Hopes and Ambitions for Key Sustainability Dimensions in 2030

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I recently wrote an article called "The four horsemen of the apocalypse", suggesting that our economic/financial, political, environmental and public health systems are all under significant stress potentially leading to total breakdown. These systems are nested within each other so that a failure in any one system could cause the others to fail. The conclusion I reached is that we must act urgently to fix the weak spots in each.

This will be a huge task. First, we have to identify what **should** be done, in particular the tradeoffs. Policies that might stabilize one system could easily destabilize another. For example, a big carbon tax to deal with climate change might push up inflation, setting off a cumulative process of wage-price increases that could easily get out of hand. Resisting this through monetary policy could also set off a debt crisis. In addition, there will be the question of what **could** be done. Do governments or agencies have the powers to do what should be done. Sadly, many of the problems (climate and pandemics) are global and demand global solutions but we do not have a global government with the requisite powers. Finally, there is the **would** problem. Would government have the will (courage) to bring in the sweeping changes required if the voting public is too short sighted to see that these changes are in their own best interests? As Jean Paul Juncker said, when head of the EU Commission, " Of course we know what to do. What we don't know is how to get re-elected after we do it."

Alex Barkawi has asked me to consider the particular role that reform of the financial system, and its governance, might play in supporting sustainability more broadly. I was initially rather sceptical, but I know recognize that finance is actually very special. Virtually all real transactions in a market economy have a financial transaction associated with them. By influencing the financial side of a transaction, we can influence the real side. In effect, financial considerations can "nudge" the system towards the outcome we want. To paraphrase something Jeremy Stein of Harvard said a few years ago, "Finance gets in to all the cracks"

Let me focus first on the sustainability of the financial system itself, before going on to how financial considerations might be used to promote sustainability in other systems. Today, the principal threat to economic and financial sustainability is the overhang of debt. Global debt ratios have risen continuously since the 1980s and problems now affect both advanced and emerging markets. Debt is not bad in itself,

but it becomes unsustainable if the debt has not been used to increase potential output and thus the wherewithal (actual output of goods and services) to service that debt.

Compared to the current system, what would a sustainable financial system look like?

1. The financial system would finance much more real investment and much less consumption.
2. The rate of return on prospective investments would reflect the positive externalities associated with certain kinds of investment (eg Green infrastructure and early childhood education).
3. Finance for investment would rely more on equity (and risk sharing) and less on debt issue and higher leverage.
4. The financial system would facilitate both the entry of new firms (without collateral) and the exit of unviable firms (fewer zombies)
5. Monetary (and fiscal) policies would be conducted more symmetrically to prevent debt levels from ratcheting up over time and interest rates ratcheting down.

What needs to be done to "get there from here"?

1. We need a paradigm shift in how we think about policy issues. We need to accept that the financial system (and the economy more generally) is a complex, adaptive system with "tipping points" . Knowing that "quick fixes" could lead to an eventual tipping point, we should give much more attention to longer term outcomes than we do. The omens here are not good. Governments are continuing to rely on more debt to solve short term problems. Moreover, consider the spread of booster shots in AME's rather than first shots in EME's. The politicians are again protecting "our people" from a near term threat, even though this increases the threat of viral mutations elsewhere and huge dangers to "citizens everywhere" over time.
2. We need to deal with the debt overhang problem. The current thinking is that easy money, combined with fiscal stimulus, will jump start growth and we can "grow" our way out of the debt problem. This is possible, but very unlikely. There are in fact many underlying changes likely to lead to slower growth (climate change, deglobalisation, demographics, declining TFP etc) and perhaps rising inflation as well. If inflation rises and interest rates rise, the whole debt structure could tumble. Alternatively, we should use structural reforms to increase growth (eg encourage older and woman workers into the labour force). As well, we need better procedure for explicit debt restructuring, even if your pension fund (and mine) might not like it.

A financial "nudge" might support sustainability objectives in other systems as well. For example, could financial regulations and central bank instruments (of which there are now many) be used to help support inclusion and help deal with climate change? Since I am running out of time, I would recommend that you read or reread the excellent CEP paper by Alex and Simon Zadec called "Governing Finance for Sustainable Prosperity". It is largely about how central banks and regulatory authorities might widen their mandates beyond price stability and financial stability (respectively). I would make only two points.

1. As noted in their paper, both central banks and financial regulators have changed their principal objectives many times over the course of the years. There should be no reason for them not to do so again, if changing circumstances (and threats) demand it.
2. However, there is a clear and present danger to be avoided. Governments might then be tempted to say that the problems of inclusion and environmental change had now been dealt

with by “independent” agencies. This would allow politicians to avoid making the tough policy decisions (like higher carbon taxes) that were actually required of governments. If this were the case, then expansion of central bank and regulatory mandates might actually prove counterproductive. The issue is one of balance between perceived benefits and perceived risks.