducement of excessive leverage and discouragement of equity financing.**

Increasing participation of equity financing for both financial and non-financial corporations is a necessary condition for a smooth transition of undercapitalized banks and excessively leveraged non-financial corporations to well capitalized banks and corporations in general. To induce the increased participation of equity financing it is necessary to reconcile financial and tax regulations as to avoid reciprocal neutralization of incentives.

Sixth recommendation: **Tax incentives to encourage home ownership based upon mortgage financing should be eliminated and eventually replaced by up-front subsidies to increase the down payment by eligible households.**

Upfront subsidies for increase the down payment of families eligible for subsidized housing programs instead of deduction of interest on mortgages will avoid excessive leverage by families and reduce the risk of defaults and foreclosures.

Seventh recommendation: **Financial inclusion of low income families and small and medium size companies should be facilitated by improved sources of information on their**

transactions and sources of income and not by relaxation of the rules governing risk management.

In addition to the increased informational content associated with electronic payments the best way for governments to promote financial inclusion is to organize efficient data bases on the sources of income and labor history of families and firms that are still excluded from financial services. This information would allow banks identify potential new clients.

3. Improving the international financial architecture in an interconnected world

The recommendations of the Astana Economic Forum 2011 to the G20 on the reforms of the International Monetary System, the International Financial Institutions and the Financial Sector that conform the "Astana's Consensus" are very comprehensive and relevant. It would help to reiterate them in a summarized way during next meeting to take place in México. However, there is one change I would suggest:

Consider replacing recommendation 6 on the chapter on Reform of the Financial Sector by the following: **The tax on international financial transactions across monetary areas should be considered as a source of revenue earmarked to the recapitalization of banks and for the purpose of covering the losses Central Banks will eventually incur in when they are asked to perform the role of lender of last resort of banks and sovereigns.**

The aggravation of the financial crisis in Europe and its political consequences have demonstrated that Central Banks will have to be much more active in acting as lenders of last resorts not only of banks but also of sovereigns, in line with the way the FED has been acting since 2008. The financial institutions will need funds for recapitalization that at least initially will have to come from taxes.

Tax payers of solvent nations will oppose the use of their money to finance recapitalization of banks and risky lending of last resort to nations in crisis. The tax on international financial transactions, in addition to reducing the velocity with which liquidity can be moved across national borders, may generate enough revenue to cover for the fiscal cost of the efforts necessary to maintain financial stability and offer sovereigns in crisis enough time to recover their solvency through fiscal consolidation and structural reforms.

The tax on international financial transactions will, in addition, reduce the incentives to conduct carry trade and will, therefore, reduce the spill- over effects of expansionary monetary policies of monetary areas that need to expand liquidity into monetary areas that need to cope with monetary pressures.