Challenges for the Future of the Global Economy

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Seven key challenges

- Recovering from the global slowdown
- Addressing global imbalances
- Creating a more stable global financial system
- Creating a new global reserve system
- Creating a new global financial regulatory system
- Addressing the problems of global warming
- Devising a better system of global governance

Globalization Perspective

- Our economy has become global; globalization has increased our interdependence
- Yet decision making remains at the national and sub-national level; economic globalization has outpaced political globalization
- We focus on benefits/costs to ourselves, with insufficient attention to effects on others (externalities)

- This was manifest in run-up to crisis
  - America exported its toxic mortgages around the world, contributing to financial problems elsewhere
  - Iceland’s inadequately regulated banks caused problems in U.K. and Netherlands
- At moment of crisis, there was an awareness of need for global cooperation
  - But that moment has passed

- Expansionary fiscal measures (stimulus packages) bring benefits to trading partners
  - But countries focus only on expansionary effects at home, and balance those benefits with cost of increased debt
  - Global multipliers larger than domestic multiplier
- Beggar thy neighbor policies result in benefits at expense of neighbors
  - Buy America provisions in stimulus
  - But WTO limited extent of protectionism
  - Competitive devaluations
  - Exchange rates are like negative beauty contests
  - US was winning; now Europe is

- In run up to crisis, there was a race to bottom in regulation—in attempt to attract financial sector
  - Everybody was the loser
  - But same concerns are playing a big role in debates about regulatory reform

Recovering from the global slowdown

- Will be slow
- Too soon for most countries to exit from unusual measures
  - But unfortunately, that seems the direction of policies in many countries
- And will be made slower by Europe's shared austerity
  - If Greece alone cut back, global effects would be limited

Global imbalances

- Problems exacerbated by large surpluses on the part of a few countries—producing more than they are consuming and contributing to lack of global aggregate demand
- G-20 framework (US consume less, China consume more) unlikely to solve problem
  - China already expanding consumption rapidly
  - But spending is not going to goods produced in the United States
  - World cannot survive if everyone consumes in profligate manner as the US

Creating a more stable global financial system

- Exchange rates highly volatile
- Financial and Capital market liberalization/deregulation has exacerbated problems, especially for developing countries
- And facilitated the transmission of the crisis from the U.S. around the world
- Financial markets did not perform as promised
  - Innovations created risk—didn't manage risk
  - Developing countries still have to bear brunt of exchange rate and interest rate risk
    - Failed to transfer risk from those less able to those more able to manage it

Response

- Better financial regulation
- Taxing speculative activity
  - Consistent with principle that it is better to tax externalities (like pollution) than good things (like work and savings)
  - In fact, some parts of the financial sector has received massive subsidies, bailouts, that have contributed to its become over bloated

Euro instability

- Likely to contribute to global instability in the near future
- Euro took away two critical adjustment mechanisms (interest rate, exchange rate)
- But did not replace them with anything
- Need a European solidarity fund for stabilization

- Current discussion are not leading to a long term effective solution
  - Shared austerity will weaken Europe and the world
  - Problem was not inadequate enforcement of budget rules
    - Spain had a surplus before the crisis
    - Can be quick turnaround in fiscal position

A new global reserve system

- Makes little sense for global financial system to be so dependent on the currency of a single country
  - Especially in a multi-polar world
  - And especially as confidence in U.S. economy is weakening
- Current system contributes to instability, weak aggregate demand, and is unfair
  - Every year, hundreds of billions of dollars are set aside as "precautionary savings" (reserves)
  - Poor countries are lending to the U.S. at low interest rates (and sometimes borrowing back at much higher interest rates)

- Increasing support for a new global reserve system
  - UN Commission
  - China, other countries holding reserves
- Well designed system could also be used to finance climate change, meet other global needs
- Old idea—Keynes advocated it 75 years ago
  - But it is an idea whose time has come

Creating a new global financial regulatory system

- Finance is global, and without a global regulatory system, there is risk of arbitrage, circumvention
- Basic principles clear: transparency, incentives (not to engage in excessive risk taking), restraints (against excessive risk taking, including through derivatives), structures (like Glass Steagall, Volcker rule, to reduce scope for conflicts of interest, excessive risk taking, etc) and consumer/investor protection

- But power of banking lobby, especially in US, too strong to get adequate regulation
  - Though Goldman Sachs, through its various exposed practices proved best lobbyist for reforms
- Each country has a responsibility to protect its own citizens and economy
  - Global coordination being used as a delaying device
  - Each country adopt its own protective rules
  - Then a period of harmonization

Addressing the problems of global warming

- Global warming is an example of a global public good—all will be affected
- There is an imperative to cut back on emissions
  - We have only one planet
  - And risk of current strategy too large
- The only question is how to share the burden

Two approaches

- Coordinated carbon taxes
- Cap and trade
  - Fair allocation of caps
- Both will need effective enforcement (like Montreal convention)—trade sanctions
- Any equitable solution will require large reductions in carbon emissions by advanced industrial countries—and the longer actions are delayed, the greater the more draconian reductions will have to be (carbon space is being used up)

- Greening economy can be part of the solution to economic recovery
  - Restoring America's consumption is not a solution
- A new economic model
  - Innovation focusing on saving resources, not labor, or financial innovations circumventing regulations, taxes, and accounting standards
  - Investments to respond to the challenges of global warming and poverty

Devising a better system of global governance

- Global financial institutions have failed
- G-20 is not inclusive and lacks political legitimacy
- What is needed: a global economic coordinating council
  - Based on principles of representation
  - Small enough to reach decisions, large enough to have diverse circumstances of different countries adequately represented
  - G-20 may evolve in this direction

- Long list of issues to be discussed
  - Those I’ve discussed today
  - Understanding better the root causes of weaknesses in the economy today
  - Understanding better the root causes of why countries have been accumulating such large reserves
  - Better systems of risk mitigation
  - Sovereign Debt Restructuring Mechanism
  - Better ways of financing developing country growth

Silver Lining on Global Crisis

- Has brought home the need for global cooperation—and the risks of failure
- In the aftermath of the Great Depression and World War II, current international institutions were created
- These are now not up to the tasks posed by globalization today
- The hope is that we will seize this opportunity