Think Tank 20:

New Challenges for the Global Economy, New Uncertainties for the G-20

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Introduction: New Challenges for the Global Economy, New Uncertainties for the G-20

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Strengthened Hopes

As G-20 leaders prepare for their seventh meeting in Los Cabos, Mexico, strengthened hopes are struggling against renewed fears in the world economy.

The stronger hopes are due primarily to the more rapid output and employment growth in the U.S. economy that have come in better than expected in late 2011. It now appears possible that GDP in the United States might grow at a rate close to 2.5 percent in 2012, compared to 1.7 percent in 2011. Moreover, for several months, job creation has exceeded new entries into the labor force, reducing unemployment to well below 9 percent for the first time since the employment plunge in 2009. While this is modest progress compared to the challenge ahead— it would take almost a decade to reduce unemployment to pre-crisis levels at the pace of recent months— it has triggered a significant stock market surge, reinforcing a positive dynamic in the U.S. economy.

There also is considerable uncertainty in the outlook for Europe with median forecasts suggesting another year of zero growth. The long awaited deep Greek private debt restructuring finally took place without the catastrophic effects that some who had argued against it had forecast. The European Central Bank provided ample medium-term liquidity to the banking system, calming markets and providing time for greater structural adjustments. A decision to augment the size of the eurozone's financial firewall was finally taken in late March. The latter involves a temporary enlargement of the eurozone bailout system to €700 billion by setting up the new bailout fund, called European Stability Mechanism (ESM) with a permanent €500 billion in capacity, but allowing the €200 billion from the European Financial Stability Fund already committed to Greece, Ireland and Portugal, to be set aside and not be folded into the ESM as originally planned.

Growth in the emerging and developing countries has slowed, but still continues at a robust pace, with their internal growth dynamics playing an increased role compared to their exports to the advanced world.

A surge in oil prices at the start of the year, linked partly at least to political uncertainties surrounding Iran and security of supply in the Gulf, signaled a new danger in the early months of 2012. A massive surge in oil prices remains a short-term threat for the world economy, but at time of writing this threat seems to have moderated, notably because of the strong resolve of Saudi Arabia to stabilize prices, although this resolve would not be of much help if there were serious disruptions of supply routes.

Renewed Fears

Despite the mixed news summarized above, we believe that there remain very serious downside risks and long-term difficulties for rapid and balanced growth of output and employment in the world economy. While there are some risks and reasons to fear everywhere, the most serious systemic risks are linked to problems in the eurozone and, notwithstanding recent progress, in the Unites States.

The eurozone remains a key concern. The massive provision of liquidity to the banking system by the

ECB has been crucial in overcoming the immediate crisis that threatened in late 2011, but it cannot by itself lead to healthier and better capitalized financial institutions. For that, serious restructuring and additional capital is needed. Time has been gained, but that time needs to be used to solve the underlying problems of the banking sector. With regard to the ratios of sovereign debt to GDP, the fear is that the contractions in GDP that could be caused by too severe austerity measures would frustrate the attempts to reduce indebtedness ratios by very restrictive fiscal policies. So both the banking sector's problems and the high debt problems remain unsolved for a number of countries.

Perhaps even more intractable than the banking sector and national fiscal problems may be the internal imbalance problem within the eurozone, within which cost structures have diverged and where some countries have lost competitiveness to an extent severely constraining their growth prospects. It is reasonably clear that the equivalent of a real devaluation is needed, but it cannot take place with the help of nominal exchange rate adjustments in a monetary union. So it must take place through "internal" price and wage level adjustments. This is extremely painful and difficult, particularly if the adjustment burden is put entirely on the "deficit" countries, as has so far tended to be the case. A real debate is now underway in Europe as to the economic and political "realism" of current policies. The search should be for the narrow limits of the possible between too much austerity imposed on, broadly speaking, the "South", that could lead to socioeconomic "growth collapse", and too little long-term fiscal adjustment paving the way to renewed crisis.

This debate is being shaped by a rapidly changing political climate in Europe. In Greece, France, the Netherlands and Germany, election results and coalition politics appear to be showing the strains of sustaining austerity programs. A new discussion of innovation and productivity growth is occurring, but against a backdrop of uncertainty over the ability of politicians to implement and sustain long-term programs.

These predominant concerns about Europe seem to have distracted attention from the very serious fiscal and long-term structural challenges that remain in the United States. The recent uptick in growth still appears to owe too much to extremely expansionary monetary and fiscal policies that will be hard to sustain. The private sector deleveraging process has made some progress but is far from completed. Fixed investment remains low despite large corporate profits and the availability of finance. The problem seems to be uncertainty, both about future demand and about future policies. With income gains accruing almost exclusively to those at the very top of the income distribution, it is far from clear what the source of broad based sustainable private demand expansion is going to be. And the uncertainty about future policies has been accentuated by the polarization of the political process and the very different approach taken by the two main political parties in the United States. It is true that bond markets continue to signal a lack of concern, but history as well as the European experience should lead to caution: markets can move very rapidly, and while the Federal Reserve has formidable restraining tools, it could not keep longer-term interest rates down in the face of a severe loss of confidence. The United States is on an unsustainable path in terms of the combination of tax revenues and government expenditures. Many avenues for reform are possible and the different policy packages proposed reflect the interests and political philosophies of the different groups. What is not sustainable, however, is a prolonged stalemate. Unfortunately this is exactly what the political system has offered over the last few years.

Twenty-twelve is of course an election year. The outcome will have huge importance not only for the United States itself, but for the world as a whole. The share of the United States in world output has diminished, but it remains by far the single largest economy, and slow growth or the absence of growth in the United States would be a powerful constraint on the world economy. The policy debate in the United States is therefore of global concern. We have been very lucky that as the problems in the eurozone took center stage, the U.S.

economy started improving; if that had not been the case, the world economy would be facing a more severe slowdown.

There are of course other risks in the world economy that do not have their primary source in the U.S. or Europe. We have already referred to the risk that a surge in oil prices could constitute. A major slowdown in China, perhaps triggered by retrenchment in the real estate sector, would be a severe blow to the world economy.

The policy debates in Europe and the U.S. are hugely important, not only for their immediate impact on the national and global economies. They also reflect deep disagreements among economic theorists and the difficult search for a post-crisis framework of analysis. And they reflect the big dilemma of globalization: how can national democratic processes and election campaigns, rooted in the very local, lead to economic decision-making that takes into account our increasing global interdependence?

Challenges for the G-20

Perhaps the most crucial contribution the G-20 process can make is to help bridge the gap between the national and the global, in full cooperation with the existing global international institutions, as well as engaging the world of academia, civil society and think tanks. There will be several new faces at the Los Cabos G-20 Summit, as well as new domestic political landscapes for many leaders. The G-20 is an opportunity to connect their concerns with global approaches. The atmosphere of finger pointing at others as the source of the world's problems can be offset by thoughtful communication about globally coherent solutions. This Think Tank 20 (TT-20) collection of essays aims to be a modest contribution to this effort. In the papers in this volume, three themes emerge clearly. First, many authors, especially those from developing countries, write about their own countries' past experiences with sovereign debt and banking crises. This is a salutary reminder that the problems now being faced in Southern Europe are not entirely new, although the common currency poses a very specific challenge. There is much to learn from economic history, and the peer review function that the G-20 performs can be very valuable.

At the same time, crises can deflect attention from long-term issues. The second theme emerging from this collection is that the new discussion on growth and innovation must be centered on a long-term vision of how to build and implement a low-carbon, energy-efficient growth model. That is a collective action, long-term endeavor for all the G-20 countries, but it is currently being pursued as a series of individual country efforts.

The third theme of this collection is that the G-20 is struggling to be a relevant process. Europe is leading the way in deliberations about problems on that continent and making its own mistakes along the way, despite the large externalities imposed on the rest of the world. A greater G-20 input would be desirable. Outside of financial stability, the G-20 has not articulated a view of long-term, sustainable and balanced growth in a way that helps advance national dialogues in a globally coherent way. There is a growing risk of beggar-thy-neighbor policies (through exchange rates, monetary policy, regulatory arbitrage and other means) as each country tries to gain an advantage in the current crisis. Addressing these considerable challenges is no easy task at a time when there are new faces among G-20 leaders and new domestic political challenges in many G-20 countries.

Addressing the Eurozone Crisis: Lessons from Latin America

Miguel Kiguel

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The countries in the periphery of Europe are facing what looks like a traditional Latin American macroeconomic crisis. All the ingredients are there: recessions that in some cases have turned into economic depressions; large fiscal deficits which are leading to increases in the debt levels and are starting to pose a threat to sovereign solvency; large current account deficits which usually reflects a loss of external competitiveness and overvalued currencies; and problems in the banking systems due to the rise in funding costs and in the stock of nonperforming loans.

What are the policy alternatives to get out of the current crisis in Europe? The focus so far has been on reducing the debt burden and the approach has emphasized efforts to improve the fiscal accounts either through cuts in expenditures and/or increases in taxes. Never mind that these adjustments have been taking place in the midst of one of the worse economic recessions that the region has experienced, and that countries such as Greece, Portugal and Spain are facing the risk of an economic depression.

These countries face a combination of lack of external competitiveness which is associated with large current account deficits, low rates of growth, and very high and increasing rates of unemployment, which in Spain and Greece exceed 20 percent, and very high long-term interest rates that are a reflection of the concerns about their inability to continue to service the debt and a possible debt restructuring.

Latin America provides what is perhaps the richest laboratory of macroeconomic crises as they have come in all variety and sizes. Examples include the debt crises of the early 1980s in which the three largest economies of the region—Mexico, Brazil and Argentina—restructured their sovereign debts, which at that time were mainly with commercial banks. In the 1990s, the Mexican devaluation of 1994—the so-called Tequila effect—started a series of attacks on the currencies that quickly expanded to East Asia (1997) and Russia (1998) before returning to the region to Brazil (1999) and then to Argentina and Uruguay (2002).

The Argentine experience of 2001 is perhaps the one that resembles most closely the current policy dilemmas faced by the peripheral countries of Europe. Argentina had a fixed exchange rate set by the so-called convertibility law, which had removed the possibility of using devaluation as a policy instrument to address domestic or external imbalances. It was experiencing twin deficits in the fiscal and the current accounts, public debt was rising and most of it was denominated in dollars, the currency became clearly overvalued once commodity prices collapsed (especially soybean which is the main export), the dollar strengthened in the word markets and international interest rates rose as the U.S. tightened monetary policy.

Argentina for almost two years tried the austerity approach in its efforts to restore a deteriorating fiscal situation that was threatening the perceived government's solvency and leading to skyrocketing levels of sovereign credit spreads. Argentina attempted to introduce further structural reforms, especially in the labor markets, to reduce labor costs and to restore external competitiveness.

In the end, the austerity-adjustment approach failed in the context of high rates of unemployment and a fixed exchange rate system. There were two problems. First, the efforts to restore fiscal solvency that were effected through cuts in expenditures or increases in taxes failed because they ultimately made the recession worse and led to a vicious cycle in which tax revenues fell further, implying that the policies were ineffective in achieving improvement in the fiscal accounts. These policies finally backfired in Argentina as they did not restore solvency while unemployment increased. The second problem was that deflation and structural reforms were ineffective in achieving the much needed depreciation of the currency. They were not a substitute for devaluation. As a result, Argentina was forced to allow the currency to depreciate, and when it did it the exchange rate overshot quite dramatically from one to more than three pesos per U.S. dollar. This sharp move in the exchange rate was very traumatic for an economy that was highly dollarized, mainly because it had negative balance sheet effects and it led to widespread bankruptcies.

The trigger of the Argentine crisis was the run on the banks, as the bulk of the deposits were in dollars in a system where there was no lender of last resort. The central bank did not have sufficient dollars to cover deposits and there were not external lines to provide enough liquidity in an emergency.

The final effects are well known. The attempts to restore competitiveness through domestic deflation failed as they generated large costs in terms of unemployment. In the end, Argentina had its largest macroeconomic crisis ever which included default on public debt, maxi-devaluation of the currency, and a banking crisis in which all foreign currency deposits and loans were forcefully converted into pesos.

One important difference between Argentina and the countries in the periphery of Europe is that the latter have not experienced a run on the banks, mainly because they have a lender of last resort that has been providing liquidity. This support largely reduces the risk of a banking crisis, but the challenges for restoring growth, competitiveness and solvency are still an issue.

Is there an alternative to the austerity approach to correct macroeconomic imbalances? When one looks at the Latin American experience there are many cases in which countries in the region managed to improve their fiscal and current accounts simultaneously; however, in all those cases devaluation was an important part component of the policy response. In what follows, we look at three episodes that can help to illustrate the point: Mexico in 1994, Brazil in 1999 and Uruguay in 2002.

At the end of 1994, Mexico was forced to make a maxi-devaluation of its currency in order to correct a severe current account deficit of almost 6 percent of GDP and to try to stop a spiraling of domestic interest rates. Once it became apparent that the current account deficit was unsustainable, there were large capital outflows and the government faced significant difficulties to rollover the domestic debt, which was to a large extent held by foreign investors. There was a run on the currency and by December reserves had dropped to around $6 billion.

In Mexico, the devaluation was a central part of the adjustment package. On the one hand, it definitely helped to stop the capital outflows, perhaps with some degree of overshooting as the exchange rate moved from 3.4 to 7.6 pesos per U.S. dollar between December 1994 and December 1995. By the end of 1995, international reserves had recovered to more than $15 billion, a remarkable turnaround. In addition, the current account improved dramatically as the deficit in 1995 dropped to just 0.5 percent of GDP.

The devaluation was also instrumental in correcting some of the domestic imbalances. In particular, it helped to improve the fiscal accounts; in fact, the primary surplus increased from 1.7 in 1994 to 4 percent of GDP the following year. The devaluation helped by increasing tax revenues through two mechanisms: first, there was a direct effect that raised the value in domestic currency in terms of those revenues linked to exports (namely oil taxes). Second, there was also an indirect effect that took place through an induced increase in the price level that had a positive effect on indirect tax revenues. This was supported by a stricter control on domestic government expenditures in pesos and in wage increases that helped to reduced primary expenditures as a share of GDP.

The devaluation in Mexico had the typical expenditure reduction and expenditure switching effects. The real depreciation of the currency was reflected in a reduction in real wages, which dropped by almost 20 percent between 1994 and 1996. The figures indicate that the increase in inflation in the aftermath of the devaluation to 52 percent in 1995 and 27 percent in 1996, but it was mainly temporary. It then continued to drop and relatively quickly returned to the historical levels (which were obviously high by international standards). The interpretation of these events is that it was in effect an increase in the price level that was helpful to correct some of the macroeconomic imbalance (namely it eroded the peso denominated debt as well as real wages).

Although the economy suffered a severe recession in 1995 (when GDP drop by 6.2 percent), the economy recovered quite rapidly as it grew by 5 and 7 percent respectively in 1996 and 1997. This new growth was much more balanced, as the fiscal accounts had improved significantly, the current account deficit had dropped to manageable levels (1.6 percent of GDP) while international reserves were again on the rise. The government was able to avoid a restructuring of the domestic debt (which was under severe pressure in 1994) to a large extent thanks to the external assistance that the country received from the International Monetary Fund and U.S. Treasury, which at the time was quite controversial as there were concerns about moral hazard.

The 1999 devaluation in Brazil took place to address a run on the currency in an environment where there was a large current account deficit. The country had been facing pressures on the currency that were leading to persistent losses in international reserves. The rise in domestic interest rates were leading to perverse debt dynamics in which high short-term interest rates and high costs of debt caused larger fiscal deficits and further increases in domestic debt. While the current account was showing a deficit of 3.9 percent of GDP, the main problem was the spiraling growth of domestic debt.

The devaluation in Brazil took place in January 1999, as the real-dollar exchange rate moved from 1.2 to 2.07. In contrast to the Mexican case, inflation did almost did not rise, though it still helped to improve the fiscal primary balance (from 0.3 to 2.4 percent of GDP) and to reduce real wages and to improve competitiveness.

This devaluation did not help the current account, which only showed clear signs of improvement in response to additional depreciations of the currency that took place in 2001 and 2002. This second round of depreciations was more effective in reducing real wages but they still had a relatively small effect on inflation.

In the case of Uruguay, the country in 2002 was facing severe pressures on the currency and losses in international reserves, which were partly due to a contagion effect from the Argentine crisis. In addition to capital outflows, Uruguay had large current account and fiscal deficits, and the country was on the verge of a full-blown macroeconomic crisis.

Uruguay, in contrast to Argentina, received significant financial support from the multilateral organizations and the U.S. Treasury, perhaps because these institutions wanted to avoid another mega crisis. The bottom line, however, is that the combination of external support and depreciation of the currency were critical for the macroeconomic adjustment.

The adjustment in Uruguay was successful by almost any standard. By 2004, two years after the devaluation, the country was growing at 4.6 percent (GDP was contracting before), the current account had improved by more than two percentage points of GDP, and the country managed to generate a primary fiscal surplus of 3.8 percent of GDP compared with a deficit of 1 percent of GDP in 2001. The maxi-devaluation in Uruguay had a very small impact on inflation, which after rising to 26 percent in 2002 (when the currency depreciated by 96 percent), it moved back very quickly to the 5-7 percent range.

What are the lessons from the Latin American experiences? The most important lesson is that macroeconomic adjustment required a real depreciation of the currency, which in the end had to be achieved through devaluation as opposed to a fall in domestic prices and wages. The so-called internal adjustment failed and the devaluation worked in several ways. First, it facilitated the fiscal adjustment mainly because there was a path through to domestic prices that helped to increase tax revenues. These effects were larger in countries in which there was a high elasticity of tax revenues to the exchange rate (e.g. in Mexico where taxes on oil exports were important).

A second effect of the devaluation-inflation package was that it helped to erode the real value of the domestic currency debt (it fell as a share of GDP) as well as to improve the competitiveness of the tradable sector by reducing real wages. Workers that were unwilling to accept reductions in nominal wages ended up tolerating a dropped in real wages as they were not able to be obtain nominal wage increases to compensate the rise in domestic prices. The exchange rate and its pass through effect on inflation appear to be still today the best option to deal with the downward rigidities of nominal wages and some prices.

What are the implications for the periphery of Europe? Those countries do not have the option of relying on a devaluation to improve the fiscal and current account balances, to reduce real wages or to erode the real value of their debts, as none of them have their own currency. The so-called internal adjustment approach has made very little progress and is likely to lead to adjustment fatigue and political unrest before it achieves any meaningful changes in relative prices.

Experience indicates that the current approach based only on austerity is bound to fail, and hence Europe will need to look for alternative options. One alternative would be to allow the common currency, the euro, to depreciate in order to induce a rise in domestic prices, but at the moment this approach does not seem to be an option either. The main problem is that the European Central Bank continues to be concerned about inflation although many countries in the periphery are facing the risk of entering an economic depression.

A second and related possibility is a more expansionary monetary policy, along the lines of quantitative easing in the U.S. It would entail a further reduction in interest rates and a more aggressive increase in the monetary base that should include direct purchases of debt of the peripheral countries that can be considered solvent (Greece and perhaps Portugal would be the exceptions). With much lower long-term interest rates, the countries could get out of the perverse debt dynamics and gradually regain voluntary access to the markets. Equally important, it would allow most countries to maintain an expansionary fiscal bias as a countercyclical policy, removing some market pressures.

The European countries have an important advantage over the Latin American ones, namely that they use one of the world's reserve currencies and the region as a whole remains solvent. One obvious way to improve the situation would be to achieve more fiscal integration and transfer resources to the countries in the periphery. This requires some political consensus, which today does not seem to exist. Alternatively, the region could start pooling the credit worthiness of the strongest with the weakest countries and issue Eurobonds to help reduce the costs of financing to the weaker ones.

One needs to keep in mind though that restoring solvency is addressing only one part of the problem. Most European countries still face a lack of competitiveness due to high domestic prices and wages. Too much emphasis on fiscal adjustment and on the debt dynamics could be myopic and could mean a protracted period of low growth. The Latin American experience suggests that expenditure switching is just as important as expenditure reducing policies to restore balanced growth.

TABLES

Brazil

	1997	1998	1999	2000	2001	2002
Devaluation (YoY)	7.4%	8.2%	49.3%	8.0%	18.5%	53.0%
Inflation (Dec/Dec)	5.2%	1.7%	8.9%	6.0%	7.7%	12.5%
Real GDP (YoY)	3.4%	0.0%	0.3%	4.3%	1.3%	2.7%
Primary Balance (% GDP)	n.a	0.3%	2.4%	2.7%	2.5%	2.3%
Primary Expenditure (% GDP)	n.a	31.1%	29.2%	29.9%	31.3%	32.4%
Domestic Public Debt (% GDP)	n.a	n.a	n.a	49.9%	54.1%	57.4%
Reference Interest Rate	40.9%	29.0%	19.0%	15.8%	19.0%	25.0%
Real Wages (2001=100)	135.0	141.4	134.1	131.4	100.0	94.7
Current Account (% GDP)	-3.5%	-3.9%	-4.3%	-3.8%	-4.2%	-1.5%
International Reserves (USD Bn.)	52.17	44.56	36.34	33.01	35.87	37.82

Mexico

	1992	1993	1994	1995	1996	1997
Devaluation (YoY)	1.6%	-0.3%	57.6%	56.7%	2.6%	2.3%
Inflation (Dec/Dec)	11.9%	8.0%	7.1%	52.0%	27.7%	15.7%
Real GDP (YoY)	3.6%	2.5%	4.8%	-6.2%	5.5%	7.2%
Primary Balance (% GDP)	4.3%	2.8%	1.7%	4.0%	3.7%	3.0%
Primary Expenditure (% GDP)	15.6%	16.3%	17.0%	15.7%	16.1%	16.8%
Domestic Public Debt (% GDP)	11.6%	11.0%	7.3%	7.1%	7.1%	8.1%
Reference Interest Rate	24.5%	12.5%	26.4%	51.4%	28.6%	20.1%
Real Wages (2001=100)	99.4	103.8	108.2	94.5	85.2	84.7
Current Account (% GDP)	-6.1%	-4.8%	-5.8%	-0.5%	-0.6%	-1.6%
International Reserves (USD Bn.)	18.43	24.41	6.60	15.59	17.51	28.00

Uruguay

	2000	2001	2002	2003	2004	2005
Devaluation (YoY)	7.7%	11.2%	93.5%	6.7%	-8.1%	-8.6%
Inflation (Dec/Dec)	5.0%	3.6%	26.0%	10.2%	7.6%	4.9%
Real GDP (YoY)	-1.8%	-3.5%	-7.1%	2.3%	4.6%	6.8%
Primary Balance (% GDP)	-1.1%	-1.0%	0.2%	3.1%	3.8%	3.7%
Primary Expenditure (% GDP)	26.9%	27.9%	26.2%	24.6%	24.0%	24.2%
Domestic Public Debt (% GDP)	13.3%	20.3%	22.7%	21.6%	22.8%	21.7%
Reference Interest Rate	16.5%	40.0%	63.1%	2.2%	0.0%	0.7%
Real Wages (2001=100)	100.3	100.0	89.3	78.1	78.1	81.7
Current Account (% GDP)	-2.5%	-2.4%	2.9%	-0.7%	0.0%	0.2%
International Reserves (USD Bn.)	2.82	3.10	0.77	2.09	2.51	3.08

Can Asia Help Power the Global Recovery?

Peter Drysdale

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When the global financial crisis hit the U.S. and European economies in 2008, the emerging economies in Asia—with their high rates of growth, huge current account surpluses and export-oriented growth strategies—were an easy target for those in the industrial world who had difficulty coming to terms with the mess they had made of managing financial markets in a era of seemingly unlimited cheap international capital. Rebalancing global growth became the mantra for how to shape the contribution of emerging economies to ending the global recession, temporarily hiding the need to rein in structural deficits and financial imprudence in the developed world. As Europe teeters toward another crisis, threatening to shatter confidence in America's tentative recovery and global markets, emerging economies have come to be seen as the savior of global economic growth rather than a culprit of the current mess.

Europe is currently facing the second-round political effects of the strategies that have been painfully put in place to engineer economic recovery. Europe's politicians were hamstrung by the difficulties in forging the parliamentary majorities needed to pass measures designed to lift confidence and get the recovery on track. Now they are confronted with the difficulty of maintaining these majorities as the blunt surgery used to root out the cancer that caused the crisis has left the body politic fragile and resentful, weakening its resolve to stay on course. The prospect of governments that committed to the European recovery strategies collapsing threatens the entire European recovery. As political turmoil compounds economic turmoil, it seems clear that restoring confidence will be a slow and painful process.

The G-20 leaders' meeting in Los Cabos will not only need to maintain leaders' resolve but also encourage new commitment to further measures to stimulate global growth. At no juncture has the G-20 had a more critical task in bridging the gap between national and global political interests.

While there are worries about slowing global growth, China and other emerging economies have forged through the global financial crisis, maintained strong rates of growth despite their shrinking export markets in industrial countries, and made a significant positive contribution to global growth. The international community and particularly policymakers in the United States have put great expectations on the contribution that China should make to global economic recovery by rebalancing its economy and reducing its current account surplus through promoting consumption growth. But there is growing evidence that this rebalancing is in fact happening.

Until recently, China's current account surplus was seen as a big problem but the current account surplus has fallen from over 10 percent of GDP in 2007 to 2.8 percent of GDP in 2011. The International Monetary Fund's most recent prediction is that the current account balance is likely to remain at normal levels with forecast surpluses of 2.3 percent and 2.6 percent in 2012 and 2013 respectively. In contrast, in September last year, the IMF was still forecasting a 5 percent current account surplus this year and the IMF's 2011 Article IV consultation with China identified the current account surplus as a problem that needed to be fixed.

With decreasing trade and current account surpluses, declining foreign exchange reserves and even expectations of a currency depreciation late last year, estimates of the undervaluation of the renminbi (RMB) have been drastically revised downwards. Wages have in fact risen rapidly (with all the indications that a wage explosion is on the way in the industrial coastal provinces), implying an appreciation of the real exchange rate in China; and while regulated interest rates did not change much, the proportion of financial intermediation subject to market-based interest rates has risen sharply. There is also growing evidence of major steps toward capital account liberalization, most obvious in the purposeful policies being put in place to internationalize the RMB. These are exactly the types of changes that are driving a rebalancing of the Chinese economy and recovery of consumption.

It is true that the Chinese authorities have not taken many concrete steps to rebalance the economy. The People's Bank of China (PBOC), for example, has not yet moved to liberalize interest rates; rather interest rates that are market-based have started to play an increasingly important role in China's financial intermediation. Policy has, however, moved to make the currency more flexible and to moderate distortions in energy markets. Changes in both labor and capital markets have also impacted positively on consumption in at least two ways. They have increased household income and reduced what were effectively subsidies to Chinese enterprises. Rising wages and interest income also advantage low-income households and should gradually help improve income distribution.

Some argue that the declines in China's external surpluses are in large part the result of a weak global economy and a modest appreciation of the RMB, not a fundamental rebalancing. The underlying drivers of the surpluses that emerged during the boom years—negative real interest rates on deposits, cheap credit for corporations, and subsidized land and input prices—are all still in place. But the pressure through the market for policy change is powerful and the current consensus is that external surpluses are unlikely to return once the global economy recovers.

Overall, the growth outlook for the big Asian emerging economies remains strong: the latest IMF forecasts are that Chinese real GDP will grow 8.2 percent this year, possibly easing back to the official 7.5 percent over the next five years; Indian real GDP will grow 6.9 percent though with a weaker outlook; and Indonesian real GDP will grow 6.1 percent with a robust outlook.

For Indonesia and other emerging economies, the focus of policy needs to be on infrastructure investment to integrate these countries more efficiently and fully into the global economy and to capture the benefits of integration. This need lies behind Indonesia's push at the G-20 finance ministers' meeting for a global initiative on infrastructure investment.

The potential for productive investment in infrastructure in the emerging economies is enormous, as I've argued before.[1] The OECD estimates global infrastructure requirements in 2030 to be in the order of $50 trillion.[2] Much of this demand is in Asia, where almost a trillion dollars' worth of infrastructural investments has already received an initial assessment from the Asian Development Bank. Despite massive infrastructure investment through the global recession and questions about its productivity, China's stock of capital relative to population and income is also low, and India and Indonesia offer vast scope for investment in infrastructure. What is needed is less government directed investment and more productive investment in infrastructure driven by the private sector.

The terms of reference of the G-20's High Level Panel on Infrastructure are too narrow to facilitate this investment and G-20 leaders need to widen the panel's terms of reference, challenging their officials, financial sector managers, and international financial institutions to use their expertise to find ways to bring more savings into commercially viable investment in infrastructure wherever it is needed, but especially in the emerging economies. Productive investment in commercially viable infrastructure in Asia's emerging economies will help to boost and sustain global recovery and present important external opportunities for the industrial countries' businesses.

Even as the developed economies recover, Asia will continue to grow as will its share of global economic activity. The challenge of the years ahead will be to manage this global economic transition and there is nothing that will guarantee its success. For the major emerging economies, and for economies like Australia, the G-20 offers by far the best opportunity of success.

Constructing the G-20 forum represents a great achievement in international diplomacy and cooperation. But the mere existence of the forum does not guarantee a solution to the major world problems of today. What finally matters are the decisions taken by the forum and the willingness of its members to, in a spirit of mutually beneficial cooperation, follow up those decisions with independent action. The effectiveness of the G-20 depends upon entrenching the belief and the understanding that such cooperation is crucial to global prosperity and stability. There is no supra-national authority or legal framework, except through narrowly circumscribed international institutions and laws, to enforce G-20 decisions and agreements—just the power of collective responsibility and will to shape the follow-through of national actions.

The value of the G-20 to date has been the willingness of leaders to engage with the pressing issues of the day; first and foremost resolving financial and fiscal crises and their economic consequences, but also in dealing with other important economic issues like development, food and energy costs, and governance and corruption. It has not only been about talk; there has been action, albeit imperfect, incomplete and with painful lags. The challenge ahead is to consolidate and entrench respect for, and the soft discipline of, the G-20 process: to understand what it is, what the process can do, and what it can't do.

So how can the G-20 continue to make a contribution and be a political driver of change?

While the G-20 is an international forum, the economics of the G-20 is largely domestic: the focus is on delivering domestic economic growth and jobs. The G-20 represents a collaborative drive by countries for growth, recognizing from the events of the global financial crisis just how interdependent our national economies now are. This domestic focus has been to G-20's advantage; the G-20 has worked so far because it has been the highest-level political catalyst for reform, compromise and change in the leaders' own countries.

One of the G-20's successes has been the "Framework for Strong Sustainable and Balanced Growth", which embodies the basic insight that internal or domestic structural balance in the economy is the source of external balance, and that competitive and well-regulated markets, strong institutions and governance, and human and physical capital (education, skills and infrastructure) are the primary sources of a country's economic growth. The Mutual Assessment Process and action plans are the operational heart of the framework. It is essential to keep the G-20's focus on growth and employment, and that will happen by getting the basics of domestic economic policy right and through collaboration, transparency and accountability between countries. Continued growth is essential to making the global economic transition work.

Also essential is the evolution of the rules that govern and shape global economic engagement. These rules are not simply black-letter law, such as the trade rules, but include norms of behavior that make the international economic system works. The rules in the post-war period were, of course, largely written by the western powers. But they were rules that served other nations well and have been the foundation of growth and prosperity for the emerging economic powers. For much of this period, the agreed rules of international finance were written in the U.S., British, German-dominated Financial Stability Forum and Bank for International Settlements; the rules of crisis resolution and development by a G7-dominated IMF and World Bank; the rules of international trade by a G7-dominated General Agreements on Tariffs and Trade.

As the emerging market economies have grown, these rules and institutional structures have been called into question because they no longer reflect the structure of global economic power or the responsibilities that different countries need to exercise in managing the global economy. There have already been fundamental changes to governance and membership of the rule-setting bodies (of which Australia has been an active advocate), but further change in governance is needed. The formation of the G-20 itself—particularly its elevation to a leader-level forum—is a powerful example of the emerging economies' growing inclusion in global economic decision-making.

These questions about the structure and foundations of the G-20 process will become more and more important as the very process itself is challenged by the growing stress of the secondary, politically induced shocks to managing recovery and getting sustained growth on course.

This will be a time that calls for the emerging economic powers to assume their responsibilities in international initiatives as Europe and America struggle to stay on course. It will be a time to actively think about how to reinforce global institutions, like the World Trade Organization, that remain so central both to international prosperity and cooperative international politics. It will be a time for taking initiatives on new problems, such as energy security, food security, climate change and the environment. The G-20 itself cannot do all the work that will be required across these areas, but it can, and will have to, initiate much of it.

Growth in Asia and in other emerging economies may not be sustainable on the pre-crisis growth model, and Asia is slowly but surely edging away from that model. But it certainly won't be sustainable under any model unless the global rules and norms are strengthened and extended under the leadership of the G-20. The opportunity to do this is here and by grasping it, Asia and the emerging economies can help the global recovery and create a sounder basis for long-term growth.

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A Monetary Tsunami? Brazil in the Cross-Fire of New Style Currency Wars

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At the beginning of the last decade (2001-03), the major economies were growing below their perceived potential. Central banks reacted by lowering interest rates and pursuing an accommodating monetary policy. The U.S. Federal Reserve Board was possibly the most aggressive: between 2000 and 2003 rates fell from 6.5 to 1 percent. At the same time, the key economies embarked in expansionary fiscal policies, with Japan in the lead; the latter caught in an apparent liquidity trap, for which low interest rates had limited impact. Although voices were heard that bubbles in commodity and real estate markets were forming as a result, the difficulty of asserting unambiguously that growth was not on solid ground postponed any policy action. Moreover, in the context of rising incomes and employment, and subdued price inflation, what were the incentives for politicians to cut the party short?

At the time, financial liberalization and intense competition led to growing private sector indebtedness. Families took on debt to acquire their first or second homes, to refinance existing mortgages and expand their levels of consumption. Firms responded with greater output and investment financed from retained earnings, and increasingly from equity and debt raised in capital markets. New, complex instruments reallocated risk, often hiding its magnitude from regulators, which on their turn were not then imbued with a sense of caution. The finance industry was having its day, or better, its decade, with managers being remunerated on account of returns unadjusted to the extent of risk being taken. If the age of "irrational exuberance" was coming to an end, most people were simply unaware that the "good times" would soon be over.

The year 2007 marks the onset of the crisis. It began in the mortgage market with New Century Financial unable to honor commitments, followed by Bear Sterns being effectively shielded by the U.S. Treasury before being taken over (by J.P. Morgan) in early 2008. Trouble moved to the U.K., which was forced to nationalize Northern Rock. Then on both sides of the Atlantic a quick sequence of major disasters followed, culminating with the collapse of Lehman Brothers on September 15. By then, the crisis had become systemic.

With credit markets paralyzed and the real sector seeing its demand collapse, there was no other option except for central banks and governments to act decisively. In addition to taking on quasi bankrupt institutions, injecting equity and providing extraordinary guarantees, governments used spending and tax cuts to act as fiscal stabilizers. Between 2007 and 2010, fiscal balances (at the start already negative) quickly deteriorated, with net borrowing increasing by 5.3 percent of GDP in the euro area, 6.8 percent in Japan, 6.9 percent in the U.S. and 7.5 percent in the U.K. Yet, after this initial attempt of a classical Keynesian fix, debt dynamics and political constraints have since forced an inflection; monetary policy became the "least cost" alternative.

Indeed, as the crisis loomed and the danger of the economies spiraling out of control became apparent, central banks began to push reference rates down to unprecedented low levels. Arguably, the Fed was the most aggressive, while the European Central Bank (ECB) was the slowest to act and certainly the most conservative (if interest rate differentials are an indication), possibly due to the influence of the Bundesbank, well known for overweighing the risk of inflation. But the overcautious nature of the ECB's policies prior to Mr. Draghi´s accession were not immaterial to the current crisis in Europe. Be that as it may, by February 2009, ECB interest rates were still 175 points above the Fed and the Bank of Japan (BoJ), and 100 points above the Bank of England (BoE); as of April 2012, all such rates are effectively close to zero.

Yet the policy toolkit was not yet exhausted. Between August and December 2008, the Fed´s balance sheet expanded by 148 percent, the BoE 156 percent, while the ECB was somewhat the "odd man out" with 41 percent. After a contraction in early 2009 (respectively 8.7 percent for the Fed and 10.8 percent for the ECB, though more significant for the BoE at 24 percent), when it appeared that the worst was over, other rounds of quantitative easing (QE) in its various shades followed, and since then the asset base of major central banks continued to grow in reaction to the lingering crisis. In fact, new rounds of monetary easing further expanded the Fed´s balance sheet, which as of the end of March 2012 stood 40 percent above early 2009 levels, while for the BoE the increase was in the order of 84 percent. Yet the most relevant shift was undertaken by the ECB under Mario Draghi. Already in the transition—between being named its new head in June 2011 and taking over on November 1—the European Central Bank expanded its asset base by 17.3 percent and, after Draghi's accession, by another 29 percent by the end of March 2012. In sum, since mid 2011, the ECB added a whopping trillion euros in assets, one-third of its total.

Although the Fed and more recently the ECB were the main players in the limelight, the Swiss National Bank (SNB) and the People´s Bank of China (PBC) have also been fast adding assets to their balance sheet, which have grown by close to 80 and 51 percent respectively since September 2008. Putting it all together, those six major central banks—namely, the Fed, ECB, BoE, BoJ, SNB and PBC—added nearly $6.6 trillion in liquidity, slightly doubling their asset base in just three and half years. Combined with quasi zero interest rates in Europe and the U.S., one has a monetary tsunami in the making. And such a cash wave should not have immaterial consequences for countries on the receiving end, Brazil among them.

Here opinions split (at least) two ways on the actual effect of such major monetary movements on exchange rates (and asset prices): for some, they explain to a great degree exchange rate appreciation in countries which attempt only to accommodate—but effectively do not control—exchange rate movements; others, without denying their impact, see the infusion of liquidity of secondary importance. The debate is further complicated by the proposition that the worst is still to come, as a good chunk of liquid assets is dammed for the moment in a few central banks, the ECB primarily. Once commercial banks and other financial institutions tire of earning negative interest rates for their voluntary central bank deposits and overcome their aversion to the risk entailed in reallocating their portfolio to financially more attractive alternatives (such as private and government bonds in commodity exporting emerging and other economies) the "currency war" might be more than an image grabbing expression.

Not that there have been no casualties. Hard pressed countries are having second thoughts on the importance of freer trade, a less intrusive industrial policy, a more open capital account or even an inflation targeting regime, if this means accepting passively growing exchange rate volatility and its adverse impact on the real economy. Governments are beginning to realize there may be sharply adverse trade-offs in taking as given WTO tariff commitments in the face of an exchange rate driven fall in levels of protection. As a result, they can ill afford to avoid industrial targeting and other discriminatory policies when major industries, including some in labor-intensive sectors, are under threat from perceived "nonstructural" factors emanating from the political imperative of pump-priming recoveries. If other countries revive their economies on a new type of beggar-thy-neighbor policy, why should they stick to a policy course which translates into loss of income and jobs?

Maybe even more worrisome, for economies with a history of hyperinflation, adding exchange rate policy to the menu of active instruments and as a means of containing appreciation to defend local industry, may potentially undermine carefully built inflation targeting systems, while accumulating reserves in excess of what is prudent brings significant fiscal costs. For countries which have to finance current account deficits with private capital inflows, slapping capital controls seems not only contradictory but also adds an additional layer of uncertainty and corresponding economic costs.

This in a nutshell describes the current policy conundrum Brazil faces. A combination of steady, inclusive growth, a booming domestic market with the *aggiornamento* of a new middle class, a fairly solid fiscal regime and a significant resource base, has made the country an attractive lot to park capital. As a commodity currency, the Brazilian real has become a good bet, with a positive twist: interest rate arbitrage ("carry trade") has in the last few years brought significant gains to investors. As of early April 2012, real interest rates (nominal reference rates minus projected 12-month inflation) in Brazil stood in percentage terms at 4.3, significantly above Australia (1.3), Mexico (1.2), Chile (1.0), India (0.5), Indonesia (0.25), South Korea (zero), Thailand (-0.6) and Canada (-1.0), while in Japan (-0,1), the eurozone (-0,7), the U.K. (-1,5) and the U.S. (-2.0), nominal rates were very close to zero, and real rates negative (as noted).

In this context, the real has appreciated with force, with the government caught in an uncomfortable dilemma: should it simply let the domestic currency appreciate, compress inflation in the tradable sector, and try to compensate by other means the loss in competitiveness (at least while a new exchange rate equilibrium is reached as interest rates lower)? Or should it intervene, have the central bank purchase foreign currency and institute capital controls, taxing the entry of "speculative capital" and/or imposing quarantine, at the risk of higher inflation? While in the beginning the Lula government used currency appreciation as an additional support to maintain inflation in check, it later leaned the other way. The new government strengthened the policy shift, mopping up excess dollars, adding to a burgeoning exchange reserves ($365 billion in early April), while imposing a relatively stiff tax rate (6 percent of the principal) in an attempt to take away excess returns from foreign financing operations with less than a five-year term. Although this dilemma is not unique to Brazil, the pressures it faces are arguably more intense, in view of the size of the economy, the depth of financial markets (particularly in government bonds), the tradition of domestic and international companies to access credit markets abroad, and the economic incentives for interest rate arbitrage.

Yet managing the exchange rate, however justifiable, is not done without a penalty. There is of course a fiscal cost (the difference between borrowing rates and the average remuneration of reserves) as the purchase of foreign currency is systematically sterilized. Further, corporate financing costs also go up, as border taxes on incoming financial flows are passed on to borrowers and eventually consumers. And at the end of the day the current account deficit (estimated at 2.9 percent of GDP or approximately $70 billion in 2012) needs to be financed, with attractive interest rates playing a key part. The larger the obstacles for incoming capital, the higher effective interest rates need to be.

However, the key policy paradox comes from the fact that to defend the currency, the government and the central bank are forced to accept a higher rate of inflation than most of Brazil's trading partners, with the result that real exchange rates tend to increase while nominal rates stand put at best. On the other hand, if the central bank decides to pursue its inflation target, it will need to lean against the wind with a more conservative stance. If it uses interest rates as the instrument of choice, it will be acting at cross purpose with the stated aim of moderating capital inflows; if it resorts to regulatory measures to compress domestic credit, it will need to do a good amount of guesswork regarding its impact on inflation, complicating further the imperative of steering agents' inflation expectations to the center of the target.

As a political entity, the government cannot simply stand on the sidelines. Well organized interest groups—unions and industrialists—cry foul to the relentless pressure on cost competitiveness as the real appreciates (which disallows increasing costs to be passed on automatically to consumers), while the price of non-tradables faces no such constraints.

Brazil is fast becoming a high-cost platform, but not only due to exchange rate distortions. There are macroeconomic impediments to the modernization of the productive apparatus related to low savings and investments rates; and there are structural obstacles ranging from poor infrastructure, low levels of education and technical training, insufficient innovation, and a complex tax regime (and accompanying high rates), which combined weaken Brazil's competitive standing. The bottom line is that firms are unable to counter higher costs with significant enough productivity gains. And they complain loudly.

The government's response has gone well beyond managing the exchange rate with support from the central bank. On the external front, it denounces the ongoing "currency war" and attempts to elevate the discussions to the G-20 and like meetings. There it looks for friends in the same predicament, looks for support to change WTO rules, allowing for currency appreciation countermeasures, while trying to argue for a redressing of the balance between fiscal and monetary stimuli, with a renewed emphasis on the former.

Domestically, it is the mirror image: it pushes the central bank toward an accommodating monetary policy and lower interest rates, combined with mopping up operations of excess foreign exchange to contain currency appreciation; it acts to protect automotive, capital goods and other sectors such as textiles and shoes from foreign competition, pushing existing WTO rules to the limit while risking retaliation; and it provides for highly targeted tax relief and subsidized finance, the latter through the National Development Bank (BNDES, which received loans from the Brazilian Treasury of over $150 billion since the onset of the crisis), tilting the playing field toward dominant firms, strengthening their market position, not only abroad but also domestically. The benefits of this policy in terms of output and employment (industrial) growth appear limited at best, although one could always argue the counterfactual. Be that as it may and to put it succinctly, it is an inglorious fight for the government: dammed if you do (which they are doing!); dammed if you don't.

Not that structural reforms are out of consideration. The Brazilian government is clearly aware that it needs to announce a credible reform agenda sometime soon and move beyond ad hoc "packages", with déjà vu characteristics: targeted subsidies and protection to well-placed incumbents, without much being asked from them. President Dilma Rousseff is hard working and well intentioned, and arguably has not committed any major blunders in the domestic or foreign affairs arena. Moreover, she was able to jettison the ministerial-level deadwood inherited from the previous government without major trauma (and in the process remain untainted by corruption scandals) and in parallel make a political statement of independence from Congressional threats. As a result, she is now more popular than her predecessor, Lula!

But something is amiss. Unlike Fernando Henrique Cardoso or Lula, she rides along without a strategy—in one case, centered on consolidating post-hyperinflation macroeconomic stability by reforming the state; in the other, making growth more inclusive by a combination of microeconomic reforms and a substantial expansion of transfers and well targeted social safety nets. Their place in history is assured. Hers, a big question mark: will she be able to devise a reform agenda and political strategy which moves it forward, or are we going to observe only well-intentioned patchwork?

With markets in the beginning of the second quarter providing a respite—temporary maybe—and the American economy on the way to sustained recovery, it may now be a good time for Brazil to be more ambitious and propose a comprehensive and intelligible reform agenda. The premise is simple:

over the next couple of years, the U.S., Europe and other economies will not budge in any significant way on their accommodating monetary policies for the simple fact that there is nothing else to put in place. This is even more so if the Chinese economy and Asia decelerate and cannot be counted on as sources of autonomous demand.

In 2012, Brazil has been crying wolf. For in fact there is not a deluge of dollars prying open the doors of the bond market. Arguably, a combination of a stronger dollar as the U.S. economy gained traction with respect to the rest of the world, and domestic capital controls, appears to have been effective in containing the influx. While the Brazilian Central Bank bought $24 billion in 2009, $41.4 billion in 2010 and $47.9 billion last year, so far this year purchases amounted to less than $2.8 billion, with the real actually devaluing 6.35 percent since February. It appears that the government would like to maintain the nominal real-dollar exchange rate in the 1.8 to 1.9 band. For the moment, and under current circumstances, the defense mechanisms seem to be working. Yet what might happen if resources deposited with the Fed, the ECB and other central banks leave their safety vaults and start aggressively looking for higher returns?

If and when countries leave the arena of a phony currency war and the true tsunami comes (which no analyst can be certain of), it is highly unlikely that current remedies will do the trick, unless policymakers would be willing to deny domestic firms access to foreign finance, slapping prohibitively high border taxes on capital inflows. Of course, that would make life for firms far more difficult, increase policy uncertainty and put a lid on growth. Why instead not prepare the country for more intense competition—including from such spurious forces—on the basis of a productivity-centered strategy? If a balanced global recovery actually takes place, so much the better. As is often the case, a constructive approach depends far more on domestic factors: political will and the ability to put forward a coherent set of initiatives.

In sum, for an economy with significant resources and endogenous sources of dynamism—both in terms of entrepreneurial capacity and a domestic market which is proving to be a boom to most producers—only self-inflicting policy mistakes can be the real hindrance to growth, short a global economic catastrophe. At the end of the day, and if one had to weigh the pros and cons of the aggressive monetary policies being pursued by major central banks, they have possibly done more good than harm by ensuring that none of the major countries and economic jurisdictions slipped into deep recessions. Not that the forces that are at work bringing a misalignment of exchange rates are immaterial to the competitive standing of domestic industry and its share in trade and output. But this cannot be used as a smokescreen to hide the need to move forward with a reform agenda that will thrust the Brazilian economy in a trajectory retaining its virtuous inclusive features, but combining it with a more efficient, innovative and resilient productive base.

Stronger Hopes and Renewed Fears: The Governance Legacy of The Global Financial Crisis

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August of this year marks the fifth anniversary of the outbreak of the global financial crisis, which began with problems in the subprime mortgage market in the U.S. At this juncture in most recessions, economies are once again growing strongly and the downturn a distant memory. As the introduction to this volume notes, however, the fifth anniversary of the Great Recession finds strengthened hopes struggling against renewed fears in the world economy. This mix of optimism and pessimism is not surprising given the prevailing economic conjuncture.

Five years later, the global financial crisis continues to weigh on a global economy that remains dangerously unbalanced and threatened by new fragilities. While growth was quickly restored in the dynamic emerging economies outside of the core of the global financial system, concerns remain about the pace of exchange rate adjustment and potential asset price bubbles in China; at the same time, many emerging economies worry about a possible new round in the currency wars unleashed, they contend, by the monetary policies of key central banks. In contrast, the advanced economies that entered the crisis with the greatest financial sector problems, and that have the most work to do rebuilding balance sheets, have experienced a more restrained recovery. Tepid employment growth in the U.S., continuing stagnation in Japan, and the spreading European sovereign debt crisis, which has contributed to Great Depression levels of unemployment in some countries, underscore the fragile nature of the global economy.

In this respect, the past five years represent a reversal of the so-called "Great Moderation" that prevailed prior to the crisis. We now know that beneath the apparent tranquility preceding the crisis fundamental problems were festering in key countries at the very core of the global economy. In mid-2007 these problems began to appear as cracks in the façade of global finance. By September 2008, these cracks had spread and widened, threatening the very foundations of the international financial system.

The Challenge Ahead

If there is one key lesson from the crisis it is that the evolution of financial markets and the integration of financial systems outpaced the development of international regulatory frameworks for the governance of global capital. Prior to the crisis, financial markets were internationally integrated, while prudential regulation and supervision was largely national. In this environment, financial institutions exploited gaps in legal and regulatory frameworks in a process of regulatory arbitrage, both across regulatory authorities within countries and across different jurisdictions, to engage in excessive risk-taking that put the entire global economy at risk.

The negative spillover effects associated with this process underscore the importance of getting the right international regulatory framework for global financial integration—in effect, globalizing regulation as the counterpart to globalized capital.[1] Such a framework would reduce the risk of future crises, yet ensure financing for the innovation and research that will drive growth going forward. Not surprisingly, addressing weakness in regulatory frameworks that contributed to the global financial crisis has dominated international policy discussions over the past five years.

At the same time, the remarkable global response to the crisis refuted Hegel's assertion that "the lesson of history is that mankind does not learn from history." Drawing on the lessons from the 1930s, G-20 countries agreed to:

- provide massive liquidity support in the face of a globally-unprecedented liquidity shock;
- adopt counter-cyclical fiscal stimulus programs; and
- eschew protectionism (trade and financial) and avoid beggar-thy-neighbor policies that would only beget even more harmful policy responses.

In addition, several countries adopted a range of "non-traditional" policies intended to stabilize markets and anchor expectations in the face of pervasive uncertainty that threatened to create an option value of waiting and a "wait and see" economy. The challenge in late 2008 and through the first half of 2009 was to prevent households and firms acting in a manner that may have been individually rational (reducing consumption; deferring investment), but was collectively irrational in that it propagated economic stagnation.

This unprecedented level of cooperation early in the crisis was facilitated by a common threat: faced with the prospect of a global financial and economic collapse that would harm all, a common, coordinated response was essential. Meanwhile, the "2 percent solution" proposed by the managing director of the International Monetary Fund, under which countries were encouraged to provide new fiscal stimulus equal to 2 percent of GDP, helped foster a sense of a shared response to the crisis and provided a benchmark against which efforts could be monitored for possible free riding.

As countries came out of the crisis at different speeds, however, the nature of the required responses changed. Rather than a common response to the common threat of collapse, differentiated policy responses were needed to rebalance global demand so that countries undertaking difficult fiscal and financial sector adjustment did not impart deflationary pressures to the global economy.

Analytically, the problem is to avoid an asymmetric international adjustment process in which the full burden of adjustment is borne solely by countries with current account deficits. Unfortunately, this is precisely the specter now haunting the global economy, as individual countries pursue self-interest to the potential detriment of all.

The objective must be to promote a more felicitous outcome, in which everyone is better off. But to secure such a Pareto improvement, cooperation is necessary; some monitoring mechanism is also needed to support a cooperative equilibrium. Successful global rebalancing requires policy responses that are both more difficult to agree on and more difficult to monitor compliance with. In effect, the level of interconnectedness in the global economy and the nature of the economic problems are such that purely national policy responses are inadequate.

Perhaps in recognition of this fact, leaders at the Pittsburgh Summit designated the G-20 as the "premier forum for our international economic cooperation" and established the Mutual Assessment Process (MAP), which seeks to promote "strong, sustainable and balanced growth" through multilateral review of and consultations on members' policies. However, the effectiveness of the MAP exercise has been constrained by a number of factors.

Most significant is the continuing "triple crisis" in Europe, as banking and sovereign debt crises, together with a crisis of growth, cast a pall over the continent.[2] At the source of these crises are monetary arrangements that, in some respects, resurrect the "bad" gold standard of the inter-war years, which propagated stagnation through an asymmetric adjustment process, as surplus countries sterilized gold accumulation, while the "old lady of Threadneedle Street" (the Bank of England) was too feeble to provide the public good of international financial stability.

As Charles Kindleberger and his student Barry Eichengreen have stressed, governments returned to the gold standard following World War I as an article of faith. This faith was based on the belief that the pre-war monetary arrangements provided symmetric, automatic external adjustment.[3] In the circumstances in which it was reintroduced, however, the gold standard led to a global economic catastrophe. What governments did not appreciate at the time was that, far from being some automatic, market-driven *deus ex machina*, the pre-war gold standard was supported by high degree of adherence to the "rules of the game" enforced by a dominant player—the Bank of England.

The problem today is that Europe does not satisfy the conditions for an optimal currency area; nor does it have risk-sharing institutions or the dominant player that is both willing and able to support the single currency. As a result, the full adjustment burden is on deficit counties and those undertaking draconian fiscal adjustment to restore "confidence" discover that, rather than rewarding them for their perseverance, financial market confidence is further eroded. This, too, was the experience in the inter-war period.

The situation in the U.S. is also troubling. Five years ago, Ben Bernanke confidently dismissed the possibility of the U.S. following Japan into a decade of stagnation. It is not clear that he can be as adamant today. The problem is that the polarization of the political process has handicapped fiscal policy as an effective tool of stabilization policy. The fiscal response to the crisis, it is argued, has been too modest and calls for fiscal tightening premature, particularly with interest rates at the zero nominal lower bound in an environment eerily reminiscent of the Japanese experience and textbook treatments of the canonical Keynesian liquidity trap.[4] The burden of adjustment has therefore fallen disproportionally on monetary policy.

At the same time, because the "black box" of traditional channels of the monetary transmission mechanism is not working as a result of the financial crisis, the Federal Reserve and other major central banks have resorted to "exceptional measures", including quantitative easing. One result of this has been large-scale capital flows to countries that are growing more quickly and which offer the prospect of higher returns. But these countries are both reluctant to absorb the accompanying appreciation of their exchange rates, and fearful of fueling asset price bubbles, particularly when some others have tied their currencies to the dollar through heavily managed exchange rates. As a result, these countries have resorted to controls on capital inflows, deemed prudential regulations, to limit the appreciation of their currencies.

The impact of all this has been to limit nominal exchange rate adjustment. And this, in turn, implies that the real exchange rate adjustments required to facilitate the needed rebalancing must either come from inflation in surplus countries or deflation in deficit countries, or some combination of the two. Given the potential costs associated with excessive asset price booms on the one hand, and the threat of a debt-deflation spiral in heavily indebted economies undergoing deflation, on the other, this outcome is not in anyone's interest. The goal should be a timely rebalancing of global demand that promotes strong, sustained and balanced growth, consistent with the MAP objectives. This rebalancing would reduce the risk of inflation in countries that did not experience a severe downturn in the crisis, for which the expansionary monetary conditions of the Fed are inappropriate, and dissipate the threat of deflation/disinflation in countries that need to undertake difficult, sustained fiscal adjustment.

Failure to secure these adjustments could cloud global economic prospects and undermine support for the open, dynamic international financial and economic system erected over the past 60 years, which has raised living standards for so many around the globe. Put differently, the threat is a retreat from global cooperation, as individually countries resort to policies intended to insulate themselves from global risks, but which collectively constitute beggar-thy-neighbor "measures destructive of national and international prosperity."[5] That was the experience in the 1930s as country after country sought to shift the "hot potato" of adjustment to others through trade and financial protectionism. The result of these measures to escape the exigencies of an asymmetric adjustment process was economic stagnation, the fraying of the social fabric, and the radicalization of politics with horrific consequences for millions around the globe.

The Governance Legacy of the Crisis

The threat of a possible retreat from international cooperation is the key governance legacy of the global financial crisis and avoiding this outcome is the major governance challenge. In this regard, policymakers today would do well to reflect on the past.

Surveying the damage wrought by the dysfunctional monetary arrangements of the inter-war period, the architects of the Bretton Woods system sought to facilitate timely, orderly balance of payments adjustment, while allowing its members to pursue policies to maintain full employment. The IMF played a key role in promoting the public good of international financial stability by encouraging timely policy adjustments and identifying potential risks through its surveillance of members' policies. At the same time, it provided short-term balance of payments financing to smooth the adjustment process, reducing the likelihood that members would "defect" from the cooperative equilibrium of sound policies and open markets.[6] In effect, the IMF was created to assist its members strik a judicious balance between financing and adjustment.[7]

Under the Bretton Woods arrangements, IMF members "coordinated" through their adherence to the obligations and responsibilities in the IMF Articles of Agreement. After the collapse of the Bretton Woods system, efforts to cooperate (usually around crises) were centered on country groupings that have gradually expanded in size, as the process of global integration has progressed.

In this respect, the G-20 and the MAP are the latest attempt to facilitate policy cooperation. But, given the divergent positions of its members and the differentiated policy requirements, the process has a formidable obstacle to overcome. Not to put too fine a point on it, the U.S. strongly supports the MAP because it needs external demand if it is to grow at a reasonable pace while the difficult, painful process of (public and private) balance sheet restructuring is in process. This underscores the need for a symmetric adjustment process. Yet, under the rules of the Bretton Woods system dictated by the U.S., the burden of adjustment was squarely on deficit countries. From the perspective of other countries, therefore, attempts to rebalance global demand are viewed with suspicion—as an attempt, in effect, to pass the adjustment burden to others.

Conclusion: Completing Bretton Woods to Promote Effective International Cooperation

The IMF has a key role to play in supporting the cooperation of its members to rebalance global demand by identifying policy adjustments and monitoring members' implementation. But to be fully effective in supporting and sustaining the vision articulated at the Bretton Woods conference, the IMF must be viewed as credible, effective and legitimate.

There are two challenges here. The first is to ensure that the IMF is capable of assisting its members deal with the challenges of the evolution in global financial markets that has occurred over the past 30 years. Over this time, private capital flows have increased to such an extent that the IMF cannot operate under the simple, transparent and incentive-compatible rules of the Bretton Woods system. Instead of filling balance of payments gaps and thereby providing members breathing space to smooth the adjustment process, the IMF now tries to influence the expectations of a heterogeneous group of private creditors to "catalyze" private sector investment. Even the most ardent supporter of the fund would concede that it is less than fully effective in this new role. Moreover, to do this, the IMF has had to quite literally "throw out the rule book" in terms of access to its resources and now operates in a world of discretion and not rules.

This is the source of the second challenge. National governments jealously guard their sovereignty and are only prepared to delegate sovereignty to a supranational organization under restricted conditions identified in advance. Members' obligations in the Articles of Agreement, which also clearly spell out the consequences of non-compliance, are a good example. In contrast, the *quid pro quo* for the exceptionally large programs associated with past financial crises was an expansion of conditionality—the policy commitments required to access IMF funds—that reach deep into structural issues. In many cases, these reforms entail decisions over the allocation of rents that involve political considerations. It is no coincidence that the IMF's legitimacy has been questioned in the wake of crises in which access limits were ignored. While efforts are now made to limit the reach of conditionality, the erosion of legitimacy suffered by the fund as a result of the financial crises of the past two decades reduced its effectiveness and its credibility.

Addressing these challenges requires that the international community complete the institutional arrangements under which the IMF operates. This is the benchmark against which measures to strengthen the Financial Stability Board and reduce the opportunities for excessive risk taking through regulatory arbitrage should be measured. The goal must be the efficient pricing and bearing of risk. Of course, the sound pricing of risk requires that investors wanting the higher returns associated with higher risk must bear the consequences of their risk taking. If investors fail to discipline imprudent borrowing *ex ante* by limiting access to debt markets, they have to bear the risk of sovereign default, *ex post*.

But absent a framework for the timely, orderly restructuring of sovereign debt, these governments and their citizens may face the prospect of a long period of immiserizing fiscal austerity or a protracted period of uncertainty, both of which constrain growth and lead to the adoption of policies destructive of national and international prosperity. In these circumstances, the IMF is less able to assist its members strike the right balance between financing and adjustment. The development of a framework for the timely, orderly restructuring of sovereign debt should therefore be a key objective in terms of filling the governance gap for global capital.

In a sense, this entails completing some unfinished business from Bretton Woods. Yet, getting the governance arrangements for global capital right is only a necessary, and not a sufficient condition for reanimating the spirit of Bretton Woods: the governance arrangements of the fund must reflect the realities of the global economy of the early 21st century and not the relative economic position of members in the mid-20th century. An institution that does not mirror the relative roles of its members will not be viewed as legitimate. And by lacking legitimacy, it will not be as effective and as credible as it needs to be.

Here too are grounds for stronger hopes and renewed fears. There is a growing appreciation that a realignment of members' relative positions in the fund is required as the first step toward getting governance reforms that would return the IMF to the center of international monetary cooperation. Unfortunately, too few countries have implemented the governance reforms agreed to at the Pittsburgh Summit to enhance the role of emerging market and developing countries—reforms that would help secure their commitment to the obligations of the Articles of Agreement to an open, dynamic international trade and payments system.

Endnotes

[1] Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Second Edition), Princeton University Press (2008).

[2] Jay C. Shambaugh, "The Euro's Three Crises." *Brookings Papers on Economic Activity Spring 2012*.

[3] *In theory at least*, the mechanics of the adjustment process are described in Hume's price-specie flow: countries recording current account deficits would suffer a loss of gold and downward pressure on prices, facilitating real exchange rate adjustment (depreciation); conversely, gold reserves of countries in current account surplus would rise, putting upward pressure on prices and resulting in real exchange rate appreciation. As long as both surplus and deficit countries responded passively, according to the "rules of the game", the process was both symmetric and automatic.

[4] J. Bradford Delong and Lawrence H. Summers, "Fiscal Policy in a Depressed Economy." *Brookings Papers on Economic Activity Spring 2012*.

[5] Article I of the IMF's Articles of Agreement states, *inter alia*, that the purpose of lending by the IMF is "...to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

[6] Supra Note 6.

[7] In its early years, the Fund was able to provide this judicious balance because most countries adopted capital controls, which limited balance of payments imbalances to differences in national investment and saving rates. Over time, however, capital controls became porous as markets found ways to evade them and were eventually removed as governments sought the benefits that capital account liberalization promised. Capital flows increased in size, impairing the IMF's ability to assist it members by smoothing the adjustment process in the wake of shifts in investor confidence. The result has been financial crises of escalating virulence. While these crises were initially viewed as "manageable" (though not by the individual countries subjected to the outflow of capital and the draconian adjustment that was required), as demonstrated by the Asian and the global crises, they are now truly global, posing genuine systemic threats.

Internal Imbalances, State Finance and the Global Recovery

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Twenty-twelve is a year of political leadership transitions for many countries. While politicians in the West are fiercely trying to win national elections and debating issues of tax adjustment, debt reduction and welfare reform to save broken budgets and boost sluggish economies, China's leaders also have similar issues on the political agenda in order to narrow income inequality and spur consumption demand of the lower and middle class. Among the many initiatives proposed, the most important policy measure is how to recast social welfare services along with their financing. Indeed, it is the focal issue faced by current and future governments in the post-crisis era, since it will determine, to a large extent, whether the global recovery is sustainable or temporary, and whether the crisis will resurge or be tamed.

Due to the fact that markets are imperfect and agents have short-term outlooks, it is crucial for governments worldwide to be allocating resources for social welfare services in periods of uncertainty over the long term. Even though state-funded welfare services vary widely across countries, they normally cover a wide range of areas, including health care insurance, retirement benefits, housing programs, poverty subsidies, etc.

Conceptually, we use "state finance" or "broadly-defined public finance" to define the public sector's involvement, participation and intervention in financial markets to fund social services over a very long-term period.[1] It is different from "narrowly-defined public finance" which focuses on the balance sheets of matching government budget sources and expenses in a fiscal year. For the time being, the core challenge for world leaders can be boiled down to reform of state finance so as to align domestic imbalances and to resume a sustainable global recovery.

Internal Imbalances in the West

During the last few decades, the public sectors in OECD countries have proliferated significantly. In recent years, an overwhelming number of European Union countries have further raised their public spending relative to GDP. As a consequence, Europe's social democratic model has led to widespread cradle-to-grave entitlements, with the public sector accounting for 40 percent of the Euro bloc's GDP and gross sovereign debt over 85 percent of GDP. Even in America's Anglo-Saxon model of capitalism, publicly-funded social welfare amounts to an astonishing size for which health care spending claims a quarter of the federal budget and almost all mortgages are either guaranteed by government-sponsored enterprises or provided by the federal government.

This reflects the dual characteristics of modern capitalism, which integrates two sectors of the real economy—a "productivity-generating market sector" and a "low-productivity state-funded social services sector".[2] In addition, there is an accommodating financial sector which consists of three partitions: the first is commercial finance to support the productive market sector, the second is state finance to fund social welfare services, and the third is hedge finance to engage in arbitrage and speculation against underlying assets from these sectors.

Nevertheless, the overexpansion of social welfare will build up welfare statism, which in turn suffocates the competitive and productive market sector.

This internal imbalance on both sides of the Atlantic is, if not a dominating reason, at least one of the major causes of the recent global economic woes. The prevailing social welfare state in many western countries is proving to be unsustainable and must be tailored in scale and scope to fit affordable state finance. The global recovery relies heavily on the direction of how internal imbalances are aligned. But there exists a "phase locking" in western countries to correct the collective irresponsibility of state-financed social welfare programs. This problem originated from the deficiencies of the political structures in these countries.

In the United States, the most serious problem of public governance is political polarization in the policymaking arena between the Republicans and Democrats. This polarization paralyzes domestic economic policy decisions, especially on issues around public finance such as deficit reduction, tax increases, health care reform, spending priorities, etc. In comparison to their predecessors a few decades ago, there is a shrinking overlap between the representatives of the two political parties in Congress.[3] This echoes deep social mistrust and a growing political divide in American society, which has increased in recent years and is restricting lawmakers and the administration in reforming welfare and state finance matters on a neutral, bipartisan, long-term and fiscally responsible basis.

As the U.S. political machine grinds to a halt, the Federal Reserve has gone astray from its long-standing independent position as the guardian of price stability and zealously engaged in the unconventional easing of monetary policy since the global financial crisis. In the name of restoring financial stability, the Fed has not only shouldered enormous mortgage-backed securities and Treasury debts to release prolonged liquidity for the housing sector and the government, but it has also depressed interest rates to very low levels in order to nurture them. Congressman Paul Ryan, chairman of the U.S. House Budget Committee, said that "the Federal Reserve is sort of bailing out fiscal policy because the branch of government in charge of fiscal policy is not doing its job".[4]

Yet there is no panacea for the problems currently being faced and the Federal Reserve's proactive easing of monetary policy to save fiscal distress has destructive consequences. It is obvious that such unconventional policy action may lead to additional uncertainty, which could prevent entrepreneurs in the productive market sector from committing investments, even though the Federal Reserve is using this policy to spur economic recovery and employment. Even worse, this practice is detrimental to the trust in the Fed's commitment to its obligations, which is a cornerstone of market capitalism. The Federal Reserve must honor its obligations (or implicit contracts) with the rest world not merely in nominal terms but also in real terms in order to safeguard the international financial markets' trust in the U.S. dollar. This contract must be accountable and irrevocable in all matters. To deliberately dilute the unit purchasing power of the U.S. dollar is equivalent to stealing wealth from its creditors both at home and abroad. This would result in a destruction of confidence in global markets. In fact, today's cure will turn out to be tomorrow's demise. For example, currently international investors that buy Treasury bonds are subsidizing the U.S. government by accepting negative real rates of returns. However, this trend could be reversed if they lose confidence in either the stability of the greenback's value or the ability of the U.S. government to address its budget deficit.

On the other hand, in the EU, the real trouble is neither a lack of a fiscal union nor a political union. Rather, it is the fault of social democratic politics, which created an over-entrenchment of the social welfare state through an overdrawing on the future. In short, the uncompromising beneficiaries of social welfare—including entitlement holders, labor unions, public sector employees and other vested interests—formed unbreakable alliances to resist the restructuring of financially unsustainable social welfare states in Europe. When backlash against reforming the social welfare state became too strong to be settled in short run, the European Central Bank departed from its sole mandate of price stability and moved to save Europe's sovereign debt woes by injecting liquidity into the region's banking system. However, this act only shifts the burden from creditors to debtors and from the present generation to the next. In fact, there is no way to save the broken social welfare programs in Europe without ideological and behavioral change of politicians and citizens alike, especially in the struggling peripheral European countries.

Internal Imbalance in China

While the provision of social welfare has overtaken the productive market in the West, China's imbalance is characterized by the underdevelopment of the social welfare services sector coupled with dominance of state-owned enterprises in the lucrative market sector. This internal imbalance is a critical source of income inequality and social resentment in China.

However, the Chinese government has recently realized this issue and has begun addressing it in order to lessen the income gap and promote domestic demand. For example, China is launching campaigns to revamp its welfare programs, including impressive initiatives like health care insurance for rural residents and the urban poor, and a housing program for low-income households in urban areas.

Contrary to the fiscal pinch in western countries, the Chinese government is well positioned in this regard. This is due partially to the government coffer, filled by China's phenomenal economic growth, and partially to the large role of state finance in the country's financial sector. Therefore, the problem of rebalancing China's real economy is not a lack of financial ability, but rather the political framework and the governance status quo regarding the ways of mobilizing and allocating resources via state finance with Chinese characteristics.

In China's prevailing unitary structure, the allocation of state-funded public resources is basically in accordance to a hierarchical pecking order. Under this framework, the provision process is opaque, discretionary and skewed toward related power groups. This feature is more likely to create a divergence in social welfare services, especially in health care insurance between different people and different regions in the country. If this problem is not properly tackled, the government's efforts to improve social justice will be eventually undermined.

Restructuring social welfare in China forces the government to mobilize enormous resources via state finance to fund welfare provisions to citizens over generations. However, under the current state of the country's public governance structure, Chinese authorities may fall into a path-dependence trap by resorting to conventional methods such as politicalized mobilization, administrative decree, mass-movement campaigns, and etc to serve the end goal. This could produce severe negative consequences for the viability of state finance to support social welfare services in the future. For example, there could be an agency problem between the central government and the localities, for which the latter would be too lenient in supplying services in order to fulfill short-term political goals, leaving a pileup of financial obligations for the central government to bail out. Another problem is moral hazard initiated from bureaucrats, who take advantage of their administrative power to seek unlawful income or nurture their inner circle at the expense of ordinary people. Eventually, these consequences would result in heavy financial burdens for the state.

The Challenge Faced

Since the end of 2008, the macroeconomic policies for stimulating aggregate demand and lessening global imbalances have shown limited effect in advancing the world economy, although they may have prevented it from free-falling into an abyss. In the post-crisis era, advanced countries should rebalance their domestic economies, especially by reforming their social welfare programs.

Yet it is not a pure economic but rather social and political matter which confines the resiliency of the global economic recovery. In all respects, there are three urgent questions must be addressed: the first is what would be an "appropriate size" of the social services sector against particulars of a country? The second is how could governments reform it in line with the optimal level? The third is how might it be financed efficiently in the long term? These questions have still not been properly answered.

The pending threat for the global recovery is unsettled political economy issues, particularly the polarization of U.S. policymakers and the uncompromising resistance of European welfare beneficiaries which have resulted in inaction in reforming social services in line with fiscal realities. As such, central banks have been forced to cross the boundary of independence by printing money explicitly or implicitly to save national budgets and to support state finance. However, this is a self-destructive policy, which will hurt the trust in the global market system. It is high time for us to refresh what Keynes warned in 1919, almost a century ago: "Lenin is said to have declared that the best way to destroy the capitalist system was to debauch its currency... Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency."[5]

To tackle the challenge, major countries need to reform their respective political structures regarding the allocation of public resources for social welfare. In the West, all stakeholders and political leaders must work together in a constructive way to solve the knot of disagreement between different interests and properly balance the interests of present and future generations. The decision-making structure also needs to be reformed for better representation in both cross-section and time-series dimensions. A possible option, for example, is to bring in interest-neutral agents in the decision-making process to represent the rights of future citizens. They should consist of a group of academics and citizens and be jointly nominated and/or appointed by administrative and legislative bodies with the goal of safeguarding the sustainability and viability of state finance for funding social welfare over the generations to come. Meanwhile, central banks must resume the ultimate duty of preserving currency values, rather than intentionally diluting the purchasing power to shift the debt burden to their local and global creditors.

In China, the main problem stems from flaws in the prevailing political framework regarding the provision of large-scale and long-term social welfare. It is very important for China to balance the development of both the productive market sector and state-funded social welfare sector in order to reach a stage of "endurable governance and long-term stability" as the Chinese proverb says. Against a backdrop of international experiences and lessons, China can learn significantly from the rest of the world. China must structure its social welfare programs in line with the rule of law, transparency and accountability. Meanwhile, it must be fully aware of the demise of the almighty government model and avoid jumping on the wagon of welfare statism in the process of rebalancing its domestic real economy.

Unless balanced development of the productive market sector and social welfare along with their appropriate financing is achieved in the major economies of the world, the global economy will not move toward a sustainable growth trajectory. This is the undeniable mission confronted by both present and future leaders, regardless of who is in power next year.

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[1] Similar to "corporate finance" or "household finance", this concept indicates that government is a subject of taking financial activities to fulfill its goal.
[2] Summers (2012).
[3] Carroll (2012).
[4] WSJ (2012).
[5] Whitson (1977).

Macroeconomic Coordination: What Has the G-20 Achieved?

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G-20 macroeconomic coordination went through three successive phases. In the first one, from Washington to Pittsburgh, the focus was on stimulating the global economy across the board. All countries were requested to contribute, to the extent permitted by the domestic fiscal situation. In the second one, from Toronto to Cannes, it shifted toward a more complex set of objectives, with the aim of combining continued support for growth, budgetary consolidation, and the avoidance of a resurgence of global imbalances. In the third phase, from Cannes onwards, the focus was on the European crisis and potential contributions to its solution from the rest of the world.

In this note, I give a broad-brush assessment of the priorities and achievements in the three phases, before offering a few conclusions on the overall performance of the G-20.

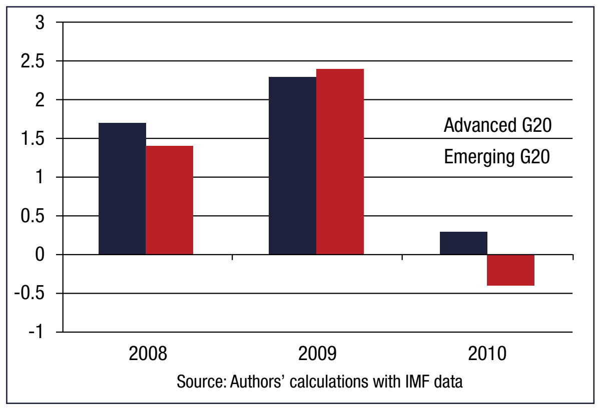
Phase 1: Saving the World, 2008-2009

The G-20 was created in extraordinary times. Its initial focus was on coordinating a global stimulus to ward off depression, equipping the International Monetary Fund with sufficient resources to cope with potential requests, and beefing up global liquidity through an exceptional allocation of Special Drawing Rights (SDRs).

The intellectual case for global action was made forcefully by the IMF[2] and it was—at the time at least—relatively consensual among economists and policymakers. If there had ever been a time for a global Keynesian stimulus, it was 2009.

On the fiscal front, data confirm that a stimulus was engineered not only in the advanced G-20 group but also, and to a broadly similar extent, in the emerging group (Figure 1). Russia, India and China were among the countries where the 2008-2009 effort was the largest.

Figure 1: Fiscal Impulse in the G-20, 2008-2010



Note: Fiscal impulse is measured by the change in the cyclically-adjusted primary balance.
Data are from the IMF's Spring 2011 Fiscal Monitor

The full participation of the emerging group to the concerted stimulus was a remarkable achievement. Emerging countries were traditionally viewed as passive players in a global macroeconomic coordination game dominated by the members of the G-7. The fact that they fully took part in the stimulus was indicative of their new global role and was an ex-post vindication of the very creation of the G-20.

To what degree was action undertaken at national levels triggered by G-20 coordination? In a situation of a global demand shortfall, high risk aversion and partial paralysis of financial markets, the policy prescription was very much the same everywhere. It is likely, however, that the G-20 action plan helped focus the policymakers' attention on a well-defined policy package, facilitated domestic consensus, and helped overcome free-rider attitudes. It made each and every government more secure than it would have been had they acted in isolation. So the G-20 probably helped overcome obstacles to the appropriate policy response.

With hindsight, whether or not the IMF was right to call for a uniform response is a matter for discussion. Whereas Italy assessed its own fiscal situation as too precarious to participate in the stimulus, Spain took part fully but soon realized that it had overestimated its fiscal space. The IMF in this respect lacked caution.[3] However it was probably still wise to advocate an across-the-board stimulus, rather than a tailored-made one whose preparation would have taken precious time and opened the door to endless disputes.

There was more heterogeneity on the monetary front because situations differed markedly. In Europe and the U.S., central banks had to resort to enhanced credit or liquidity support, but no such action was in order in Japan or the emerging world. Even after the Lehman shock, access to domestic-currency liquidity remained much less problematic in the emerging world and in Japan than in the U.S. and Europe.

The London G-20 Summit also agreed on a $500 billion increase in IMF resources and on a special allocation of SDRs. The increase in IMF resources was enacted swiftly and made possible a large increase in lending through standard programs, as well as the granting of credit lines to selected countries through two new facilities, the Flexible Credit Line (FCL) and the Precautionary Credit Line (PCL).

Angeloni and Pisani-Ferry (2012) find that without the replenishment of resources at the time of the London G-20 Summit the commitment capacity of the IMF would have been severely constrained already in 2009. With hindsight, the increase in IMF resources seems to have been of the right magnitude, at least taking into account the size of the subsequent assistance programs. Other initiatives were less successful: by end-2011 only three countries, Colombia, Mexico and Poland, had had access to the FCL and only one, the FYROM (Macedonia) to the PCL. None had drawn on these facilities. As to the exceptional $250 SDR allocation, subsequent data suggest that effective usage of SDR by IMF members was limited and restricted mainly to small countries. It seems unlikely on this basis that the allocation contributed significantly to revive global demand and growth.

A particularly important development, but one that took place outside the remit of the G-20, was the provision of U.S. dollar liquidity by the U.S. Federal Reserve. Dollar liquidity was a global concern and the Fed played its role as the provider of the international currency through exceptional swap agreements with selected partner central banks across the globe. However this was done in a discretionary way, with selected partners only and without any institutional involvement of the G-20.

Summing up, this first period can be considered a high point of international macroeconomic coordination and the G-20 played a significant role in fostering coordinated responses to the global crisis. For a group of rather heterogeneous countries with little tradition of dialogue and joint action, this must be considered a significant achievement.

Phase 2: Addressing Imbalances, 2010-2011

Whereas warding off depression was conceptually simple, the aftermath was more complicated because it involved addressing a conceptually debatable and politically delicate issue: the so-called global imbalances. The intellectual background to the policy agenda was the fear that the recovery would leave preexisting international imbalances largely untouched. Writing at the end of 2009, Blanchard and Milesi-Ferretti (2009) warned that "one of the three central adjustments emphasized in the earlier multilateral consultations has taken place, namely the increase in U.S. private savings. Two remain to be implemented, lower fiscal deficits in the U.S., and lower current account surpluses in

China and a number of other emerging market countries. If these do not take place, there is a high risk that the recovery will be weak and unbalanced. Staying in midstream is dangerous."

Against this background, the goal from the Pittsburgh G-20 Declaration was to develop "a forward-looking analysis of whether policies pursued by individual G-20 countries are collectively consistent with more sustainable and balanced trajectories for the global economy" that would feed into the leader's discussions and help decide on joint action. This was the purpose of the Mutual Assessment Process (MAP)—the aim of which was to make all participating governments more conscious of the international spillover effects of their actions and, through peer pressure, to lead them to amend their policy course in the case of global inconsistency.

This was a difficult endeavor. To start with, there had never been a consensus among economists on the risks involved in the persistence of global imbalances. Pre-crisis discussions had highlighted differences both on the normative front (are "uphill" capital flows welfare-reducing?) and the positive front (is there a risk of abrupt unwinding of the imbalances?). Second, previous attempts at global discussions on imbalances—through the so-called multilateral consultations on global imbalances initiated in 2006 by the IMF—had failed to deliver any meaningful result. Third, the G-20 itself had experienced difficulties with the topic, as indicated by the absence of an explicit reference to it (apart from an oblique allusion to "unfavorable macroeconomic outcomes") in the Washington Summit Declaration of 2008.

The initial strategy for making coordination work was to ask each country to submit medium-term policy frameworks and plans. The IMF staff was entrusted with the task of checking the consistency of national assumptions and policy directions, providing feedback to G-20 members and evaluating policy alternatives. This was intended to be a multistage iterative process involving: (1) initial submissions by G-20 governments; (2) aggregation and multilateral consistency check by the IMF; (3) evaluation of alternative policy paths by the IMF; and (4) discussions on policy adjustments among G-20 members.

As conducted for the Toronto and Seoul G-20 meetings, the MAP was a cumbersome exercise technically and it resulted in projections of uncertain accuracy. Discrepancies between the MAP and the World Economic Outlook projections were supposed to signal biases in the evaluation by G-20 countries of the likely global outlook—in its report for the Cannes Summit, for example, the IMF staff (2011) assessed national projections underlying the MAP outlook as "too sanguine"—but they could also indicate forecasting errors by IMF staff. The coexistence of two sets of projections, both of which emanated from the fund, was also confusing for observers and policymakers. Furthermore, the MAP was not an indispensable input to policy simulations: those could equally be carried out on the basis of WEO projections. Its value was probably more in the bottom-up process leading to the diagnosis. More than in a top-down exercise, this may have facilitated ownership of the outcome and genuine discussions on the challenges facing the world economy.

At the Seoul meeting, it was agreed to "enhance" the MAP by outlining "concrete policy commitments" for each of the members and by assessing "the nature and root causes of impediments to adjustment" behind "persistently large external imbalances". Clearly, the G-20 had gone beyond the Washington stand-off. This agreement opened the way to a more ambitious attempt at multilateral surveillance. A set of indicators and guidelines intended to help tackle global imbalances through policy adjustment in the key countries was adopted in April 2011 at the G-20 ministerial in Washington. These indicators were in turn used by the IMF staff to identify seven key countries experiencing imbalances, to provide a broad-brush assessment of their underlying causes, and to make corresponding recommendations.[4] In effect, the IMF essentially indicated that imbalances had been driven by saving behavior and it recommended fiscal consolidation for some (France, Japan, the U.K., the U.S. and India), the removal of distortions that keep Chinese savings artificially high, and measures to lower corporate savings in Japan and Germany. These recommendations were in part taken on board in the Cannes G-20 Action Plan adopted by the leaders; there was agreement on differentiated budgetary consolidation strategies, including through letting automatic stabilizers work in Australia, Brazil, Canada, China, Germany, Korea and Indonesia (without excluding further discretionary stimulus if needed). This was a non-negligible achievement but it obviously does not guarantee implementation.

Whether the MAP will have lasting traction and help fruitfully change the policy conversation in the main participating countries also remains to be seen. The process faces three difficulties.

First, the model of international interdependence underlying the MAP may not capture the relevant channels of transmission of shocks. Standard international macroeconomics puts emphasis on interdependence through flows (of goods and services, capital and, in some cases, labor) and prices. It provides the intellectual framework for the MAP assessment and simulations. At the same time, however, empirical research, notably the evaluations provided by the IMF (2011b) in the context of its *spillover reports*, emphasizes other channels of interdependence through cross-border holdings of financial assets. Neither the open-economy models à la Mundell-Fleming of the 1980s nor those à la Obstfeld-Rogoff that were developed in the 1990s offer much insight into the type and extent of interdependence through stocks, not flows, documented in these reports. Empirical research undertaken by the IMF highlights that interdependence through traditional channels can be dwarfed by that arising from gross holdings of financial assets and the bellwether role of U.S. capital markets. Except for countries like Canada, Mexico, China and Saudi Arabia, for which the U.S. is primarily an export market, asset price links are significantly more important than traditional links and taking them into account typically multiplies spillover effects

Box: Indicators and Guidelines for Identification of Required Policy Action

The G-20 finance ministers in February and April 2011 agreed on:

- A *process* leading to the identification of countries whose policies deserve closer examination.
- A set of *indicators* to monitor, which include: (1) internal imbalance indicators (public debt and fiscal deficits; private savings rate and private debt); (2) external imbalance indicators (current account balances, though they are not named because of China's reluctance to have them explicitly included in the list). External imbalance assessment is to take "due consideration of exchange rate, fiscal, monetary and other policies".
- Indicative *guidelines* against which each of these indicators is to be assessed. It is stated that "while not policy targets, these guidelines establish reference values for each available indicator allowing for identification of countries for the second step in-depth assessment".
- Four *approaches to assess individual country positions*: (1) a "structural approach" presumably inspired by the IMF's GGER methodology for the assessment of equilibrium exchange rates[5]; (2) a statistical approach which benchmarks G-20 countries on the basis of their national historical trends; (3) a statistical approach which benchmarks G-20 country's historical indicators against groups of countries at similar stages in their development; (4) a statistical approach which draws on data, benchmarking a G-20 country's indicators against the full G-20. The three statistical approaches are primarily based on data for the 1990-2004 period and they are expected to be based on simple methodologies. In all cases, forecasts for 2013-2015 are to be assessed against the four guidelines.
- A *categorization of countries* into two groups: seven systemic countries, and the rest of the G-20. Selection criteria will be stricter for the second group, so that they will only be selected for review if they depart significantly from benchmarks. The goal is to help the process focus on the most important countries—presumably again the U.S. and China.

of U.S. shocks by a factor comprised between two and five, or even more. Furthermore, these linkages are asymmetric as U.S. developments affect the rest of the world much more than vice-versa. These phenomena, which constitute the bread and butter of policy discussions at the global level, are often assumed away in standard models like those underpinning the MAP.

Second, the whole exercise is predicated on the assumption that global imbalances remain a serious concern for the world economy going forward. Indicators, guidelines and processes may serve coordination well if this assumption proves correct. The pattern of imbalances, however, has changed significantly with the reduction of the Chinese surplus and the rise of those of oil-producing countries. Building on the insight of Caballero, Fahri and Gourinchas (2008), some observers[6] do not see current-account imbalances as a problem but as a normal response to the asymmetry in the state of public finances between the advanced and the emerging countries. Furthermore, should other problems—say, sovereign solvency risks in the advanced countries or global inflation—become a major cause for concern, they may rather prove to be a distraction. There is a difficult trade-off here: to keep focusing on the same issue helps narrow down differences through the development of common concepts, indicators and guideposts. As indicated by the European experience, however, this process takes time, and for the outcome of this process to influence national policies even more time is needed. The same requirement applies even more to coordination within a large group whose participants are not used to speaking openly to the others about their policy choices. But keeping the focus on a particular set of issues involves the risk of focusing the policymakers' attention on a certain set of problems at the expense of others. Again, Europe provides a clear case of attention distraction: its focus on making its fiscal pact operational has distracted the policymakers' attention from the build-up of large imbalances in the private sector.

Third, it is not clear which of the participating countries is ready to trade a change in its own policy for a change in its partner's policy. Would, for example, a Chinese exchange-rate adjustment facilitate a U.S. budget agreement? The political economy of international horse trading is highly uncertain. As things stand, a conversation has been created but to claim that significant policy action has been triggered as a consequence would be an overstatement.

On the whole, this second period was clearly less successful than the first one. A significant process of assessment and dialogue was launched and it went much beyond what had been achieved in the pre-crisis context. Nevertheless policy achievements are few and doubts remain on the adequacy of the process.

Phase 3: Assisting Europe, 2011-2012

The Cannes G-20 Summit was meant to be devoted to global discussions, not least about reforming the international monetary system. However, it was largely hijacked by the euro crisis. In the months that followed, the international discussion was again largely dominated by the European crisis, the responses to it, and the potential contribution of the rest of the world through increasing IMF resources.

Decisions announced on the occasion of the 2012 IMF and World Bank spring meetings in Washington resulted in pledges to increase IMF resources by $430 billion. Although these resources are not earmarked for any particular country, they are widely regarded as motivated by the precarious state of the euro area and some countries within it. Euro-area countries (for €150 billion or about $200 billion), were joined by other European countries including the U.K. (for about $60 billion), Japan ($60 billion), South Korea ($15 billion), Australia ($7 billion), and Saudi Arabia ($15 billion). Emerging countries such as China, India, Brazil and Russia also committed contributions, but no specific number was announce officially and there are suspicions that their commitments remain conditional on changes in the governance of the IMF. Finally, neither the U.S. nor Canada took part.[7]

On this occasion, the G-20 as an institution failed to provide the "premier forum for international economic cooperation" it had expressed its intention to be. First, two major members broke ranks with the consensus on increasing IMF resources. Second, disagreements on the policy prescription for Europe and in particular on the nature of the appropriate fiscal response could not be resolved. In a context of serious concerns about the pace of the recovery in part of the world economy, the communiqués of Mexico (February) and Washington (April) did not go beyond the usual platitudes. Third, several emerging and developing countries reacted with suspicion to the very notion of assisting a group of prosperous and financially wealthy countries.

It is hard therefore for the G-20 to claim success on this front. There are probably two reasons for this disappointing result. First, Europe is difficult because of its internal coordination process. It takes time for the Europeans to agree among themselves and when they have reached an agreement they are not ready to reopen it in the context of G-20 discussions. Two-level coordination is inherently difficult and this applies to Europe.

Second, the problem at stake is highly asymmetric. The rest of the world expects Europe to sort out its problems. While those outside Europe have shown a willingness to extend a helping hand, this inevitably comes with strings attached in the form of a faster rebalancing of power within the international organizations. This is not the easiest of all sorts of dialogue.

Conclusions

Macroeconomic coordination is by no means the only or even the main field for assessing the performance of the G-20. Financial regulation has been in recent times an equally important topic. However, it is one on which the G-20 focused at an early stage and also one on which it promised to deliver. So it is worth a specific assessment.

The picture this note has presented is one of major initial achievement and diminishing returns. The effectiveness of the G-20 in the macroeconomic coordination field seems to have declined from one phase to the next one. To what extent is this due to the nature of the problems on the agenda and to what extent to the evolution of the dialogue and the participants' commitment to the process? There is no easy answer to this question. Clearly, global coordination cannot be expected to proceed with the same intensity when facing a global recession or regional troubles. What was done in 2008-2009 was by nature exceptional and the following steps were bound to be of lower intensity.

There is also certainly more value in the process initiated by the Pittsburgh Summit than what casual observation suggests. The mere willingness to discuss global policy issues and their national ramifications is a non-negligible achievement. Issues that are traditionally thought of as domestic choices are not anymore considered beyond the reach of international discussions. Yet the outcome remains disappointing. One cannot but ask questions about the ability of the G-20 to avoid the traps that over time greatly reduced the effectiveness of the G-7 and G-8 summits. It is certainly too early to claim that the G-20 has failed, but early enough to wonder whether it is on track toward lasting success.

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[1] A version of this note, which draws significantly on Angeloni and Pisani-Ferry (2012), was presented at the conference "Searching for Strategies to Restore Global Economic Stability and Growth" organised by the Chicago Council on Global Affairs on 2-4 May 2012.

[2] See, for example, Spilimbergo, Simansky, Blanchard and Cottarelli (2008).

[3] Pisani-Ferry, Sapir and Wolff (2011).

[4] IMF (2011).

[5] IMF (2006).

[6] See , for example, Landau (2012).

[7] Statement by IMF Managing Director Christine Lagarde on April 20, 2012.

1 Euro = 1.325 U.S. Dollars: The Surprising Stability of the Euro in a Period of Financial Turbulence

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Since the first G-20 meeting in Washington in November 2008, financial turbulence has agitated the world economy and has been the epicenter of the leaders' debates and actions. One surprising aspect of this turbulent period is the stability of the foreign exchange market. As compared with other dramatic evolutions, this proved a welcome source of relief. Mentioning that particular point with any official provokes a sigh: "at least we don't have a currency crisis adding turmoil to the whole set of difficulties for markets, banks and governments!"

But the stability of the euro-dollar exchange rate is like the dog that did not bark. Given all the dire predictions concerning the eurozone, the stability of the euro is a surprising, unlikely, even discordant fact and, as such, it has not attracted sufficient attention. It cannot be convincingly understood if looking only to European affairs; the exchange rate says something about both currencies; in a globalized world, the fate of any currency is the result of global interdependencies. This paper starts from the observation that the euro-dollar exchange rate offers a significant clue about the state of international monetary affairs which has been carelessly neglected and which deserves a more explicit analysis. Could this missing piece become a major determinant of things to come?

Announcing the Death of the Euro Was Premature

For two years now, we have been living with the threat of a collapse of the European currency. How many times have we heard or read definitive judgments like this one: "I was giving 10 years to the euro and I was the most optimistic one in the room." Such comments were supposed to reflect widely spread views in the market. Given such continuously dire predictions, one would have expected to witness a dramatic weakening of the euro.

Looking back, it is easy to remember what a "weak euro" is. Shortly after its introduction in 1999 at a rate of €1 euro for $1.19 U.S. dollar, the European currency entered in a downward trend that lasted two years. In the summer of 2001, its value had been reduced to a record low of 86 U.S. cents. This proved to be a road to hell for a powerless Eurogroup, which month-to-month only received bad news for the euro but had to pathetically reassert its confidence that "a strong euro was in the best interest of the Eurozone".

By comparison, the current sovereign debt crisis in Europe has the appearance of an even more disastrous process. The intractability of many Southern European deficits, the unending conflict between debtors and creditors, and the vicious link between banks and sovereigns were a sure recipe for a slow, messy and inconclusive decision-making process. There were ample reasons to express skepticism, contempt and finally distrust. Following this course of events, a flow of reports and op-eds convincingly detailed the troubles of the sovereigns and the wrongdoings and ineffectiveness of the authorities. Many of these contributions usefully introduced in the debates new ideas, which have been or could possibly be part of the solution. But others, occasionally the most vocal ones, dramatically emphasized quasi-apocalyptic conclusions: "Is this really the end?" asked the cover of *The Economist* in November 2011.

The repeated announcement of a pending collapse of the euro should have had devastating consequences: facing the imminent and chaotic return to the drachma, to the peseta, to the lira, etc, what should have been more rational and more urgent for a global investor than to disengage from a currency without a future? Shouldn't the euro have fallen below its previous low? Remember the size of the forex market at $4 trillion a day; investors have had ample time and opportunity to reorganize their portfolios. However, the market reality proved different. Market reactions have surprisingly been the opposite of the ones observed 10 years ago. This time around, the euro-dollar exchange rate has imperturbably fluctuated between $1.25 and $1.40, with the euro standing in average 12 percent above its purchasing power parity. Those who bet against this stability made losing bets: 2011 proved a bad year for hedge funds working the currencies. "Striking" is thus a weak qualification of the astounding stability of the euro in this context.

A Tale of Two Global Currencies

Why did the euro fluctuate in such a narrow band? This question has one and only one disarmingly simple answer: despite so many pronouncements, the euro remained for most global investors attractive. Despite the European sovereign debt crisis, there was simply no crisis of the euro. The euro remained widely used for trade, it remained widely used as an investment vehicle, it remained widely used as an official forex reserve instrument. These are facts, nothing here is judgmental. And what is striking is that the sovereign debt crisis did not change anything in this matter.

We consequently have two conflicting stories. The seductive comparison with the Titanic until now proves inconsistent with the facts: the attractiveness of the euro has not sunk. We clearly need an alternative narrative and properly understanding the stability of the euro in the forex markets requires a more systemic view of the issues at stake. This is a preamble to any judgment about the future both of the Eurozone and international monetary affairs. Attention has been too narrowly focused on the interaction, as important as it is for endangered debtors and anxious creditors, between the European authorities and the European debt markets. The spotlights illuminating the Eurozone summits or the central bank's procrastinations only let in the dark parts of the scene. The euro is the currency shared by the Germans, the Greeks and a few others, with all the family-style troubles we have witnessed in the open. However, the euro is more than that: it was and it remains a global currency.

Soon after its creation, the euro quickly became an international currency. The extent and the logic of this statute have been well documented and properly assessed. The euro never was a competitor to the dollar and this was neither its purpose nor the result of its short successful debut. But it eventually became a junior alternative to the dollar in the international monetary realm. The important point here is that such a recent statute could and arguably should have been severely damaged by the sovereign debt crisis. The above mentioned negative scenario describing the euro as an artificial and unsustainable regional currency implies that, after 2010, the euro experience had failed and that there was nothing in the world economy reasonably qualifying as a "junior alternative" to the dollar. This is precisely what the reality of the markets disproves. "Monopoly No More" is the title of a chapter in Barry Eichengreen's book on *The Exorbitant Privilege*, a title that was accurate and proves premonitory: the sovereign debt crisis in the Eurozone created the conditions for a return to monopoly; that didn't happen.

The Dollar under Scrutiny

The stability of the euro as a testament to the unimpaired attractiveness of the European currency is nonetheless hard to believe. Due to the many weaknesses of the Eurozone, both in terms of its economic dynamism and political governance, this cannot be convincingly attributed only to its present substantial strengths. But the point is that "attractiveness" is by comparison only. The euro sinking in the previous decade to 86 U.S. cents did not express a decidedly negative perception of the European currency (a perception which by the way reversed as early as 2001) but rather the tail of a period of irrational exuberance greatly overestimating the promises of the "new economy" in America. An exchange rate is always the result of a dual judgment; it ponders both sides of the equation. Note that nothing in this analysis is related to the level of the exchange rate. It happens that, at an exchange rate of 1.325 dollars to the euro, the European currency is slightly overvalued. But what we described as a clue in the introduction is that the changing perception of the respective attractiveness of the two currencies has followed the same pattern since the summer of 2007.

That the stability of the exchange rate between the euro and the dollar reflects a balanced judgment on the attractiveness of both currencies could be discounted as trivial. But, given what we know about the euro, this finding speaks volumes about the dollar. With all the benefits of its reserve currency statute, the dollar has the dubious distinction of having done as well or more crudely as badly as the euro. Limiting our investigation to the impact of recent financial turbulences, this means that "global investors" in aggregate proved as anxious about the unsustainable evolution of U.S. debt as they were about the unmanageable debts in Europe. Since the crisis of the Eurozone has correctly been described as a political as well as a financial crisis, it can be concluded that a stable exchange rate finally reveals as severe a judgment about the Washington decision-making process as it does about the Brussels decision-making process.

Turning to Washington to understand the fate of the euro, it is interesting to briefly focus on the downgrading of U.S. debt by Standard and Poor's in the summer of 2011. The decision was not followed by any change in the financing conditions of the U.S. Treasury, interest rates even modestly declined in the following weeks. The loss of the AAA credit rating consequently turned out to be a non-event and the U.S. dollar continued to be as attractive as it always has been. Another interpretation, more in line with the present analysis, is that the downgrading was already priced. This was noticeably the case for a Chinese rating agency, Dagong, which had attributed an "A+ with negative watch" to the U.S. debt as early as November 2010. It is tempting to dismiss this reference since this rating agency is a young player, equipped with a weak methodology and was possibly influenced by political considerations. The problem is that these data, with all their limitations, are part of the information system of the world's biggest investor in dollar-denominated assets. Experts can qualify such a quotation as arbitrary, but it nevertheless seems to be in line with what we anecdotally know about the Chinese sentiments regarding the financial situation of the U.S. government.

For years now, the Chinese authorities have expressed their preoccupation with the lax design of American monetary and tax policies. They have been reported as having expressed their dissatisfaction in a series of public and private comments. The one, which attracted the most attention, happened in March 2009 when the governor of the Chinese central bank called for a revitalization of the Special Drawing Rights, which is considered as an international reserve currency safer than the dollar. The proposal never got traction but the dissatisfaction with the U.S. dollar only increased. The year 2011 eventually amplified the fears about the way Washington was addressing its financial troubles. In the spring, the inconclusiveness of the debate on the national budget pushed the Obama administration to prepare for an interruption of its business. This "countdown to shutdown" was considered as traditional theater by most pundits familiar with American politics. But Beijing's reaction to the budget battles in Washington was that it didn't make sense for the U.S., the most powerful on country in the world, to be marching endogenously toward "shutdown". A few months later, the debt ceiling debate started another war on Capitol Hill. Tensions mounted at a point where part of the American government acted as if it were ready to push the country, and possibly the world, into a financial abyss. In China, this is not political theater, but 2.5 $trillion of "hard won money" at stake. Where do we go from there?

Chartered Seas

Let us start with the major lesson of Reinhardt and Rogoff's historical inquiry. These authors have described how severe financial crises cast a long shadow on the economy. They produce a deep recession, the recovery is weak, and public debt reaches pharaonic levels. This is where we are today on both sides of the Atlantic and we can unfortunately expect new developments of the financial crisis in the second part of 2012. Interestingly enough, we are not entering unchartered seas; European fragilities, most recently exposed by the tensions surrounding Spanish finance, are perfectly known as are American ones, which are expected to dramatically rise in the weeks following the November elections. The way the global economy will cruise among these dangerous reefs depends on an increasingly tense mix of unsustainable debt and fractious politics. At the intersection, when politics is facing the prospect of unsustainable debt, the question is "who owes what to whom"? This is what we must focus on now.

The decisive intervention of the European Central Bank in December produced a welcome relief in the financing conditions of Southern European countries in the winter of 2012, but it proved short-lived. As of April, tensions are back, particularly for Spain, which after Greece, Ireland and Portugal is the elephant in room for the Eurozone. Increasing concerns regarding austerity and recession have renewed a vision of the Eurozone pursuing its two-year long "debacle". Is this finally the end, already announced months ago? Or is it another episode of the distorted narrative we have criticized in the previous paragraphs?

In 2012, according to the World Economic Outlook, the International Monetary Fund expects contrasting transatlantic evolutions with growth rates at 2.1 percent in the U.S. and at -0.3 percent in the Eurozone; the government deficit is expected to amount to -8.1 percent in the U.S. and –3.2 percent in the Eurozone. Given better GDP figures than in previous years, the U.S. is frequently said to have embarked on a more promising, even if fragile, recovery thanks to a more aggressive use of fiscal policy. This is true, but at what price? The initial financial crisis in the U.S. was so severe that an oversized Keynesian stimulus was required to avoid the repetition of the Great Depression. The cumulative public deficit in the U.S. between 2007 and 2011 amounts to a huge -42.6 percent of GDP. But the results, after closer examination, are less than impressive. In the Eurozone, deficits have been limited to 19.5 percent and the resulting growth rates are nonetheless very similar (+0.9 and +0.6 percent respectively during the period of 2008-2011). The most disappointing fact in the American recovery is that the private sector has not geared up. The level of the private gross fixed capital formation in the U.S. in 2011 remains at 14 percent below its pre-crisis level whereas the corresponding gap has been closed in the Eurozone.

Different policies, followed for years, now place public debts on widely diverging trends (see the IMF Fiscal Monitor). The U.S. debt increased from 67 percent of GDP in 2007 to 107 percent in 2012 and is expected to reach 113 percent in 2017; the similar figures for the Eurozone are 66 percent, 90 percent and 87 percent. In addition, given the public guarantee offered by the U.S. government to Fannie Mae and Freddie Mac, one should consider the outstanding debt of government related enterprises which in 2011 amounts to more than 50 percent of GDP in the U.S. (as compared to 20 percent in Germany and 10 percent in France); even if only a small fraction of these amounts could end in fiscal outlays, Fannie and Freddie have been massively financed by Asian investors, China in particular, and the government sponsored enterprises will have huge refinancing needs. These data, as well as others major indicators like the cyclically adjusted primary balance or the gross financing needs taking into account the maturing debt, are well known but frequently discounted for two reasons. The intractability of U.S. debt is reduced to a fact of life, with which the rest of the world has to adapt since Congress is definitely not willing to curb these trends; and the comparison with the Eurozone is disqualified since the Eurozone is not a country. With the insight of the previous analysis, these arguments should be considered more attentively.

The last well known difference between the U.S. and the Eurozone is that the former has had and is expected to have in the coming future net external financing needs amounting to 3 percent of GDP while the latter has had and is expected to have a limited external financial surplus. The statute of the dollar as a reserve currency as well as the euro's weaknesses in recent years have protected the dollar against the dramatic consequences which American profligacy would already have had for any other country; but the stability of the dollar-euro exchange rate demonstrates that this protection is suspended to the supervision of global investors whose confidence has to be constantly renewed. The statute of the euro as a regional currency has had the unenviable consequence to highlight the conflicts inside the monetary union. But the stability of the euro-dollar exchange rate demonstrates that these financial tensions, as long as they remain politically manageable within the union, fundamentally remain a domestic political issue and have limited financial international consequences. Thus, China's Premier Wen Jiabao has expressed that both America and the Eurozone must "put their houses in order" and the ways this recommendation will be followed will determine the state of the world economy at the end of 2012.

The Reefs Ahead

The risks for Europe remain high. But the vision adopted in this paper is that the transformations of Eurozone governance since 2010 are underestimated and the role of Germany improperly analyzed. Germany, for sure, was never ready to "offer its credit card" to its fellow Europeans and this is more than understandable. But, if Germany demonstrated steadiness in the defense of its domestic interests, it also proved cooperative in the pursuit of common interests. The rescue mechanisms, in which Germany is by far the most exposed country, have been implemented with wide support of the Bundestag; successive "urgency" measures, which run so contrary to the German monetary doctrine, have been adopted by the ECB and tolerated by the German government. These are undoubted political achievements without which the worst predictions concerning the Eurozone would have been realized.

There is broad agreement in the Eurozone about what went wrong and the red line in the political debate has been sequencing. Germany could not accept going further (the creation of Eurobonds for example) without sufficient protection against reckless behaviors in the union. This is why the design of a sustainable framework—the so-called "fiscal compact"—was an absolute preamble before any other issue was put on the table. Now, the European crisis is entering a new phase, both in economic and political terms. On one side, austerity measures are, as expected, pushing the European economies into recession, debilitating German export markets and making the rehabilitation of public finances more difficult; on the other side, the power balance established under the leadership of German Chancelor Angela Merkel and former French President Nicolas Sarkozy is changing, with the election of François Hollande as France's new president. After Italy and Spain, France and the Netherlands are now desperate to push growth to the top of the agenda. It will be time to enlarge the Eurozone political economic debate and to more closely associate the timely enforcement of fiscal discipline with broader issues, which could include some sort of mutualization of past debts and a pan-European initiative for growth. Is this credible? If past is a prologue, the most likely forecast is that the search for compromise will continue to be the rule because, as they visibly demonstrated, all the member countries, whether debtor or creditor and whatever the color of their government, have huge common economic and political interests at stake.

What about the United States? In its debt-ceiling showdown last August, Congress came close to a spectacular act of self-inflicted damage. Voluntary default was only narrowly avoided. Financial gridlock has become the natural outcome of a dysfunctional political system described by Francis Fukuyama as a "vetocraty". The two parties are ardently nurturing a radical disagreement about what went wrong. The possibility of compromise simply seems to have vanished. Action is not blocked by a divergence about sequencing but by a frontal opposition about principles. The frightening thing is that no one in Washington sees this ending soon. Later this year, the American government will face even more difficult challenges: Congress will be simultaneously asked to raise the debt-ceiling again, to determine the fate of the Bush tax-cuts and of the Obama payroll tax holidays and social benefits and finally, would it fail to find a solution, to face the cataclysmic consequences of the $1.2 trillion 10-year automatic spending cuts which were part of the August 2011 compromise. All these deadlines will happen during the so-called "lame duck session" which will follow what is expected to be the most bitter elections in decades. Many hope that Congress will be able to complete this program successfully in time. Should this be considered as another illustration of hope triumphing over experience?

Conclusion

The present essay doesn't share the widespread pessimism about the Eurozone. Much more has been achieved than frequently recognized and the willingness to stay the course and find compromises have been regularly confirmed. Designing a new governance for the monetary union has been a messy political process but it has a direction and moves forward. This vision is arguably backed by the striking stability of the euro on the foreign exchange market since 2007. We demonstrated that this is the result of a balanced view of global investors regarding the respective financial situations and political processes in the Eurozone and in the U.S. Given what has been extensively written on the former, this finding says a lot about the less publicized global skepticism surrounding the latter. Following a traumatic year in 2011 and a brief period of relief in the first quarter of 2012, the second half of this year now promises to be a defining moment on both sides of the Atlantic.

Risks remain high in Europe, as the threat of recession, renewed tensions in Spanish finance, and the potential for contagion to Italy or France are all very real. European governments will need to audaciously extend their cooperation which has until today been based on commitments to fiscal discipline. The "fiscal compact" is the basis of a better functioning monetary union but governments now have to design a broader agenda, which probably includes some mutualization of past debts and new initiatives to restore growth.

Risks remain high in the U.S. as well. The recovery proves fragile and the rise of public debt seems out of control. Returning public finance to sustainable levels will unavoidably require tax increases as well as spending cuts. But the political willingness to compromise has disappeared. The government is paralyzed by a camp that sees any tax increase as a threat to American exceptionalism. There is a threat that, whatever the result of the November election, this camp will have a veto power precisely when the time arrives to make hard financial decisions. Inaction in December would be a surefire recipe for pushing the U.S. into a severe recession and into a dramatic default.

These are challenging times for policymakers. In the months following the Lehman Brothers' failure, they demonstrated their willingness and ability to shape circumstances; these qualities will be tested again shortly.

Note: On April 30, 2012, 1 euro = 1.324 U.S. dollars. The exchange rate was 1 to 1.326 prior to that.

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The Eurozone: How to Grow out of the Crisis?

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The G-20 Summit in Cannes last November was overshadowed by the eurozone crisis. Since then there have been several instances where drastic measures have been pushed through a cumbersome European negotiation process: (1) the European fiscal compact, introduced in order to create trust in the long-term fiscal stability of the eurozone; (2) the three-year longer-term refinancing operation (LTRO) of the European Central Bank, which is supposed to give a lifeline to the European banking system and thus indirectly to the governments of the crisis countries; (3) the second rescue operation for Greece which entails a debt write-down of around €100 billion; and (4) the decision to increase the financial firepower of the European Financial Stability Facility (ESFS) as well as the International Monetary Fund, the latter with financial support also from China and other emerging countries.

During the IMF and the World Bank spring meetings, the German government in tandem with the European Central Bank voiced confidence that with those measures enough had been done to stabilize the eurozone. Therefore, the eurozone would not stand in the way to global financial stability anymore. Other countries and regions would have to bring their house in order and reduce their public debt as was agreed to at the G-20 Toronto Summit in 2010: "advanced economies have committed to fiscal plans that will at least halve deficits by 2013…" However, only a few days after the spring meetings, the crisis of the eurozone was back with sovereign bond spreads in Spain and Italy again growing and financial markets jittering. It has become clear that the European fiscal compact and the financial firewalls are not sufficient to create trust in the longer-term solvency of the European crisis countries. Continued austerity leads to a continuing increase in the debt ratio and will neither create the economic nor political conditions for Southern Europe to regain the competitiveness that is required for the internal rebalancing of the eurozone. Against this background, it can be foreseen that the eurozone crisis will again be the main subject at the June G-20 Summit in Los Cabos.

Austerity versus Growth

In the run-up to the national elections in France and Greece, the public discourse on the eurozone crisis had already changed. It became clear that the austerity strategy of the German government was losing political backing, not only in the Southern European countries. Suddenly, everybody was talking of a growth strategy and even the German government got prepared to negotiate on specific measures for growth in the framework of the European Union, with the new French government as the driving force. This was actually a welcome development for the German government, which became increasingly isolated, to moderate its "bad cop" image in Europe. In the discussion about a European growth strategy, Germany could show its goodwill—"who could be against growth?"—and still insist on the principles of the European fiscal compact which had been signed by 25 member states only on March 2, 2012 and still needs to be ratified by national parliaments.

The interesting question will be whether the fiscal compact, calling for sanctions on those member states that fail to meet targets, will be compatible with growth measures that require higher spending or whether it will fail before it has even come into force on January 1, 2013. Growth measures without neglecting the fiscal targets can be made possible only with off-budget instruments, such as increasing the lending capacity of the European Investment Bank (EIB) or creating new instruments such as the "European project bonds", which would not be accounted for in the public budgets. But will this strategy—targeted investments in infrastructure projects which would take years to materialize —break the vicious circle of recession, increasing debt and loss of trust in the financial markets that had rendered the European rescue strategy ineffective after two years of crisis management? Most probably, it would be again too little, too late, and therefore not the appropriate strategy to generate growth in the short run.

Breaking the Vicious Circle

If a policy of breaking away from the fiscal compact is ruled out, there are basically two core elements of a renewed strategy that would have to be introduced: (1) a policy to delink the weak financial sectors from the public budgets and thus regain the trust of the financial markets in sovereign bonds and (2) a policy to restructure and reduce the public debt in the crisis countries, instead of relying on continuous liquidity measures such as the purchase of sovereign bonds by the ECB, which is a feasible but unsustainable solution to keep the Southern European countries afloat.

The first strategy—stabilizing the financial sector, particularly in Spain—is already under intense discussion, particularly since it has become clear that despite the efforts of the ECB a credit crunch is looming and banks will not be able to raise enough funds in the market for meeting the targets under the Basel III standards. Since the EFSF and its successor, the European Stability Mechanism (ESM), to be operational by July 2012, in their present legal form cannot be used to recapitalize European banks, another instrument will have to be created to fulfill this function or the rules have to be bent somewhat to make the use of the ESM for bank recapitalization possible. In the past, European governments as well as the banking industry have continuously resisted a European solution to the weakness of the banking system since the financial crisis. A U.S.-style solution such as the Troubled Asset Relief Program (TARP) of October 2008 was ruled out. Now it is clear that there is no alternative to a European instrument of bank recapitalization if the eurozone is to survive because the financial interdependence of weak sovereigns with weak banks has turned out to be the crucial bottleneck for regaining the trust of the financial markets and returning to market-based financing of the public sectors. This will entail additional financial contributions from member states through the ESM or another vehicle as well as changes in the European system of banking supervision and regulation. In addition, it will entail an intrusion into the sovereignty of countries whose banks will benefit from the fund. Both will require bold steps which will be resisted by those who prefer a continuation of the "easy credit" strategy with unlimited firewalls and the ECB purchasing of sovereign bonds—in other words, further debt monetization.

A strategy to restructure and reduce the public debt of European countries and break the cycle of spiraling debt in low-growth economies has been proposed by the German Council of Economic Experts in November 2011.[1] The proposed Debt Redemption Fund—modeled after a fund for the restructuring of U.S. government debt after the War of Independence—would entail a joint liability for all debt of eurozone countries surpassing 60 percent of their GDP and would require strict fiscal discipline as well as a medium-term consolidation and growth strategy for the participating countries. Due to the notion of joint liability in this proposal, it was ruled out immediately by the German government and met with fierce opposition by a large part of German economists. However, in contrast to the various proposals for a Eurobond, the joint liability would be valid only on past debt and it would thus recognize the construction failures of the eurozone, which are the responsibility of all eurozone countries. The mutualization of future debt, still anathema to Germany, is still a far way off because it will require legal and institutional changes ensuring strict surveillance of member states' fiscal policies even beyond the fiscal rules of the fiscal compact.

It appears that both pillars, a bank recapitalization fund and a temporary joint-liability fund for refinancing public debt, will be necessary to regain space for the private and public sectors in order to avoid a continuing downward adjustment, particularly in Southern Europe, without jeopardizing the fiscal compact. It will also be crucial to end the period of financial repression where banks focus on carry trades on the basis of near-zero interest rates with negative long-run effects on capital allocation. Banks would be in a position to resume lending to the private sector and the public sector would gain space through lower interest rates on its debt.

In an ideal world, both policies would have been part of a comprehensive rescue strategy for the euro two years ago when the ECB started purchasing sovereign bonds because there was no alternative to avoid a "sudden stop" in the refinancing of banks and governments. German economists in particular have always viewed the ECB's policy with skepticism. Axel Weber and Jürgen Stark resigned from their posts of members of the ECB Governing Council mainly for that reason. But they were not able to propose a feasible rescue strategy apart from a massive downward adjustment in the form of "internal devaluation" in the crisis countries which, without complementary measures, is putting enormous political pressure on those countries and may eventually lead to the break-up of the eurozone.

The Politics of Eurozone Reform

A quick solution of the eurozone crisis has been hampered by various factors, not least the German government's hesitation to accept any "grand solutions", such as outright purchases of government debt by the ECB or the issuance of "Eurobonds". It has to be taken into consideration, however, that it is mainly the German parliament as well as lobby groups and a large part of the economists, including the Bundesbank economists, which are responsible for the somewhat narrow and predominantly national perspective of the economic policy discussion in Germany, which did not allow the government to embark on a comprehensive crisis management strategy.

In the view of a mainstream member of parliament, who had to vote for the substantial capital contributions and guarantees to the ESFS and the ESM, the strategy of muddling through was the only feasible way of moving forward since the financial costs and risks for the taxpayer were perceived as too huge to be digested by a population that had suffered from two decades of reunification "solidarity taxes" and a tough reform program of the labor markets since 2005. A large part of the population had not seen any increase in real wages for many years and was just now seeing the first benefits of labor market reforms in terms of declining unemployment. A considerable part of the working population, particularly in the Eastern part, had to migrate and to completely change their lives in order to regain an economic livelihood in the past two decades. Against this background, it was not possible for the government to ask taxpayers for a higher degree of solidarity for Europe in the framework of a more comprehensive strategy.

Furthermore, there is a broad consensus in the population that government debt—which has been rising inexorably since the 1970s and is up to almost 80 percent of GDP in 2011, higher than in Spain—should be reduced. A national "debt break" meant to prevent any further increase in government debt from 2016 for the national government and from 2020 for the federal states met with a broad consensus in principle in parliament. The notion of intergenerational equity is taken seriously in view of the aging society and the shrinking population. A critical public discussion on the merits of economic growth and on new concepts of measuring well-being beyond GDP-growth contributes to a public sentiment that more growth, particularly growth that is based on credit, will not improve the quality of life.

This is reinforced by the predominant view among German economists that supply-side policies are more effective for growth than any demand stimulus. It is assumed that the liquidity injections by the ECB as well as the support through the ESFS and ESM constitute an incentive for bankers and policymakers in the crisis countries to postpone hard but inevitable decisions. It is argued that without the German rejection of "easy" solutions—such as the introduction of Eurobonds which would entail a mutual liability for new debt without control on the budgetary decisions in other countries—there would have been no radical policy changes like the ones that have taken place in Italy and Spain. However, as the crisis unfolds and political realities change, there will be the willingness to discuss new, more comprehensive steps and also contribute to common solutions as long as there is trust that all sides contribute and that there are no free riders.

Agenda for Growth: Toward a Cooperative Solution

At the G-20 Summit in Los Cabos, the European heads of state will present a European growth compact which will go alongside the fiscal compact. This will constitute yet another intermediate step but not the grand design which would include the two major elements mentioned above: a plan for bank recapitalization and a restructuring of public debt with a joint liability for the debt built up in the past. The political dynamics in Europe will just not allow the region's policymakers to arrive at the necessary conclusion in the short time that has passed since the French and Greek elections. These developments have changed the political realities in Europe. In this context, it will be important for the non-European G-20 members to understand the difficult political economy processes within and between European countries that make the crisis so difficult to manage. Anyone expecting quick fix solutions will be disappointed yet again. However, it can be expected that some breathing space can be won provided that the G-20 will endorse the European proposal in principle and thus reassure financial markets.

It will be essential, however, that the G-20 clearly endorses a stronger role for the IMF with regard to its role in Europe and globally. The Mutual Assessment Process—agreed to at the Pittsburgh Summit 2009 in order to provide the technical analysis needed to evaluate how G-20 members' policies fit together and whether collectively they can achieve the G-20's goals—has not yet become fully operational. The imminent global risks of the eurozone crisis should give the opportunity for the IMF to provide a clear and balanced view on the scope for collective action in Europe and beyond. A coordinated medium-term fiscal policy framework for the eurozone that addresses the weaknesses of the banking sector, provides a financial envelope for the Southern European countries, and is tied to the implementation of structural reforms would give the necessary signal to Europe to get its act together. The IMF has been a junior partner in the "Troika" which devised the adjustment program for Greece—a program which was intellectually flawed because it was based on far too optimistic assumptions on a resumption of growth in a situation of continuous public expenditure cuts. It is time for the IMF to resume its role as an independent multilateral institution with a global perspective. If this will be achieved, it will add to its credibility as much as the reform of its governance which is still to be completed in the years to come.

Endnotes

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Greening the G-20 Agenda: A Way Forward

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The setting up of the G-20 has resulted in 20 of the most powerful economies[2] of the globe coming together to discuss and address issues that supersede exclusive national interests. Despite the fact that the group was primarily set up for cooperation on matters related to the international financial system and its stability, energy and environmental issues have become important components of the G-20 agenda over time. In fact, the transnational nature of various environmental issues has made the G-20 an important forum for cooperation on potential energy and climate change action.

The ongoing discussions may be easier to think of under three divisions. First, many of the existing constituents of the G-20 green agenda support initiatives already undertaken in other multilateral platforms—such as climate change finance (CCF), and clean energy and energy efficiency (C3E). Second, new initiatives were also undertaken by the G-20 and given immediate high-level attention. These include issues of fossil fuel subsidy (FFS) reform, global marine environment protection (GMEP), and a database for mapping price volatility of oil and natural gas. Third, it is worthwhile exploring what initiatives the Mexican presidency of the G-20 may undertake given that it has elevated issues concerning the green economy and sustainable development by placing them at the top of its agenda.

A Supportive G-20 Role in UN Discussions

First, rationalization of fossil fuel subsidies (FFS) is one of the most important priority items within the broad theme of energy and climate change. Under this agenda item, all G-20 member countries were asked to report the FFS given by them under different headings and submit a timeline for its reform. In each following summit post the 2009 Pittsburgh Summit, countries' progress was monitored with respect to this program. This was the first time that top economies of the world had tackled head-on the tricky issue of FFS. This issue, while discussed in other multilateral forums such as the United Nations Framework Convention on Climate Change (UNFCCC) and different academic circles, had always been relegated to the background due to its political and national sovereignty implications.

Second, clean energy and energy efficiency (C3E) initiatives was another field in which G-20 discussions supported negotiations held elsewhere, for example the UNFCCC's Ad-hoc Working Group on Long-term Cooperative Action, and G-20 members agreed to monitor performance under the head of domestic mitigation action and its assessment. The initiative is important since countries monitored their clean energy deployments and the policy progress made.

Third, the mandate of the Climate Change Finance (CCF) Working Group of the G-20 was to provide a supporting role to UNFCCC's discussion on CCF. It sought to explore the aspect of scaling up CCF for mitigation and adaptation in developing countries. In fact, it aimed at building upon the work carried out by the UN secretary-general's High Level Advisory Group on Climate Finance (AGF).

The G-20's New Initiatives

The new initiatives of global marine environment protection (GMEP) and oil price volatility aim to close information gaps. The GMEP initiative shares the best practices to protect the marine environment with the final aim of preventing accidents related to offshore exploration and development and marine transport. On a similar note, the oil price volatility initiative tries to close gaps in crude oil (and now natural gas) data reporting and promote greater transparency. It attempts to standardize the reporting process and ensure timeliness to improve predictability of markets and facilitate project planning.

New Initiatives of the Mexican Presidency

Under the Mexican presidency, two new items have been included in the energy and environment agenda: green economy and sustainable development,[3] and infrastructure. The United Nations Environmental Program (UNEP) defines green economy as one that results in improved human well-being and social equity, while significantly reducing environmental risks and ecological scarcities. In other words, while the existing G-20 agenda items (mentioned above) denote important but small pieces of a larger puzzle, the newly incorporated issues of the green economy and sustainable development might be viewed as broader in their scope and vision.

How the Mexican Presidency Should Move Forward

Inter-relation between energy and environment: The G-20 needs to recognize that energy and environmental issues are interrelated and thus working groups need to be more cognizant of the work done in other working groups and incorporate the lessons learned. To illustrate, FFS reform has been mentioned as one of the most promising options for generating CCF that could be diverted to fund climate action.[3] These ends or climate actions on which the green funds would be spent are discussed in the clean energy and energy efficiency (C3E) working group. Thus, looking at the broader picture and fitting the existing pieces together provides clues to the missing bits of the picture and these are thus the aspects that need to be incorporated to make the G-20 agenda greener.

Feasibility of adaptation: Following from the above, it can be noted that an important aspect that has been hitherto missing from the agenda is the issue of adaptation. It is true that the inclusion of sustainable development and infrastructure under the Mexico G-20 Summit agenda would address this issue to some extent, but more pointed attention needs to be focused here. This agenda item thus needs to be broadened to focus on economic infrastructure not just in a general sense of roads, bridges, ports, etc., but also hospitals, coastal embankments, water storage facilities, water-saving irrigation facilities and rain water harvesting, all of which improve the coping capacities of people to climate change.

Technology and intellectual property rights (IPR): Another important missing piece is the issue of knowledge and technology dissemination such that countries can initiate national-level projects. This issue has been highlighted and discussed within the G-20, albeit for a small component of GMEP. This issue needs to be scaled up to cover other issues of environmental services and climate technologies (for both mitigation and adaptation).

The G-20 could discuss, by transforming into an innovation hub or powerhouse, ways and means of supplementing the work done in the UNFCCC's Subsidiary Body for Scientific and Technological Advice (SBSTA). The group could discuss the ways and means for making climate-friendly technologies more accessible, surmount IPR issues and make technology transfers easier. This issue can be covered by the G-20 by broadening the scope of the knowledge sharing working group (under the item of development) initiated under the French G-20 presidency.

Land use and forestry: For environmental services, two important issues relate to land management and forestry. The combination of the issues of land use, land use change and forestry could provide the answer to problems of air and water pollution as well as land degradation within countries. Under the agenda item of commodity markets and food security, the G-20 has already discussed issues of land management. These can be broadened to incorporate the environmental ramifications of agricultural practices as well.

Green jobs: One aspect that fits well into the existing structure of the G-20 agenda items is green jobs. With an intensified move toward sustainable development patterns, green jobs in renewable energy and infrastructure would account for a progressively larger share of total job creation. This aspect could be investigated in greater detail in the job creation item of the G-20's development agenda.

Energy trade: This is also an important aspect that needs to be highlighted under the Mexican presidency of the G-20. The issue is already being tackled loosely under the items of oil price volatility and C3E. It is also expected that the green economy agenda item would discuss this issue. In view of the high and rising import dependency and the often predicted scramble for resources, this issue assumes great importance.

Conclusion

Plugging the gaps in existing efforts while adding new and innovative concepts and actions should comprise how the Mexican presidency could take forward the G-20 agenda to make it greener. To sum up, the G-20:

- should plug existing holes in the UNFCC working group's tasks in a complementary fashion;
- should continue with earlier initiatives of previous G-20 summits; and
- can make the agenda greener at the Mexican Summit in Los Cabos by: pushing for the reform of fossil fuel subsidy; initiating discussions on a global carbon tax for buttressing climate change finance since any financing gap of G-20 proposals would, in the final analysis, need to be filled; ensuring adaptation principles that might be supportive of emerging economies; facilitating technology transfer to emerging economies and removing constraints posed by intellectual property rights of technologically advanced economies; continuing to emphasize water and air pollution and land degradation not only through its commodity markets and food security efforts but by deepening its strategy; laying the foundation for creating green jobs in renewable energy and green infrastructure by giving it visibility under its job creation window; and setting up policy-supportive indicators for energy trade, and extending the field to the scramble for resources that is challenging the sustainability of global development.

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Endnotes

[1] This paper is based on inputs into the discussions with the Mexican G-20 sherpa in preparation for the 2012 G-20 Summit of the Mexican Presidency, organized by the Mexican Council on Foreign Relations (COMEXI).

[2] Nineteen countries plus the European Union account for over 80 percent of global GDP.

[3] Brundtland Commission defines sustainable development as development that "meets the needs of the present without compromising the ability of future generations to meet their own needs."

[4] One idea that should also be revived is financing through a global carbon tax. The idea is described in some detail in Shome (1996).

The Eurozone Crisis Still Threatens Global Growth

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The outlook for the global economy in 2012 is clear, but doesn't look very reassuring: recession and stagnation in Europe, anemic growth at best in the United States, and a sharp slowdown in China and in most of the emerging market economies. Under the present conditions and policies, there are very serious downside risks for the global recovery; the most serious of these being a new deterioration of the eurozone crisis.

In the eurozone, fiscal austerity measures applied on a large scale are determining recessionary effects on output in many Southern European economies and stagnation in the core euro area. Interest-rate spreads for Italy and Spain are widening again, while borrowing costs for Portugal and Greece remain high.

The European Central Bank's longer-term refinancing operation to provide nearly $1 trillion in cheap three-year funding to European banks has temporarily stabilized the eurozone and the global financial system, but has not addressed the underlying problems of the crisis in the peripheral countries: large and rising private and public debt as a share of GDP on the one hand, and a deepening recession and large macroeconomic imbalances on the other.

The major risk is that the eurozone is going to repeat the fundamental mistakes of the Great Depression. Under present conditions, more turmoil is likely and Europe will suffer along with the rest of the world.

Looking ahead, the primary goal of the G-20 and the international community should be to call for a rebalancing of some aspects of the current strategy in Europe to ensure that there is not an excess of near-term austerity. The recessionary effect caused by fiscal austerity may itself fuel market doubts about government solvency and thus worsen the fiscal position of the euro area's highly indebted countries, defeating the very purpose of the initial austerity measures. In light of these considerations, a common European commitment to growth is strongly needed. Furthermore, a push for balancing trade within the eurozone should also be made compatible to the new overall global equilibrium. In the past, the eurozone has largely balanced trade with the rest of the world, although countries like Germany ran large trade surpluses against the rest of the eurozone. The risk is that future adjustment could transform the eurozone as a whole from a region with balanced trade with the rest of the world to another trade surplus and export-led growth area like East Asia. That would make it even more difficult to stabilize and promote growth in the global economy as a whole.

The Conventional Narrative of the Eurozone Crisis

Since the start of the crisis, European leaders have misdiagnosed the problems and set the wrong policy course based on fiscal austerity. On the conventional (German) reading of the crisis is that it is not the product of the eurozone system itself, but of misbehavior of individual countries within the region in terms of fiscal laxity and irresponsibility. There is a banking crisis as well, but it is not seen as a central part of the problem in Europe. Therefore, under this reading of the crisis, the adjustment should be entirely one-sided and centered on the highly indebted countries. The resulting prescription was austerity and economic reforms. According to the current approach if the periphery can achieve this then the eurozone debt crisis will be resolved without new great institutional changes.

Fiscal austerity measures have been introduced and diffused everywhere in the eurozone from Greece's unique fiscal problems to countries such as Spain and Ireland which have banking and not fiscal crises. The belief is that these countries should restrain from excessive spending enough to restore credibility, bring down interest rates and restart economic growth. However, what is happening is that growth has suffered and recession has hit all peripheral countries. If most eurozone country governments are cutting spending at the same time, the contractionary effect on GDP is further magnified. The deficit countries must improve competitiveness and save more to pay down their debts, without offsetting a decline in saving and expansionary policy in the surplus countries like Germany. Slowdowns in one country will reduce demand for exports in others.

Fiscal austerity in individual European countries has resulted in excessively tight macroeconomic policy for the euro region as a whole. Together with Europe's inability to handle the problems in Greece, it contributed to weakening market confidence and creditworthiness in many countries, notably Spain and Italy. The decline in sovereign bond prices of highly indebted countries has exposed the banks' undercapitalization. The prospect that European governments will have to finance recapitalization has driven up risk premiums on government bonds. The sovereign debt crisis in the periphery is thus bound up with a banking crisis across the euro area as a whole. As a consequence, the banking crisis and sovereign debt crisis has been so far interacting with each other in a perverse direction.

Fiscal Austerity Alone Will Not Solve the Crisis

It is very clear that the fragility of the financial system, together with the sovereign debt crisis, represents the biggest threat to the long-term stability of the eurozone. It's also clear that fiscal austerity alone will not solve the crisis. EU countries, particularly those across Southern Europe, would be well-advised to take supply-side reforms more seriously than they have in the past. But there are obvious contractionary effects for the eurozone as a whole deriving from such an asymmetric approach. As previously noted, increases in saving and exporting in eurozone deficit countries have to be offset by equal increases in spending and importing in surplus ones. Peripheral Europe cannot possibly succeed in reducing its borrowing substantially unless surplus countries like Germany pursue policies that allow their surpluses to contract.

For the past two years, policymakers across Europe seem to contest this point and argue that fiscal consolidation by itself will boost growth. The main hypothesis is that confidence-inspiring measures will foster and not hamper recovery. However, these assertions have little empirical evidence to support them. As a careful study conducted by the International Monetary Fund concluded in 2010, "fiscal consolidations typically lower growth in the short term". In other words, their net effect on demand is contractionary, rather than expansionary. Furthermore if a eurozone deficit country were to reduce its trade and current account deficits without Germany playing any offsetting role, this would implicitly assume that the rest of the world would have to absorb a huge shift in the eurozone's external position, from broad balance to large surplus. Currently, there seems to be very little room to shift the euro area's imbalances to the rest of the world by transforming the region as a whole into another export-led growth area like East Asia. Such an action would also make it even more difficult to stabilize and promote growth in the world economy as a whole.

An Alternative Diagnosis and Therapy

In the light of what has been said, it is no wonder that Europe's economic prospects are so poor. Twelve European countries are in recession—meaning they have suffered at least two consecutive quarters of negative growth—including big countries like Spain and Italy. Eurozone unemployment has risen for a 10th consecutive month to reach a new record high of 17.1 million in February, with the pace of increase showing little sign of slowing due to austerity programs across the continent.

To avoid further recessionary trends in the eurozone and the potential for another major global crisis, it is crucial that European policymakers modify their policy strategy. First, they should recognize that fiscal austerity has become part of the crisis. We need an alternative therapy based on a better understanding of the causes of the crisis since the diagnosis and the corresponding therapy are strictly related.

Contrary to the official narrative of the underlying cause of the eurozone crisis, with the exception of Greece, the real cause of the crisis is not the fiscal irresponsibility of some EU member countries but rather the unsustainable accumulation of debt among private actors (households and banks) linked to the large and persistent imbalances in the euro area. Up until the time of the global financial crisis, the euro area as a whole remained relatively close to external balance. However, the current account balances and the competitive positions of individual EU member countries have widely diverged.

The launch of the euro did produce a key effect on creditor and debtor countries—a common monetary policy. Removing exchange rate risk with the introduction of the euro encouraged massive capital flows to and as a consequence large current account deficits in the Southern European nations—Greece, Italy, Portugal and Spain. Nordic countries run spectacular current account surpluses, notably Germany (6 percent of GDP in 2011). External divergence also took the form of steadily widening and different competitive positions of the two groups of countries.

For many years, however, very little attention was paid to these imbalances by national authorities and the European institutions. The assumption was that changes in competitiveness and current accounts are not necessarily bad in a monetary union. This assumption was accepted even more so because for many years large current account deficits were easily financed by net private capital flows of surplus countries in the euro area. In other words, the banks of the core countries (Germany and France) heavily financed the excess demand in the peripheral countries, thus promoting the accumulation of large macroeconomic imbalances within the eurozone.

The global financial crisis in 2008-09, however, has put an end to this easy financing and has revealed many weaknesses in the euro architecture. Private funding of imbalances dried up and the system of euro area central banks has had to replace the banking sector as a key source of funding of current account imbalances and private capital movements. This massive intervention was to a certain extent successful, but the cost was the dramatic increase of budget deficits and sovereign debts in deficit countries. In the years after the crisis, highly indebted European countries with large external deficits experienced the highest sovereign bond yield spreads. Current account imbalances were placed at the heart of eurozone crisis. As a result, the euro system has become exposed to the risk of sovereign and bank defaults. High public deficits and debts are much more an effect than a cause of the eurozone crisis.

A Mix of Austerity, Liquidity and Growth Policies Needed

The diagnosis sketched above shows us the complex and systemic nature of the eurozone crisis. Countries in the euro area are facing major structural problems and need prolonged technical assistance to implement the necessary adjustment policies over the next decade.

First, the excess of private and sovereign debts requires fiscal adjustment and consolidation measures in the highly indebted peripheral countries. In short, these countries need a significant dose of austerity to impose a new discipline in the conduct of national economic policies in order to correct past mistakes. To be effective, however, these adjustment policies need time and adequate financial resources in the hands of the European Central Bank and/or the European Stability Mechanism (ESM) to avert the risk of a liquidity crisis inherent in a currency area such as the eurozone. In addition, the solution to the crisis requires a dynamic growth environment in Europe, which will involve both national reforms and policy strategies implemented at the European level.

A more articulated approach to addressing the crisis in Europe should involve a composite mix of policies based on austerity, liquidity and growth measures. A specific role should be assigned to each of them since the various combined effects may generate very different outcomes in the painful adjustment process that is currently affecting euro-area countries.

The trouble today is that the eurozone has an austerity strategy but a very inadequate liquidity policy and no growth strategy at all. This biased composite mix has led to the current recession trend that makes austerity and national reforms self-defeating because in peripheral countries output continues to contract and debt ratios continue to rise to unsustainable levels. Moreover, the social and political backlash in these countries will eventually become overwhelming.

A radical rebalancing of the eurozone's strategy is thus needed by introducing effective adjustment mechanisms of both liquidity resources and enhanced growth capability. Only a more composite balanced mix of policies for austerity, liquidity and growth can offer a solution to the crisis in Europe. While the austerity strategy remains the responsibility of each individual member-state, a much more coordinated effort at the European level is needed for liquidity and growth. In this perspective, two key problems should be solved for the euro area as a whole: the banking sector's problems and the low growth-stagnation problems.

The Banking Sector's Problems: A Comprehensive EU-wide Plan

It is evident that no solution to the solvency/liquidity capability of peripheral European countries, and in particular Italy and Spain, could save them if the restructuring and/or recapitalization problem of many European banks is not addressed and solved. Thus one should focus on a comprehensive EU-wide plan to restructure and/or recapitalize and/or shrink troubled banks. Only until very recently, were we able to talk openly about the need to implement a plan to restructure and recapitalize banks and this should be part of a large, comprehensive strategy for the whole euro area.

The plan should be managed at a common European level and not on a national scale, as agreed to last year at October Euro Summit. We already made a mistake at the beginning of the global financial crisis in 2008 by requiring each country to save their banks with their own resources. This approach created rising public deficits in weaker European economies and the subsequent increases of the interest rate spreads. In turn, this led to a vicious circle: recapitalization undermined the creditworthiness of governments and then this fed back into the banks, which saw the values of their assets decline further. Instead, the reinforced European Stability Mechanism, or the European bailout fund, should support weak banks in eurozone countries with weak economies. Capital buffers can also be built up by enacting a moratorium on bonus and dividend payouts. A complementary fundamental pillar is new bank resolution legislation, making it possible for any bank, including large cross-border banks, to fail and thus not reimburse fully their creditors and equity holders—with the sole exception of insured (retail) depositors. Such a system would introduce strong incentives for bank managers and equity holders to limit risk taking and to create more stringent market discipline, which would also be extended to sovereign borrowers. Finally growth is a fundamental ingredient to reduce the fragility of the banking sector.

It is clear that in facing these problems the recent generous supply of liquidity made by the European Central Bank in favor of banks across Europe only offers extra time to implement the necessary reforms mentioned above but is hardly a solution to the existing problems.

A Growth Agenda Is Even More Pressing

As I have already pointed out, a protracted recession in Southern Europe would quickly again put the single currency in danger. The European Union's growth agenda has become even more pressing because growth is what is needed in order to counter the falling economies of the peripheral European countries. From this perspective, the EU should launch a new initiative to mobilize the array of available policy instruments to boost growth. Without a quick return to growth, the main problems of the eurozone will likely become even more unsustainable.

More than just a fiscal crisis, the situation in Europe is more a crisis of unsustainable private debt accumulation linked to large and persistent imbalances in the euro area. The huge challenge now is to make managing the crisis compatible with the adjustment of these external imbalances. Austerity measures and/or the indefinite financing of them are not the solution. The former will exacerbate recessionary trends in the eurozone while the latter will create economic and politically unsustainable tensions among countries.

An effective approach requires looking at both competitiveness (euro-area relative performance) and stronger growth (euro-area absolute performance) so to introduce: (1) structural reforms to strengthen key markets (products, service, housing) to increase investments and boost growth; (2) effective mechanisms to address long-term external imbalances, including in surplus countries since current account imbalances lead to asymmetric adjustment in monetary unions too.

In order to restart economic growth, there is a need for both traditional demand management policies and pure supply-side economics. Demand is crucial and this requires growth-orientated macroeconomic policies: the fiscal policies of EU member-states must be coordinated and trade balances narrowed symmetrically. Countries with imbalances will have to demonstrate how they intend to close them, with the onus being as much on those running trade surpluses as those with deficits.

The other challenge is how to implement simultaneously a sort of Schumpeterian supply-side policy. A classic example in this direction is a substantial increase in investments for the single market infrastructures (material and immaterial). It would bring great benefits by boosting demand in the short term and by raising the European Union's potential output in the long term.

Under present conditions, the market alone cannot produce a demand recovery rapidly enough by itself due to the current imbalances and divergent growth pattern in Europe. And it cannot produce structural adjustment until a demand recovery is well underway. Even as structural reforms are implemented, they only pay off in the long run but slow growth in the short to medium term tends to fuel austerity fatigue and political risk. This is even more so the case with the lack of aggregate demand at the global level given the deleveraging of households and governments and the glut of capacity due to the massive overcapacity in China and in other Asian countries. The need for balancing trade within the eurozone should be made compatible in order to achieve a new overall global equilibrium. In the past, the eurozone has largely balanced trade with the rest of the world, although countries like Germany have run large trade surpluses against the rest of Europe. One should avoid transforming the eurozone as a whole from a region with balanced trade with the rest of the world to another region of trade surpluses and export-led growth like East Asia. That would destabilize the world economy even more and hurt global growth.

Therefore, it is essential that eurozone countries put in place a comprehensive policy response geared at speeding up and improving intra-area regional adjustment mechanisms. The present zero-sum game approaches will be very risky for the stability of the euro area and the rest of the global economy as well. New policy priorities are thus required in the eurozone that put more emphasis on cooperative games in convergence and competitiveness.

Rethinking Japan's "Lost Decade": Some Post-Crisis Reflections

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There are many parallels and similarities in the aftermaths of financial crises. What distinguishes the current state of the world economy four years after the global economic crisis from the situations of previous crises and from Japan's "Lost Decade"? What can this imply for the world economy in the future?

The Crisis and its Long Aftermath

Four years have passed since the outbreak of the global financial crisis. World financial markets now seem to have regained a measure of stability from its immediate aftermath thanks to swift and forceful policy actions taken by many governments and central banks working in concert. The sense of panic has certainly subsided and the desperate pessimism has been gradually replaced by cautious optimism. There seems to be more confidence now on the policy actions that should be taken, although differences still exist among policymakers over the speed and the magnitude with which they need to be implemented. The initiatives to reform the financial system to prevent future crises were launched globally, mostly in the G-20 framework. Remarkable progress has been made on many fronts, including in strengthening banks' capital adequacy standards and dealing with systematically important financial institutions. All of these developments are brightening prospects for the world economy.

The current state of the world financial system, however, is far from normal. While global economic growth has been helped by the buoyant economic development of emerging market economies, the growth of developed economies seems still hampered by the suboptimal health of their financial systems. Deleveraging has been prevalent and seems to have increased in the last four years. To cope with liquidity crises and deflationary impacts, central banks have resorted to bold non-traditional policies and expanded their balance sheets on an unheard of scale. No signs of reversing these policies are likely for the foreseeable future in the United States, Europe or Japan. Rather, the policy debate is mostly focused on whether we need another round of monetary expansion. The bold and unconventional monetary policies are affecting the foreign exchange markets and the relative competitiveness of countries as well is creating an unprecedented environment for policymakers. At the same time, many countries have sharply increased their public debt in response to the financial crisis and from high spending and lackluster tax revenues. Efforts to contain public sector debt are being made in those countries, but progress seems slow given the need to sustain demand in addition to the political and social difficulties that any fiscal reform would entail.

Under these circumstances, the core function of the financial system of allocating scarce risk-taking capital for the future growth of the economy seems constrained everywhere, and the role of the financial system is overshadowed by the need for securing financing for the public sector.

Implementation Challenges Rising

While financial crises are caused by similar underlying factors, the past four years revealed that there are three major aspects that have made this global financial crisis distinctly different from previous financial crises. These factors will continue to pose significant challenges to policymakers not only at the current juncture but also over the foreseeable longer-term horizon. The implication of these factors will affect the way the financial system will evolve and will impact the performance of the world economy in the long run.

First, the financial system has clearly shifted from a bank-based to a market-based system. A market-based financial system allows fair and flexible allocation of risk and returns, and efficient allocation of capital and sustainable economic growth. It brings about enormous benefits to the economy by strengthening financial freedom and inclusion, allowing entrepreneurship to flourish. At the same time, under the market-based system, the potential ability of debtors to repay, regardless of whether they are corporate, household or sovereign, is quickly assessed by the markets and reflected in market prices. This encourages prompt corrective action, contributing to the stability of the financial system under normal circumstances. When a crisis hits, however, it leads to swift deterioration in the quality of the balance sheets of creditors and causes concomitant liquidity problems, particularly for banks. Even in the cases where borrowers are concentrated in specific sectors or countries, the impact spreads across the globe instantly through rapid balance sheet effects and strains in liquidity positions. Any potential vulnerabilities of the financial system are exposed much more quickly than a decade ago, compounding the challenges to policymakers.

The European crisis highlighted this point. In the immediate wake of the global financial crisis in 2008, blame was directed at the United States. Critics made a number of points, including reckless lending by mortgage companies, excessive borrowing by consumers, and inadequate oversight by regulatory agencies. However, it became immediately clear that the crisis exposed the weaknesses and vulnerabilities in the financial systems everywhere and especially in Europe, where the impact turned into an unprecedented crisis of confidence. The underlying fiscal imbalances and differences in internal economic fundamentals within Europe became clear.

A weakness in the financial system impacts the real economy, as credit becomes dangerously tight, consumer confidence plunges, and unemployment surges. The deterioration of the real economy, in turn, adversely affects the soundness of financial institutions and increases the risk of a serious vicious cycle. No country is immune to these effects. The initial complacency is replaced by the loss of pride and humility. Governments and financial institutions are responding quickly and boldly, but it takes considerable time for these efforts to bear fruit, testing the political will of policymakers and the patience of voters.

The second aspect relates to the cost and responsibility of resolving financial crises. With the emergence of highly integrated financial markets, it has become much more complicated to assess the real burden borne by various stakeholders as it involves much greater cross-border implications. When the financial crisis hit Japan about a decade ago, the Japanese government declared that Japan would not be the one to trigger a global financial crisis. The crisis was largely a banking sector crisis and the government effectively succeeded in containing the impact within its own borders. The cost of resolving it was also shared mostly within Japan's borders. In the context of the current crisis, however, it seems extremely difficult for any country to make such a declaration. The crisis in Europe is a glaring example of this difficulty, not just because of the single currency but also because of the very high degree of economic integration.

The solution for today's financial crisis requires a far more systematic and globally consistent approach. In the aftermath of any financial crisis, the post-crisis political situation is prone to creating an environment in which populist policy actions are appealing. Tensions arise between the desire of policymakers to appear tough and forceful to introduce drastic changes on the one hand and the desire to be supporters of "traditional values" on the other in the face of entrenched public expectations. In addition, the resolution of today's crisis involves a far more complex international dimension. Tensions arise between the need to take a globally coordinated and consistent policy approach and the desire to address the concerns of domestic voters. It may be tempting to blame other countries for domestic problems and take unilateral actions at a time when international coordination is indispensable. While the collaborative approach is being actively pursued in the G-20, the European Union, the Financial Stability Board and various international bodies, there are also many policy actions being taken or proposed that have not fully taken account of broader international implications.

The third aspect is that the conflict between policy objectives is becoming more evident and acute, often polarizing politics and creating gridlock and further delaying needed actions. Ideologies have become more important in the political arena than pragmatism. The policies, which moderate and centrist voters think are necessary and acceptable, are becoming politically unpopular because of the stronger political appeal to take extreme positions. The ability to foster compromise and carry forward the needed policy, which is most needed in such a moment, is undervalued in the age of sound bites and in the face of frustrated voters. This is particularly acute on the fiscal policy side; any retrenchment in fiscal spending or tax increase has been fiercely resisted in the name of supporting the economy, regardless of the seriousness of the fiscal situation. While fiscal stimulus to support the economy can play an important role under normal circumstances, the effects of fiscal stimulus would be diminished when fiscal deficits are beyond a certain threshold as longer-term fiscal sustainability becomes threatened and public anxieties increase.

Are the Markets to Blame?

One of the most difficult challenges today is to embrace the merit of open and vibrant markets. Against the backdrop of the frustrating pace of the economic recovery, markets have been increasingly blamed for the problems created. Combined with the perceived problems of corporate governance in the financial industry, public confidence in financial markets seems especially eroded in many developed countries. In countries where public funds were used to deal with the critical crisis situation, criticism has become particularly harsh and hostile toward policies to enhance the role of market mechanisms. Efficient, transparent and open capital markets, which have long been accepted as an indispensable engine for economic growth and development, are now viewed with a measure of skepticism. While the criticism toward market systems may be exaggerated in many instances, the anxieties and uncertainties are real and cannot easily be dispelled over a short span of a few years, particularly for the deeply affected segments of the population.

Is it right then to blame the market-based system? Markets may often turn out to be irrational, but no alternative systems have ever come to exist that could play the role of efficiently allocating scarce capital. Under the market based system, investors who make poor decisions suffer quickly and those who take contrarian risks contribute to dampening excess in the markets. The market based financial system itself has mostly functioned effectively and allowed for a much quicker resolution of problems and resumption of normalcy than the bank-based system. One can argue that without the market-based system, the recent problem could have been much worse and the adverse impact much larger.

It is particularly important to distinguish between the role of the market system and the abuse of the system by market participants. Episodes of abuse of the markets, which often tend to surface in the aftermath of financial crises, exert powerful impact on public opinions and policymakers. However, the existence of the episodes of abuses itself is not necessarily a sign of weakness in the system. Rather, early and effective detection of abuses is a sign of strength of the system. These episodes could have been prevented if rules had been clearer and enforcement had been more effective. There is always room for improving regulation. The initiatives to improve them should be taken forcefully. These improvements are in fact mostly on the side of enhancing the role of markets rather than on the side of reducing it.

Japan's "Lost Decade" and "Déjà Vu"?

In the wake of the financial crisis, the motto worldwide was to avoid Japan's perceived mistake, the "Lost Decade"—the vicious deflationary trap of prolonged stagnation. Four years after the global financial crisis, it is worth asking ourselves if the world economy has succeeded in avoiding the Japanese experience and, if so, in what sense.

In the first place, it is useful to ask if and in what sense the past decade was "lost." It is true that for more than a decade the nominal and real GDP growth was low and often in the negative in Japan after its financial crisis. Deflationary pressures persisted and the stock market performance was lackluster. Fiscal deficits ballooned. Demographic problems became acute, with a declining birth rate. The Japanese yen appreciated significantly as a result of the changes in the relative stance of monetary policies, adversely affecting the competitiveness and continuously exerting deflationary pressures. But the unemployment rate stayed at a relatively low level by international standards. Many corporations are sustaining investment and taking international opportunities offered by strong growth in the region. While there have been major setbacks from the earthquake and tsunami of March 2011, the manufacturing sectors have recovered from the damage quickly, showing resilience and willingness to overcome the difficulties.

Importantly, this resilience has been supported by many reforms that were undertaken to strengthen market mechanisms and modernize the financial sector, opening up the markets, encouraging competition and upholding international standards. In fact, in terms of policymaking, the "Lost Decade" was not really a lost one, but rather a decade of substantial reform of Japan's financial and economic systems. Since Japan launched its "Big Bang" in financial reform in late 1990s, initiatives were launched to make Japan's financial system more open and competitive in international finance. Japan has embraced the standards and codes promulgated by international groups and institutions, including the Basel Committee. In light of accelerating integration of financial markets, Japan's reform of accounting and auditing standards has also been advanced in light of the ongoing of global convergence. These reform efforts were undertaken in earnest when banks were struggling to deal with non-performing loans. A permanent safety-net deposit insurance system was also put in place, which can be activated to inject public funds to capitalize failing banks or nationalize them if systemic risk is detected. These reforms also created dynamism, contributing to structural changes in the Japanese economy and corporate governance. Cross shareholdings were unwound and international investors now hold about 27 percent of shares issued by listed Japanese companies. Labor mobility increased. During the process, foreign financial institutions operating in Tokyo also enhanced their role, contributing to a deepening in the markets and diversifying financial services. As a result, the Japanese financial system has become more robust and Tokyo's financial market has become one of the most open and vibrant markets in the world.

Why then is there this perception of the "Lost Decade" in Japan? It is probably more to do with appearance than to reality. It is also related to the perception of policy stalemate that has often persisted. The process of reform and transformation is long and painful. Japan has been going through major changes affecting many segments of society. It is not difficult to detect the ambivalence toward reform that has been created in the aftermath of the crisis. The mood of the public has become wary and less forward-looking. Political debate becomes driven less by reality but by nostalgia.

When the global financial crisis erupted, many in Japan felt a sense of "déjà-vu". This may also have reinforced anxieties and bred a degree of complacency. What seemed to be the weakness in Japan's financial system has proved to be much more universal this time around. The series of difficulties faced by the United States and European financial institutions seemed similar to what Japan saw a decade ago. The ensuing policy responses also looked strikingly alike: aggressive injection of liquidity into the money market by central banks and the lowering of interest rates—effectively to almost zero interest rates—and capitalization of banks and liquidity injection. The short-selling in stock markets was restricted, particularly for financial sector shares. In the days when Japan's previous crisis was at its height, the economy was portrayed as a unique and opaque form of capitalism and some of these policy actions, including restricting short-selling, were criticized as heavy-handed or excessively interventionist. But these are now more prevalently used to prevent market abuses. Having gone through these humbling and agonizing processes on the one hand and witnessing the parallels between Japan's crisis and the subsequent global crisis, the Japanese public may therefore have strengthened their ambivalence toward reform. Difficult decisions, particularly in the area of tax and social security reform to ensure fiscal sustainability, have been postponed and exacerbated problems, although the current account surplus has masked them.

Certainly, more needs to be done to make the Japanese economy competitive and dynamic. This should mainly come from revitalizing market forces by increasing transparency, encouraging risk taking and entrepreneurship by focusing on long-term investment in education and research. The process of reform is ongoing and is far from complete. The Japanese economy needs to be more globally oriented as well in order to reap the benefits of rapid integration of world economy and dynamic growth of emerging markets, particularly in Asia. The banking sector and the financial sector also need reform to better serve the economy by embracing globalization and regional economic integration. Such reforms will continue to entail anxieties. Fortunately, however, the global reform initiatives are perfectly in line with the reforms that had already been embarked on. Japan should feel confident in continuing to pursue these goals proactively and forcefully.

A Balanced Approach

Financial crises require similar solutions. It is the complexity, scale and political situations that differ in each crisis. In the aftermath of the crisis, the political situation may easily turn into polarization and stalemate, particularly in open and democratic countries. Whether the world economy has succeeded in avoiding the "Lost Decade" remains an open question, especially if the reform entails long-term difficulties and political stalemate becomes persistent in many countries. The overhang of public sector debt makes people ambivalent and less forward-looking. What Japan's experience can offer is not really what should be or should not be done in terms of policy recommendations, but rather a sense of realism and difficulty of policy implementation. The solution requires political leaders to refrain from polarization and to stay balanced. The stalemate from political polarization is the real problem that can prolong the difficulties, which should be avoided in all cases.

Déjà Vu All over Again: The Depressing Debate on the Financial Crisis and Democratic Politics

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The Great Depression and its sequels have shown that four interrelated challenges must be met to overcome an international financial crisis of significant scale: (1) securing access to a reserve currency to deal with "the original sin" of issuing debt in a currency not under one's own control; (2) shoring up aggregate demand in response to a deleveraging shock; (3) debt restructuring to resolve the stock of nonperforming loans and mitigate moral hazard; and (4) structural reform and adjustment to improve efficiency and realign prices and productivity levels. However, policy debates in the wake of the global financial crisis of 2008 have often displayed a depressing lack of awareness of the lessons from previous crises and reverted to "zombie ideas" for ideological or political reasons. Without a comprehensive understanding of the nature of the interrelated challenges, partial measures would be adopted in response to some aspect of the crisis to calm down the markets, but then a false sense of security would set in and pave the road for counterproductive measures that aggravate the situation, triggering another round of crisis. Unless a full set of policy measures are adopted to address the four interrelated challenges, this stop-and-go pattern will repeat itself.

Because the global financial crisis of 2008 originated in countries with reserve currencies (namely, the United States and Europe), the problem of "the original sin" was not fully appreciated until it became clear that the members of the eurozone could not, or would not, print euros the way the United States or the United Kingdom could issue dollars or pounds. The eurozone can deal with the original sin of borrowing in someone else's currency by making the European Central Bank (ECB) the lender of last resort for all eurozone countries, in return for ensuring economic reform and growth in these countries. The ECB made a clever move in this direction near the end of 2011 by making low-interest, three-year loans available to commercial banks through its long-term refinancing operation (LTRO) so that these banks could buy more sovereign debt. However, there is uncertainty as to whether this ad hoc measure can be extended and expanded. More fundamentally, if rising political and economic risks in the eurozone put more pressure on the sovereign debt of such countries as Spain and Italy, commercial banks taking on more of this sovereign debt would find their asset quality deteriorate, despite the liquidity relief provided by the ECB. To stem the tide, the ECB should consider buying sovereign debt directly from the secondary market across national boundaries as long as the interest rate remains above a level consistent with debt sustainability, which in turn is premised on economic reform and growth in crisis-stricken countries. In addition to making the ECB the lender of last resort, the eurozone countries should secure additional financial resources. The primary responsibility of dealing with the eurozone crisis must rest with the eurozone countries themselves. Financial contributions from the IMF and outside the eurozone should be supplementary, so as not to give the impression that the eurozone countries are trying to use other people's money to save the euro without risking their own money and changing their policies. The G-20, among others, must continue to exert peer pressure and insist that eurozone members increase their own war chest to deal with the risks of sovereign default.

Of the four interrelated challenges, the least well-understood and the most contentious one is that of shoring up aggregate demand in response to a deleveraging shock, the main topic of academic and political debates on Keynesian economics. In the pre-crisis period, most mainstream macroeconomists supported the interest rate rule that targeted a low and stable level of core inflation, with little regard for asset prices. In hindsight, however, it now seems clear that the *appearance* of stable inflation and a stable output gap during the period of the "Great Moderation" concealed serious risks in the balance sheets of households, firms, and financial institutions. Faced with a low interest environment for a prolonged period, financial institutions engaged in imprudent lending and investment behavior, which pushed up asset prices but not consumer or producer prices. What might be called a deregulatory capture of financial supervision further encouraged this trend, by making it easier to leverage and avoid regulation. When a series of defaults on subprime mortgages and other businesses raised doubts about the underlying asset quality and debt sustainability of financial institutions, a sudden downward revision of acceptable leverage took place. How this "deleveraging shock" occurs when it does remains something of a mystery.

In response to the initial deleveraging shock, the G-20 successfully coordinated a macroeconomic expansion and launched the Mutual Assessment Process (MAP) to resolve global imbalances in 2008 and 2009. However, this initial response was not sustained. As soon as the financial Armageddon was averted and recovery got underway, policy debates shifted to fiscal consolidation, even though the bond market was signaling that the U.S. and other major advanced industrial nations had room to undertake aggressive fiscal expansion.

Proponents for fiscal consolidation regarded the global financial crisis as a severe recession, which could be cured in a short period through a large dose of easy money and "shovel-ready" projects. They believed that more proactive fiscal policy would be counterproductive given the lags in implementation. However, this focus on "shovel-ready" projects ignored the fact that a financial crisis triggered by a deleveraging shock is very different from a recession precipitated by a rate increase or a non-financial shock. In the case of a financial crisis, it would take a long time for highly indebted economic agents on their own to repair their balance sheets because their liabilities denominated in nominal terms remain the same whereas their asset values collapse after a deleveraging shock. Faced with the zero lower bound on the nominal interest rate, conventional monetary policy would have a limited effect and fiscal policy would have to step in to shore up aggregate demand.

Even in the face of continued deleveraging on the part of the overly indebted private sector and despite the lack of empirical evidence, many European countries adopted the idea of "expansionary contraction" in 2010. As indicated by the ongoing crisis in the eurozone and the double-dip recession in the United Kingdom, however, the idea of gaining market confidence through fiscal consolidation to produce an expansionary effect on output did not lead to the intended result.

A morality tale, oblivious to any discussion on aggregate demand, provided a rather different rationale for fiscal consolidation. According to this tale, the financial crisis was triggered by overconsumption, or living beyond one's means, and people should now tighten their belts and start living responsibly. Former U.S. Treasury Secretary Andrew Mellon, as quoted by President Herbert Hoover in his memoir, voiced this sentiment in the middle of the Great Depression. The secretary "had only one formula: 'liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate.'" Liquidation, according to Mellon, would "purge the rottenness out of the system; high costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted and enterprising people will pick up the wrecks from less competent people."

Yet another motive for fiscal consolidation was the desire on the part of small government advocates to "starve the beast" and dismantle what was left of the New Deal institutions. They saw a chance to push ahead with their deregulation agenda under the guise of fiscal rectitude when that agenda was responsible for the onset of the crisis in the first place.

As far as debt restructuring is concerned, creditors and debtors have been engaged in a tug of war on cost sharing. In Europe, creditors claimed that fiscal irresponsibility in GIPSI (Greece, Ireland, Portugal, Spain and Italy) was the root cause of the eurozone crisis and prescribed austerity; however, they tended to ignore the fact that except for Greece, these countries had been held up as role models for fiscal improvement and rectitude in the pre-crisis period. By contrast, debtors pointed to the increasing current account imbalances since the launch of the euro and called for debt restructuring and symmetric adjustments.

This tug-of-war between creditors and debtors is a common feature in financial crises, but the desire to preserve the euro and the European project may eventually strengthen the bargaining position of debtors in this case. In international financial crises, such as the previous ones in Latin America and Asia, creditors backed by their governments and international financial institutions typically minimize their losses and impose adjustment costs on debtors. This in turn reinforces moral hazard on the part of creditors and provides support for the argument that *ex ante* restrictions on credit should be imposed to prevent crisis if *ex post* debt restructuring is not credible. In the ongoing eurozone crisis, however, there is a shared appreciation that the European project has helped to ensure peace and prosperity for Europe since World War II and that it would be a shame if this project falls apart due to a failure to agree on equitable burden sharing between creditors and debtors.

This sentiment also has important implications for the last of the four interrelated challenges. Although GIPSI countries have benefited from lower inflation and lower borrowing costs since joining the euro, they have forfeited their ability to adjust the exchange rate and must take drastic measures to realign price and productivity levels unless they are supported in their efforts by creditor countries' corresponding actions. Unless creditor countries provide support and reduce the need on the part of debtor countries to make nominal wage cuts and adopt austerity measures, their only option is to leave the euro with serious repercussions for the European project. Indeed, what is at risk is not only the interconnected financial system, but peace and prosperity in Europe. Those who side with the creditors and prescribe austerity for the debtors at all cost should be reminded that the suffering masses could make radical choices as was the case in the 1930s.

The eurozone countries should change their disastrous policies and mobilize their resources to meet the four interrelated challenges. The eurozone must deal with the "original sin" of borrowing in someone else's currency by making the European Central Bank the lender of last resort for all eurozone countries, in return for imposing sustainable reform and growth packages on these countries. The eurozone should scrap the idea of "expansionary contraction" and give priority to growth and employment. It would be helpful if macroeconomic expansion can be combined with investment and structural reform to improve productivity. Also, instead of making matters worse by continuing to perpetuate uncertainty about the magnitude of potential losses on the stock of nonperforming loans, the eurozone must agree on a clear debt restructuring strategy with a credible stress test for residual risks and a measure to mitigate moral hazard. For the flow dimension of the problem, the eurozone countries must rebalance by reducing price-productivity disparities, while maintaining the single currency. This international, intra-eurozone rebalancing would be easier if creditor countries adopt expansionary policies while debtor countries try to consolidate, rather than just forcing debtor countries to assume the entire burden of adjustment through austerity and deflation.

Recent elections in Europe, from Greece to France, have clearly shown that voters are no longer willing to put up with the austerity program which prescribes suffering for the masses while sparing the financial elite of any accountability. Popular anger evident in the "Occupy Wall Street" movement is beginning to translate into substantive political outcomes. Creditor countries such as Germany are finally coming around to see the need for symmetric adjustments to realign price and productivity levels as well as to share costs for debt restructuring. Despite all the depressing debates on crisis management, democratic politics is forcing policymakers to move away from contraction and instead promote growth and employment. However, it remains to be seen how democratic politics will play out in the next few years. When the unemployment rate is over 20 percent and yet policymakers, under pressure from international creditors, continue to prescribe more suffering, politicians who call for radical solutions will gain more popularity. International creditors must realize it is in their own interest to take responsibility for their past investment decisions and work with the reformist center in debtor countries to keep extremist forces in check.

The False Dilemma between Austerity and Growth

Guillermo Ortiz

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Recently, the general discussion regarding the eurozone crisis is focused on the trade-off between adjustment and growth. The International Monetary Fund, for instance, argues that all countries with fiscal space should use it and should have flexibility in the short term to respond to the challenges of slackening global activity. Also, some policymakers claim that, due to the current recessionary context, a gradual but steady pace of adjustment is preferable to heavy front-loading. However, there are very few countries that have fiscal space; and economies in the middle of a financial crisis cannot afford to postpone adjustment. Particularly, in the current eurozone context this argument of a trade-off between adjustment and growth does not hold.

Peripheral European countries are under the market lens and need to regain credibility in the eyes of investors in order to recover sustained growth, just as many emerging markets did in the financial crises of the 1990s. As an example, over-adjustment in the fiscal front along with a renewed commitment to structural reforms were essential for Mexico to pull swiftly through the financial crisis in 1995-96. It is also true that the surge of exports to the U.S. at the onset of NAFTA, helped by a sharp currency depreciation, contributed significantly to this success. In the light of the Mexican experience (and that of other emerging markets), a more favorable international environment brought about by a much more assertive external rebalancing of surplus countries—especially, China and Germany —and a convincing commitment to adjustment and reform would be more conducive to restoring growth in non-German Europe than the illusionary lifting effects of budgetary relaxation.

Today, it seems that markets are taking a contradictory—even schizophrenic—view of current policy stances in the eurozone. On the one hand, any deviation from fiscal targets is punished in the bond market by an increase in the sovereign's risk premium. On the other, markets fear that fiscal austerity could trigger a recessionary spiral by damaging domestic demand, which would in turn harm government revenue. In market perceptions, this combination of higher interest rates and slow growth could ultimately turn into an ever-expanding public debt. Yet, if an economy has spent for an extended period more than what it can sustainably produce, there must eventually be a period of corrective consolidation—which means there will be a phase of weak growth and persistent high unemployment. This was true for emerging markets where governments did not hesitate (or had no option but) to apply harsh adjustment programs to recover investors' trust.

The trade-off between adjustment and growth only exists (and perhaps only for a limited period of time) for countries that are not in the middle of a financial crisis, like the U.S. and the U.K. For peripheral countries, this is clearly not the case. Several of these economies have been postponing adjustment for too long now; many European leaders have been in denial for too long. The truth is that the European debt crisis has been underestimated from the outset and localized problems have been allowed to metastasize. The financial crisis was initially misdiagnosed as Anglo-Saxon in nature, with limited ripple effects on continental Europe. The accumulated balance sheet disequilibria of both the public and the private sectors in most European countries were ignored. The need to deleverage was underestimated. Liquidity and solvency issues were inadequately handled, creating perverse interactions between them. The spillovers between bank and sovereign risks were acknowledged only after the fact. The chimera that financing from the rest of the world (the IMF or the BRICs) would allow Europe to postpone solving its own problems was irresponsibly entertained by some. The current debate about the fictitious trade-off between adjustment and growth seems like another exercise in denial. With no institutional and political ability (nor willingness) to decisively implement the necessary policies, the crisis will remain unresolved and governments will be forced to endure the market's unrest and voters' revolt.

From the viewpoint of the markets, not even the "successful" Greek debt restructuring has been a solid step forward. After the agreement reached on February 21, a Greek default was averted, at least for the time being. Nonetheless, markets are still nervous, as the risk of the second Greek program going off track remains very high, particularly after the recent elections and the failure of Greek parties to form a coalition government. The yields on new Greek PSI bonds are quite steep and the yield curve remains inverted. Indeed, the Greek program failed to put an end to funding concerns; Greece will most likely need another round of debt restructuring and/or additional financing with continued fiscal consolidation. The prevailing uncertainty even raises the real possibility of a Greek exit from the euro.

Even if Greece's problem remains inconclusive, markets are now more concerned about Spain. The Spanish government has recently done most of what has been prescribed by the European Union. For instance, it launched new measures to cut public spending on health and education by up to €10 billion. Authorities also pushed through a labor market reform to make it easier and less costly to hire and fire workers. Additionally, the government requested banks to make provisions and raise capital buffers of €50 billion against property and construction loans, strengthening the banking sector.

However, despite these concrete policy measures, markets are uneasy. Given Spain's complex multilayer political organization, it appears to be arduous for the central government to control spending by the *Autonomías* or rule the powerful regional thrift institutions (*cajas*). Paradoxically, as it was previously stated, markets fear both the difficulty of achieving fiscal consolidation and the recessionary impact of austerity. Fiscal consolidation in the face of a recession is a testing exercise. Non-performing loans are growing and private sector indebtedness is high. Leaders need to find the right balance between market demands and mounting political difficulties without putting aside the urgent need of fiscal consolidation. They need also to carefully target budget cuts, so as to protect items that are conducive to growth in the medium term. Spain will have to experience a long period of painful corrective tightening. The IMF forecasts that the size of the Spanish economy will not recover to the level of 2008 until 2017 and that this and next years' Spanish budget deficits will exceed the targets and reach 6.0 and 5.7 percent of GDP respectively. In addition, revolts against austerity and structural reforms are further complicating the adjustment process.

Another concern is that a deeper recession and Spain's unprecedented unemployment rate of 24 percent will likely worsen the credit quality of private sector debt (currently at nearly 300 percent of GDP). The country experienced a huge construction boom and is now suffering the corresponding bust. Spanish house prices have fallen between 20 and 30 percent since their peaks in 2007. Moreover, the excess supply of housing is adding to downward pressures on house prices and further large drops are expected, judging by price declines in other countries that underwent similar property booms and busts. For example, in Ireland house prices have been declining since 2006 and by 2011 are estimated to have dropped by more than 45 percent.[1]

According to the central bank, Spanish banks have around €660 billion in mortgages on their books and loans at risk of default are rising rapidly.[2] Hence, with home prices expected to continue to fall and 80 percent of household wealth tied up in real estate, the quality of the loan books will worsen and Spanish banks' non-performing loan ratio, already above 8 percent, will rise further. To a large extent banks have been postponing adjustment, mainly holding on to repossessed homes and buying back mortgage securities at high prices. Whenever banks and securities investors are required to acknowledge and absorb their losses, capital buffers won't suffice to stand the banking system "storm".

So what will happen next? Spain will probably try to avoid at all costs resorting to the European Union rescue mechanism. However, if the situation continues to follow the Irish path, Spain will have no option but to ask for help. And the eurozone, in turn, will have no alternative but to aid Spain. The equity support required by the Spanish banking system has been estimated above €100 billion[3], probably too high an amount to be either provided by the Spanish government or financed by the banks' disposal of non-Spanish assets, mostly in Latin America. To get around this painful track, the European Financial Stability Facility should be allowed to directly capitalize banks, which is not the case today. This way, Spain would escape a sharp increase in its sovereign debt—an upsurge that would certainly be punished in the bond market, setting off a vicious circle of higher debt and higher interest rates.

Social and political opposition to austerity has spread across Europe. Spain is by no means alone. Italy, like Spain, will not reach its deficit target this year. In the Netherlands, the government collapsed because of dissent on acceptable budget cuts. In France, François Hollande was elected on a platform that opposed the harsh German-enforced fiscal tightening. He plans to cut the budget deficit by raising taxes. However, Hollande promised to hire 60,000 new teachers, spending an extra €20 billion over five years and augmenting the size of the state.[4] Also, Greece's election on May 6 has revealed deep resentment over the severe recession that austerity has induced. Soon, Ireland will hold a referendum on the fiscal compact that intends to promote balanced-budget rules across the eurozone and the outlook remains uncertain.

In the late 1980s, austerity fatigue was also observed in Latin America, but only after years of continued macroeconomic adjustment and structural policies. Debt write-offs under the Brady Plan took place at the end, not at the beginning, of the adjustment process: this is why it triggered a full recovery of market confidence and a re-launching of growth. On the contrary, today's markets have lost faith in the European decision-making process and in the leaders' ability to solve the crisis. Thus, instead of explicitly relaxing fiscal consolidation to ease the pain for growth, eurozone countries need an overshooting in financing and adjustment to recover market credibility. Mexico's 1994 peso crisis is helpful to illustrate the importance of recovering the market's trust.

In the years leading up to the "tequila" crisis of 1994-95, Mexico received huge capital inflows, drawn mainly by a favorable economic outlook that followed several years of stabilization and rigorous structural reforms. For instance, thanks to these efforts, in 1993 inflation dropped to single-digit levels for the first time in over 20 years. The start of a comprehensive effort to liberalize the financial sector in 1988 gave an additional boost to foreign capital inflows. It is also relevant that, at the time, due to low domestic interest rates, investors from developed economies were looking for better returns abroad. As a result, net capital inflows reached a record high of $29.4 billion in 1993.

The Mexican economy was transformed by these developments: financial depth and bank financing to the private sector increased substantially, and domestic demand grew due to widely available resources stimulating massive current account deficits. In sum, financial institutions, firms and households all incurred in a strong leveraging process. At the same time, a number of vulnerabilities began to emerge. The current account deficit that was mostly financed by short-term flows in the context of a fixed exchange rate regime was very large. In addition, the strong growth in credit to the private sector occurred while financial supervision and regulation were inadequate. Eventually, the crisis was triggered by the sum of numerous factors: rising international interest rates, federal elections, and criminal acts caused significant economic and political uncertainty. Suddenly, investors changed their risk perceptions. This led to bouts of panic and large capital outflows that, in turn, unleashed a profound crisis in the domestic financial system.

But, why was Mexico hit so hard during the tequila crisis? The crisis was so acute because, along with the vulnerabilities previously mentioned, there was a massive loss of confidence in the country and its institutions. Financing to Mexican banks was cut and trade financing became scarce. The new administration obtained financial aid from the U.S. government, the IMF and other international organizations that helped avoid a liquidity problem that would have resulted in a systemic financial debacle. President Clinton offered a loan from the Exchange Stabilization Fund of $20 billion that required no congressional approval. The IMF then agreed to lend another $17 billion, an unprecedented amount at the time.[5] Together with other funds from international organizations, the loans to Mexico were close to $50 billion.[6] There was an overshooting in financing.

At the same time, Mexican authorities undertook a harsh fiscal consolidation strategy, even more front-loaded than the programs implemented in the 1980s, which included higher taxes, steep increases in energy prices and deep expenditure cuts. There was an overshooting in adjustment: the primary surplus of the public sector was increased in just one year by 3 percent of GDP, from an already high level of 2 percent in 1994 to 5 percent in 1995. Still, at the time it was impossible to say whether the measures would work. Turning market sentiment around is by no means an easy task, but it is of the essence in resolving a crisis induced by economy-wide balance-sheet disequilibria.

Fortunately, the program did work in the end. The results of the efforts set in motion in Mexico as a response to the crisis of the early 1990s are a testament to the success of this strategy. By mid-1996, less than a year after the program was implemented, Mexico was able to enter the voluntary capital markets for financing once again. Also, it was in a position to repay both the U.S. government and the IMF years ahead of schedule. Nonetheless, the costs were high. In 1995, GDP declined 6.2 percent and the fiscal cost of the associated banking and financial crisis is estimated at around 18 percent of GDP. Yet, recovery was "V" shaped; by the end of 1997, output was substantially higher than before the crisis. Of course, this rapid recovery was also supported by a fast export growth associated with NAFTA and a favorable international context.[7]

This episode is an example that recovering market credibility is crucial in the resolution of a crisis. Decisive action was key for the positive outcome of the Mexican peso crisis. The program was designed to overshoot both in financing and adjustment, and to stay ahead of the curve. This is what allowed authorities to enhance credibility; and this is what the actions undertaken to deal with the euro crisis are missing.

Contrary to the Latin American experience, now some policymakers are suggesting that an "easy does it" approach to fiscal consolidation would be preferable to heavy front-loading even in countries with mild fiscal space. In general, very few advanced economies have enough fiscal room to even consider slowing the pace of near-term adjustment. These are countries that are not currently under market pressures, which is basically why they can postpone the inevitable fiscal retrenchment. One of these countries is the United States. The U.S. is a very particular case; first, because the dollar is the main reserve currency worldwide and, second, because its fiscal problem is not so difficult to solve. At least conceptually, it is easier to visualize fiscal consolidation in the U.S. than in most other developed economies that need to set government debt on a sustainable course. The U.S. government (measured by total spending) is smaller than those in the rest of the G-10 countries.[8] The real challenge for the U.S. is to stimulate economic growth and job creation in the short term while, at the same time, credibly addressing the issue of fiscal sustainability in the medium term.

The U.S. needs a mix of income and spending measures to achieve long-term fiscal sustainability. On the income side, a value-added tax (VAT) should be introduced. Although a VAT would be new to the U.S., this is a levy that exists in more than 150 countries worldwide and in every OECD country other than the U.S. On the spending side, for many, the central question regarding profligacy is about entitlement programs. Growth in entitlement spending associated with the aging population and its rising health care costs are the main factor in general federal spending dynamics. At 17.4 percent of GDP in 2009, health care spending in the U.S. exceeds that of any other developing nation.[9]

Economically, the U.S. fiscal problem is not so hard to solve. But there are of course huge political obstacles. Unlike peripheral countries in Europe where the austerity versus growth debate is nonsense, markets will probably allow the U.S. to implement a gradual but definite fiscal adjustment while maintaining growth support in the short run. Still, markets will not wait forever. The U.S. government needs to establish soon a credible medium-term plan that aims to regain sustainability otherwise markets will force this country to adjust.

More than fiscal relaxation in countries undergoing domestic adjustment, the relevant question for the world economy is how to exit the debacle of a continued aggregate-demand shortfall through the rebalancing of adjustment toward countries with large external surpluses. Almost four years after the Lehman Brothers bankruptcy, global economic growth remains feeble. Given the fiscal crisis in developed markets and the measures being taken to correct it, there has been a further fall of effective demand. Moreover, the prospects for growth in these countries look dim for the next few years. For countries in the middle of a financial crisis, there is no dilemma between austerity and growth. Eventually, they will have to adjust, hurting economic growth. A plausible strategy is to continue with austerity while accelerating structural reforms that will support growth in the medium term. Thus, in order to support aggregate demand, surplus countries need to stimulate much more domestic consumption. The asymmetry in adjustment between deficit and surplus countries—an issue that was conspicuously raised by Keynes in the Bretton Woods debates—has not been properly addressed since the outset of the current global financial crisis.

Fundamentally, China and Germany need to reduce their external surpluses because they stand against a sustainable adjustment path for deficit countries. It is true, as often claimed, that Chinese and German surpluses have already been reduced since the inception of the crisis, from 10.1 percent to 2.8 percent of GDP in the case of China and from 7.5 percent to 5.7 percent of GDP in the case of Germany since 2007 to 2011.[10] But, given the depth of prevailing disequilibria, this adjustment is clearly insufficient. The real growth of Chinese GDP has been 65 percent[11] and the Chinese renminbi appreciated by 20 percent against the U.S. dollar during the same period, which means that China's GDP has basically multiplied by two in nominal dollar terms. Thus, the current account surplus of China has been cut in dollar terms from $353 billion in 2007 to $201 billion in 2011, a significant but not overwhelming reduction. The problem is that the rebalancing of the world economy probably requires China to run a deficit, not a surplus. Certainly, the German surplus with the rest of Europe has shrunk because exports have fallen. The problem is that what is required is a sizable deficit induced by import growth. China and Germany still need to boost their domestic consumption, through wide transfers from the state to households in the first case and through significant increases in wages in the second.

International cooperation remains fundamental for achieving sustainable global growth. Last year, the G-20 agenda was dominated by discussions regarding the eurozone turmoil and long-term matters were set aside. However, the G-20 was created with a far-reaching purpose and its role is not only to respond to short-run issues, but also to lay the foundation and create the fundamental underpinnings for long-term global economic stability. Now, the need for action on the long-standing areas of concern—international imbalances and the adjustment mechanism—seems even more urgent as many industrialized economies will have to go through a painful period of corrective consolidation.

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[1] International Monetary Fund (2012).
[2] Banco de España (2012).
[3] BCA Research (2012) and Roubini and Greene (2012)
[4] The Economist (2012).
[5] The loan from the IMF represented 5.1 percent of Mexico's GDP. In contrast, IMF resources in the rescue package agreed for Portugal in May 2011 (over $38 billion, current prices) were equivalent to 15.1 percent of Portugal's GDP. The total loan packages approved were $50 billion (14.9 percent of GDP) for Mexico and $116 billion (45.4 percent of GDP) for Portugal. Source: International Monetary Fund (2012).
[6] Ortiz (2011).
[7] For a detailed study of the Mexican 1994-1995 crisis see Boughton (2012).
[8] U.S. average government expense between 2006 and 2008 was less than 22 percent of GDP, while in countries like Belgium, France, Italy and the U.K. it represented more than 40 percent of GDP. World Bank (2011).
[9] OECD (2011).
[10] International Monetary Fund (2012).
[11] Ibid; national currency, constant prices.

What Should Other Countries Learn from the U.S.'s Regulatory Response to the Crisis?

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As the recent global financial crisis originated in the U.S. financial sector, it is natural that the first regulatory response also came from the United States. The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Barack Obama in July 2010. The act set the tone for the other countries' plans to improve and increase regulation of the financial sector. Other countries are likely to follow the U.S. regulatory response for two reasons. First, as the U.S. is perceived as a stronghold of market economics, others countries' policymakers prefer to have regulation that is not laxer than regulation in the U.S. Second, as the previous deregulation efforts in the U.S. preceded the crisis, the other countries believe that deregulation may have been the root cause of the crisis. In this sense, the Dodd-Frank Act may be the single most important influence that the U.S. will export to the rest of the world as a consequence of the crisis. In what follows, we argue that while reform of financial regulation is certainly required, the world—and especially emerging markets—should also consider the cost of excessive financial regulation and the need for smarter rather than more extensive regulation.

Lessons from the Crisis

One of the most important lessons from the recent global financial crisis is that existing regulations created the wrong incentives for risk management in the financial sector. Financial institutions around the world took on excessive risks, both at microeconomic and macroeconomic levels. The former issue is related to moral hazard due to the socialization of losses while the latter is related to the possibility of contagion and the dangers to the financial system as a whole and consequently to the economy and to fiscal stability. These macroeconomic dangers that the financial sector posed were known but had never been taken seriously before the crisis as the leading financial institutions had never been so large and so systemically important.

As several of these institutions failed or nearly failed, they had to be saved and taxpayers in the U.S. and other developed countries witnessed a new phenomenon—the massive bailouts actually undermined the sustainability of public finances themselves and imposed a substantial debt burden on future generations. It is not surprising that voters around the world are now demanding stricter regulation of the financial sector to make sure this problem is not repeated. The ire to the financial sector as a cause of the crisis is exacerbated by what many perceive as excessive compensation for bankers and fund managers, increasing already skewed income distribution.

The Costs of Excessive Regulation

One potential solution to prevent possible future crises is to significantly curtail the ability of the financial sector to take on risks. The pendulum of financial regulation—which was most likely too lax before the crisis—is swinging back and has perhaps swung too far toward the side of overregulation in the current political climate.

What would be the consequences of a significant tightening of financial regulations? An important danger is that stricter rules governing the financial sector may, and likely will, decrease the ability of the financial system to innovate. Now, after the financial crisis and the ensuing Great Recession, the phrase "financial innovation" has such negative connotations that it borders on obscenity. However, one should not forget the importance of financial markets and institutions to economic growth.

The deregulation and development of a much deeper and broader financial system in the U.S.–which resulted in the so-called financial revolution[1]–was crucial for financing new industries[2] like the revolution in information technology and telecommunications[3] that brought substantial increases in productivity both within and outside the United States. Financial development also brought tangible benefits to the developing countries. While many of these countries enjoyed fast economic growth, their financial systems lagged behind. However, these countries could provide their economies with financial intermediation services through the West's sophisticated financial system.

It is very difficult to evaluate the impact of such a comprehensive reform package as the Dodd-Frank Act. For more narrow regulatory changes, the estimates have been rather modest. For example, a recent OECD study entitled "The Macroeconomic Impact of Basel III" finds that stricter regulation of liquidity and capital of banks of Basel III will have a medium-term impact on GDP growth only of 0.05-0.15 percent of GDP per year.

But Basel III is nowhere near the Dodd–Frank Act in terms of its wide-reaching implications for the U.S. financial system. In this sense, one should look at more comprehensive regulations such as the Sarbanes-Oxley Act of 2002. As it turns out, even though Sarbanes-Oxley is a much more modest regulatory intervention than Dodd-Frank, its cost was quite substantial.

Sarbanes-Oxley was also a regulatory response to a crisis. Following a string of corporate and accounting scandals, the Sarbanes-Oxley Act significantly tightened regulation and standards for all U.S. public company boards, management and public accounting firms. On the one hand, the response from the regulators was much needed and well justified following the scandals and egregious corporate behavior at Enron and WorldCom. On the other hand, the act significantly increased the compliance costs for listing on U.S. exchanges. Luigi Zingales[4] argues that such compliance costs may be a significant factor for the U.S. losing its dominant positions on the IPO market for foreign listings. Zingales uses surveys of board members to show that the compliance costs for a relatively small listed company from the S&P Small Cap with an average capitalization of $750 million are equal to about $2 million. For large companies listed on the S&P 500 with average capitalizations of $24 billion, the compliance costs are close to $10 million. This research compares other potential explanations for the loss of competitiveness of the U.S. markets (as many companies preferred London and Hong Kong to New York), and concludes that the most likely cause is a significant tightening of compliance regulations.

The Main Trade-off in Financial Regulation

Policymakers understand that regulation which reduces risks and prevents crises also slows down economic development and growth. So they usually make regulatory choices resolving the trade-off between lower volatility and lower growth due to tighter regulation and lower risks on the one hand, and higher growth and higher volatility due to deregulation on the other hand.

Regulators prefer lower volatility because volatility brings social pain and also hurts long-term growth. The most important support based on empirical economic research for the proponents of financial regulations comes from the classical paper by Garey and Valerie Ramey, "Cross-Country Evidence on the Link between Volatility and Growth".[5] Their study examines 92 countries from 1960-1985 and shows that countries with higher volatility of growth have lower economic growth (controlling for country-specific growth correlations). Their analysis implies that one standard deviation of the volatility measure across countries translates into over half of a percentage point of annual per capita growth in the case of the 92 countries, and one-third of a percentage point of annual per capita growth in the case of the OECD countries. In other words, this research says: reducing volatility can significantly increase long-term economic growth. This would seem to be a perfect justification for increased financial regulation—as long as it helps to reduce volatility.

However, this argument may be misleading. One can argue that deregulation does result in higher risks, and higher risks are bad for growth; but, at the same time, the direct positive effect of deregulation on growth may be even higher. In this case, deregulation would actually pay off—even though it results in higher volatility.

This is the question addressed in a recent paper by Romain Ranciere, Aaron Tornell and Frank Westermann.[6] They start with a simple example—comparing the growth rates of India and Thailand between 1980 and 2001. India's growth was slow but steady; GDP per capita grew by almost 100 percent. Thailand's growth was much faster (almost 150 percent) but also included a serious economic crisis. Their estimates indicate that about a third of the growth difference between India and Thailand can be attributed to systemic risk taking. This of course does not imply that systemic financial crises are good for growth. Rather, deregulation of risk management may be beneficial to growth even despite the cost of occasional large crises.

The experience of just two countries is not sufficient to draw conclusions on the role of systemic risk in growth. The authors studied 83 countries over the period of 1960-2000. It turns out that the countries with a lower number of systemic crises grew significantly slower. The size of the effect was similar to that in the Ramey and Ramey study. If one would expand regulation so that there are three fewer crises for a typical country then it would grow on average slower by 0.3 percentage points a year. The effects are the strongest across the set of countries with weak institutions but functioning financial markets which encompass many of the emerging economies. In this sense, the reduction of systemic risk is the costliest for the emerging markets.

Crises and the View from Post-Socialist Countries

The finding that countries with a lower number of large crises grow significantly slower, at first, looks incredible as each crisis leads to a fall in GDP. Of course, nobody likes financial crises. On the other hand, only a cemetery has absolute stability. The research of Ranciere, Tornell, and Westermann shows that getting rid of systemic crises may actually come at a significant cost to long-term economic growth. Given the substantial potential for fast catch-up growth in the emerging markets, its benefits may well outweigh the costs of crises due to lax regulation.

This is where the economic history of Russia and of the other socialist countries provides an important lesson. The socialist economies were much more regulated than India, credit was centralized and financial markets were banned. It is no wonder that these economies had no crises. However, they lagged behind the West in terms of productivity growth and eventually went bankrupt in the late 1980s. Since then, market reforms resulted in the building of imperfect but functioning financial markets, integration into the global economy—with inevitable vulnerability to financial contagion and economic crises. However, the market reforms also provided the conditions for economic growth that allowed the closing of a substantial part of the gap with the OECD countries.

Financial Development and Volatility

Another important lesson from emerging markets is that financial development may help to mitigate the shocks brought on by financial crises. For most emerging markets whose economies are not diversified and depend on a single commodity or a single export market, the main problem during global economic crises is the sudden shock to the exchange rate. However, the economic impact of this shock depends on the level of financial development. In a recent paper, Aghion et al. (2009) show that exchange rate volatility has a strong negative effect on productivity growth only in countries with low levels of financial development. While their data come from 83 countries in 1960-2000 and therefore do not cover the recent crisis, their results are in line with what we have seen in 2008-09 in the commodity exporting economies. These economies received a similar exchange rate shock in 2008 (when commodity prices went down by a factor of 2-3 times) but their GDP fall varied greatly. In Australia, the crisis resulted in a growth slowdown (from the long-term average of 3 percent to 1.4 percent), in Brazil, Chile, and Saudi Arabia there was flat growth or a fall but less than 1 percent, in Mexico GDP fell by 6 percent, and in Russia it fell by 8 percent (compared to 6 percent growth a year earlier). The output fall in Russia was certainly an implication of a few policy mistakes[7] but those mistakes were driven by the understanding that the financial system is too shallow to withstand a major exchange rate shock.

The main takeaway from the research by Aghion et al is the importance of financial development for mitigating the impact of crises. This argument is mostly relevant for the emerging markets. In the developed economies, where mature financial systems are already in place and where the economies are well-diversified so that large exchange rate shocks are unlikely, the regulators usually miss this additional cost of regulation—the slowdown of financial development.

Smarter Regulation, Not More Regulation

The arguments above imply that we need a functioning and effective financial system and for that we need functioning and effective regulations. This does not necessarily mean more regulation. The kind of regulation should provide incentives to take risks but at the same time rule out moral hazard where taxpayers bailout losses that arise due to excessive risk taking. Economists have long proposed specific regulations that can help solve these incentive issues.

First and foremost, regulations have to reduce informational asymmetries and enforce disclosure.[8] Second, regulators should promote financial literacy and financial education. Then, given that all the risks are disclosed and understood by customers and investors, the regulators should allow for financial innovation and for competition of business models.

The problem of course is that the logic above only works as long as there are no externalities. But the recent crisis has shown that it is very difficult to not bail out too-big-to-fail institutions. This means that regulation of the financial system should make sure that systemic institutions either do not arise or are regulated in a different way (through adding special resolution regimes for systemically important financial institutions).

The other source of externalities is the emergence of credit cycles: in a high-leverage economy, a bankruptcy of one institution may initiate a chain of fire sales and bankruptcies. If a leveraged institution is bankrupt, its creditors take losses and therefore have to sell some other assets. This in turn drives down asset prices (including prices of collateral) which results in losses of other institutions. In order to avoid this chain reaction, the regulators can use contingent capital, which has now become a tool of choice of macroprudential regulation. Contingent capital is a convertible security which is debt that is automatically converted to equity in case of a macroeconomic downturn.

All these and many other reasonable ideas have been included in the Dodd-Frank Act. It is certainly too early to judge whether these regulations are going to be implemented well. But certain elements of the Dodd-Frank Act may go too far—especially if we assume that the other elements, such as disclosure, resolution regimes and macroprudential regulations, work well. For example, the "Volcker rule"—which virtually reinstates the Glass-Steagall Act, separating commercial and investment banking—is likely to undermine the ability of U.S. banks to innovate and compete.

Should Emerging Markets Import Dodd-Frank?

So to what extent should the emerging markets follow the U.S.'s regulatory response to the crisis and implement something like Dodd-Frank? On the one hand, there are all the reasons for emulating the U.S. regulation listed above. Also, it makes no sense to allow for "regulatory arbitrage". If regulation is laxer in some countries than in others then corporate mobility will render the tougher regulatory environment irrelevant. This issue already is and will certainly continue to be in the center of the G-8 and G-20 debate.

However, there are at least three reasons to be cautious. First, there is a risk of stifling the competition of regulatory regimes. If U.S. regulation is too tough or not as well designed as regulation in other countries, standardization of regulation may actually undermine the quality of regulation in the long run. For example, if after Sarbanes-Oxley, companies could escape the excessive burden of regulations and list in Hong Kong or London, global harmonization would leave no route to escape. If there are mistakes in Dodd-Frank, in a few years we may well be asking: why have the world's capital markets lost their competitive edge?

The second important reason for caution is that the emerging markets differ from the developed countries in their need for growth and for development of the financial system (the latter exactly because financial development helps mitigate the shocks caused by crises).

The third reason is also related to the fact that emerging markets are different. One should take into account the quality of regulators in the emerging markets, which is usually inferior to those in developed countries. In this sense, implementing sophisticated regulation in emerging markets is usually harder.

The latter argument implies the least common denominator in regulation. The emerging markets should only use those regulatory interventions that work in any context and that are easy to implement. The most obvious candidates for this list are transparency/disclosure and capital requirements (including contingent capital).

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Global Shift, the G-20 and Europe's Double-Move

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It is a common truism nowadays to propose that the world as we know it is in turmoil and radically changing. Many of our assumptions about the world are rapidly falling apart. The tectonic forces are changing and reshaping global relations. Not only have the feelings of uncertainty and ambivalence begun to mark the nature of the present, but the center of gravity has also been radically shifting from the West to the East. Although written as early as the 1930s, Antonio Gramsci's famous statement that "the old is dying and the new cannot be born: in this interregnum a great variety of morbid symptoms appear" captures the emerging reality in our international and inter-human relations.[1]

In *The Eighteenth Brumarie of Louis Bonoparte*, Karl Marx suggests that "men (actors) make their own history, but they do not make it as they please; they do not make it under self-selected circumstances, but under circumstances existing already, given, and transmitted from the past".[2] Marx's suggestion indicates first that even though actors, their decisions and choices matter in the process of making their own history, yet they do so "under circumstances existing already", that is, under a specific historical context in which they are embedded. There is a dialectic relationship between agency and structure in that agency always operates under the conditioning or enabling impacts of structure. Moreover, relying on Marx's insight, it would be possible to suggest that only those actors whose strategies and actions have derived from an adequate reading of the circumstances existing already and transmitted from the past could make history successfully and be able to shape the direction of history.

The current nature of global relations echoes Gramsci's and Marx's statements; in fact, the old system, based on the unquestioned dominance of the West is dying, and the new cannot be born yet. The globalizing world is in a period of "interregnum", "great transformation", undergoing a severe crisis and "turmoil" with uncertainty and ambivalence. As Charles Kupchan has correctly pointed out, the emerging world is "one in which power is diffusing and politics diversifying, not one in which all countries are converging toward the Western way. Indeed, the world is on the cusp of a global turn. Since the 16th century, the West has been both the main 'anchor of a globalized world' and 'the leading edge of history'". But now, "East Asia has been anointed as the candidate most likely to assume the mantle of leadership. It is doubtful, however, that any country, region, or model will dominate the next world. The 21st century will not be America's, China's, Asia's, or anyone else's; it will belong to no one. The emergent international system will be populated by numerous power centers as well as multiple versions of modernity. For the first time in history, an interdependent world will be without a center of gravity or global guardian. A global order, if it emerges, will be an amalgam of diverse political cultures and competing conceptions of domestic and international order".[3]

In this paper, on the basis of the insights provided by Gramsci and Marx, we will first analyze briefly the tectonic forces giving rise to increasing uncertainty and ambivalence in global relations, and secondly suggest that it is imperative for the West, especially Europe, to make a serious effort to undertake active global cooperation in order to respond effectively to "no one's world". Today, Europe suffers from an increasingly gridlocked political system with shortsighted political leaders incapable of enacting serious policy decisions. Moreover, it also faces the risk of losing its relevance. We suggest that rather than becoming more and more introverted and reactive, Europe should focus on its deficient economic and political performance, and attempt to revive itself as a global player capable of contributing to the much needed global democratic and fair governance. This requires a double move: working in unison with a global strategic vision, which includes an effort to renew the European Union and Turkey's full membership in a way to act with Turkey in a coordinated way to help the Arab Spring to strengthen the process of transition to democracy; being active in the G-20 process in order to "strengthen hopes against renewed fears in the world economy".[4] Secondly, Europe should revitalize its economic performance in a way to link it with democracy and human development, and in doing so it should link its own interests with its global responsibilities.

Historical Context: Tectonic Global Forces Acting Simultaneously

Indeed, tectonic forces are reshaping our globalizing world and bringing it into turmoil. One could discern four intertwined forces, each posing unprecedented challenges: (1) the multiple crisis of globalization; (2) the global shift from the West to the East; (3) the global political awakening[5]; and (4) the enduring power of nationalism and its new forms. The process of globalization that is currently taking effect is not only severe, but also encompasses multiple ongoing crises, including the global economic crisis—which involves serious international financial problems, the global recession and global unemployment crisis simultaneously—and the global security crisis. Moreover, globalization has been confronted by the energy crisis, food crisis, a severe global poverty problem and climate change. The multiple crisis of globalization has been compounded by the global shift, giving rise to the simultaneous processes of the decline of the West and the rise of the rest, and more importantly, as Charles Kupchan suggests correctly, to the "no one's world" in which a global power shift is creating a tendency toward both multipolarity and multiple modernities; multipolarity in that "rather than embracing the rules of the current international system, rising powers seek to adjust the prevailing order in ways that advantage their own values and interests," and multiple modernities referring to both the increasing disjuncture between modernization and westernization, and the existence of "a politically diverse landscape in which the Western model will offer only one of many competing conceptions of domestic and international order".[6] In this sense, the global shift also means the end of the West's hegemony over the rest.

In a time when the multiple crisis of globalization has begun to go hand in hand with the global shift, political awakenings and social movements have begun to occur across different parts of the world. The most unexpected and important one of late has been the Arab Spring—a movement toward the transition to democracy in the Middle East and North Africa (MENA). The Arab Spring has given rise to powerful revolutions that have brought down some of the world's most enduring authoritarian regimes. Yet it has also created a power vacuum in these countries. In particular, the lack of experience with democratic governance in this part of the world poses a significant challenge in terms of laying the groundwork of democratization in Arab Spring countries, as in the case with Syria and Libya.

Finally, the multiple crisis of globalization and the global shift have also paved the way for the enduring power of nationalism. It is likely that nationalism in its different forms will be one of the defining elements of global affairs. In countries like China and Russia, it will frame the primacy of economic and security concerns over democracy; in other countries, such as South Africa, it will be manifested as "resource nationalism"; and in Europe, it will shape the xenophobic and exclusionary discourse of the extreme right and its growing political power.

It can be suggested that the future of globalization will likely be marked by the enduring power of nationalism over democracy unless the West—the United States, Europe, Turkey as a full member of the European Union, and Russia with a stronger anchor to Europe—attempts to act as a constructive global player and achieve global cooperation effectively within the G-20.[7]

Europe's Double Move

Can Europe do it? Can it make itself once again an active and constructive global player? In contrast to the 1990s, today Brussels is rattled by severe global economic crisis and metastasizing sovereign debt problems. The recent attempts to respond to the Greek financial meltdown by major EU actors have demonstrated the constraints on Europe's capacity to mobilize its resources and rally public support to resolve some of the most pressing issues of our time. Although the Greek situation is contained at the moment, a possible spillover—and political aftershocks—still haunts Italy, Spain and Portugal, and reinforces concerns over the future of the EU. As Kemal Derviş and Homi Kharas correctly suggest, although there have been developments in Europe that have strengthened hopes, there continues to be fears about finding a solution to the region's crisis. To fortify the case for renewed fears, Brzezinski has put it rather strongly that "the EU thus faces potential irrelevance as a model for other regions. Too rich to be relevant to the world's poor, it attracts immigration but cannot encourage imitation. Too passive regarding international security, it lacks the influence needed to discourage America from pursuing policies that have intensified global cleavages, especially with the world of Islam. Too self-satisfied, it acts as if its central political goal is to become the world's most comfortable retirement home. Too set in its ways, it fears multicultural diversity. With one half of the geopolitical West thus disengaged from active participation in ensuring global geopolitical stability at a time when the world's new pecking order of power lacks coherence and a shared vision of the future, global turmoil and a rise in political extremism could become the West's unintended legacy".[8]

For Europe to become a global player again, a serious effort is needed to revive the European Union-Turkey full accession negotiations in a way that these actors can act together in a coordinated fashion to respond effectively to global challenges and contribute to the process of democratic transitions in the Arab Spring countries. Yet, at the same time, Europe should also focus on governing the economic crisis effectively and strengthening its democratic culture.

Eurozone Economics: Where to Start?

Clearly, in order to play a global role, Europe needs to put its economic house in order. As Derviş and Kharas argue, the economic problems of the eurozone continue to generate fears of a renewed financial crisis, even threatening the euro itself according to some observers. Differences of opinion (and indeed serious conflicts of interest) persist on how to combine growth in the short run (especially for Southern Europe) and fiscal austerity in the medium term, and it seems like the mood in Europe may be moving away from rigid austerity to growth at least in the short term.

The debate over the right dose of austerity versus growth in the short term is of course an important one. However, it is not clear that it really focuses on the root dynamics of the eurozone crisis. We have a picture that is all too familiar for Turks: a very fragile and undercapitalized banking system and its relation to fiscally troubled member states. It was this type of a cozy relationship that resulted in the banking system holding most of the public debt of a state close to bankruptcy, which played a significant role in Turkey's economic crisis of 2000-01. During the crisis, almost half of Turkey's banking system was wiped out. Turkey recovered rather quickly from that devastating crisis because resolving the liquidity and solvency problems of the banking system was a top priority for the government's recovery program. A huge restructuring program was initiated during which insolvent banks were taken over and bad assets were exchanged for government securities, an operation that gave rise to a large increase in the ratio of public debt to GDP. Very little of the cost of this adjustment fell on depositors thanks to a deposit insurance system. A new and tough regulatory and supervisory framework was established. With a new banking system cleaned from bad assets and under strict orders to recapitalize, the financial system was no longer a threat to growth.

The problem with fragility in the banking system and the existence of bad assets is that it presents a time-bomb for policymakers: early intervention has huge benefits and delays in intervention can generate exponentially larger costs because problems in just a few banks can spread to the whole banking system. Furthermore with a fragile banking system, improvements in other spheres of economic activity may be lost very quickly. Hence the lesson from Turkey is that in any recovery program, cleaning the banking system should come first. Conversely, any program that does not put the banking system center stage risks jeopardizing the benefits that might be generated in other policy areas.

Of course, the problems of the eurozone banking system are not as severe as those of Turkey before the crisis. But the point is that contagion among banks spreads very quickly and weak growth is likely to increase the degree of nervousness in financial markets. For the eurozone countries, intervention needs to be designed at the eurozone level. But as Wolfgang Münchau of the *Financial Times* reports, some sort of consensus is beginning to emerge "among experts about the first necessary step to solve the eurozone crisis: a eurozone-wide system of banking resolution, prudential supervision and deposit insurance." The problem with this approach is that this means delegating tremendous decision-making power away from EU member states. If done properly, decisions regarding which banks should be closed and which should be capitalized, and under what conditionality, would be decided by a supranational body. Münchau himself calls the proposal "unpalatable" and argues that "among all crisis resolution choices, the centralization of bank resolution and supervision will be among the least popular." We are not so sure. Moving regulation to the supranational level has precedence in the EU: witness competition policy, energy, and telecommunications, among others. Delegating policy away from the nation-state to the European Commission, especially in the energy sector has not been easy and nation-states still resist some initiatives of the commission. Delegating some policymaking to supranational entities may be easier in the banking system than say in the case of fiscal policy. And even if limited, member states of the European Union did reach a "fiscal compact" back in March. There is an added incentive for states with troubled banking systems: the cost of cleaning would be socialized. Presumably this would be in exchange for more say in governance in the banking system, making the deal more acceptable to Northern Europe as well. Such an initiative may also enlarge the bargaining space between Northern and Southern Europe.

The irony is that if early action with respect to the banking system is not undertaken, eurozone countries may be pushed to take actions after the economic situation gets much worse. The cost would be much higher. This is just one example underlining the fact that the current economic situation in the eurozone requires bold coordinated action, possibly requiring further delegation of policymaking to central and supranational institutions.

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Investment, Recovery and Growth

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Growth, Savings and Sustainability

If the international economy functions well, this decade could see substantial *growth* and improvement in the quality of life across the world with the possibility of lifting hundreds of millions of people out of poverty. There is, however, a great risk that this decade could see instability, stagnation and recession.

Europe is a key potential source of this instability. The electorates of France and Germany, and indeed the United Kingdom, have this month delivered a clear message that they insist on action to promote growth. Europe does indeed urgently need a growth strategy. But such a strategy must be founded on three basic economic realities: first, fiscal responsibility and growth are inseparable – the absence of one undermines the other; second, consumption-led growth on its own will not be enough in the long term and lacks fiscal credibility; third, long-term growth needs strong foundations in structural reform that can improve productivity and competitiveness but it takes time for the growth effects to come through.

Thus, Europe must have an investment-led recovery and one that carries the credibility of being a route to a sustainable future. That investment will be largely private sector but it will depend on clear and credible signals from government on its policies and on a strengthening of the capabilities of its financial institutions, including the European Investment Bank and the European Bank for Reconstruction and Development for the continent as a whole and national level institutions such as the Green Investment Bank in the U.K. For Europe, the priorities are energy efficiency and infrastructure for energy security and reduction of emissions. This would include a smart supergrid that can accommodate solar energy where it is sunny, wind where it is windy, and the efficient integration of different energy sources.

But beyond Europe further economic imbalances between the rich economies, between developed and developing countries, and among developing and emerging markets pose serious threats to the ability of the global economy to grow at the scale and pace required to meet the world's aspiration for growth and development.

Key large, fast-growing countries around the world have agreed on the need to direct some of the global *savings* to developing countries as part of the response to the current global imbalances.[1] Their huge exposure to developed country bonds now looks like a worryingly unbalanced portfolio. Simultaneously, the weak functioning of financial systems in developed countries was a central cause of a serious misallocation of savings toward risky financial propositions—including bets on inflated housing markets—and consequently of the current economic and financial crisis.

There is a further important imbalance that threatens the global economy: its resource productivity. High-carbon, low-efficiency growth leads to huge risks of potentially catastrophic societal and economic consequences from climate change. We know that over the next four decades, in order to have a reasonable chance of avoiding global warming of more than 2°C, we will have to cut total emissions from 50 billion tons CO_2e[2] per year today to less than 20 billion tons in 2050. This means, on reasonable assumptions on growth, prices of natural resources and with sound management for economic growth, reducing the current emissions per unit of output by a factor of about 7 or 8 in order to reduce absolute global emissions by a factor of at least 2.5.

Developed and developing countries are realizing that growth and development should take a different path: a systemic transformation of the economy based on reduced emissions and higher resource efficiency. They are starting to lay out their green growth plans, which are the foundations for a new energy and industrial revolution that can bring decades of economic growth, help reduce poverty, promote stability and security, and help manage sustainability and the risks of climate change. Although it is insufficiently recognized, many developing and emerging countries are pioneers on this new path: this is where the bulk of infrastructure and other investment in coming years will be.

All this points to the opportunity and importance of channeling some of the flows of global savings to the emerging markets and developing countries where plans for growth are clear and sound investment opportunities with strong financial and social returns exist.

In the years before the crisis, there were complaints in some advanced industrial countries about a global "savings surplus"—so large that it was referred to as a "savings glut"—and several fast-growing emerging economies are indeed characterized by high saving rates. Some of these countries are now looking for investment opportunities to diversify their portfolio beyond U.S. or Euro bonds. Even before the crisis there was a feeling that something was amiss: there were better ways of deploying the world's savings, given the enormous needs for investments to promote development and to respond to the challenge of climate change. Today, the world is operating well below its potential. Something is wrong if, simultaneously, there are excess funds looking for uses, unutilized labor and capital, and vital needs that have to be satisfied.

The G-20, among others, has been calling for those countries with high savings to reduce their savings and to consume more. But the planet will not survive as a viable habitat if everyone aspires to the kind of *resource-intensive* lifestyles and production methods that have marked some of the advanced industrial countries. The solution surely is not discouraging savings, but rather recognizing that global financial intermediation has not functioned well, and there is a great misallocation in how savings have been "recycled". We observed massive flows of money going in the *wrong* directions—from developing and emerging markets to the advanced industrial countries—rather than taking advantage of opportunities for sound investment in economic growth and low-carbon and climate-resilient infrastructure in the developing world. Developing countries have been exporting their hard-earned savings and have often been importing risky portfolios that do little to advance the well-being of their own people.

Over the last few years, we have seen a substantial trend in developing countries pioneering a new approach to growth, focused on *sustainability:* growth that uses more efficiently natural resources and limits emissions. This contrasts markedly with past growth strategies in the more advanced industrial countries, which traditionally have focused on labor productivity, treating natural resources and the environment with abandon. This focus on the environment and sustainability is driven not only by the recognition of the planet's limited resources and by an awareness of the adverse effects of environmental degradation on quality of life, but also by the desire to be less dependent on fossil fuels and less vulnerable to sharp rises in the prices of natural resources.

These are initiatives of immense value to the world as a whole. They are based on the recognition that low-carbon growth and the new energy-industrial revolution is the growth story of the future. As we stand on the verge of a new growth model, it is apparent that there will be immense needs for investment in infrastructure over the coming years, to generate growth, overcome poverty and manage the risks of climate change.

A New Development Institution

Many emerging markets and all low-income countries require a major step increase in infrastructure investment to tackle growth constraints, respond to urbanization pressures and meet their crucial development, inclusion and environmental goals. In aggregate the incremental investment spending across emerging markets and developing countries is estimated at around $1 trillion a year more than what is currently spent.[3] Electricity, water (upstream and downstream) and transport are expected to account for the bulk of the spending needs.

In addition to the scale of the requirements, the financing of these infrastructure investments poses a number of challenges. Beyond the normal commercial and physical risks, greenfield infrastructure projects require large risk capital for upfront investment associated with the development and construction phase. Additionally, many projects face risks around revenue streams associated with policy uncertainties and affordability (e.g. water fees), making many projects unbankable unless policy risk is managed and reduced. Finally, many governments need support to ensure that there is a viable and high-quality pipeline of projects for investors to finance.

Infrastructure projects will have a large impact on ensuring the sustainability of future growth. Between 10-15 percent of the required infrastructure investment could be attributed to making such investment sustainable, by ensuring lower-emissions, higher efficiency and resilience to climate change. The returns to this extra investment are strong not just in the value of reduction in emissions but also in the many and faster appearing co-benefits, including a cleaner, quieter, safer and more bio-diverse production and the strong technological learning-by-doing that we are already seeing.

Current spending on infrastructure in developing countries is approximately $0.8-0.9 trillion per year, of which the majority is financed on domestic public budgets. The remaining annual financing is provided by a mix of private sector institutions, developed country overseas development assistance, multilateral development banks and, more recently, by emerging countries such as the BRICS—Brazil, Russia, India, China and South Africa. Annual infrastructure spending will therefore need to more than double by 2020, in the context of rapid urbanization and aspirations for growth and poverty reduction. Domestic budgets will continue to play an important role, but the amount they can take on will inevitably be constrained by macroeconomic considerations regarding sustainable levels of debt.

The existing architecture is highly deficient in providing financing on the scale and with the characteristics needed. It is conservative on the amount of debt it is willing to take on, often preventing economically productive investments from being financed and thus holding back growth prospects. Current institutions often also lack the ability to invest adequately in project preparation, a detailed enough understanding of local policy risks, and sufficient experience in infrastructure projects in similar circumstances. This means they often are unable to adequately assess risk-return profiles, deal with uncertainty of revenue streams, and hold assets in appropriately diversified, large portfolios.

The reallocation of global savings, in the context of tackling current macroeconomic imbalances, will need to play a key role in making finances available for investment in infrastructure. While initially the extra investment would come largely from the pool of extra savings worldwide, some would come from a recovery in demand and a better reallocation of savings. Given the scale of the gap and the complexity of the issue, a broad based effort is warranted to revamp global, regional and national institutions to enable them to play a role in rechanneling global savings. But as we have argued, a response to the challenge of a rapid increase in infrastructure investment cannot lie only in the reallocation of world saving, important though that is. It also requires management of the numerous market failures that are preventing investment to flow as well as the reduction of policy risk.

A new development bank as proposed by the BRICS could play an important direct and catalytic role in this effort.[4] It could serve as a vehicle that can reduce and absorb part of the up-front risk, finance key bottlenecks in the project pipeline, and generate sufficient knowledge and reputation through scale, could encourage investment flows in early stages and could unlock investment opportunities in later stages. The presence of such a bank in a project itself reduces project risk since governments are much less likely to behave inconsistently or irresponsibly if the bank is involved. This has been a clear lesson, for example, from the EBRD's experience in its support for transition to open-market economies in Eastern and Central Europe, and Central Asia.

Such a bank could also be a key convener and syndicator of programs in a way that closely involves the private sector and other public institutions such as development banks and sovereign wealth funds. It is much more likely to be treated as a convener than a single private sector investment bank or single government. Over time, it could develop the technical capabilities to support countries as they develop their project pipeline, by ensuring projects are high quality and bankable.

The way to recovery in Europe and to sustained growth in the emerging markets and developing countries have much in common: infrastructure investment for resource efficiency and a low-carbon economy. Many of the arguments overlap although they are not the same. Crucial to the investment being realized are clear, credible and consistent policies and greatly strengthening financial institutions, public and private. Part of the credibility comes from the understanding that low-carbon growth is essential for future prosperity and stability. Action is urgent both for Europe and for the developing world.

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The U.S. Economy: Sustaining the Recovery—Policy Challenges, Political Differences and an International Context

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The U.S. economy continues to expand, but the recovery from the deep recession remains slow and economic slack appears still to be considerable. The economy expanded at a 2-1/2 percent pace in the second half of 2011 and preliminary data indicate it grew at a 2-1/4 percent annual rate in the first quarter. Nonetheless, there are some signs that a stronger foundation for growth is being established. The labor market has strengthened and with it household incomes and spending—despite the sharp rise in gasoline prices this winter and spring. Balance sheets are being rebuilt: household debt and especially debt service levels have fallen relative to income, and banks and other lenders have rebuilt capital and are making credit more freely available, except in the residential real estate market. Relative to late 2011, financial conditions have eased considerably, with equity prices rising, volatility lower on balance, and credit spreads coming in. Headline inflation has been lifted by rising gas prices, but those prices are expected to level out or come off some, and core inflation rates are close to the Federal Reserve's new 2 percent target. Wage inflation remains quite damped—less than the rise in prices—suggesting that considerable slack remains in labor markets.

Some of the most recent data have been on the soft side and most forecasters are expecting only a gradual strengthening of the expansion over the balance of the year, despite the continued exceptionally accommodative stance of monetary policy, which the Federal Reserve expects to be in place "at least through late 2014." The growth of business investment has tailed off this year; the housing market remains quite weak, held back by tight credit and the overhang of houses that will likely come onto the market as borrowers and lenders cope with the still-considerable volume of underwater mortgages and economic distress; and fiscal policy is swinging toward restraint—perhaps by a considerable amount on January 1, 2013 when various temporary tax cuts expire and the spending cuts agreed on last summer come into effect unless action is taken on a long-term plan to restore a path to debt sustainability.

This is an environment in which policy action to sustain and strengthen a tepid expansion—at a minimum to avoid undermining the expansion—would seem to be required. But the political parties have such starkly contrasting views of the role of government in the economy that they have been unable to reach the required agreements. The Republicans favor small government, believing that the private sector will supply growth if the government gets out of the way; they are deeply skeptical of the efficacy of the government's fine tuning of resource allocation toward particular industries or of macroeconomic policy, fiscal or monetary. The Democrats believe that excessive reliance on private sector discipline was one cause of the crisis and government should compensate for what they see as substantial market externalities; they emphasize a collective responsibility exercised through government for a social safety net; and they see activist fiscal and monetary policies as providing needed support for the economy in the short to medium terms. No one expects the parties to agree on anything before the U.S. elections in November, and the outcome will shape the exact nature of the subsequent approach to the problems, but action or agreement on at least three policy areas as soon as possible after the election would seem to be required to sustain expansion:

1. Fiscal Policy

The U.S. faces a "fiscal cliff" in January 2013 in which, without a change in law, expiring tax cuts and new spending reductions are slated to tighten fiscal policy by an amount estimated from 3-1/2 to as much as 5 percent of GDP. This cliff comes about as a consequence of U.S. legislators and the executive branch being unable to agree on a medium- to long-term strategy to put debt and deficits on a sustainable track. Recognizing the long-term problems, policymakers have had to make tax cuts temporary and to require spending reductions to demonstrate their awareness of the longer-term issues and as a way of trying to force themselves to come to terms with the longer-term problems.

The economy is unlikely to be strong enough to sustain moderate growth—and could even go back into recession—if these scheduled tax increases and spending cuts go into effect for very long after January 1. The evidence from Europe suggests that fiscal restraint really does damp demand, especially when monetary policy is constrained from offsetting easing. The U.S. does not face the monetary policy constraints of eurozone periphery nations, but with short-term rates at the zero lower bound, monetary policy using unconventional methods is unlikely to be able to offset the adverse effects of such a sharp fiscal tightening. Many expect the deadlines to be extended if agreements can't be reached immediately after the election, but delay without signs of tangible progress risks declining confidence in the ability of the political system to come to grips with the problems and downgrades from the credit rating agencies with the potential for increases in interest rates. Although bond purchases by the monetary authority can keep rates low for a time and avoid overt default, at some point such purchases will clash with the objective of price stability, and giving up on that objective would entail default in another guise—unexpected inflation, would only work for a short time before the rates on government securities adjusted, and would be very costly in terms of longer-run economic stability. Moreover, the huge amount of uncertainty about future tax and spending of the federal government must be complicating the planning of households and businesses and, at the margin, damping spending.

The fixes are difficult and require some sacrifices relative to sustaining the current trajectories, but broad outlines of the path to fiscal sustainability have been clear for some time and embraced by several bipartisan groups: reduce the growth of entitlement spending and increase charges on higher income recipients for social security and Medicare; raise tax revenue by broadening the base through reductions in tax deductions and credits that favor particular types of expenditures. The election will help determine the mix of spending and tax changes, but the hard decisions can't be postponed much longer without running increasing risks of sudden fiscal tightening, eroding confidence, and, as the economy recovers, the crowding out of private investment.

Two critical issues are trajectory and commitment. Any credible plan for fiscal retrenchment will tend to damp aggregate demand to some extent as people adjust spending and saving in anticipation of higher taxes and lower governmental support in the future. But, with the expansion so modest, it will be important to phase retrenchment in very gradually so as not to cause a sudden pullback in near-term spending. Moreover, a gradual or even delayed phase in would give people a chance to plan for reduced support in retirement. At the same time, maintaining market confidence and facilitating planning will require that the commitments not be seen as likely to be reversed by future Congresses or administrations. And that will require some degree of bipartisan accord; this would be especially important for adjustments that are phased in slowly or with a lag.

2. Housing

Problems in the housing market have been a major impediment to a more robust economic response to extraordinarily low interest rates. The overproduction and over-pricing of houses earlier has left an overhang of houses coming onto the market in the recovery, especially given the effects of the weak economy on household formation. The problems created by this fundamental disequilibrium have not been alleviated—and in some cases exacerbated—by government policies with respect to housing finance. Finding policies that facilitate loan restructurings for large numbers of households without engendering perceptions of unfairness and moral hazard has been extraordinarily difficult and is perhaps impossible. What may be most helpful now is to settle on some programs both parties can agree to and leave them in place for a while—without the promise of a new program around the corner— so both lenders and borrowers can work within their parameters. In addition, private lenders need to step up the pace of both restructurings and foreclosures to work through the overhang; this requires more private resources being brought to bear, but it also would be facilitated by more assurance that appropriately undertaken actions would not be subject to adverse government actions, such as forced repurchases of mortgages guaranteed by government sponsored enterprises (GSEs) or government lawsuits.

One reason residential real estate credit remains so tight is that private mortgage securitization has not revived. The authorities need to set the rules of the road for such securitizations—including the required "skin in the game" under Dodd-Frank, which remains pending. More fundamentally, the administration and Congress have not come to grips with the longer-term issue of what the role of the government should be in the housing finance market—how Fannie and Freddie should be reshaped or whether there should be any role at all for governmental entities in housing finance. Until those decisions are made, it will be difficult for private lenders to plan their own roles in the mortgage market and commit resources to the origination, holding or distribution of mortgages.

3. Financial Regulation

The buildup of imbalances and vulnerabilities in the lead up to the crisis and the necessity to use taxpayer resources to limit the damage from the subsequent collapse revealed deep flaws in the financial system and its oversight. The job now is to fix the flaws while impeding the recovery as little as possible in the process. It's not clear the latter objective is being met. The extent of the changes, the length of time to implement them, the possibility of global inconsistencies must be making it difficult for financial intermediaries to adjust business plans and commit resources. Moreover, rapid implementation of some new requirements—like higher capital levels in Europe—appear to be reducing the availability of credit.

The answer is not "repealing Dodd-Frank" or rolling back higher capital requirements as some have argued. Much in that legislation goes in needed directions—for example by requiring greater capital and liquidity for systemically important institutions, by giving the authorities new ways of resolving systemically important institutions while increasing the odds of preserving stability, by making derivatives markets safer, and by increasing the oversight of clearinghouses and other financial market utilities. And internationally agreed increases in capital and liquidity buffers are the most robust means to protect markets and taxpayers, reduce regulatory arbitrage, and set a level playing field for competition. But implementation of Dodd-Frank has been delayed and weighed down by the sheer volume of new rules to be written—a number of which are unrelated to the causes of the crisis; by the difficulty of applying cost-benefit analysis within the parameters of the law; and by the problems of coordinating across agencies in the U.S. and across countries.

Perhaps it is time to prioritize—concentrate on the most important aspects, especially the capital and liquidity buffers and risk management of the most important institutions and the possibility of their resolution in a global context, and strengthening the financial market utilities at the center of the markets. Get bipartisan support for these basic reforms, subject them to rigorous cost-benefit analysis, and speed up getting those rules in place.

International Dimensions of U.S. Policy

The most important responsibility of U.S. policymakers is to promote sustained, noninflationary growth at home in a stable financial environment. Deviations from any of those objectives would have negative implications for the global economy. And, as I have emphasized, the sooner the needed steps are agreed and taken, the better for the U.S. and global economies.

Relative to the years before the crisis, the U.S. will need to rely less on consumption and government spending to support economic activity and proportionately more on investment and net exports, with a much smaller current account surplus. The reliance of global growth on the debt-financed U.S. consumption manifestly was not sustainable. In terms of policy mix, as noted, the U.S. needs to embark on a gradual tightening of fiscal policy; unless private sector spending strengthens more rapidly than now, fiscal restraint will need to be accompanied by highly accommodative monetary policy in order to promote higher employment and inflation near the 2 percent target. This policy mix should support a shift of production toward exportable goods and services and a shift of expenditures toward domestically produced goods and services. Changes in relative prices are a critical part of the market mechanisms inducing such shifts and those changes may imply some further weakening in the foreign exchange value of the dollar, or at a minimum no significant reversal of the decline already experienced.

For the rest of the world, greater domestic demand and perhaps appreciating currencies, on average, will be required to promote sustained global expansion—less reliance on exports. Low interest rates in the United States may foster capital flows to countries with higher returns, most likely emerging market economies, reducing the "uphill" flow of capital from the emerging markets to the advanced economies. Thus, there will be spillovers from the policies of the U.S. into the rest of the world, just as there have been spillovers from the policies in the rest of the world into the U.S.—especially those policies that have blocked exchange rate appreciation in order to promote export-led growth.

Expectations—bordering on demands in some cases—that the U.S. shift its policies—for example run less expansionary monetary policies— to take account of these spillovers are misplaced. In the current circumstances, what is required for domestic growth and balance in the United States and in surplus countries is also required for global growth and balance—no conflict exists. What the U.S. must do will make the global economy less subject to disruption from debt-caused problems in the U.S. and from an erosion of confidence in U.S. government obligations, which play such a critical role in global financial markets, reflecting the reserve currency status of the dollar and the depth and liquidity of dollar financial markets. Moreover, it is not reasonable to expect U.S. residents to sacrifice their own economic welfare to benefit other countries, especially when those countries also need to rebalance and have the tools to do so. Greater exchange flexibility, macroprudential policies for their financial systems, greater reliance on domestic demand in surplus countries will also promote global and domestic growth and stability. Although there may be a theoretical "co-operative solution" that fosters even stronger global growth with U.S. sacrifices, there is no way to transfer the gains from the winners to the losers.

Countries must make macroeconomic policy with full awareness of the global context. Actions taken by one country—especially a large globally important country—will have wide ranging implications for other countries. Such a country needs to be cognizant of the effects of its policies on other countries and the likely response of those countries' policy initiatives. Some types of policies, such as those affecting globally integrated financial markets, must be harmonized and coordinated to a considerable extent to avoid regulatory arbitrage and to control externalities. The alternative would be interference in the free flow of global capital and less efficient resource allocation. With respect to fiscal and monetary policies, the need for this type of coordination is much less clear. Discussions and analysis of macroeconomic policy spillovers are a valuable addition to the international economic dialogue. But in the end, countries have the obligation to stabilize their own economies and the means to achieve their own economic objectives in a variety of global economic circumstances without requiring sacrifices by their trading partners.

Global Growth and Adjustment: The Energy Dimension

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Various dimensions of the global energy system have been discussed by the G-20 leaders since the group was first convened in late 2008. The sharp spike in crude oil prices in mid-2008, just before the Lehman crash, and their volatility in the period that has followed impelled the French G-20 presidency to examine price formation and transparency in commodity markets. Climate change finance as a part of broader development finance has been a recurring theme, as has been the need to phase out subsidies on hydrocarbon consumption, something which is particularly prevalent among the emerging market members of the G-20. The links between high and volatile oil prices, the balance of payments, and food prices and affordability have been another preoccupation of the G-20 leaders. A healthy, resilient and stable global energy system is as important to strong, balanced and sustainable global growth as the global financial system.

Since February this year, I have been fortunate to obtain a deeper perspective on these issues in my new role as the chief economist of Shell International. I am grateful to Brookings and to Kemal Derviş and Homi Kharas for allowing me to remain a part of the Brookings Think Tank 20 (TT-20) group, and to continue to contribute to its series of reflections on policy coordination in the global economy. Accordingly, in this contribution I would like to reflect on adjustment in the global energy system as part of the overall adjustment of the global economy. I will concentrate on longer-term structural developments rather than concerning myself with the short term. I do so also because such structural analysis is the hallmark of work that Shell has been doing for 40 years as part of its global scenarios (www.shell.com/scenarios), and in which I am now immersed.

Shell's current published energy scenarios (labeled 'Signals and Signposts') date to early 2011 and were designed to take on board the global financial crash of 2008 as well as the outcome of the 2009 Copenhagen conference on climate change. The long-term perspective on energy demand and supply in those scenarios was, however, substantially based on work undertaken at the height of the boom in 2008. Using Shell's own World Energy Model, that work attempted to reconcile global growth, energy needs and environmental constraints in the period until 2050.

In this effort it was not alone. Particularly in the run-up to the Copenhagen conference a number of international, academic and policy organizations were similarly engaged in peering into the world's carbon future over the medium run. Being exposed now to the scenario process, what I personally find valuable about the Shell discipline is its willingness to examine alternative futures even-handedly, recognizing the inherent uncertainty of global developments. Once having systematically examined a range of alternatives, Shell as a business is obviously obliged to form its own view both for business decisions as well as in its advocacy. Through experience and practice, though, it has found that its corporate interests are better served if such considerations do not influence the scenario analysis.

To be helpful, even scenarios have to be grounded in a view of the future. Given the ebullience of that time, it is hardly surprising that the 2008 scenarios accepted that the economic growth of the major emerging markets was likely to be sustained into the foreseeable future. Given their earlier stage of development, this growth was likely to be both faster and much more materials-intensive than growth in the mature economies, and would therefore put demands on a range of global resources particularly, but not only, the global energy system. A relook at growth prospects following the crisis concluded that the fundamental drivers of poor country growth remained largely intact, even as the prospects for growth in the rich countries had been harmed for at least a while. The prospect of key economies encountering a "middle-income trap" or encountering a financial crisis cannot be discounted. These at a minimum could affect the trajectory of growth, if not the end point.

Global demand for energy in 2050 could triple from its 2000 level if the energy intensity of the emerging economies were to follow historical patterns, including that followed by successful recent developers. Ordinary market forces and developments will of course respond to this enhanced demand, although most probably along a rising cost curve as cheaper sources of energy, particularly crude oil, are replaced by less easily accessed sources. Sensible policies on both demand and supply (on which more below) could help these trends to deviate from historical experience to a degree, but the finding of the World Energy Model is that, by 2050, there could remain a gap between prospective demand and supply equivalent to the size of the entire global energy industry in 2000. This gap, (dubbed a "Zone of Uncertainty" in the Shell work) could be bridged either through smart and purposive national and global policy actions, or by chaotic and disruptive economic and energy market adjustments. One implication was that there was little margin for choice among energy alternatives: coal, oil, gas, wind, nuclear, solar, all would need to be pressed into service if poor countries were to grow and to urbanize.

The Shell energy scenarios broadly accept the scientific consensus on global warming and its causal association with global concentrations of carbon dioxide. While a rising share of renewables in the primary energy mix is both desirable and likely, the transition will take a long time. Both policy and technology matter. Taking technology (and finance) first, the basic observation of the scenarios on the supply side is how slow change is likely to be, given the sheer scale of the global energy system, and the need for new technologies to go to competitive scale. Work done by Shell staff, and published in the peer-reviewed science journal *Nature,* examines the historical experience with the introduction of new energy technologies. It finds that it typically takes 30 years for a new energy technology to go from pilot-plant scale to the point where it constitutes even 1-2 percent of the world's primary energy resources. Emerging technologies studied since the 1960s include nuclear, liquid natural gas, bio-fuels, wind and solar photovoltaic. The scale of the global energy system implies that even this level of penetration requires a sustained compound growth rate of 26 percent per year.

Following this "establishment phase" which typically requires exceptional policy support, the technology in question enters the zone of "materiality". Thereafter growth moderates, and the technology in question assumes its long-term position in the energy mix based on considerations of commercial competitiveness and convenience. With the best will in the world, then, there are limits to the rate at which the supply mix can evolve, even in the presence of policies supportive of technological development. If we assume that the next 30 years are critical for the world's carbon future, an important implication of this work is that the technologies for shifting the world's primary energy mix are already known. The point is to rear them from youth to adulthood.

This then leads to policy, and the implications of different policy pathways for global warming. Interestingly, even as far back as 2008, well before Copenhagen, the Shell scenario team was not particularly optimistic about action by national governments being the principal driver of coordinated regulatory policies toward climate change. Instead in a scenario that it labeled "Blueprints" the spur to action initially comes from a patchwork of local initiatives which in turn stimulate business and government to back coordinated and consistent global policies. The tipping point occurs as consumers and investors realize that "change is not necessarily painful, but can also be attractive". Success breeds success and ever more ambitious actions become politically possible.

The crucial variable is timing: policy actions are taken early on and the world is able to stay on a high growth, but economically sustainable growth path. The alternative (but equally plausible) scenario, entitled "Scramble" is one where the imperative of energy security in a world of apparently finite energy resources puts a premium on negotiation of bilateral agreements and incentives for local resource development, both bio-fuels and coal. This focus on supply leads to demand and climate action being postponed until supply shortages and climate events force drastic action. This delay imposes a larger, though later, growth penalty than under "Blueprints".

Even under the more orderly "Blueprints" scenario, there are expected to be immense difficulties in keeping greenhouse gas atmospheric concentrations below the 450 parts per million (ppm) threshold that scientists believe is the safe limit if global warming is to be restrained to the politically endorsed target of no more than 2^0C (above pre-industrial levels) by 2050. Achieving this goal would require, among other things, greenhouse gas emissions to peak before 2015; a zero-emissions power sector by 2050 and a near zero-emissions transport sector over the same period. Under "Scramble" the dynamics of adjustment are harder because of the later start.

This brings us then to the world of today and the prospects currently facing both the U.S. (the specific focus of this TT-20 volume) and the G-20 in the global energy economy. Here, important recent developments are the reappraisal of nuclear energy by the advanced countries, particularly Japan and Germany following the Fukushima failure a year ago, and the dramatic expansion in hydrocarbons extracted from shale, both gas and liquids. The former has not so far affected the nuclear investment plans of the developing countries and, as such, is more likely to have short-term rather than long-term effects, and is currently particularly affecting global liquid natural gas (LNG) markets.

Similarly, the shale revolution is also so far largely restricted to the U.S., for both geological and institutional reasons, and this is likely to remain so for some time before other parts of the world are able to replicate the U.S.'s success, even though promising geological structures do exist elsewhere, such as China and Argentina. However the U.S. is a big part of the global energy scene, so that these domestic improvements in gas and liquids supply, when coupled with moderation in demand resulting both from slower growth and improvements in efficiency, could affect global markets by reducing U.S. oil imports in the medium-term. The fragmented structure of the shale gas industry in the U.S. with a number of smaller-scale operators, has resulted in considerable volatility in natural gas prices (currently below the long-run marginal cost of supply), which acts as a disincentive for the huge investments needed for sustained LNG exports. There are also regulatory constraints on the export of such gas. Some investments in liquid natural gas for export (largely to Asia)from the U.S. Gulf Coast, based on these unconventional gas finds, are now beginning to be made, exploiting the huge price differentials that currently exist.

For the present, therefore the major application of this unconventional gas bonanza is likely to be within the U.S. itself, as a replacement for coal in the generation of electric power, with attendant benefits for reduced emissions of greenhouse gases. Some analysts have claimed that this cheap energy advantage will confer significant benefits both to the U.S. balance of payments (and hence the dollar); others argue that this additional source of cheap, locally sourced hydrocarbons will provide the basis for an American industrial renaissance particularly in chemicals. What is more certain is that, in the absence of exceptional government regulatory or financial support, hydrocarbons in the U.S. will continue to provide stiff competition for the expansion of renewable energy sources at commercial scale.

In many ways these developments in unconventional gas and oil are consistent with the fundamental supply adjustment mechanisms foreseen in the Shell scenarios. High oil prices, sustained by expectations of buoyant long-term demand from the poorer countries, have stimulated exploration and innovation, one outcome of which has been the unconventional gas revolution in the U.S. This should be seen less as the application of a new energy source than a dramatic expansion in application of existing technologies in response to attractive price prospects. The fact that this expansion has been largely in gas, at least so far, is also in line with the Shell 2011 scenarios, which predicted a steady shift in the global primary energy mix away from crude oil toward natural gas, both conventional and unconventional. The acceleration of this trend could mean a slight easing in the pressure on energy supply, so that the world may actually have a choice in reducing the importance of coal as a source of primary energy while maintaining the growth prospects of poor countries.

It also seems that another premise of the Shell scenarios will remain valid for the foreseeable future. Divergence in national resource endowments and differing environmental beliefs together with profound disagreements on international burden-sharing will continue to make it difficult to agree on a uniform, global long-term price for carbon, even though this is what would most efficiently encourage the massive investments needed to bring renewables to scale. While the world waits for a series of local initiatives to cumulate into a consistent global consensus, an important task facing the G-20 is to ensure that diverse local initiatives do not fracture the framework of global commerce, in pursuit of the ever-elusive "level playing field". While finance steals the headlines, rules-based trade is the true flywheel of the global economy. The G-20 must ensure that it remains so.

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