Reflections on International Economy and Finance Reforms

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In the last months, with renewed emphasis, many have been asking the following question: will this economic and financial crisis give rise to a fundamentally new geopolitical architecture? Many think it necessary; others, inevitable; some are skeptical. Maybe we should formulate it in a slightly different way. Can we expect changes in the international system structure that will improve the coordination of the international economy and, hopefully, will reduce the likelihood of major economic and financial crisis?

In trying to draft an answer this kind of questions, what are our major points of reference and the likely obstacles? Such an understanding is essential if we do not want to be mere passive observers of events that affect us all. Therefore, let's try to identify, in relatively broad terms and as objectively as possible, how did we get here and what are the main elements of the present context that we must take into account.

Before I attempt to do just that, let me make clear that this is no more than a personal reflection, a contribution to a necessary public debate on the current state of the world. Hopefully, it will help the general reader to make sense of what it is happening and encourage a reasoned debate. Certainly, no claim to any sort of irrefutable truth is made here. Others may have divergent opinions and perceptions, which may well be plausible and defensible. But that’s the nature of a public debate, and that's exactly how it should be.

Obviously, the backdrop against which this discussion has to take place is the current international crisis. I feel that we face here our first problem. In the public mind and most of the public media, the causes and culprits of the current situation seem to have been identified. Consequently, the solutions seem more or less obvious; and governments feel the pressure to take actions that punish the guilty ones or, at least, prevent them from doing further harm. At the very least, they cannot be seen as being soft or hesitating. Let us keep a prudent distance from this battleground.

As it happens, the common narrative – greedy financiers on the loose – is quite superficial (even if there is some portion of truth in it). The causes are more complex than it may appear at first sight; they involve wider social and economic sectors than is commonly acknowledged; and the sought for solutions are not without their own problems either. This is more the case of a death by a thousand cuts than as the result of a single strike. So, a first word of caution: we may be hoping to find fast (and, if possible) easy solutions for problems which are still incompletely formulated, based on causality relationships that are poorly or insufficiently understood. If that's the case – and I believe that, in some measure, it is – the discussion of possible paths from here requires that we re-frame our understanding of the sources and timing of the crisis.

Certainly, the crisis, in the precise guise it took, was not inevitable. It is surely arguable that some actions might have been taken (or avoided) that could have delayed its outset, or reduced its intensity. Those issues alone will keep historians occupied for a long time to come. But this situation was also a possible outcome of a long process of international economic growth increasingly marked, some would argue, by some unbalanced trade patterns and unsustainable national policies and strategies. To put it into a different perspective, we can see it also as the outcome of the actions of a multitude of economic agents that, within their respective frames of responsibility and scope for decision, were not necessarily behaving irrationally. We, in general, appear to have difficulties in grasping how complex the world (political) economy has become.

But let us concentrate on just a few factors whose combination seems to be the most important. They are: international flows of trade and capital and the underpinning structure of the world economy; the cost of money and the monetary policies of major economic actors; the regulation of the financial sector, at both the national and international levels; the housing bubble and the social policies, mostly in (but not restricted to) the US.

Without trying to go even further back, let us be reminded that since the 1980's the world economy went through a remarkable growth period. Looking back, it all may now seem only 'natural'. But, let us not underestimate the stakes. To name but a few, this period is marked by the entry in the world economic and trade systems of Russia and China, previously centrally planned economies; by the progressive opening of India, a rather closed economy for most of its existence since independence; and by the increased integration of countries like Brasil or Indonesia, that seem to have achieved finally the political and economic stability required for them to play increasingly relevant global roles.

That is, albeit with different flavors and various levels of government intervention, we have witnessed the integration in the global capitalist system of more than half of the world population, in the time frame of one generation. As part of this process, the expansion of trade and foreign investment boomed and contributed to a reduction in world poverty without historical precedent. But nothing in history of the world or the expansion of capitalism could make us expect that such a profound shift could be made without setbacks or that crises were things of the past.

One of the distinctive features of the evolution of the world economy in this period has been the almost symbiotic relationship between the US (and the rich countries, in general) and China (replicated, at various levels, by other countries). It can be summarized, in very simplified form, as follows. The rich countries exported capital and technology to the rest of the world; the rest of the world provided mostly cheap labor and land. That allowed the production of cheap goods exported to the rich countries, whose consumers kept buying ever more – and saving ever less.

On their side, the exporting countries limited domestic consumption and accumulated foreign reserves. These were used mainly to buy American bonds, helping to keep the interest rates low. This was also the more or less explicit objective pursued by the Federal Reserve and most central banks across the world, as a tool to keep demand high and unemployment low. As long as the export platforms scattered around the world kept producing ever cheaper goods, central banks could hope that inflation could be kept in check. And as long as this arrangement could go on, consumer demand in the US would keep the steam and pull the world economy.

This process was never completely smooth. As could be expected, it was subject to cyclical contractions and not a few regional financial crises. But, those occasional disturbances apart, this arrangement suited almost everyone. It was in the interest of no one to risk triggering a crisis. Regardless of concerns about its long term sustainability, it was to be enjoyed as long as it lasted.

This crisis has gained a particular dimension because it started in the US or, to use the cliché, because the growth engine of the world lost steam. The origin of the series of events that triggered the crisis starts in a policy domain that seems remote from our concerns. Since the Clinton administration the American government was promoting a policy of home acquisition aimed at socially and economically weaker sections of the population. That meant the concession of the so-called sub-prime loans. That is, high-risk housing credit, guaranteed – implicitly, at first, and, later, explicitly – by the state. Mortgage specialists were encouraged to lend to customers which usually would not be able to get loans from the financial institutions.

The good intentions aside, that was a risky proposition. Risky loans guaranteed by the government invite ever more risky loans – and creative and highly leveraged financial instruments that rely, one way or the other, on that guarantee. Not too surprisingly, a housing bubble ensued (one that, note again, was not limited to the States). What was clear was that, as the more fragile sections of the population were becoming seriously indebted and dependent on never decreasing real estate values, the risk of high default rates, if a contraction occurred, could not be ignored. But if the default rate could be kept within normal margins, the risk seemed manageable and relatively painless adjustments looked possible.

As it happened, smaller mortgage operators started to face extremely high default rates. The first casualties occurred in early 2007. The system started to unravel as, so to speak, leveraged growth implies, when the tide changes, leveraged contraction. There is some consensus that until the bankruptcy of the Lehman Brothers the rot appeared containable. From then on, everything changed. Uncertainty about the solvency of many financial operators and their ability to recover loans led to a 'credit crunch'. Some fundamental credit flows, such as credit between financial institutions and commercial credit to companies, contracted violently. The risk of a serious crash became credible: our economies cannot function without credit and properly functioning financial institutions.

Governments and central banks rushed with the usual Keynesian prescriptions to try to attenuate the contraction and re-establish confidence in the financial markets. Their intervention was, we could argue, inevitable. As our financial markets are designed, governments accumulate several roles: they only have the power to authorize the emission of money; they monitor and control the credit and money creation by the financial sector; they supervise and regulate the financial institutions. As a result, the state is the cornerstone of the financial system and its guarantor of last resort.

We might discuss the appropriateness of this arrangement; question what constitutes an adequate intervention – in nature, timing and intensity; or contend that some short term solutions may be the harbingers of future problems. But that discussion would lead us too far away from our purposes here. The point is that, in these circumstances, the intervention was inevitable and likely to be massive – as it was.

This brings us to the issue of regulation of the financial markets, both nationally and across borders. That is one of the most difficult topics, as all that has been said above should help to make clear. Two topics stand up. First, what should be regulated? And, by extension, how do we define the right level of regulation? The right measure of regulation is usually not unlike the right dose of a medicine. Too little, one may die from the illness; too much, one may die from the cure. And the task becomes particularly difficult when we have to deal with increasingly complex global financial systems and several new financial tools whose effects and risks may not be totally understood. Second, how can we ensure effective and consistent enforcement? That is: what is the appropriate institutional design? how are the policy objectives designed and decided upon? and who has effective powers to ensure compliance? These aspects are especially critical at the international level. There, issues of sovereignty and perceptions of national interest may easily result into conflicting interests, and lead to situations where the enforcement of norms and policies, even if formally agreed, becomes a practical impossibility.

The issue of regulation is certainly among those who have been the focus of a lot of attention and which have forcibly brought to the fore the theme of the re-design of international institutions. In this frame, the role of the so-called G20 (or a similarly constituted group) can or should have in the new international institutional architecture entered firmly the international political agenda. Much of what will happen in the future will depend on how this process will evolve. Therefore, that's where I will concentrate from now on. Two issues require our attention. First, what is the rationale for involvement of the G20 as a core structure to deal with these issues? Second, what are the topics and problems that we should focus on?

The first issue is probably the less contentious. As the world economy expanded and new actors have risen to the fore, there is an inevitable demand for new institutional structures and mechanisms. These must accommodate and provide adequate avenues for expression of the interests of the new global actors. That does not mean that the process is easy, obvious or fast. How to re-define the international organizations, their mandates and scopes, their inter-relationships, is an on-going and continuous process, running in parallel with each international crisis or issue requiring some kind of international and coordinated approach.

The G20 meetings are a part of that adjustment process. But no one should expect that by some kind of miracle the group will become a kind of ‘world managing board’, much less an uncontested one. It will never be easy for all participating countries to put what they perceive as their national interests behind and think only or mostly in terms of the world or international community interests, however defined. Those meetings will necessarily involve posturing, bargaining and all the usual predicates of international negotiations – including tests of force and will. As long as the outcomes – namely the policy decisions and the agreed courses of action – are reasonable and feasible, that is not too important. But major issues will still subsist: for instance, how will the decisions be enforced or how should one deal with failures to comply with them? These issues are not likely to be solved within the foreseeable future. International enforcement mechanisms are relatively weak and the widening of the decision *fora* complicates both the decision and enforcement processes.

Those structural issues aside, what should the G20 members be focusing on, so as to help to re-establish confidence and, some would expect, the foundations for renewed world economic growth? Many proposals and suggestions have been floated by various international organizations, economic and political leaders, social activists and international political think tanks. Without going into a detailed analysis of the multiple ideas put forward, let's try to systematize them somewhat. We can start by distinguishing short- and long-term issues.

In the first case, we find the efforts to get some level of coordination between the various national stimulus plans and actions. These actions are complemented with a short term reinforcement of the role and resources of some critical international organizations, namely, the International Monetary Fund (IMF) – and its assistance mechanisms for countries which may face currency difficulties – and the World Trade Organisation (WTO) – in what concerns the monitoring and prevention of a protectionist drift. They appear to be producing the expected results, at least in the short term. For our purposes here, no further analysis or comments are justified.

On their side, however, the longer term objectives deserve some additional comments, as they are harder to deal with. They fall into three complex and inter-related categories: the regulation of an increasingly diversified financial sector; the role of the international organizations, with a particular view to those relating to the international financial flows; and, finally, the overall structure of trade flows and international economic relations. That's not a minor agenda!

We start with the regulation of the financial activities. It was mentioned before that the right balance of regulation is a delicate task. There is a perception that a major cause of the current crisis was insufficient regulation, even if not all claims in that sense are fully substantiated. Many ask for more regulation and oversight powers that should aim at preventing the repeat of the same problems and also at avoiding the next crisis. How much is attainable is open for debate. But whatever our opinion on the subject, careful drafting of regulation is called for. People always adapt and change their behavior as a result of new regulations. Different rules, conceived to deal with past situations, often result in changes in the behavior of the economic agents that do not follow necessarily along anticipated or even foreseeable lines.

Then the focus should be on understanding and adapting, not blaming and punishing. So, besides care and measure in drafting, a successful attempt to lower the 'crisis potential' of the system requires also mechanisms for monitoring, enforcing and adapting rules over time, as circumstances change. Uncertainty and conflicting national interests may make such approach practically difficult or politically costly.

So, the critical question becomes how, under the present circumstances, do we design an international system of organizations that is representative, efficient, flexible and able to generate compliance with the rules collectively agreed on? The international role of the G20 is certainly an important element. But it cannot be seen in isolation form other on-going international processes or discussions – namely, those relating to the composition of the Security Council and the role of the United Nations and its agencies; the status of the WTO's Doha round; the governance and resources of international organizations such as the IMF and the World Bank; the development of regional trade blocks, to name just the most obvious. That is, we face a set of inter-linked agendas to be dealt with for many years to come. One should not expect easy, straightforward or fast solutions.

Finally, how to deal with what is, probably, the most complicated of all the issues: how to re-adjust the international economy? How do we move from a world built on the ashes of two world wars around the one single country left standing, so to speak, to a much 'bigger' world, with more distributed sources of power? We may say that the post-Bretton Woods world is coming to an end. But that end is not for tomorrow or without dangers. The challenge is to achieve a peaceful transition to a new world order without sacrificing the extraordinary improvements brought by the last 60 years – in life expectancy, in material wealth, in social and economic opportunities. And, in particular, to avoid the temptations of nationalism and protectionism which, lest the lessons be forgotten, gave the world a devastating first half of the twentieth century.

All the discussions about trade and currency imbalances must be put within this wider context. They may require changes in most of the concerned countries – and I underline, most – that may conflict with domestic organized interests or ingrained understandings of the national interest and the associated domestic policies. In areas that are as sensitive as the openness of markets – including the services and capital markets – or the national monetary and exchange policies, to name just the most obvious. How the G20 representatives will manage to combine the requirements (and ambitions) of world leadership and international coordination with the pressures and demands of their national constituencies will test of their caliber and will be the touchstone against which their international status will be measured.

Authors'profile: cf. CCC 5.1, p. 156.