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Reshaping the Global Economy

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The economic and financial turmoil engulfing the world marks the first crisis of the current era of globalization. Considerable country experience has been accumulated on financial crises in individual countries or regions - which policymakers can use to design remedial policies. But there has not been a world financial crisis in most people's living memory. And the experience of the 1930s is frightening because governments at that time proved unable to preserve economic integration and develop cooperative responses.

Even before this crisis, globalization was already being challenged. Despite exceptionally favorable global economic conditions, not everyone bought into the benefits of global free trade and movement of capital and jobs. Although economists, corporations, and some politicians were supportive, critics argued that globalization favored capital rather than labor and the wealthy rather than the poor.

Now the crisis and the national responses to it have started to reshape the global economy and shift the balance between the political and economic forces at play in the process of globalization. The drivers of the recent globalization wave - open markets, the global supply chain, globally integrated companies, and private ownership - are being undermined, and the spirit of protectionism has reemerged. And once-footloose global companies are returning to their national roots.

So what role has globalization played in the genesis and development of the crisis? how is the global economy being transformed? And what are the possible policy responses? These are the key questions we address in this article.

More than regulatory failures

At the start, many analysts failed to grasp fully the character of the crisis. The focus was almost exclusively on market regulation and the supervision of financial institutions, whereas little attention was devoted to the root global macroeconomic causes of the crisis. Indeed, as late as November last year, when the Group of Twenty (G-20) leading industrial and emerging market economies issued a communiqué at the end of an emergency meeting in Washington, D.C., the main focus was on failures in regulation and supervision and, correspondingly, the remedies were considered to be of a regulatory nature - hence the long G-20 agenda.

Partly, this was because the expected crisis did not occur: there was no precipitous depreciation of the U.S. currency, nor a sell-off of U.S. Treasury bonds. But the truth was that, however real the microeconomic failures, their effect would have been much more contained absent the insatiable appetite for AAA-rated U.S. assets. It was the combination of strong international demand for such assets, largely in connection with the accumulation of current account surpluses in emerging and oil-rich economies, and an environment of perverse economic incentives and poor regulation that proved to be explosive (see F&D, June 2008).

However, the complex interrelationships in the global system helped mask how it operated, and for a long time there was a collective failure to grasp fully the link between global payments imbalances and the demand for safe (or seemingly safe) financial assets and the manufacturing of those assets (Caballero, 2009). Discussion at the international level was further complicated by political overtones: ever since Ben Bernanke's 2005 "global savings glut" hypothesis, the United States has insisted that the key macroeconomic problem in the world economy was not its current account deficit, but rather China's high propensity to save.

A second related mistake dates to the early stages of the crisis. It was hoped, until autumn 2008, that economies immune from the direct fallout of the subprime crisis would sail through the storm with sufficient strength to pull along the entire world economy.

There were some superficial grounds for this "decoupling" view. According to the IMF, U.S. banks suffered 57 percent of the financial sector losses on U.S.-originated securitized debt, and European banks suffered 39 percent, but Asian institutions took only a 4 percent hit (IMF, 2008). This explains the simultaneous drying up of liquidity on the interbank markets in Europe and the United States in summer 2007 and is consistent with a degree of transatlantic financial integration far more intense than between any other pair of regions (Cohen-Setton and Pisani-Ferry, 2008). Thus, the subprime mortgage–related clogging of the banking system, and the resulting credit crunch, were mainly a U.S.-European phenomenon.

But it is now apparent that growth is declining sharply in all regions of the world. The decoupling hopes were put to rest on September 15, 2008, with the bankruptcy of Lehman Brothers and its consequences for capital markets. Vividly represented by the IMF's "heat map" of the crisis (Blanchard, 2008), emerging and developing markets were almost immediately hit by the sharp rise in risk aversion and the resulting sudden stop of capital inflows. The shock was especially severe for capital-importing countries, notably in Central and Eastern Europe, where it compounded preexisting imbalances and prompted calls for IMF assistance. But it was severe also for those that had accumulated foreign exchange reserves, such as Korea. The channel of transmission here was net capital flows rather than capital market integration in the form of gross external assets and liabilities (some of these countries held almost no U.S. assets or mainly held treasury bonds, whose value has increased in recent months). Net private capital flows to emerging economies had dwindled at end-2008 and are now projected to be $165 billion in 2009, 82 percent below the 2007 level (IIF, 2009). Once again, the high volatility of international capital flows has been a powerful factor in crisis contagion.

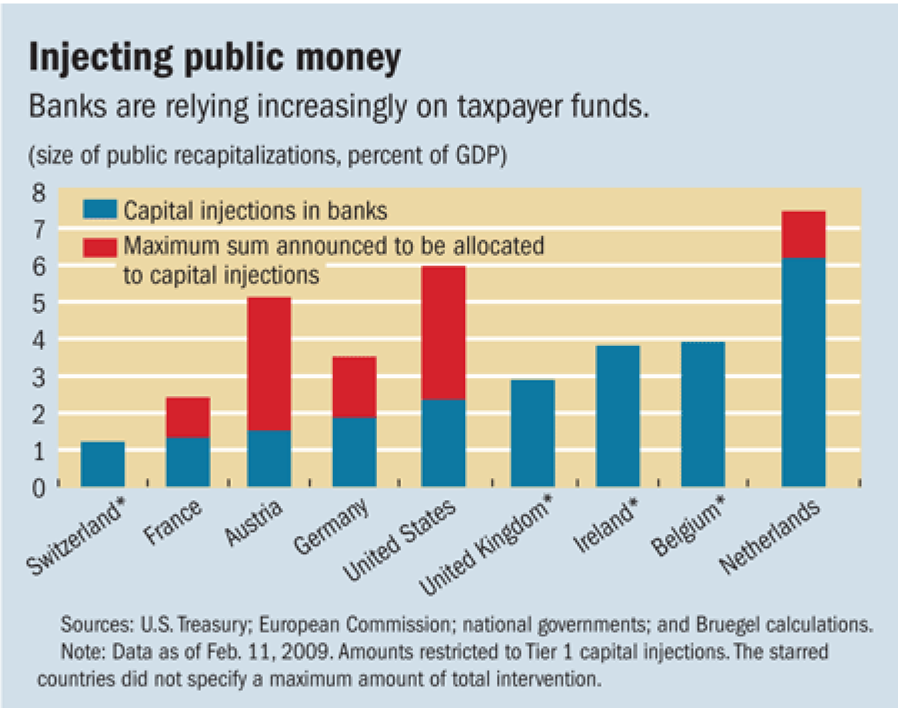
Finally, trade was bound to be a major channel of transmission for East Asia, whose combined exports to North America and Europe amount to a staggering 12 percent of the region's GDP. This was enough to make decoupling an illusion. Trade has not only been a vector of contagion, but an accelerator. Figures for end-2008 show world trade and industrial production declining in tandem at double-digit rates. Several Asian countries have seen their exports fall by 10 to 20 percent year on year. It is not possible yet to disentangle what can be attributed to a fall in demand and the adjustment of inventories and what is the result of clogging of trade finance. What is clear is that the contraction of international trade is both a channel of transmission and a factor in the acceleration of output contraction.

Beyond the specifics of shock transmission, the crisis has exposed that, in spite of regional integration and the emergence of new economic powers, the global economy lacks resilience. After all, the losses on subprime and Alt-A mortgages that set in motion the dramatic deleveraging process amounted to some $100 billion; in other words, just 0.7 percent of U.S. GDP and 0.2 percent of world GDP—a trivial amount by any standard. With the world economy now having succumbed to recession, the questions are what toll it will take on globalization and how national economies and international organizations can manage the ongoing changes.

Globalization: reshaping or unmaking?

The crisis has already started to affect the drivers behind rapid globalization in recent years—private ownership, globally integrated companies, the global supply chain, and open markets.

To start with, public participation in the private sector has increased significantly in the past few months (see chart). Of the 50 largest banks in the United States and the European Union, 23 and 15, respectively, have received public capital injections; that is, banks representing respectively 76 and 40 percent of pre-crisis market capitalization depend today on taxpayers. Other sectors, such as the automobile and insurance industries, have also received public assistance. Whatever the governments' intention, public support is bound to affect the behavior of once-footloose global firms.



Second, this crisis challenges globally integrated companies. Economic integration in the past quarter century has been driven largely by companies' search for cost cutting and talent. Yet globally integrated companies were first put to the test early on in the crisis, with the collapse of banks that acted across international borders. Once-mighty transnational institutions were suddenly at pains to identify which government would support them. In some cases, governments responded cooperatively—as in the case of Belgium and France with Dexia Bank—but other cases ended in a breakup along national lines—as with Fortis, a Belgian-Dutch lender and insurer. This not only made clear that the existing supervision and regulation systems were inadequate for this transnational company model, but also showed that only national governments had the budgetary resources required to bail out financial institutions. Public aid risks turning global companies into national champions. Today, no CEO of a firm that has received public support would echo the words of Manfred Wennemer (CEO of Continental, a German tire maker): when justifying layoffs at the company's hanover plant in 2005, he said: "My duty is to my 80,000 workers worldwide" (The Economist, May 18, 2006).

Third, national responses to the crisis can lead to economic and financial fragmentation. There is initial evidence that as governments ask banks to continue lending to domestic customers, credit is being rationed disproportionately in foreign markets. This was what happened recently when the Dutch government asked ING Bank to expand domestic lending while reducing its overall balance sheet. Because companies in emerging and less developed economies depend largely on foreign credit, this leaves them especially vulnerable to financial protectionism. Furthermore, government aid—driven by a legitimate concern with jobs—often, implicitly at least, shows preferences for the local economy. The French bias toward domestic employment in its auto industry's plan, the U.S. "Buy American" provision in the stimulus bill, and U.K. Prime Minister Gordon Brown's now infamous "British jobs for British workers" slogan are but a few examples.

Last but not least, despite the G-20's commitment last November not to increase tariffs, these have gone up since the start of the crisis in several countries, from India and China to Ecuador and Argentina. This follows a similar move one year ago when export restraints were introduced as countries tried to isolate domestic consumers from increasing international food prices.

It is hard to say whether these changes are merely short-term reactions to a major shock or amount to new and worrisome trends. At the very least, the balance between political and economic forces has been significantly altered. Because political support for globalization was at best shallow while the global economy was in a buoyant state, this suggests the pendulum is now swinging in the opposite direction. Against this background, two lessons from history are worth keeping in mind. One, dismantling protections takes time. It took several decades for many of the trade barriers erected during the interwar period to be brought down. Second, even if a significant part of the progress in liberalizing trade in recent times has been institutionalized and strong reversals à la 1930s are not likely, the downward spiral of protectionism acts fast.

Taken together, these risks pose a significant challenge for global integration. This is true also at the regional level. Economic divergence is rising within Europe, and cooperation within East Asia has been limited to say the least, in spite of the violent shock affecting the region.

No doubt, global governance and the economic landscape will emerge from this crisis reshaped. The main test remains fostering international cooperation at a time when there is a big temptation to look for solutions at home. It is in deeper multilateralism, rather than in nationalism, that many of the answers to the current challenges lie. But what exactly should global actors and national governments do?

The policy agenda

The evidence suggests that reforms of the regulatory and supervisory frameworks are only part of the answer. At its next meeting in April, the G-20 needs to turn to a broader set of issues that includes trade, financial integration, and macroeconomic policies. Furthermore, policy cooperation at the global level requires an adequate institutional framework; for this reason, the reform of international financial institutions is once again bound to be on the menu of discussions. Therefore, we suggest a five-point agenda, with the first three issues referring to global trade and the macro agenda and the last two to tasks for the international financial institutions.

Preserve trade integration. There is an urgent need to avoid actions that can make the crisis and the contagion worse. The November G-20 commitment to “refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing WTO [World Trade Organization]-inconsistent measures to stimulate exports” is clearly insufficient. From increases in applied tariffs, subsidies, and biased public procurement to mandated bank lending to domestic customers and pressures on manufacturing and services companies to preserve jobs at home, the G-20 commitment leaves many routes to protectionism wide open. Instead, governments in the G-20 should agree on a code of conduct that establishes which rescue and support measures are acceptable or not in times of crisis (whether they affect trade directly or indirectly) and entrust the WTO and the Organization for economic Cooperation and Development with the policy monitoring task. Similar provisions should apply at the regional level.

Design national stimulus programs and aid packages that support globalization rather than undermine it. Governments should take stock of plans made at the G-20 November meeting to foster global recovery through stimulus packages, and review the size and adequacy of efforts announced so far. International cooperation in this field is by nature delicate because, as bluntly stated by an Irish minister, “From Ireland’s point of view, the best sort of fiscal stimulus are those being put in place by our trading partners. Ultimately these will boost demand for our exports without costing us anything” (Willie O’Dea, Minister of Defense, in the Irish Independent, January 4, 2009). Packages announced so far vary greatly in terms of size and content and, even when they do not include any distortionary measures, many tend to favor supply measures in industries with high local content, such as infrastructure. This is perfectly legal and, to a certain degree, inevitable because governments are accountable to national taxpayers who want to benefit from the injection of public money. But it is not efficient because the tradable goods sector is (with construction) the one most affected by the crisis. As a stopgap measure, the G-20 should agree on a set of principles concerning the content of national stimulus and support packages and include their potentially most distortionary elements in the code of conduct proposed above.

Avoid exchange rate policies that trigger external instability. In a deep recession, the temptation to export unemployment through beggar-thy-neighbor exchange rate policies inevitably arises. Fortunately, this has not yet been the case on a significant scale, but for the future, the G-20 should reaffirm the need to avoid such measures and ask the IMF to carry out real-time exchange rate monitoring and report infringements immediately. This principle was agreed in 2007, and it is of particular relevance in the present context.

Build confidence in multilateral insurance rather than self-insurance. There is an urgent need to avoid the recessionary combination of drying-up capital flows to emerging and developing economies and an accumulation of large foreign exchange reserves. The danger is very real. Most emerging economies have been suffering from a sudden stop of capital inflows (or capital flow reversals) with dire consequences, especially in Central and Eastern Europe—the one region of the world that had until recently relied on foreign capital to catch up. Moreover, the lesson many may draw from the crisis is that there is a need for even more reserves to self-insure against such events. This would imply, including in Asia where reserves are already high, a widespread move toward current account surpluses at the worst possible time—an international “paradox of thrift.” Moreover, in addition to contributing to the crisis by fueling excess demand for U.S. financial assets, reserve accumulation is an individually costly and collectively inefficient way to protect against crises stemming from a lack of confidence in multilateral insurance through international financial institutions, especially the IMF. Rather, there is a need to rebuild confidence in the system. The level of resources this requires and the best combination of multilateral and regional insurance needed to achieve this goal are legitimate topics for discussion. There is no reason for the combination to be uniform across regions, but, whatever the form, it would result in significant capital savings.

Make international financial institutions more representative of current realities. The recent reform of quota and voice at the IMF has evidently not been sufficient to create or recreate the needed ownership in the emerging and developing world, which is why further governance reform should be on the agenda. The G-20 has mandated that ministers prepare proposals to reform international financial institutions, including giving greater voice and representation to emerging and developing economies. This indispensable change—which in practical terms implies a reduction in the number of European seats and the renunciation of the U.S. veto power—will be easier to achieve if the debate over power redistribution is put in a broader context (as suggested above).

The tasks ahead for the G-20 are thus daunting, but the G-20 is the appropriate venue for dealing with them. Admittedly, many of the items in the November 2008 declaration were primarily the responsibility of the countries or regions with the most sophisticated financial markets. In contrast, ensuring that in the short term the crisis does not result in economic fragmentation and that international trade and finance do not become powerful engines of economic contraction requires a wider forum, such as the G-20. If the G-20 governments are able to successfully link to existing international institutions and rely on their analytical capabilities, it could mean the transformation of the crisis into an opportunity for a stronger and more legitimate governance of globalization.

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