Fixing the broken world economy

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It is not difficult to argue that global economic crisis calls for global solutions. National and regional efforts can only help contain the fallout and minimise the adverse impacts of the global economic meltdown. At best, national and regional measures can complement or supplement global initiatives in curing the ailing world economy – they cannot substitute them.

It appears that the global economy is still spinning out of control in the downward direction. All indications are that the global economic crisis continues to widen and deepen with no let-up in sight.

The best-case scenario suggests that the recession will hit the bottom by the end of the year and begin to recover next year with normalcy returning in 2011. The worst-case scenario paints a bleak picture with the world economy staying at the bottom much longer before crawling back into a growth trajectory, a process that may take as long as five years. The base line projections would lie between these two extremes.

Needless to say, much would depend on how the global community responds to the global economic crisis, which in turn would depend on the political will of world leaders. As is often said, tough times call for tough measures. Such considerations raise the hope that the G20 Summit in London on 2 April will confront the crisis head-on and come up with bold measures.

The global economic crisis is so complex, and the demands on the G20 are so diverse, that there is a danger of the London meeting biting more than what it can possibly chew. There is certainly a need to focus on priority areas that would arrest and reverse the downward spiral.

To be sure, firefighting should be at the top of the G20 agenda. The collapse of demand in developed countries has been transmitted to the rest of the world through the trade channels. National measures undertaken by small economies in the form of fiscal stimulus packages are inadequate. Developed countries should lead the way by committing 2-3 per cent of the gross domestic product (GDP) for fiscal stimulus in a coordinated fashion to take up the slack in private consumption and investment.

The G20 must categorically say no, in no uncertain terms, to protectionism in the implementation of fiscal stimulus packages. It is indeed disturbing to see many countries striving to confine their fiscal spending to domestic goods and services. Beggar-thy-neighbour policies in an increasingly interdependent world will be counterproductive. A surge in protectionism will undermine global efforts to jumpstart the stalled world economy.

It is worrisome that the limited capacity of the International Monetary Fund (IMF) will be put to severe test in the coming months, with more and more countries seeking IMF help. Obviously, IMF cannot do firefighting at so many fronts. IMF needs not only more resources but also greater flexibility. It is time the G20 seriously considered the establishment of regional monetary funds in Asia, Africa and Latin America to complement the IMF in Washington.

While the situation warrants the G20 to top up IMF resources so that the latter can reach out more, there are serious concerns that IMF tends to overlook the needs of poor countries. There are also concerns that developed countries in distress would soak up funds, leaving hardly anything for less developed countries.

Poor countries also face drastic cutbacks in developed country ODA (Overseas Development Assistance) flows. The G20 must factor in the plight of the poor and renew developed countries' MDG (Millennium Development Goal) commitment to contribute 0.7 per cent of their GDP as ODA.

What the world is experiencing is a perfect storm, with all conventional instruments for dealing with downturns failing simultaneously. Monetary policy, pushed to the hilt with interest rates close to zero in many countries, has become impotent.

Although there is still some space for fiscal policy, fiscal fatigue arising from prolonged pump-priming threatens to limit the impact. With foreign exchange rates no longer reflecting macroeconomic fundamentals, the exchange rate policy instrument appears to be in disarray.

Now that conventional instruments are not working, governments tend to resort to unorthodox measures, such as bailouts of distressed companies and institutions, in a move to save jobs and prevent knock-on impacts. While such rescue operations may be justified under the current conditions, the G20 should subject bailouts to stringent conditionality, lest they look like rewarding failures and unwittingly formenting moral hazard. In other words, lifeline should be offered to ailing companies only at a price.

The G20 must also look into the governance issue by devising a system to plug the holes that allow fraudulent practices by the top executives like Bernard Madoff and Alan Stanford, in addition to re-examining the practices of credit-rating agencies and accounting standards.

It is bewildering to note that Bear Stearns was Basel-compliant when it fell off the cliff and that AIG (American International Group Inc) could enjoy a Tipple-A rating, despite its financial fragility. All this underscores the need to regulate the regulators as well.

It is quite obvious that the existing international financial architecture, which is based on the Bretton Woods system of the 1940s, needs a complete revamp, as it has become outdated and outmoded.

This, admittedly, is a tall order for the G20 to handle, but a strong G20 commitment would be a major starting point. The role of the US dollar as the global reserve currency is central to the way in which the international financial system operates, giving the US the right to borrow in its own currency with zero exchange rate risk.

The current strength of the US dollar would only serve to keep the world economy in the doldrums for a long time, as it tends to scuttle the recovery process. For the US economy to rebound, it needs a weaker currency that would stimulate exports and divert demand to domestic goods and services, although countries that lend to the US are loath to see a weaker greenback for obvious reasons.

It is imperative that the G20 adopts measures that will allow the dollar to depreciate gradually, for a hard landing would have deleterious consequences.

The near-term challenges are so huge that no country, no mater how powerful, can afford to go it alone. Since the G20 consists of the developed G7 and 13 others as a proxy for the rest of the world, one would expect this grouping to network in the interest of the world economy and navigate it through the troubled waters.

The situation calls for regular consultation, cooperation, and collaboration among G20 countries on macroeconomic policy interventions. Monetary authorities, in particular, have a pivotal role to play in this regard. The importance of institutionalising such arrangements can hardly be exaggerated.

Stakes in the G20 are high. So are the expectations. It is time for the G20 to deliver.

Adapted from "Can G20 fix the broken world economy?", New Straits Times, 31 March 2009