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The catastrophe if another global financial crisis strikes

Multilateral co-operation is on the wane today but is essential, says Arancha González of the International Trade Centre

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IT IS 2020. The world economy is in a deep recession. Two years have passed since America imposed tariffs on many of its trading partners, prompting retaliation from China, Canada, the European Union and others. Negotiations to resolve differences faltered amid tensions over trade surpluses and deficits. The effects of the protectionist measures seemed modest at first, when global economic growth was still fairly strong. But costs gradually started to add up for businesses and consumers. Investments faltered. Global supply chains choked.

Then, in 2019, the American business cycle turned. In China, confidence in corporations' ability to service debt fell. Financial markets plummeted. As the renminbi lost value, making Chinese products cheaper abroad, the American government placed even tougher quotas on many imports. Surplus goods from China flooded into other markets, where pressure to raise import barriers became irresistible. The downturn worsened. Job losses soared into the tens of millions.

This account is fiction, of course. But ten years ago this autumn, something similar might well have unfolded.

When Lehman Brothers, an investment bank, imploded in September 2008, a casualty of the subprime mortgage meltdown, contagion quickly spread to major financial institutions in America and Europe. Banks stopped lending money to each other. Borrowing costs skyrocketed, business lending shrivelled up, trade finance almost dried up. The world economy was suffocating.

In the twelve months from April 2008, global trade, industrial output and the value of the stock market all fell faster than they had during the first year of the Great Depression of the 1930s.

Fortunately for us, that is where the parallels ended. Four years on from the crash of 1929, global economic output was still well below pre-crisis levels. World trade had fallen by two-thirds. In contrast, by 2012, not only were output and trade volumes well above pre-2008 levels, but foreign direct investment had more or less recovered, and extreme poverty had continued its steady decline.

Why was the period after 2008 different?

For one, governments had a better policy toolkit. They were able to stimulate their economies by spending more and slashing interest rates. Their predecessors in the 1930s, in thrall to misguided ideas about balanced budgets and the gold standard, had resorted to import restrictions, which proved collectively catastrophic.

Another big reason for the effectiveness of governments' response to the 2008-09 crisis was international co-operation. In November 2008, the G20 collectively pledged to provide fiscal and monetary stimulus and to refrain from protectionism. This assured each country that its policies would be reinforced, not weakened, by those of its counterparts. Through the World Trade Organisation (WTO), governments monitored each other's trade and investment restrictions, and worked to solve a shortfall in trade finance. Governments did end up introducing various small-bore protectionist measures, but markets remained broadly open.

This co-operative response relied on positive-sum thinking. The Federal Reserve provided trillions of dollars of liquidity to foreign as well as domestic banks, directly and through swap lines with central banks in Europe and Japan, because it recognised that financial stability abroad would enhance financial stability at home. The focus on "win-win" outcomes allowed governments to invert the late MIT economist Charles Kindleberger's famous description of 1930s policymaking. This time, countries kept the global public interest in mind, and by doing so, better protected their respective national private interests. The system worked.

Would it work again today? It doesn't look promising. The ongoing trade hostilities are the product of a zero-sum approach to global economic relations. Too many leaders now dismiss international rules as unfair impingements upon national sovereignty.

Yet the fact is that cross-border flows of goods, services, capital and data have left us profoundly interdependent. One country's fiscal, monetary, and regulatory policies affect another's growth. Even if trade and investment were drastically curtailed, we would still have to deal with the cross-border implications of climate change, migration, cyber-security, terrorism and pandemic disease. To claim the nation-state can exert complete sovereignty in the face of these transnational challenges is not just a lie; it deliberately lowers defences against their economic and social consequences. National stability and prosperity demand that governments co-operate to build global resilience.

To be sure, multilateralism in the age of instant communication can no longer be the primarily inter-governmental process of the post-war decades. Modern multilateralism will be the collective product of different actors engaging across borders in different configurations. This is already happening. The Paris Agreement on climate change has spurred research and development into low-carbon technologies; major cities have allied to share information and technical advice about reducing emissions. International agreements have taken useful steps forward on curbing banking secrecy and corporate tax avoidance, and making big banks less vulnerable to destabilising failure.

The frontiers of trade governance can be usefully pushed forward by bilateral and regional agreements, as well as within the WTO. Governments could, for instance, usefully define shared parameters for policies to encourage emerging digital technologies such as artificial intelligence and advanced robotics. Clear global rules would minimise trade tensions and solidify incentives to invest. They would also foster competition based on ingenuity rather than "buy domestic" policies or other market restrictions like forced tech transfer or breaches of intellectual property rights. Authorities currently playing regulatory catch-up with a handful of powerful tech companies might welcome the opportunity to redefine a more open and fairer playing field.

Multilateral co-operation is frequently derided as naïve idealism. In fact, the opposite is true: it is a matter of cold self-interest for countries' future economic and security prospects. As Benjamin Franklin put it, we must hang together, or we will hang separately.

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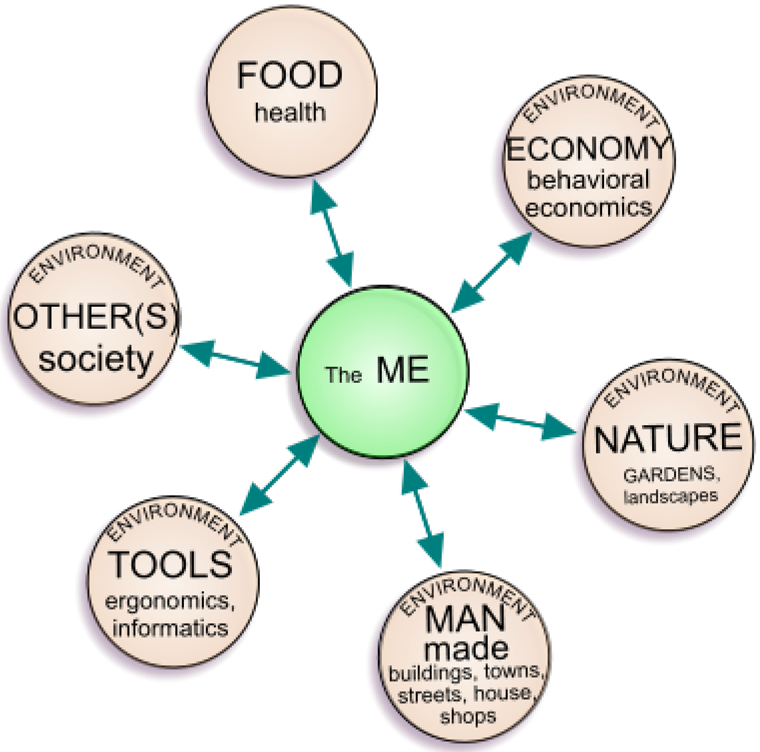
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