The Imperative for Improved Global Economic Coordination

BY JOSEPH E. STIGLITZ

ALTHOUGH THIS IS A GLOBAL CRISIS, the policy responses, both to accelerate the recovery and to prevent a recurrence, are taking place at the national level. That is why global coordination has been strongly recommended by the UN Commission of Experts on Reforms of the International Monetary and Financial System, on which I served as chair.

The importance of coordinating the macroeconomic response, which is the intervention needed to prevent the downturn from becoming even worse, is obvious. Each country evaluates the costs and benefits associated with the impact on its own economy. Although the costs are reflected in increased debt, a well-designed stimulus that spends money on needed investments may arguably have a negligible net cost. But because some of the extra income earned in a

Demonstrators protest against bailout funds outside of Bank of America in Washington.

country is spent abroad, some of the value of the stimulus leaks to other countries, that is, some of the benefits accrue outside the borders. This is why the global multiplier, the ratio of the increase in global income for each dollar of government spending, is much higher than the national multiplier. Every country focuses on its national multiplier which measures the benefits that accrue internally. The result is that, without coordination, there will be too little stimulus.

But matters may be even worse. Without coordination, countries will try to design their stimulus packages to maximize the national multiplier, regardless of the adverse effects on the global multiplier. For example, even if a national investment project had greater long-term benefits, the fact that it may require importing many of the critical inputs and thereby diminish the national multiplier might cause the country to choose a domestic road project instead.

In an attempt to increase domestic multipliers still further, many countries have engaged in protectionist measures. Indeed within a few months of the G20 resolving not to engage in such measures, 17 of the 20 had done so. Since then, matters have only gotten worse. Such measures are likely not only to be counterproductive, since others will take retaliatory measures, but many of them also discriminate against developing countries. The "buy America" provision of the U.S. stimulus package illustrates this point. America included an exception for countries with which it had procurement agreements—mostly other developed countries. Thus, even though the developing countries are innocent victims of the failure of U.S. regulatory and macroeconomic policies, they are being in effect targeted for protectionism. Only through coordinated action can we prevent such self-destructive measures.

Developing countries are the worst hit

THERE IS A THIRD DIMENSION of coordination. Developing countries are among the innocent victims of this crisis which is negatively affecting even many of those that did a far better job of macromanagement and regulation than the U.S. Indeed, those countries that are most closely integrated into the global economy, having followed the advice of the international economic institutions and opened themselves up the most, have been among the worst hit. Developing countries have been affected by unprecedented decreases in exports, a drop in export prices, a decline in remittances, and a decrease in capital flows—in some cases even a reversal. And they do not have the resources to protect their families who are losing their jobs or to save their businesses that are threatened with bankruptcy, let alone to provide an effective stimulus. While in the North, the crisis began in the financial sector and then moved to the real sector, in the developing countries, the crisis began in the real sector and is quickly moving into the financial, starting a vicious downward spiral. A crisis of this magnitude is certain to generate follow-on effects in the financial sector. Even banks that did a good job of credit assessment could not have anticipated a downturn of the magnitude that many countries are experiencing in, say, the export sector.

The North has every reason to lead a coordinated global response to help the developing countries. In recent years the developing countries have been part of the world's engine of economic growth, and it is hard to imagine a robust global recovery in which the developing countries did not play a role. A recovery in the North that was not matched by one in the South could worsen global imbalances, including trade imbalances which in turn could give rise to further protectionist pressures.

The G-20's inadequate response

THE GOOD NEWS IS THAT the G-20 has recognized the problem. The bad news is that it has failed to respond effectively. Most of the money provided has been in the form of loans, and the primary responsibility for disbursement has been given to the International Monetary Fund (IMF). Many developing countries, just emerging from an overhang of debt, are reluctant to get back into the debt trap. Moreover, while the IMF has promised not to impose on "good countries" the counterproductive pro-cyclical conditionalities that have marked its lending in the past—and which would undermine the effectiveness of any assistance—many developing countries wonder whether they will qualify. Some of the programs, while less stringent than those of the past, still seem austere. Besides, in many developing countries there is strong domestic opposition to turning to the IMF, regardless of IMF assurances. Countries worry about losing their economic sovereignty, and in democracies, governments have to pay attention to the views of their citizens. Past IMF behavior has not earned it a great deal of affection, and many citizens are suspicious about claims of reform. As its critics inside and outside the developing countries are wont to point out, the IMF not only did not take steps to prevent the crisis but it also had pushed those deregulatory, financial, and capital market liberalization policies that played such an important role in the creation of the crisis and its rapid spread. The result is that many countries are reluctant to turn to the IMF until they have no other choice, while others are engaged in bilateral borrowing in the hope that they can "squeak" through. Global coordination of a much larger assistance program is needed, more in the form of grants and disbursed through a variety of mechanisms, as the UN expert commission urged.

In short, without coordination, we are likely to have a smaller and, from a global perspective, a much more poorly designed global stimulus, resulting in a more prolonged downturn and slower recovery.

Agreement on a coordinated stimulus faces several obstacles. First, there is the question of enforcement. Under current arrangements, compliance rests on good will. This may be especially problematic in presidential democracies, where parliament or congress may not support the leader's commitment.

Reaching an agreement may also be constrained by the varied circumstances in which different governments and economies find themselves. Although the United States boasts of a large stimulus, a significant fraction of Federal Government expenditure increases is being offset by expenditure reductions and tax increases at the state and local levels. Moreover, the United States has fewer automatic stabilizers than many European countries, with less progressive tax structures and smaller unemployment insurance systems. Similarly, practices in the private sector, which may have been influenced by government policy, also contribute less to stability. For instance, in recent years the U.S. has moved from a defined benefits pension system to a defined contributions system, which may lead to greater volatility in consumption during a crisis such as this one, as millions see their retirement accounts diminished. In light of these differences, it is difficult to ascertain what one might mean by comparable "efforts."

There may be disagreements too about whether all countries should make comparable efforts (however that might be measured). Should a country already heavily burdened by debt have to make a comparable effort as one with no inherited debt? Should richer countries have a greater obligation? Should a small open economy have a greater obligation than a large one? One might argue that the United States, with the dollar as the principal reserve currency, can borrow more easily, has a higher income and lower debt burden than many European countries, and should therefore play a proportionately larger role in the global stimulus.

It could also be argued that the U.S. should take more responsibility both in stimulus and assistance to developing countries, because of the central role that its mistaken policies played in generating the crisis. Yet, so far, the U.S. has lagged behind others in offering assistance.

By the same token, agreeing on what is meant by protectionism may not be easy. There are some obvious examples, such as the U.S.'s Buy America policy, mentioned earlier, and tariffs; but subsidies and guarantees are just as distortionary as tariffs. They are even more unfair, since only rich countries can afford them. Moreover, symmetric policies can have asymmetric effects: a government guarantee in a developing country is less credible than in the U.S. And if the government charges a premium for the guarantee, how can we know whether it is really at a subsidized price? The U.S. and European bailouts and bank guarantees have totally distorted the level playing field—if there ever was one. Even firms that have not received benefits can undertake riskier investments, knowing that if they have large enough losses they may be bailed out. Commitments that governments will not engage in such bailouts in the future have little credibility.

Hidden protectionism

MOREOVER, INTERNATIONAL TRADE agreements contain "legal" forms of protectionism. Should all of these be acceptable under the rules of the game, or should some of them be viewed as abusive? For instance, as tariffs have come down, nontariff barriers have increased. The procedures used to determine dumping duties are not based on sound economic principles and put developing countries in a particularly disadvantageous position. Some even argue that dumping duties are a "protectionist safety valve." I would argue that an increased use of dumping duties as advanced industrial countries appear to be doing is, in fact, protectionism. Many of the developed countries, however, view the practice as totally legitimate, while at the same time, criticizing developing countries for making use of the leeway they have between current and bound tariff rates.

Of particular concern in the current crisis is financial protectionism, often associated with the massive bank bailouts. Financial market integration has meant that developed country banks play an important role, often a dominant role, in the financial markets of many developing countries. But as the crisis has heightened, some of these international banks have focused what limited lending they are willing to do on their home country, with obvious adverse effects on the developing countries. These problems are exacerbated when the government gives the bank money in the expectation of an increase in lending at home. While there has been much discussion of the consequences of financial market protectionism, little has been done.

Coordination is essential for regulation

REGULATION IS THE SECOND AREA in which coordination is absolutely essential, and for many of the same reasons. The actions of one country affect another. This global crisis has very much a "made in USA" label: the U.S. exported its deregulatory philosophy and then, when all guards were down, it exported its toxic mortgages. To be sure, the U.S. economic downturn would have been far worse had it not done so, but the crisis reminds us that globalization means that both good things as well as bad things can cross borders more easily. If we are to have globally integrated financial markets, there has

Protestors in satanic costumes at the G-20 Meltdown Protests at the Bank of England, London.

to be some confidence that foreign institutions and financial products imported from abroad will not induce economic devastation. This can only be the case if there is coordination in regulatory policy. But not just any kind of coordination will do. The world had been moving to a common "deregulatory" framework, and this framework bears considerable responsibility for the current crisis.

In the absence of such coordination, there was a risk of a race to the bottom. Financial firms told their governments that if they didn't deregulate, they would move elsewhere. Governments, worried about the loss of jobs and revenues, gave in. Today, however, many governments are more aware of the costs of this race to the bottom. Iceland provides a telling example: its citizens, many of whom never benefited from their banks' irresponsible behavior, will be paying the price for decades to come. Some argue that the high cost of America's bank bail-out—with bondholders and in some cases even shareholders being protected, as the Obama Administration has created institutions that are too big to be financially resolved—is the international ramification of a collapse. But ordinary American citizens are paying a high price for a global financial system from which they benefited little.

Moreover, governments with well-regulated financial institutions should rightly be wary of allowing these institutions to deal in an unfettered way with institutions from countries with inadequate regulation. They are aware that American banks sold toxic products, not just the toxic mortgages, but also dangerous derivatives.

There is an obvious need for coordination in the regulatory structures so that one country can trust the products produced in another. This will require not only good regulations but effective enforcement. In the United States and elsewhere, there were regulators who didn't believe in regulation and, not surprisingly, didn't do a very good job in regulating. There needs to be a restoration of confidence in the entire regulatory system. It will be difficult to do this overnight.

Especially discouraging are the half-hearted attempts at regulatory reform, for example in the United States. Yes, there is a move in the right direction, but is it enough? Little is being done about many of the underlying problems: banks that are not only too big to fail, but too big to be financially resolved; incentive structures that encourage short-sighted behavior and excessive risk-taking; insufficiently transparent and overly complex over-the-counter derivatives sold by banks with depository protection; inadequate restrictions on risk taking by depository institutions; too little being done about conflicts of interest; accounting standards that may even be getting worse. Indeed, some of the big banks are engaging in enhanced risk taking—to make up for the losses of the last couple of years.

Conclusion

THE RISK IS CLEAR: if countries cannot rely on foreign financial institutions and the products they produce, there will be a marked weakening of global financial market integration. Governments have a responsibility to protect their citizens and their economies from the dangers of financial markets. The systemic consequences of failing to do so are already too evident. Until confidence can be restored, there will have to be reliance on host country regulation. Financial products and dealings originating from under-regulated countries and even from countries with a problematic history (such as the U.S.) which "promise" to be do better in the future, will have to be carefully supervised.

There will be less financial market integration, but this is part of the price we will have to pay for the failure to adequately coordinate regulatory policy in the past.

While coordination is absolutely essential, success in achieving it may prove difficult. As I wrote in Making Globalization Work, economic globalization—the integration of the economies of the world especially through finance and trade—has outpaced political globalization. If we are to succeed in achieving globalization that leads to a more stable and more prosperous world for all, we will have to manage it better than we have in the past; and that means more and better coordination.

Joseph E. Stiglitz is University Professor at Columbia University. He served as Chief Economist and Senior Vice President of the World Bank from 1997-2000. He was awarded the Nobel Memorial Prize in Economics in 2001. He He was also chair of the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System.