PART 6: Are new system-wide accords needed to promote rebalancing or to discourage persistent imbalances?

23 Global governance: Pre and post crisis

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The global economy is operating with little room for error. This chapter warns that, while it may be natural for countries to look inwardly in these circumstances, this would be a big mistake. The global economy is too inter-connected across borders to be subject to national solutions. Indeed, proper global coordination and governance must play a critical role.

The global economy is resetting after the traumatic 2008-09 financial crisis that shook the banking system, disrupted growth, raised unemployment, and increased tensions among and within countries. The crisis exposed big gaps at virtually every level of national societies – from individuals that bought homes that they could not afford using exotic mortgages that they did not understand; to firms that had inadequate risk management systems, poor incentives and partial disclosures; and to governments that failed in their regulatory responsibilities and prudential supervision.

These consequential breakdowns occurred in multiple national jurisdictions – most critically in the highly finance-dependent economies of the UK and US. Yet they do not constitute the whole story. They were also accompanied by amplifying failures at the global level. More than ever before, the crisis exposed the damaging inadequacies in the governance of a global system that has become highly interdependent and lacking in prudential redundancies and circuit breakers.

In contrast to the national level where large parts of society were caught unaware by the extent of the underlying vulnerabilities, recognition was less of an issue at the global level. After all, there were many analyses of the persistent and well publicised payments imbalances, unfair country representation at the international financial institutions, and the general legitimacy deficit in global governance. There were, and continue to be concerns about an international exchange rate regime with a mixture of floating and managed exchange rates with little effective oversight of the collective interests.

High recognition did not give way to meaningful action until the global financial crisis imposed a "sudden stop" on trade, contaminated economic activity and fuelled a surge in joblessness. The global reaction that followed was instrumental in avoiding a global depression. And rather than be coordinated through the long-standing mechanisms of the G7 and the IMF, this crisis management brought to the fore a relatively new grouping – that of the G20 –

which involves a more sensible representation of both industrial and emerging economies.

Notwithstanding this critical success of the global crisis *management* response – and despite the even more evident prior failures in global crisis *prevention* – the focus on better global governance is already dissipating. National and, in the case of Europe, regional issues are again becoming much more dominant; and not only in absolute terms but also in a fashion that is undermining recent gains at the global level.

If this phenomenon continues – and it will continue if left to its own devises – it will reverse some of the achievements and make the resetting of the global economy an even bumpier, lengthier and more partial process. The result will be a global economy that retains an important element of instability that, regrettably, will again prove problematic over the medium-term.

The purpose of our chapter is threefold. First, to summarise the manner in which failures at the global level contributed to the financial crisis; second, to show how the subsequent enthusiasm for globally coordinated policy responses has already given way to conflicting national and regional initiatives; and third, to explain why, in the absence of corrective steps, weak global governance will remain a hindrance to medium-term growth and financial stability.

Global governance in the run-up to the global financial crisis

It is widely recognised today that many factors contributed to the global financial crisis. One of these multiple factors was the persistence of global imbalances – the seemingly endless willingness and ability of surplus countries to run persistent surpluses, and of deficit countries to run persistent deficits.

This "willingness" was a reflection of national beliefs that the status quo was in the interest of individual countries, be they in surplus or in deficit.

Among the surplus countries, led by China, the initial driver was a desire to accumulate large stocks of international reserves for prudential (self insurance) reasons. This was soon overtaken by the reality of how a dynamic net export orientation facilitates massive job creation, income generation and poverty alleviation.

In the deficit countries, led by the US, it was hard to resist the temptation to maintain consumption well above levels warranted by national income generation. This was particularly the case when appreciating asset prices appeared to be continuously increasing the wealth of households, businesses, non-profit institutions and even governments.

How about "ability"? Two elements were in play here which asymmetrically impacted surplus and deficit countries: first, the ability to control one's destiny and, second, the ability to change course.

Surplus countries maintained much greater ability to maintain their chosen course. Unlike the deficit economies, they did not need to rely on others to fund consumption. And the longer the imbalances persisted, the greater the improvements in their international financial balance sheet.

By contrast, deficit countries relied on external borrowing to cover the inadequacy of their internal savings and, with time, incurred a growing cost of servicing that part of the debt. The extent of their reliance varied depending on whether they could borrow in their local currencies, how far they could extend maturities, and their overall stock of debt.

There were also variations across countries in the extent of net borrowing by households and governments. For example, in the USA, both rose rapidly in the run-up to the crisis. The same was true of the UK and Spain. Many other EU countries, however, did not experience a significant expansion of household debt.

The ability to change course was also material. It was not easy. At the very root of the analysis, the persistence of the imbalances reflected structural – and not just pricing/exchange rate – issues. As such, policy adaptations faced complex design and implementation challenges. The socio-political narrative required considerable attention which was mostly lacking or badly handled. Moreover, as tends to be the case with structural reforms, short-term political considerations often clashed with the required longer-term economic and financial re-orientations.

This combination of willingness and ability factors fuelled growingly unstable conditions at both the national and the global levels. Too large a range of activities was enabled by a system that lacked the needed national and international infrastructures. The system built to a critical state. It was like a mound of sand: incremental grains went from growing the mound into an imposing shape to suddenly demolishing it in a disorderly fashion.

By early 2007, the growing excesses were starting to give way to instability. Initially, the cracks were within specific sectors at the national level (e.g., the subprime segment of the US housing market). But the combination of deep-rooted excesses and poor circuit breakers fuelled a morphing crisis that first went national, then global. The world witnessed a cascading series of market and policy failures, resulting in the major global financial crisis that put large segments of populations at risk, and the world on the verge of a great economic and social depression.

At that stage, policy makers scrambled, adopting a "whatever it takes" mode. The policy response abandoned careful planning and conventional tools in its well-intentioned attempt to stabilise the situation at any cost. And policymakers had no choice but to risk a combination of collateral damage, unintended consequences, moral hazard, incentive mis-alignments and eroding the long-standing integrity of key institutions.

The global response – effectiveness

As policymakers gathered in Washington DC in early October 2008 for the Annual Meetings of the IMF and World Bank, they quickly recognised that their national narratives were echoing around them. It became evident that they were all in the midst of a major global crisis. And it also became clear that this global crisis required a global response.

This global response essentially came in two steps. The first, which was led by the UK at the October Annual Meetings, involved a coordinated multi-country approach to stabilising the banking system and, within that, the functioning of a range of funding mechanisms. The second, which emerged from the April 2009 meeting of the G20 in London, involved a multi-country effort to arrest the collapse in economic activity using massive fiscal and monetary policy stimulus.

Both policy reactions were successful. The banking system slowly regained its footing, helped by massive injections of capital, guaranteed borrowing and steep yield curves. Funding markets started to normalise. However, the sheer size and distributional aspects of bailing out the banks left a large residue of anger that impacted political outcomes, with consequences for subsequent reform directions.

On balance, we suspect that this historical episode will be viewed as an impressive example of economic global coordination. A lot of it was designed on the fly. The catalyst was a sinister crisis that was morphing from bad to worse. And, particularly when it came to substance, the response essentially bypassed the long-standing institutions that had stood for years at the centre of the international monetary system (most notably the IMF and the G7) – illustrating once again that the global architecture was in need of urgent reform.

The question then turned to whether, having emerged in the crisis, global coordination could also prevail in the post-crisis phase. Could such coordination help clean up the collateral damage and the unintended consequences of the emergency measures; and could the coordination develop deep institutional roots that would ensure perseverance and long-term effectiveness?

The global policy response – dilution

Unfortunately, it did not take long for national and regional considerations to dominate once again. This was most evident in the US and in Europe.

Pushed by internal political pressures, the US and certain European authorities announced a series of policy measures that effectively pre-empted the discussions that were taking place at the multilateral level. Examples included US announcements on the taxation, the regulation of banks, and financial sector reform. They also included the country's bilateral dealing with the Chinese on exchange rate policy, and the low interest rate monetary policy that complicated the management of capital flows, asset prices and inflation in a range of countries.

Some European countries also moved independently. Witness the initiatives to regulate hedge funds and, in the case of Germany, the dramatic announcement on the banning of naked short selling.

For sure many of these items were on the agenda of the G20. Yet, when push came to shove, national authorities showed little interest in working through the collaborative mechanisms that had worked so effectively in the immediate aftermath of the global financial crisis.

All this led to more than just recriminations and heated multilateral discussions; it also sent confusing signals to the markets and to businesses, providing an additional headwind to investment activity and, more generally, the sustainable level of final private demand needed to make a meaningful dent in the high unemployment rates prevailing in many industrial economies.

Europe had an additional problem. The collateral damage from the 2008-09 “whatever it takes” policy responses manifested itself in the form of huge budgetary deficits that the weaker members of the Eurozone could no longer fund in an orderly fashion. Greece was the poster child, having run persistently high deficits even before the global financial crisis. Portugal also faced market pressures.

Spain did not enter the crisis with huge fiscal deficits. But it soon became evident that its fiscal situation was tentative, the product of a leveraged-fuelled real estate bubble whose collapse caused government revenues to fall and social insurance payments to rise. A difficult lesson relearned in many countries and subunits is that financial and economic imbalance cause fiscal imbalance; and fiscal issues can quickly translate into pressures on the banking system.

Facing a quickly-amplifying crisis of its own, Europe’s policy response was dramatic, albeit less than sufficiently effective. It involved agreement on large fiscal stabilisation funds, a complete turnaround in the ECB’s attitude towards asset purchases, and a series of national announcements on fiscal austerity.

Interestingly, this dramatic response was formulated at the regional level, with little global coordination. This was most vividly illustrated by the initial strong aversion expressed by European policymakers to having the IMF involved in regional issues – a stance that was reversed in a humiliatingly public fashion. Indeed, Europe went from insisting that it needed no IMF help to counting on the institution for over $200 million of the $1 trillion “shock and awe” package aimed at safeguarding and stabilising the Eurozone and the Euro. Europe also looked to the IMF for technical expertise in managing the conditionality of the package.

It mattered little in Europe that the IMF was in no position to pre-commit such an amount to a region. It mattered little that the issue had not been properly discussed by the Board of the IMF which represents its 186 member countries. And it mattered little that the announcement went against the long-standing principle that the IMF treats its individual member countries on a case-by-case basis and adopts a uniformity of treatment when it comes to assessing financing needs and policy conditionality.

Europe’s initial exclusion of the IMF, followed by its co-option, sent a signal that goes beyond the subservience of global considerations to national and regional ones. It also highlighted the persistence of representation and legitimacy deficits in global governance.

Looking forward

The global financial crisis demonstrated that our globalised world has reached a level of international connectivity that far exceeds the reach of national policies and the effectiveness of the global architecture. It also demonstrated the extent to which the system as a whole lacked the redundancies and circuit breakers that underpin a degree of systemic resilience.

Initially, the crisis forced national governments to coordinate their policy responses and to abandon representation mechanisms that made sense 60 years ago but no longer do so today. Yet the post crisis period is already seeing a dilution in this trend toward greater cooperation.

Should we worry about this reversal and can something be done? Yes and yes.

The post-crisis world involves a multi-year resetting of the global economy. Elsewhere, we have likened it to journey, on an uneven road, through unfamiliar territory, and to a new destination. Importantly, this "bumpy journey to a new normal" is being undertaken with most of the spare tires having already been used up, resulting in a very limited capacity to accommodate any additional market accidents and policy mistakes. Political accommodation is also an issue given the trend towards greater polarisation and anti-incumbency.

Post-crisis we are looking at a world of more muted growth in industrial countries, re-regulation, partial financial de-globalisation (as a way to diminish the impact of disruptive financial transmission channels) and, more generally, a shift in the balance between unfettered markets and government involvement. It is also a world where systemically important emerging markets can probably maintain their development breakout phase provided they are properly accommodated within the international financial system.

The restoration of growth in major emerging markets to near pre-crisis levels has been extraordinary. Further, because of their size and expanding share of the global economy their growth can make the inevitable transitions and frictions, including those in the industrial countries, less costly.

This type of world urgently needs a steady hand at the helm of global governance. Yet, as argued above, the trend is going the other way.

What can be done to reduce this important weakness?

First, the G20 needs to succeed in addressing its two main challenges: (i) coordinated financial regulatory reform and (ii) restoring and rebalancing global demand. Its main supporting institutions in these efforts – namely, the BIS, the FSB, and the IMF – need to be more effective. They have to be, and must be seen to be governed in a way that is consistent with the evolving economic and financial standing of the participants – the global economy of today and tomorrow, rather than that of yesterday.

Second, politically, for the international agenda to get the attention it urgently deserves, a pattern of sustained growth needs to be restored and unemployment brought down in the industrialised countries. Some of this requires patience as the de-leveraging process has further to run. Trying to accelerate that process by over-using the government wallet will negatively impact an already risky drift toward fiscal imbalance and sovereign debt risk in the industrial countries, and ultimately damage growth. Accordingly, governments must do a much better job at communicating to their citizens the reality, and the related multi-year programs to improve the outlook.

Third, major emerging economies need to become more comfortable with their increased global responsibilities, including accepting their roles in helping to manage the international economic and financial systems, and engaging more forcefully in the reform processes referred to above. Because this comes at stages of development where per capita incomes are still very low by historical standards, this will not be easy. A delicate and sophisticated balancing act will be required between purely domestic growth and development agendas, and international priorities.

Fourth, restoring balance to the global economy and maintaining it along with growth requires structural change in many economies, industrial and emerging. International policy coordination efforts need to reflect this reality and the timelines that are implied.

As part of that effort, exchange rate regimes need to be brought back into the sphere of international coordination. The present configuration dating back to the 1970's came from a shift away from managed exchange rate regimes toward floating rates and market determined outcomes in the industrial countries. That was never workable in the developing world where exchange rates have generally been managed for years. This latter group is now larger and the hybrid system is breaking down and adding to potential instability.

The present configuration is a diverse set of unilaterally determined approaches to the exchange rate interspersed with periodic bilateral negotiations and threats. The result is inevitably likely to be suboptimal uncoordinated equilibria. The system needs to be rebuilt with a view to accommodating the growth, development and structural adjustment goals of all countries.

Fifth, the EU governance structures are broadly acknowledged to require institutional reform. As one of the two largest economies in the world, its stability and that of the Euro have important global implications. While views on the right direction for reform vary, there is agreement that a stable common currency requires fiscal discipline. The shared and deep interest in fiscal discipline is simply inconsistent with complete fiscal decentralisation.

That was recognised in the original Maastricht rules. Whether these rules and oversight procedures can be modified so as to accommodate responses to shocks, structural adjustments and countercyclical policies while maintaining discipline is rightly subject to analysis and debate. The alternative is a greater degree of fiscal centralisation with questions about the political feasibility of moving in that direction.

Concluding Remarks

The global economy is at a critical juncture. It has emerged from the 2008-09 financial crisis weaker, and still subject to a lengthy process of resetting and rebalancing. It is operating with little room for error, at a time when unemployment in industrial countries is unusually high, the credibility of the banking system is very low. Moreover, public debt and deficits have exploded, and the credibility of central banks is being questioned.

It is natural for countries to look inwardly in these circumstances. Yet this would be a big mistake. The global economy is too inter-connected across borders to be subject to orderly national solutions. Proper global coordination and governance must also play a critical role.

The run-up to the global financial crisis and the subsequent crisis management process carry important lessons about global governance. Sadly, it appears that some of these lessons are already being forgotten, and others are being negated. Let us hope that this pattern is changed so that the global economy may reduce the probability of even more economic and financial volatility in the years ahead.

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