AVERTING THE THREAT OF A NEW GLOBAL CRISIS: A Critical Opportunity for Emerging Market Economies to Shape the Global Response

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Framing the Issue

Recent global financial and economic crises have led to reforms in global governance. During this time of extraordinarily difficult domestic economic and political conditions in large industrial economies, a key question for the future is whether the global governance system is now strong enough to cope with the sovereign debt crisis in Europe and whether this crisis will lead to a further strengthening or to a weakening of global governance? In a context of weak economic and political leadership by the industrial countries, the emerging market economies have a special opportunity to help shape a global response to the looming economic crisis.

Since World War II, global crises have spurred reforms to strengthen the global economic and financial governance system. At the end of World War II, the prospects of a major global post-war recession brought about the creation of the International Monetary Fund and the World Bank at Bretton Woods, along with the creation of the United Nations and, subsequently, the General Agreement on Tariffs and Trade, the forerunner of the World Trade Organization. The collapse of the Bretton Woods currency system in the early 1970s, the first global oil crisis of 1973 and the subsequent global economic instability led to the creation of the Group of Seven (G-7) in 1975. In 1999, the G-20 forum of finance ministers was established in the wake of the financial crisis in East Asia in 1999. The first G-20 summit was held in November 2008, in response to the unfolding global financial and economic crisis of 2008–2009. During the early summit meetings, the G-20 agreed on various measures to strengthen the international financial institutions, inter alia, by hastening the governance reform of the IMF and giving it substantially larger financial resources, and by transforming the Financial Stability Forum into the Financial Stability Board. This prompt action, including the coordinated stimulus response and efforts to strengthen the global institutions of financial management, oversight and safety net, helped turn around the global economy after a relatively short and shallow recession, when compared to the calamity of the Great Depression in the 1930s.

Now the sovereign debt crisis in Europe is once again creating great distress in the global economic and financial system. The risks of a sovereign default in Europe and its impact on the global banking system are huge and the ability of the euro to survive as a common currency for much of Europe is at stake. With the U.S. economy already weakened by the continuing fallout of the 2008 crisis—a weak housing market, high unemployment, large government deficits and crushing public sector debt—and Japan's economy immobilized by long-simmering economic difficulties reinforced by natural disasters, the industrial world now faces a serious risk of a new, and perhaps even deeper, economic crisis than in 2008.

Policy Considerations

With the domestic economic realities of the most systemically important countries, the scope for a global policy response—similar to the coordinated stimulus package of 2009—is constrained by their limited fiscal space for further monetary action. This makes it nearly impossible for them to counteract an additional economic downturn.

Furthermore, the difficulties of domestic economic management are reinforced by a fundamental malaise in the political systems of most mature democracies around the world. In the United States, a persistent and acrimonious standoff between the Democratic president of the United States and a Republican House of Representatives is creating economic policy gridlock. In Europe, fractured coalitions, weak leadership and conflicting national interests, combined with cumbersome decision making mechanisms in the eurozone, inhibit a decisive response to Europe's financial crisis. In Japan, the political system has produced a persistent pattern of weak and frequently changing leadership, which has been unable to pursue adequate structural reforms to address the fundamental malaise of Japan's economy.

As the leaders of the traditional global economic powerhouses—the U.S., Europe and Japan—face huge domestic economic and political challenges, it is clearly their principal responsibility to come quickly and effectively to grips with their economic calamities. Their current weakness, however, has created an opportunity for emerging markets to play a significant role in stabilizing the world economy. Brazil, China and India, among others, have a great stake in preventing another global recession. While they also face domestic economic and political challenges, they have a greater degree of freedom in responding to the current global financial and economic risks.

With their rapidly growing economic and political leverage, the emerging market economies have the opportunity to shape the global response to the current crisis at a time when their partners in the industrial countries are immobilized by their domestic economic and political problems. If they forcefully engage in the global organizations and forums, including the G-20 finance ministers' meetings, the international financial institutions and the WTO, their actions could help not only avert a global economic meltdown, but would also give them a greater opportunity to realize their ambitions to have a greater voice in global governance.

Unfortunately, an alternative scenario cannot be ruled out: Continued poor domestic economic management in the industrial countries might be reinforced by actions in the emerging markets. Growing trade protection, competitive devaluations and capital controls, acrimonious debates in the G-20 and a lack of readiness to support the international financial institutions would hasten a downward global economic spiral and further weaken the global economic institutions. As a result, not only would the world face a global economic collapse, but also the potential collapse of major economic institutions.

Action Items for the G-20

During each global financial and economic crisis in the decades since World War II, the world's leading economies were able to avert the threat of a global depression and to strengthen global international institutions. However, there is no guarantee that this will happen again. Speedy and effective domestic action by the industrial countries, matched by constructive engagement of the emerging market economies in global economic management are required to stem the growing risk of a global economic and institutional disaster. The following steps should be taken:

- Emerging market economies must not backslide into protectionism and they need to pressure their industrial G-20 partners to do the same;
- Emerging markets should further strengthen their role in the IMF by being more proactive, vocal and assertive about governance reforms, and by being willing to provide additional resources for the IMF, which would strengthen its ability to help governments in crisis particularly now in Europe;
- Emerging market countries need to reject pressure to reduce lending and concessional assistance by global development institutions, such as the World Bank, the regional development banks, and the United Nations economic agencies, such as the International Fund for Agriculture and Development. They also need to actively identify ways to increase programs and resources for these agencies by augmenting their own resources to assist the developing world through the crisis; and
- Emerging markets need to vigorously participate in peer reviews of financial system reforms in the Financial Stability Board and the IMF in order to ensure adequate harmonization of best practices in all G-20 countries, as well as be active in establishing more effective regulatory and supervisory capacities for the whole global financial system.

As emerging market economies become more actively engaged in supporting the global financial institutions, the industrial countries need to welcome this engagement, rather than try to suppress or reject it. Although this was the case during the last capital increase of the World Bank, in the recent appointment of the IMF's managing director, industrial countries need to increase engagement with emerging markets, particularly since emerging market governments have offered to provide additional funding for the IMF to help with the rescue of the eurozone.