FOREIGN POLICY AND THE GLOBAL FINANCIAL CRISIS[1]

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We are experiencing the most dangerous financial and economic crisis since the 1930s. But it is also a crisis for foreign policy: a deep recession will shake political stability a across the globe; and it threaten the long-standing US goal of an open and dynamic global economy. Perhaps most important, the US is currently seen as the source of the problem rather than of the solution.

This crisis is, therefore, a devastating blow to US credibility and legitimacy across the world. If the US cannot manage free-market capitalism, who can? If free-market capitalism can bring such damage, why adopt it? If openness to the world economy brings such dangers, why risk it? As the shock turns to anger, not just in the US, but across the world, these questions are being asked. If the US wishes to obtain the right answers, it must address the crisis at home, and do what it can to rescue innocent victims abroad. This is not a matter of charity. It is a matter of enlightened self-interest.

The global economic crisis has become extremely severe: the financial system is on life support, with trillions of dollars of support by governments; three of the world's four most important central banks – the Federal Reserve, the Bank of Japan and the Bank of England - have interest rates at close to zero, with the European Central Bank likely to follow; governments are also loosening fiscal policy aggressively, with the deficits of advanced countries that are members of the G-20 forecast at 6.7 per cent of GDP this year and 7.6 per cent in 2010.

This massive policy support comes in response to increasingly dire economic conditions: the International Monetary Fund forecasts that global output will shrink by between 0.5 per cent and 1 per cent this year, a downgrade of 1 to 1.5 percentage points in two months; it also forecasts that the economies of advanced countries will shrink by between 3 and 3.5 per cent, the worst performance since the 1930s.

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[1] Testimony before the Senate Foreign Relations Committee, March 25th 2009.
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None of this is surprising. Not only did the global financial system seize up at the end of last year, but the Asian Development Bank has reported that the total loss of worldwide market wealth is $50 trillion, close to a year's world output. The loss of stock market wealth alone is $25 trillion. Demand for manufactures, world manufactured output and world trade in manufactures fell off a cliff at the end of last year: Germany's industrial output was down 19.2 per cent year-on-year in January, South Korea's down 25.6 per cent and Japan's down 30.8 per cent.

Inevitably, and tragically, the most adversely affected are countries that have opened themselves up to global capital flows, particularly emerging countries in central and eastern Europe. These were the only significant group of emerging economies to be net importers of capital in the 2000s, with results often seen before over the past three decades when capital takes fright. These countries face the risk of a meltdown, precisely because they trusted both Europe and the capital markets. The consensus of forecasts for growth of Eastern Europe this year has fallen from 6 per cent to minus 0.5 per cent since last June. It will surely fall far further. But all emerging economies are adversely affected by the loss of external demand, the shrinkage in global capital flows and the associated jumps in the price of borrowing.

In a recent article for the Financial Times, which launched our series on the "Future of Capitalism", I argued that it is impossible to know where we are going. In the chaotic 1970s, few guessed that the next epoch would see the taming of inflation, the unleashing of capitalism and the death of communism. What will happen now depends on choices unmade and shocks unknown.

Yet the combination of a financial collapse with a huge recession will surely change the world. The Great Depression transformed capitalism and the role of government for half a century. It led to the collapse of liberal trade, fortified the credibility of socialism and communism and shifted many policymakers towards import substitution as a development strategy. It led to xenophobia and authoritarianism. The search for security will strengthen political control over markets. A shift towards politics also entails a shift towards the national, away from the global. This is already evident in

finance. But protectionist intervention is likely to extend well beyond the cases seen so far: these are still early days.

In emerging countries, the number of people in extreme poverty will rise, the size of the new middle class will fall and governments of some countries will default. Confidence in local and global elites, in the market and even in the possibility of material progress will weaken, with potentially devastating social and political consequences.

The ability of the west in general and the US in particular to influence the course of events will also be damaged. The collapse of the western financial system, while China's apparently flourishes, marks a humiliating end to the "unipolar moment". As western policymakers struggle, their credibility lies broken.

These changes will endanger the ability of the world not just to manage the global economy but also to cope with strategic challenges: fragile states, terrorism, climate change and the rise of new great powers. At the extreme, the integration of the global economy on which almost everybody now depends might be reversed.

The decisions taken in the next year will shape the world for decades. So what has to be done? I suggest the following, focusing on the role of the International Monetary Fund.

First, we must realise that this is a crisis of the global economy that the US played a dominant role in creating. If that achievement, with all the promise it offers, is to survive, the crisis must be solved globally.

Second, the meeting of the G-20 heads of government in London is a recognition of this fact. Management of the world economy cannot be achieved by advanced economies alone. While not all the countries there present are systemically important, all systemically important countries will be there. The world looks for achievement at this summit. It must not be disappointed.

Third, the immediate priorities are to sustain demand, fix the global financial system and avoid a collapse into global protection. The longer-term aim must be to reconsider the regulation and structure of the financial system and reform the system of

international economic and financial governance. Some progress has been made on these fronts. But it is not nearly enough.

Fourth, there is a very good chance that this crisis will lead to a much deeper decline in the world economy than is now expected and a slow and limping recovery. This risk must be eliminated, if at all possible.

Fifth, if the emerging economies are to trust themselves to the world economy, it is essential to offer generous help now. At the moment, they blame the west for what has happened. It has been helpful for the Fed and other central banks to advance loans to a few selected central banks. But much more is needed.

Sixth, the current lending capacity of the IMF is about $250bn, which is grossly inadequate. The US treasury has proposed that this be raised to $750bn. That is the very least now needed. Remember that global foreign exchange reserves, predominantly held by emerging economies, rose from $1.5 trillion to $7 trillion between January 1999, after the Asian financial crisis, and their peak last year. This is an indication of the demand for reserves. It would be far more efficient, however, if reserves were pooled than if every country tried to insure itself, in this expensive way. That is what the IMF exists to do. It should be used for this purpose.

Seventh, in addition to increasing its resources, the governance of the IMF must be changed. Asian countries, in particular, still remember the humiliation treatment they received a decade ago at the hands of the IMF and the US treasury. They will want a much bigger say in the running of the Fund. An important step is a huge reduction in Europe’s voting weights, which are now about a third of the total. Also important is an end to the traditional practice of having an American head the World Bank and a European head the IMF.

Eighth, serious thought must be given to making an annual allocation of SDRs (special drawing rights) – the IMF’s own reserve asset. This would satisfy the world’s demand for reserves at no cost in resources. Traditionally, the US has regarded the SDR as a rival to the dollar as a reserve asset and treasured the ability to finance its external deficits through simple expansion of the supply of dollars. But the economic developments of the past decade should have shaken US complacency. The ability to run

very large current account deficits, has turned out to be a calamity, since, in my view, it offers a large part of the explanation for the current financial crisis in the US and so the world. Furthermore, the US needs to be able to export its way out of its current recession. Otherwise, it is likely to be stuck with a huge fiscal deficit for the indefinite future, to offset the higher domestic private saving and structural current account deficit. Increasing the purchasing power of emerging countries, through an annual allocation of about one trillion SDRs (a little less than 2 per cent of world GDP) would go a long way towards solving this problem. I fear that if this does not happen, a return to generalised protection would become likely, as a way for deficit countries, such as the US, to strengthen demand for domestic output and employment.

What I have outlined above is only a small part of the agenda. But it is a vital part. The more imaginative and energetic the US now is, the better able it will be to restore its reputation and influence across the globe. This is a time of decision. The US can either do everything in its power to restore and strengthen the global economic system it worked so hard to create. Choices must be made between outward-looking and inward-looking solutions. We tried the former in the 1930s. This time we should try the latter.