A global formula for tackling the global crisis

With policymakers increasingly aware of the dictum "never waste a good crisis", OECD's Deputy Secretary General ***Pier Carlo Padoan*** *sets out his proposals for global architectures that would create a more resilient world economy*

Most crises are drivers of change because they are deep and prolonged, they often lead to the breakdown of key mechanisms and so create the need for new ones. The crisis that started in the U.S. sub-prime mortgage market is the most severe in eight decades and is also truly global. When it is over, the international economy will never be the same again.

The crisis has destroyed the fundamentals of the so-called "Bretton Woods II model" (BWII) on which global growth has been based for the past decade or so. In our BWII world, excess savings in emerging economies, including oil producing ones, were reinvested in the centre of the system, for the U.S. economy was considered the "safe haven" *par excellence*. Now the crisis has destroyed the credibility of the centre and, with it the main engine of growth and the financing of growth. It is highly unrealistic, not to say unthinkable, that in the foreseeable future the main engine of global growth will still be U.S. household demand, fuelled by sophisticated but opaque financial instruments.

Growth will resume after the global recession but it will most likely be a structurally lower growth. More important, global growth will be driven by several engines rather than by a single one, and each of these engines will be less powerful than the one that has collapsed, as well as partly disconnected from the others. Household demand in the U.S. will be partly replaced by American exports that are driven by a weaker dollar, and also by the still powerful U.S. productivity engine. It remains to be seen if U.S. investment and innovation will be able to generate, at least in part, a productivity cycle as long and intense as the one that lay behind the "new economy" of the 1990s.

Now the question on many lips is whether the BRICS will move into the driver's seat of the world economy and become global engines of growth? Long-term projections usually place China, and India much less so, as the top economy 20 to 30 years from now. But most of these projections extrapolate for the future a scenario that is not there anymore; a relatively stable world economy in which global markets are open, economic integration continues to progress and there is major crisis. The key question, therefore, is how it will be possible to maintain such a scenario. A post-BWII economy will have to be based on two pillars – more domestic demand in emerging economies and more "investment integration" globally.

On the first pillar, emerging economies both large and small will sooner or later have to face the challenge of their own internal transformations because domestic demand will have to be given more space so export-led growth will be less relevant. This sort of transformation will need to be accompanied by, and will quite possibly need to support high and sustained growth rates, necessary conditions for these countries to raise the standard of living of the large part of their populations who are still below the poverty line. Needless to say, such a transformation will be even more demanding politically than economically.

As for the “investment integration” pillar, the BWII model has been dominated by the debate on global imbalances. Excess investment in the U.S. led to America’s growing current account deficit, while excess savings led to the accumulation of the reserves in many emerging Asian economies and in oil-producing countries. The scenario that worries countries like China is the risk that their reserves will lose value because of the U.S. dollar’s depreciation and/or capital losses in the U.S. treasury market. The request for reform of the international monetary system and the creation of an alternative reserve currency to the dollar proposed of late by top Chinese officials reflects this very real concern.

But this is only a part of the story. A look at gross rather than net capital flows shows that while China exports capital that is invested in U.S. financial markets, it also imports capital from the U.S. and elsewhere that adds to its physical, knowledge and human capital resources. China has become a fast-growing base for international R&D and a key component of global value and innovation chains, which could not have taken place without a massive inflow of capital from the world’s advanced economies. Much the same can be said of India and a number of other Asian economies. A more sophisticated interpretation of the BWII growth model therefore suggests that the massive investment of Chinese reserves in U.S. Treasury bills is a way of providing “collateral” so as to attract the levels of investment from American and other multinational companies in China that are essential to sustaining its high per capita GDP growth. This interpretation also highlights the idea that China sees its own best interest in the long-term profitability of its invested resources, not in short-term gains. Of course, this works both ways, as China increasingly values long-term capital outflows as can be seen in the increasingly important role of its Sovereign Wealth Funds. These, in China as in other emerging economies, are instrumental in directing huge reserves towards long-term investment and thus boosting the long-term growth rate.

A sustained long-term growth rate of the Chinese and other Asian economies is fully consistent with a post BWII model where stronger growth in emerging Asia would compensate for lower growth in the U.S., especially if increased productivity growth in China is accompanied by a gradual slackening of the Chinese propensity to save. This largely reflects structural rather than short-term factors as the high saving propensity of Chinese households reflects the need to counter the absence of social protection. And the high saving propensity of companies reflects the inadequacy of China’s domestic financial sector, which has led to high levels of retained profits.

What about Europe? Europe during the BWII years has been a slow-growth economy, and could grow even more slowly in the future. The massive use of fiscal measures to deal with first the last year’s financial emergency and now with the recession is loosening fiscal disciplines and will make the sustainability of long-term debt more difficult still, as is also the case in the U.S. More flexibility in the application of the EU’s Stability and Growth Pact is welcome and needed, but there is a risk that the credibility it has earned over the past decade could quickly vanish. On the other hand, a long-term European growth strategy based on a revamped and “green” Single Market as well as the Lisbon Agenda for competitiveness has yet to be implemented to any large extent.

In a post BWII scenario, we could and should see smaller global imbalances, and especially smaller current account deficits and surpluses in the U.S. and China respectively, but we could also possibly see larger gross capital flows between the world’s main economic regions. These flows would transfer both physical and knowledge capital and thus drive productivity growth on a global scale. This would be all the more so if climate-related and green technologies are transferred much more than at present. But to be really effective, these gross flows would have to be complemented by flows of goods and services whose role in a knowledge-driven economy is essential. Open markets will be more important than ever.

No international system works without the appropriate economic governance and institutions, so the big question is: what international institutions will we need to support a post-BWII world?

The post-crisis response led by the G20 includes a commitment to major reform of the IMF and a strengthening of the Financial Stability Board (formerly the Financial Stability Forum). The IMF has already received substantial additional resources, and its governance is to be reformed to give more room to the emerging economies. It will also carry out, together with the FSB, the enhanced monitoring of systemic stability. The FSB is leading the reform of the regulation and supervision of the financial system, even though it still remains to be seen whether this will lead to a truly global framework. All this is welcome, but it is not enough.

The post-BWII world should be based on more open economies and on stronger long-term capital flows. For this to happen we need a “global investment regime” based on shared regulation and standards related to investment activity so as to complement the FSB’s sound “financial regime” and the IMF’s stable “macroeconomic regime”. Investment will go where there is a transparent relationship with governments and where the cost of doing business is low, where sound corporate governance prevails, where there is no corruption, where reliable and possibly cheap skills are available, where a level playing field does not discriminate against foreign companies, where competition policy lowers barriers to entry and supports innovation and where a free flow of goods and services complements investment flows.

But such a regime does not yet exist globally, and an agreement between all major economies, both developed and emerging, on all these points still needs to be established. Such a regime would require an institutional framework to update and monitor rules and standards that are shared by all the major players. In other words, what is needed for the post-BWII world is an enlarged and reinforced OECD, for the OECD is the only international organisation that brings together all the expertise needed for a global investment regime to operate effectively, whether alone or in collaboration with other international organisations. The present-day OECD would clearly have to expand its membership to all major emerging economies so that a new regime can be built on a shared view of the post-BWII world. The response to a global crisis requires truly global institutions.

Pier Carlo Padoan is Deputy Secretary General of the Organisation for Economic Co-operation and development (OECD). PierCarlo.PADOAN@oecd.org

END