Chapter 12

CRISIS, AUSTERITY, AND STAGNATION

Article 12.1

GLOBAL ECONOMY VULNERABLE A DECADE AFTER

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Ten years ago, deteriorating confidence in the value of U.S. sub-prime mortgages threatened a liquidity crisis. The U.S. Federal Reserve injected considerable capital into the market, but could not prevent the 2008-2009 global financial crisis (GFC).

The 2008 meltdown exposed the extent of finance-led international economic integration, with countries more vulnerable to financial contagion and related policy "spillovers" exacerbating real economic volatility. It also revealed some vulnerabilities of the post-Second World War U.S.-centered international financial "architecture"—the Bretton Woods system—modified after its breakdown in the early 1970s.

Robert Triffin, the leading international monetary economist of his generation, had long expressed concerns about the use of a national currency as the major reserve currency. International liquidity provision using the greenback required the United States to run balance-of-payments deficits, ensuring U.S. monetary policy spillovers to the world economy while eroding confidence in the greenback.

The Bretton Woods system was under increasing strain from the late 1960s, as U.S. President Lyndon Johnson funded the increasingly unpopular Vietnam War by issuing debt, rather than through higher taxes. The system finally broke down when the Nixon administration unilaterally cancelled the U.S. commitment to dollar (gold) convertibility in August 1971.

What emerged was a "non-system" for Triffin. Since then, the U.S. dollar, issued by fiat, has relied on the greenback's own credibility and legitimacy to continue as de facto world currency.

Current "Non-System"

In 1985, Triffin identified three systemic problems of the international financial "non-system." First, "its fantastic inflationary proclivities, leading to world reserve increases eight times as large over a brief span of fifteen years" since the breakdown of the Bretton Woods system.

Second, "skewed investment pattern of world reserves, making the poorer and less capitalized countries of the Third World the main reserve lenders, and the richer and more capitalized industrial countries the main reserve borrowers of the system."

Third, "crisis-prone propensities reflected in the amplitude" and frequency of financial crises such as the 1980s' debt crisis causing developing countries' "lost decades." Other critics have identified further flaws.

First is the "recessionary bias," due to the asymmetric burden of adjustment to payments imbalances. While deficit countries are under great pressure to adjust, especially when financing dries out during crises, surplus countries do not face corresponding pressures to correct their own imbalances.

Second is the cost of the perceived need of emerging and developing countries to "self-insure" against the strong boom-bust cycles of global finance by building up large foreign exchange reserves and fiscal resources, especially after the 1997-1998 Asian financial crisis.

Such precautionary measures enabled emerging market economies to undertake strong counter-cyclical measures during the GFC. But they have huge opportunity costs as such reserves are generally held as presumably safe, liquid, low-yielding assets, such as U.S. Treasury bonds.

Hence, Triffin complained that "the richest, most developed, and most heavily capitalized country in the world should not import, but export, capital, in order to increase productive investment in poorer, less developed, and less capitalized countries… [The] international monetary system is at the root of this absurdity."

Reform appeals

There were renewed calls for reform of global economic governance in the wake of the GFC, especially by the 2009 UN Conference on the World Financial and Economic Crisis and Its Impact on Development.

Governance reform of the IMF and World Bank should ensure fairer, more equitable representation of developing countries. This should improve the accountability and credibility of the Bretton Woods institutions, enabling them to better address current financial and economic challenges in the world.

The UN also called for a "multilateral legal framework for sovereign debt restructuring." Without a fair, legally binding, multilateral sovereign debt work-out mechanism, developing countries remain vulnerable to private creditors, including vulture funds.

There were renewed hopes for trade multilateralism and early successful completion of the Doha Development Round of the World Trade Organisation (WTO), giving developing countries better access to external markets, seen as vital for balanced global recovery and development. The promise to keep international trade open echoed G20 leaders' unfulfilled commitment to eschew protectionism.

However, only a few of the modest promised reforms have been implemented, with limited changes in international financial governance, still dominated by G7 economies. After all, every financial crisis is followed by appeals for reforms, with complacency setting in with hints of recovery.

Less Coping Capability

Most developed country governments are now more heavily indebted than in 2008, when they bailed out large financial institutions, but failed to sustainably revive the world economy. Major monetary authorities do not have much policy space left after long pursuing unconventional expansionary policies.

Meanwhile, developing countries have been subject to increasing international integration, e.g., through global value chains, foreign financial institutional investments and increased short-term capital flows induced by the unconventional monetary policies of the U.S. Federal Reserve, the European Central Bank, and the Bank of Japan, while debt-sustainability concerns for some are growing again.

These vulnerabilities have been compounded by growing trade protectionism, and dwindling precautionary reserve holdings of many developing economies as global trade has slowed. Even before President Trump's election, developed countries had effectively killed the Doha Development Round, not least by opting for bilateral and plurilateral, instead of multilateral free trade deals.

Trump's more explicit rejection of multilateralism in his efforts to eliminate major U.S. bilateral trade deficits are now expected to further set back prospects for world economic recovery. Despite pious declarations to the contrary, most national policymakers typically turn from rhetoric about international cooperation to focus on domestic issues.

It has not been different this last time. A decade after the worst economic downturn since the 1930s' Great Depression, the world economy remains vulnerable. ❑