Policy Analyses 11-01

Changes in the International Economic Order after the Global Financial Crisis

Edited by *Bokyeong Park and Barry Eichengreen*

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The global financial crisis of 2008 exerted a huge impact on the world economy which is still suffering from its aftermath. Both advanced and emerging economies explored various policy measures to recover from the crisis. The crisis not only led to sharp fluctuations in the global business cycle, but probably induced changes in numerous areas of the world economic order. Specifically, changes are presumed to have taken place in the balance of economic power between advanced and emerging countries, global economic governance, international trade and financial environments. It is highly interesting and meaningful to examine those overall changes and predict their future direction.

Against this background, the Korea Institute for International Economic Policy (KIEP) has decided to launch an international research project to investigate the post-crisis changes in the world economic order. The project was planned and spearheaded by Dr. Bokyeong Park (KIEP) and Professor Barry Eichengreen (U.C. Berkeley), and this book is the final outcome. I'd like to express my deep appreciation to the two co-editors and authors of this book. I would also like to thank Jisun Lee, the researcher at KIEP for taking on the responsibilities of correspondence.

The papers in this volume illustrate that the crisis already led to substantial changes in the world economic order. Furthermore, they suggest that the final direction of the changes is yet to be observed because the aftermath of the crisis such as the European fiscal crisis remains unresolved. The task for the Korean economy is to properly adjust itself to the changed global economic environment. It is my hope that this volume serves as a useful reference for the task.

December 2011
Wook Chae
President, KIEP

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1

Introduction

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The global credit crisis of 2008-9 was the most serious shock to the world economy in 80 years. It was for the world what the Asian crisis of 1997-8 had been for emerging markets: a profoundly alarming wake-up call. By laying bare the fragility of global markets, it raised troubling questions about the operation of the 21st-century world economy. It cast doubt on the efficacy of light-touch financial regulation and, more generally, on the prevailing commitment to economic and financial liberalization. It challenged the managerial capacity of institutions of global governance. It augured a changing of the guard, pointing to the possibility that the economies that had been leaders in the global growth stakes in the past would no longer be leaders in the future.

Given that the 2008-9 crisis was first and foremost a *financial* crisis, it is appropriate that analysis should start in Chapter 2 with Nicolas Véron's assessment of the causes of recent financial problems and the successes and failures of post-crisis financial reform. The mainstream narrative emphasizes impetuous deregulation in advance of the crisis and a swing back to re-regulation in its wake. Véron offers a more nuanced view: he argues that the traditional separation of macroeconomic and financial policies – the "Tinbergen principle" of assigning monetary policy to the maintenance of price stability and regulatory policy to financial stability – is part of what caused the crisis, and that the development of a synthesis, which flies under the flag of "macro-prudential" or "macro-financial" policy, points the way to a solution.

But the devil is in the details. How exactly macroeconomic and financial policies should be harmonized to ensure financial stability without undermining the efforts of the monetary-policy authorities to hit their price-stability target remains to be determined. The question of how to regulate and, in the worst case, resolve large cross-border financial firms has barely been touched. The international coordination of financial reform has been inadequate; with different countries and regions adopting different approaches, there is the danger of conflicts leading to fragmentation of the global financial space – in other words, there is a risk that the fruits of financial globalization, such as they are, will be lost. Finally, and most importantly, the implications of new regulations and procedures for economic growth remain imperfectly understood.

Another striking aspect of the crisis was the abrupt collapse of international trade, which declined even more precipitously than the production of goods and services. Why the impact on trade was so dramatic continues to be debated. There was the collapse in the demand for consumer durables, which bulk large in international transactions. There were disruptions to the supply of trade credit. There was the growing importance, by the standards of the past, of far-reaching and often fragile international supply chains.

Then there was the protectionist response, described by Simon Evenett in Chapter 3. A few governments responded to the crisis and recession with overtly protectionist policies, but more important, Evenett's data suggest, was "murky protectionism" defined to include not simply import tariffs, quotas and export taxes but also subsidies, bailouts, preferential public procurement practices, and other policy supports only indirectly related to trade. The good news, such as it is, is that is that only 11 nations implemented discriminatory measures covering more than a quarter of the possible product categories. This is in contrast to the Great Depression, when many countries imposed to barriers on imports across the board.

Multilateral disciplines, notably those to which governments commit when becoming members of the World Trade Organization (WTO), are widely cited as preventing countries from resorting to a protectionist response. Evenett questions this contention. While no country violated its tariff bindings at the WTOs, governments in fact resorted to a variety of other discriminatory measures that were not, in practice, covered by WTO disciplines. Evenett suggests that other factors, such as the opposition of multinational firms to measures that augured disruptions to trade, were a more important source of restraint in practice. Still, if WTO disciplines are not as effective as typically assumed, then the multilateral trading system may not be as robust as the conventional wisdom would have it. Evenett concludes by warning that prudent policy makers should prepare for this possibility.

The global crisis also deepened disenchantment with the structure and operation of the international monetary system. It was already a commonplace that a system in which the U.S. dollar enjoyed the "exorbitant privilege" of providing the vast majority of global foreign exchange reserves was dangerously prone to imbalances. The crisis then highlighted these risks. Official foreign purchases of U.S. treasury and agency securities, by central banks and governments seeking to accumulate reserves, rendered U.S. treasury rates lower than they would have been otherwise and thereby contributed to Federal Reserve Chairman Greenspan's famous bond-market "conundrum." Low treasury rates encouraged investors, stretching for yield, to move into riskier instruments. This fueled the housing boom and the securitization market, permitting the United States to crawl further out on an unstable financial limb. Then, in the ultimate injustice, the dollar actually strengthened when the crisis struck, as foreign central banks and governments desperate for liquidity scrambled into dollar-denominated assets.

While this much is clear, less obvious is how to remake the system to avoid such problems in the future. In Chapter 4 Barry Eichengreen sketches likely future trajectories for the international monetary arrangements. He is dismissive of far-reaching reforms ranging from a regime based on

Special Drawing Rights on the one hand to restoration of a gold-based system on the other. But he is equally skeptical about the viability of a dollar-centric monetary system like that of the recent past. The remaining option being a system organized around several national currencies – not just the dollar but also the euro and the Chinese renminbi, the question then becomes how to ease the transition to such a system and to smooth its operation once it arrives. Eichengreen concludes that reforms of national policies, of multinational institutions like the International Monetary Fund, and of regional arrangements will all be needed in order to achieve this.

Among the notable long-term consequences of the crisis has been the emergence of the Group of Twenty (G20) as the de facto steering committee for the world economy, displacing earlier advanced-country-centered groupings, notably the Group of Seven/Eight (G7/8). When with the collapse of private demand it became necessary to organize a coordinated fiscal response, it was clear that a group in which emerging markets like China were not represented would not do. The emergence of the G20, which better reflects the composition of the 21st century world economy, was one concrete consequence of the crisis. In a structural sense it was also perhaps policy makers' most important achievement.

But, institutionally, the G20 remains a work in progress. As Ignazio Angeloni explains in Chapter 5, it has no permanent staff or written constitution. It has no global mandate; why it includes the countries it does reflects the particular historical process out of which it emerged. The details of how the G20 will work with multilateral organizations such as the International Monetary Fund and Financial Stability Board when additional problems arise remain to be determined.

Angeloni argues that the G20 would be strengthened by measures to enhance its legitimacy; its membership could be harmonized, for example, with that of the Executive Board of the IMF. More could be done to ensure continuity as the chairmanship rotates from one country to another, by inter alia establishing a multi-year work program and a permanent steering committee and secretariat. Most of all, the G20 requires a shared vision of what needs to be done to stabilize and strengthen the functioning of the world economy. At the time of writing, consensus on the important issues of substance – such as reform of the international monetary system, of which Eichengreen writes in Chapter 4 and which putatively dominated the work program of the G20 in 2011 – is notable by its absence.

As the growing prominence of the G20 reveals, another consequence of the crisis has been to enhance the weight of emerging markets in the world economy. Their economies held up best in the face of the shock, and they continue to grow robustly. Eswar Prasad in Chapter 6 marshals a number of indicators showing just how fast the emerging markets of East Asia, South Asia, Latin America and Africa have grown and how importantly they now figure in the world economy.

At the same time, as Prasad explains, these countries face serious challenges in the post-crisis environment. Stagnation in the advanced countries is a challenge for their traditional strategy of export-led growth. Very different economic conditions in emerging and advanced-country regions imply different monetary and financial policies, in turn producing large and disruptive capital flows. As emerging markets as a group become large relative to the world economy, their policies become even more important determinants of global economic outcomes. Hence the governments of what are still relatively poor economies will have to acknowledge and act on the fact that they have effectively become stewards of the world economy.

Where Prasad considers emerging markets, broadly defined, in Chapter 7 Bokyeong Park focuses more closely on the challenges facing the emerging markets of East Asia in particular. The global crisis of 2008-9 and, more recently, financial turmoil in Europe had relatively little impact on East Asia's fast-growing economies. To be sure, the region saw an abrupt decline in exports in 2009, but the substitution of domestic demand in the form of government spending and, in the Chinese case, bank lending to the construction sector helped keep growth going in the face of this external-sector weakness. Asian countries had limited exposure to the subprime market in the United States, and they had accumulated ample reserves which they could now deploy to keep imports flowing. Aside from a few cases like South Korea, where banks had substantial offshore foreign currency exposures, the temporary shortage of dollar liquidity had little impact on their financial markets. The emerging markets of East Asia, it was increasingly asserted, had successfully decoupled from the advanced-country world.

Park asks in his chapter whether this will remain the case going forward. As global liquidity strains rose again in the latter part of 2011, a number of East Asian currencies weakened substantially, highlighting the region's continuing dependence on external financial conditions. International reserves, having risen steadily, reversed direction as central banks intervened to support their exchange rates. China, having ramped up bank lending in 2009 and encouraged local governments to borrow, now has less capacity to respond to additional shocks, given now heavier debts and the prospect of nonperforming loans going forward. The inflation associated with previous policies of stimulus is, increasingly, a problem. All this heightens the urgency of rebalancing from foreign to domestic demand as a way of reducing the vulnerability of East Asia's emerging markets to external shocks. This in turn makes it disturbing that most of the region's economies, and above all China, have not moved faster to develop their financial markets, strengthen the domestic safety net, and permit the exchange rate to strengthen faster and fluctuate more freely.

But if the challenges that emerging markets will face in the new post-crisis environment will be formidable, they pale in comparison with those that will confront the advanced economies. The advanced economies as a group emerged from the crisis with large budget deficits and heavy debts. Winding down those deficits without derailing recovery and damaging the prospects for growth will not be easy. Deleveraging by households raises doubts about whether consumer demand will be able to substitute for public demand as fiscal consolidation proceeds. All this takes place against a gloomy demographic backdrop that implies rising old-age dependency ratios, heavy pension obligations and health care costs, and a declining share of the population participating in the labor force.

Joseph Gagnon and Marc Hinterschweiger take up these issues in

Chapter 9. They frame their analysis around a number of distinctions. In the short run, there is the distinction between the countries of Southern Europe that face severe immediate fiscal challenges and other advanced countries that still enjoy unprecedentedly low interest rates. In the medium term there is the distinction between countries with more and less favorable demographic outlooks, which in turn point to different prospects for the growth of health-care and pension costs. But, notwithstanding these differences, medium-term fiscal challenges are daunting across the advanced-country world. Under any plausible projection of the evolution of macroeconomic variables, current policies are not sustainable. Difficult decisions are unavoidable.

Gagnon and Hinterschweiger acknowledge the existence of major uncertainties clouding the forecast. Prominent among them are the likely future cost of health-care technology and the scope for delivering health services more efficiently. Also uncertain are the appetite of investors for government bonds and the likely future path for interest rates. Finally, there is uncertainty about the pace of growth in the advanced economies – about whether that capacity has been permanently impaired by the financial crisis and about whether technical change has been slowed by a "Great Stagnation." But even under optimistic assumptions, current policies if maintained will result in the explosive growth of public debt and, sooner or later, fiscal crises.

The authors chart a number of paths along which debt-to-GDP ratios stabilize at sustainable levels and crises are averted. The requisite adjustments are straightforward in economic terms: they involve a combination of reduced discretionary spending, increased in current revenues, and reductions in the growth of health care and pension costs. But timing is everything; Gagnon and Hinterschweiger show that costs of adjustment are substantially lower when that adjustment is initiated early than it is delayed. And the politics, unquestionably, are fraught.

The global financial crisis has cast a long shadow. It has profoundly affected the advanced economies, emerging markets and the balance between them. The implications for the international trade, the monetary and financial system, and global governance are far reaching. Drawing out those implications and beginning to comprehend what they mean for the future is the task we take up, collectively, the remainder of this volume.