MENA ECONOMIC OUTLOOK:
ISSUES & CHALLENGES
FEBRUARY 2009

Dr. NASSER SAIDI
CHIEF ECONOMIST
DIFC AUTHORITY

FISCAL RESPONSES

- *Any fiscal response should be commensurate with the shock experienced.* avoid an unnecessary or excessive fiscal response
- Policy makers need to coordinate monetary and fiscal interventions.
- *Fiscal expansions need to be sustainably financed. TO AVOID DEBT MONETIZATION AND A DEBT CRISIS*
- Only governments with strong fiscal positions and large reserve stocks are well placed to undertake a successful fiscal response to the crisis.
- ENSURE THAT FISCAL RESPONSE RESULTS IN PRODUCTIVITY GAINS AND ARE REVERSIBLE: crucial to ensure that long-run fiscal and debt sustainability is not jeopardized by a countercyclical spending increase. China’s successful fiscal expansion in response to the East Asian financial crisis of 1997–98 spent heavily on infrastructure projects for which there was strong local demand.
- *Fiscal expansion must be timely but not rushed. To minimize the potential for waste and fraud, policy makers should not rush into new and untried public spending projects.*
- *The success of a fiscal expansion depends greatly on how it is delivered. In a deflationary environment, increases in spending on public projects will generally be more effective at stimulating aggregate demand than tax cuts or direct transfers to households, which tend to be saved rather than used for consumption*

FINANCIAL MARKET FAILURES

- **Policy responses to the financial crisis have shaken the confidence of the development community in the financial and macroeconomic policies underpinning Western capitalist systems.**
- The turbulence was triggered by a sudden and widespread loss of confidence in securitization and financial engineering and by the failure of respected statistical models for assessing and pricing credit risk. These now-doubtful techniques had previously been hailed as the cornerstones of modern risk management. Moreover, the turbulence proved greatest in countries whose supervision of credit risk had been thought to be the best in the world. Indeed, these countries' regulatory standards and protocols were being emulated worldwide.
- Systemic financial fragility stems instead from a web of contradictory political and bureaucratic incentives that undermines the effectiveness of financial regulation and supervision in every country. Weaknesses in supervisory incentives encourage modern safety net managers not only to tempt financial institutions and their customers to overleverage themselves in creative ways, but also to close their own eyes to the unbudgeted costs of the loss exposures that excess leverage passes on to financial safety nets until it is too late to control the damage that results
- ultimately the goal of financial regulation and supervision is not to reduce financial institutions' risk taking but to manage the safety net so that private risk taking is neither taxed nor subsidized. This goal implies that supervisors have a duty to see that risks can be fully understood and fairly priced by investors. No
- First, crisis preparedness is important to avoid short-termism in crisis management. Accountability would be greatly improved by requiring that regulators establish and regularly test a well-publicized benchmark plan for crisis resolution.
- Second, regulators need to draw on market signals to overcome information problems and improve their ability to track risk in and out of crisis.
- Third, the safety net needs to be strengthened by making authorities more accountable for its cost.

POLICY ISSUES

- • Are blanket guarantees inevitable to halt a systemic crisis?
- • Should governments bail out and own financial institutions?
- • Should governments regulate finance much more aggressively given the failures in market discipline?
- • Should monetary policy target asset prices?
- • Should countries resort to capital controls to contain the crisis?
- To be effective, regulatory reforms must improve the chain of incentives under which market discipline and official supervision operate. Reform proposals usually address the structure of regulation but not the incentive structure of regulators, which is likely to limit the effectiveness of the reforms.
- Two objectives for monetary policy: price stability and financial stability.
- Attempting to achieve two objectives with one instrument is not a promising strategy. A second instrument is needed for financial stability, and the best option is a prudential regime capable of dampening financial cycles of boom and bust. This is primarily a task for financial regulation. An important pillar of such regulation is the establishment of capital requirements that can automatically be adjusted over the business cycle, providing incentives for financial intermediaries to hold more liquid assets in good times so that they can be run down in bad times.
- Despite their inherent fragility, financial systems underpin economic development. The challenge for financial sector policies is to align private incentives with public interest without unduly taxing or subsidizing private risk taking. Public ownership or overly aggressive regulation would simply hamper financial development and growth. But striking this balance is becoming increasingly complex in an ever more integrated and globalized financial system.