Post crisis blues

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Abstract

Debates that emphasize rapid economic recovery from major crises can extinguish progressive views that examine fundamental issues for sound economic management of present-day capitalist systems, such as: the determination of appropriate modes of cooperation including the procedures for intervention during crises, the introduction of structural changes that enable domestic economies to pursue appropriate industrial policies as well as erect institutions that could withstand external shocks, and, more importantly, the pursuit of fundamental reforms in the international economic architecture to allow for the management of cross-border flows of resources as well as coordinated adjustments to economic imbalances. There remains a lot to be done to make present-day capitalist systems reach a balance between domestic and global goals and thereby allow them to enlarge economic welfare without compromising national sovereignty.

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JEL Codes: E32, E61, F02, G01, H10, O20

1. Introduction

A plethora of publications has appeared in the wake of the 2008 Global Crisis. As to be expected, the present crisis is yet another opportunity to revisit the usefulness of economics in addressing the problem. More importantly, there is also an opportunity for a comparative analysis between two recent global crises (i.e., 1997 and 2008) and see what really needs to be done. Since the 2008 Global Crisis is evolving even two years after it emerged, what follows is necessarily gives a directional analysis.

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2. Reminiscing Two Crises

Beyond the fact that the 1997 Asian Crisis and the 2008 Global Crisis are, in essence, capitalist crises, there are important elements that warrant serious consideration. Five elements are outlined below.

Wreckage after the Storm

One element that both crises share is their deep and wide-ranging negative impacts in the crisis-affected economies: both pushed the world to the brink of another economic depression. Yet before these crises wreaked havoc, there was elation about the prospect of unstoppable economic growth. There was a view that the last major crisis was far back in history and could be considered irrelevant to current circumstances. Many analysts even thought that advanced and developing economies had decoupled from each other; that there was resiliency to any external shock; that there was room to proceed with the current mode of policies. The situation was hopeful even in the developing economies because, at last, economic development was possible despite the continued dominance of the advanced economies in international capital and trade flows.

When the crises broke out, however, the notion of decoupled economies was quickly quashed. Economies were, in fact, getting more tightly connected with each other because of greater economic globalization. Because of the interconnections, external shocks — both good and bad — turned out to be more forceful than before in impacting economies. Negative shocks were magnified because capital and trade flows overreacted by quickly retreating from crisis areas and, nevertheless, consolidating in advanced economies, where financiers and investors felt relatively safer than elsewhere. Still, the impact of negative shocks was asymmetric both in 1997 and today; that is, the advanced economies did better in sheltering their societies from harm than the developing economies simply because the former had the resources to do so.

Asia was salvaged from its crisis in the late 1990s after the advanced economies had put their acts together, so to speak, with the reduction of interest rates, deployment of sizeable rescue packages, and reversal of the pro-cyclical prescriptions like those imposed by the International Monetary Fund (IMF). There was concerted effort from the advanced economies because the Asian Crisis evolved into something that already threatened their economies.

The challenge is greater in the case of the Global Crisis. If the experience of Japan during the 1990s is any indication of what the advanced economies would have to endure in the process of adjustment during and after a crisis, the advanced economies need to put their acts together quickly and embark on unprecedented measures in order to stabilize their economies and (yet again) avert an economic depression that would pull everyone down as the world shrinks to find its balance.

There is now enough evidence showing that the Asian Crisis radically altered the economic growth trajectories of the region (c.f., Cerra and Saxena 2005; Ghosh and Chandrasekhar 2009; Park et al. 2010). The crisis-affected economies have yet to recover their losses today, more than a decade past the crisis. In fact, they are still burdened with large costs that seem too difficult to undo because of the limitations imposed by subdued economic growth rates and external pressures. That the Global Crisis will change the growth trajectories of the advanced economies and those affected by it is no longer an issue. In fact, an L-shaped growth trajectory has been conceded to be the scenario for the United States once the bottom of the Global Crisis has been reached, perhaps mimicking the trajectory of Japan throughout its economic doldrums. The other advanced economies will experience the same pattern, albeit of differing magnitudes, given the variations in contexts and how the Global Crisis operates in their region.

The Global Crisis is not near the bottom of its contraction. Indeed, there has been no easing up in its effects. What is disturbing is that the Global Crisis will push many economies into serious difficulties and burden them with huge losses despite having no direct involvement in the production of the crisis. It is also saddening, if not ironic, that developing economies will actually suffer more from the Global Crisis even if they are at the sidelines of the global economy.

Deregulate and Liberate

Deregulation and financial liberalization are common features to both the Asian Crisis and Global Crisis; they are preconditions of the problem, so to speak. Basically, financial systems were opened in response to demands for greater competition and freedom of capital and trade, but the rules and institutions to manage competition and international flows were not established or even removed in the process of deregulation and financial liberalization. In fact, the way regulations were removed precluded the introduction of new regulations to discipline international flows when it was found necessary to do so.

It is important to understand the context of deregulation and financial liberalization. Right-wing economics and politics moved to remove market regulations; they extolled the virtues of free markets and despised any form of government intervention, which was identified as the cause of economic problems. It was believed that markets always worked well because they are self-rational, self-regulating, and therefore self-reproducing. Indeed, the mere existence of markets is itself self-legitimizing of their virtuosity and the possibilities they provide to economies. If markets were not carrying out their role as understood, they would be easily replaced through competition — it was thought that competition was enough to discipline the market. Government intervention simply arrested progress, which is believed to be possible only with unregulated markets.

Indeed, there was the assurance that society should not worry about market operations because, on their own, markets evolved smoothly; they were preprogrammed to reach equilibrium no matter what. All that was needed was to unleash the market. And with economies performing well as the regulations were progressively being removed, governments were emboldened to embark on more aggressive deregulation and financial liberalization. Markets insisted to be free, to do whatever they desired, and to go wherever they wished, and so governments had no choice, so to speak, but to deregulate and liberalize their economies to accommodate the demand.

In the case of the Asian Crisis, massive capital and financial inflows ensued in the decade prior to 1997. Because the domestic productive capacities did not expand as fast as the pace of the inflows, more funds went increasingly into speculative and unproductive activities. By the early 1990s, the prices of stocks and assets such as real estate had accelerated. With the weakened regulatory institutions in the region, capital flight proceeded without restraint, as if governments were indulgent to the revolving nature of the international flows. The large inflows also contributed to an expansion of consumption as currencies appreciated and cheapened imports, in turn, undermining industrial strength. Easy money enabled governments to pursue easy credit, too. In the end, flows of funds reinforced the consumption binges and unproductive expansion in the region.

The Asian Crisis unveiled the weaknesses in the Asian region. Rapid economic growth in the decade before 1997 was therefore only possible because capital continued to flow to the region. With the crisis erupting in 1997, the flows stopped then reversed. In the end, the region did not have enough funds to keep up with the outflows as capital rushed to safety.

The debacle in 1997 radically changed the perception about Asian economies. The region was quickly rebuffed for its cronyism, corruption, inefficiencies, and structural rigidities, supposedly the causes of its collapse. Interestingly, these elements were present all along even with Asian economies labeled as miracle economies. There was, however, belated recognition that the main problem was liquidity: funds were not enough to restart financial systems and governments were inutile to stop the bleeding of their economies.

Not surprisingly, the Global Crisis shares the same trends with the Asian Crisis. In the United States, where the Global Crisis erupted, the separation of commercial banking and investment activities mandated by the Glass-Steagall Act of 1933 was abolished with the passage of the Gramm-Leach-Bliley Financial Modernization Act of 1999, which effectively opened the United States financial system to free-for-all competition among commercial banking, investment, securities, and insurance entities. Of course, there were earlier pieces of legislation that weakened the Glass-Steagall Act of 1933. The rapid advances in computing power, information processing, and financial know-how actually contributed to accelerating the process of removing regulations even as they facilitated the rapid expansion and sophistication of financial markets.

As financial activities progressed, more activities occurred outside regulatory control; nobody knew how much transactions occurred in the so-called shadow financial system. Besides, the removal of regulatory power pushed out authorities from intervening in the financial markets. The aggressiveness of finance led to the creation of highly sophisticated and very complex financial instruments that did not have secondary markets; no one could resell the instruments when they went bad even at discount prices. Worse, a lot of the financial instruments were not backed by real values.

In other words, changes were increasingly focused on the secondary problems of financial markets, that is, on market operations through the use of prices. Increasingly, the primary problems of financial markets were downplayed, that is, the requisite structures and institutions for market development were set aside as irrelevant to a deregulated and financially liberalized economy. It was enough to assume that deregulation and liberalization generated the demand for sound structures and institutions. Again, the view was that markets cleared and the economy stabilized with them and international flows were enough to discipline both the market and government.

Observe how the Global Crisis was caused by the wobbling of the United States financial system, which in turn has threatened the collapse of the global financial system. The Global Crisis showed once again that unregulated financial markets are not durable and do not promise long-term benefits even in the most advanced economy. Put in another way, the most sophisticated financial system is fragile. In economies with less advanced financial systems, there is an embedded wisdom toward a precautionary approach to deregulation and financial liberalization.

This time, however, the United States was caught in a gridlock-cum-vacuum because the financial system was rapidly sucked out of liquidity even as it was infused with huge funds. The United States problem burrowed deep into the financial system in complex ways. Because of the linkages, a stalling United States financial sector stalls the United States real sector. Owing to the international linkages between the real and financial sectors, the United States problem was extended to the world. In short, the nature of the problem is worse than that in 1997 because of the greater scope.

Recall that the Asian Crisis put to doubt the notion that markets could operate well by themselves. There were efforts to reign on markets through government regulations in the wake of the Asian Crisis. After a while, though, as the world recovered and, in due course, regained its pace of economic expansion during the 2000s, the attitudes changed and government intervention was again seen to be unnecessary. Interestingly, the Global Crisis revived the convictions declared due to the Asian Crisis, namely, to redefine the international economic architecture and institute sound regulation to manage international capital and trade flows.

The Global Crisis is once again a reminder to return to the structures and institutions in order to soften market operations, to the fundamentals of production, and to balanced economic growth, including the interactions of various factors, which are needed for dynamic performance and improved economic welfare. Part of this recollection is to recall how to re-embed finance in the economy and, again, make it support production, contribute to growth, and help improve economic welfare.

People who believe in regulation should be tasked to run the regulatory agencies and given ample room by government to execute regulations. It is meaningless to have financial regulatory agencies or an integrated financial regulatory body when the people placed there do not believe in regulation or think that any regulation is bad or see that the removal of regulations is their mandate.

Re-regulation is in no way a license or approval to embark on authoritarianism or antidemocratic measures. It is not even close to such view. Rather, it is a challenge to the position that the un-regulated markets are the best ways to organize economic activities. There is a need to reconsider the essential roles of government in a market economy and find a balance between planning and market, to return to the fundamental purpose of economic management. The fundamental principle that underpins re-regulation is the promotion of a shared society wherein economic progress does not create extremes of wealth and poverty, a shared society which provides access and creates opportunities for everyone to overcome adversities and challenges through hard work and dedication, tempered with the mutual responsibility to ensure that the economy continues to be robust in the long term.

Success Breeds Failure

It is natural that success raises confidence. Equally natural is that continued success will breed contempt of failure. There will always be a belief in the permanence of success and the emergence of a new stage of advancement. Thus, a period of exuberance always precedes a crash.

Another interesting parallel between the Asian and Global Crises is that they are both results of economic successes that lasted for some time. The successful period was thought to be the consequence of policies that stressed limited strategies or government action, which set markets free with the removal of regulations.

In Asia, the success of export-oriented growth strategy masked the ersatz nature of economic progress. Asia was thought to be relatively coherent in constitution, relative to the other developing regions. Indeed, two-and-a-half decades of continuous economic expansion among roughly contiguous economies was unprecedented, even a miracle, because such a scenario was statistically improbable (c.f., Jomo 2001). In fact, Asia was thought to be the economic model that the developing world should emulate and aspire.

In a way, the Asian economies were Janus-faced economies. The region had macroeconomic discipline and maintained balance. It had adequate physical infrastructure and provided basic social services like public education and health. Governments were embedded in that they coordinated investment activities, supported the rising industries, and encouraged reinvestment of capital for further production. More importantly, the region became an aggressive exporter to the advanced economies.

Behind the front of robustness, however, Asia had uncompetitive domestic sectors. There were aspects overlooked like increasing inequalities and environmental destruction. Domestic adjustments were not pushed because economic growth masked the problems. Rapid growth was thought to assuage demands for redistribution and environmental sustainability.

By the 2000s, the Asian economies had geared back to growth momentum. The export-oriented growth strategy was functioning again. New drivers of economic growth emerged, like China and India, to supersede earlier drivers like Japan and South Korea. Because of the painful experience with the Asian Crisis, Asian economies accumulated international reserves as precautionary resources against illiquidity or another crisis.

This huge pool of Asian liquidity had to take some form and was placed somewhere in the interim that it was not utilized by the economies. Thus, there emerged the international liquidity glut that characterized the 2000s.

The United States mainly but also other advanced economies were willing to take in Asian and emerging economies' international reserves because the funds financed trade and fiscal deficits. The United States no longer produced most of the goods it consumed, and so it imported a lot from the world, especially from China. It also did not want to be worried about basic services for its workers and so it opened its doors to immigrants, albeit offering the latter relatively lower wages and lesser social security than American workers.

United States authorities encouraged the situation by reducing interest rates and keeping them low for a while despite key indicators pointing to the need for a reversal of policy. The sustained capital inflows, of course, provided easy money that, in turn, supported consumption binges and the rapid expansion of the United States financial markets. With tougher competition, financial standards were lowered and thus emerged the sub-prime mortgage bubble in the 2000s.

The capital flows into the United States and other advanced countries left little resources to developing economies. China, for instance, has the largest international reserves today, but a large part of its funds is locked in United States treasuries and other fixed instruments. China and other developing economies are effectively providing foreign aid to the United States. This unhealthy pattern, together with the fleeting nature of flows because of deregulation and financial liberalization, has not only limited economic development but also created and enhanced the existing vulnerabilities of developing economies.

The United States enabled other economies to flourish because, as the global consumer-of-last-resort, it gobbled up goods from the world. Again, global imbalances have supported United States consumption since the 2000s. Needless to say, the current international economic architecture requires one or two global consumer-of-last-resort economies to enable global economic growth. Now that the United States is unable to perform its role, the world is devastated. Still, the Global Crisis impacts the developing economies in significant ways despite being at the margins of global economics.

Of Debts and Bubbles

There are two essences of the Asian Crisis and Global Crisis. The first is debt. Both crises originated in borrowings. They are different only in terms of the nature of indebtedness and its development. For the Asian Crisis, there was a mismatch of maturities and liquidity, that is, the Asian economies borrowed funds in international currencies but lent out in local currencies; they borrowed in short term but lent in long term. When the crisis struck, economies found it difficult to meet debt obligations and respond to the massive international outflows.

The Global Crisis, in contrast, originated in the securitization of debts. Securitization is basically the creation of hybrid financial instruments through (re)combining existing instruments then (re)selling them like conventional financial instruments to, say, investment banks, hedge funds, insurance companies, and so forth. The most recognized of these instruments because of the Global Crisis is the collateralized debt obligation. The securitization process was thought to be safe, clean, and transparent. Again, competition guaranteed that it would proceed just fine and bring benefits to the economy in the long term.

Recall that in the conventional approach, banks extended loans to households and businesses. If borrowers defaulted on the loans, banks suffered. Thus, there were strong incentives for banks to ensure that good loans were made and the borrowers paid.

In the United States, things markedly changed in the 1990s. Banks shifted to the so-called originate-and-distribute system in making loans. In the new approach, banks still issued loans as before, but then they had other financial institutions or, on their own if they had enough capitalization, packaged the loans into hybrid instruments. Notice that the issuer of loans need not be the holder of loans. In contrast to the conventional approach, there was no strong incentive to make good loans in the new approach.

With no strong regulations or monitors because of deregulation and financial liberalization, the transactions continued like ordinary business, expanded, accelerated, and then went out of hand. There was a perverse incentive to create more hybrid instruments, sell them off, get bigger fees and bonuses, and then redo the process all over. Why should market players worry about defaults when they got their big fees and bonuses already? Besides, government allowed, if not encouraged, the expansion of such transactions.

Rating agencies contributed to the securitization process, too. The business of rating agencies is exactly that: rating securities and related financial instruments. Their business is fundamentally linked to selling and underwriting financial products. Put simply, those who sold the hybrid instruments got rating agencies to rate their products. The perverse incentive was to give very high ratings to earn more and not be concerned about the integrity or truthfulness of hybrid instruments like collateralized debt obligations.

As competition in the financial market intensified, more loans were extended to people who did not have the capacity to pay loans, or the so-called subprime borrowers. Because United States housing mortgages were basically non-recourse debts, there was a big problem right from the start.

It is easy to understand why loans need collateral. In the case of the United States sub-prime lending, the collateral was (still) the house. But loans were non-recourse debts, which means, in case of default, recovery of the loan is limited to the mortgaged property. The rest of the borrower's properties (if any) are not covered by the mortgage. In short, it is possible for the borrower to return the mortgage to the bank because of inability to pay then walk away. Indeed, since the housing bubble burst in 2007, people walked away when they defaulted. There was therefore a perverse incentive on the part of the borrower to not make good on the loan.

Besides, insurance against defaults was available to the bank, which is called credit-default swaps or insurance derivatives. Simply put, the bank could purchase insurance on a loan that was given in the sub-prime market to cover losses in case that loan went bad. Again, there was perverse incentive to not make good loans.

What was overlooked during the securitization episode was that the transactions evolved into hybrid instruments that remained outside regulatory controls. In short, nobody recognized the profound changes in the financial system; in the end, nobody knew the amount of toxic materials created during the securitization episode. Moreover, the hybrid instruments did not have secondary markets. In short, nobody could resell their toxic materials if people did not want to hold them anymore, even at discount prices. What made things worse is that these instruments were actually not backed by real value, thus it was difficult to stabilize the situation when the crisis broke out in the financial system. And because the regulatory infrastructure was decimated throughout the 1990s, it was difficult to intervene in the financial system. In short, securitization set the course toward catastrophe. After the bubble burst, a financial gridlock-cum-vacuum emerged.

The Global Crisis is, however, a bigger problem than the Asian Crisis simply because, first, the advanced economies are affected and, second, which is a consequence of the first point, it is global in scope. Interestingly, the Global Crisis obliged governments to reconsider nationalization, albeit for the wrong motivations. This move would have been unimaginable during the Asian Crisis, when governments were forced to close and privatize the erring banking and financial institutions and corporate enterprises. At the same time, massive bail-out packages were provided to failing institutions and enterprises, which, again, were ruled out as a viable response during the Asian Crisis.

As a matter of fact, several advanced economies have posited that nationalization is a necessary step to distinguish the good from the bad assets, remove the toxic ones, and facilitate the recapitalization of financial institutions to restart capital flows. But that idea is mistaken because nationalization should be done primarily to secure the real productive sector and not to alleviate the problems that the financial sector created on itself.

In the United States, a serious financial cleanup is needed. Bailout is definitely an expensive endeavor. It needs to be acknowledged, though, that the United States capitalist system today is characterized as "corporate welfarism," or a predisposition to first attend to the demands of corporate and financial interests and not to have second thoughts about cutting budgets for healthcare, education, housing, and other basic services. Like it or not, United States taxpayers are going to assume a disproportionate burden of the bailout as the toxic assets are socialized. With the labor already weak and powerless after years of assault, the working class is going to suffer the most despite the bailout. It seems that those who profited from their irresponsible actions would not be asked to take the burden of paying for the bailout. There is simply no socialization of profits for the rich and powerful.

As the events unfolded in 2008, bailout was extended to giant finance players like Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, Goldman Sachs, and Citigroup; insurers like Fannie Mae, Freddie Mac, and American International Group; regional banks like Washington Mutual; and auto companies like General Motors, Ford, and Chrysler.

The United States financial sector needs to bail itself out because the alternative scenario of a United States financial collapse is worse in terms of its impact on its economy and the world, as well as on global security. The alternative scenario of reliving another depression is unacceptable to the United States and the world.

The amounts for the United States bailout are large in any yardstick. But United

States authorities can carry it out because its economy does not have a currency constraint problem, unlike most other economies. Put another way, United States authorities can provide the liquidity needed to have a successful bailout and save the financial system by simply allowing the release of money.

But the fundamental issue is whether United States authorities realize that a bailout would necessarily help those who profited and took advantage of the situation that brought the United States financial system to a brink of collapse or that the bailout would necessarily help those who were complacent in building the United States productive sector. A related important issue is whether United States authorities have the seriousness to fight the good cause and take up actions in good faith to avert the greater costs because, in the event of a financial collapse, there would be no “soft landing” for everyone. An equally important issue is whether United States authorities would run after those who placed the financial system in the United States at the brink of collapse or, for other economies, to break down.

Because of the financial mess, those who placed their money in, say, pension funds for a good objective will not be able to look forward to a secure retirement. Many people will lose incomes, jobs, and houses as the financial mess spreads through the United States economy. Since it is not well understood how the money will be recovered, bailout will create a huge hole in the financial system even if it saves the financial markets. As those who profited from irresponsible actions are not going to take any burden, bailout will strengthen the view that the United States has become a society that protects the wealthy and powerful and gives token care to the poor and powerless. The bailout will penalize the taxpayers for a long time, even as the United States authorities purge the toxic financial products.

No doubt, the United States financial mess requires a quick and solid resolution because, even at the interim of the Global Crisis, the costs have become too large to be fathomed. After that, there will be serious re-regulation to discipline capital, resuscitate the financial regulatory structures and pull the financial system out from its setup that encourages financial casinos and, more importantly, make finance once again serve the people rather than the reverse. There will also be serious actions against those who took irresponsible and arrogant transactions without the actual capital to back them up.

Like the Asian Crisis, the Global Crisis originated in a bubble. Bubbles do not usually have any effect beyond the domestic sector. The Asian Crisis evolved into a more virulent crisis because the advanced economies and international organizations like the IMF were disinclined to provide assistance to extinguish the problem as it hit other regions. The opportunistic nature of the intervention did not help ease the problem in Asia because the economic contraction led to a general doubt about the integrity of developing economies in general. Economic integration and globalization also facilitated the transmission of the problem.

The Global Crisis, however, is different from the Asian Crisis because the United States bubble has burrowed quite deeply into the United States financial system. Securitization has transformed the bubble in complex and intractable ways. Owing to the domestic linkages, a stalling United States financial sector stalls its real productive sector.

Consider the following transmission. The collapse of the housing industry affects the sectors that are directly connected to housing, like construction and materials, furnishing, and utilities, and eventually the workers and incomes in these associated sectors as well. Of course, it does not necessarily mean that if the housing industry collapses it will automatically affect the other real sectors, say, automobile, airline, shipping, and so forth.

There may be secondary effects of a housing industry collapse. For instance, as the furnishing industry is adversely affected, people lose their jobs and income. Thus, there may be fewer people who want to travel, thereby affecting the airline industry in due course. The same goes for industries linked to airlines, and so forth. In short, a problem like housing collapse may lead to secondary problems that can immobilize the whole real sector of the economy. Of course, the speed of transmission and extent of the effect greatly depend on the health of the economy.

The housing sector and the other industries are linked to the financial system. It is possible for a housing company to put up its own lending company, providing people who bought houses with access to some form of financing. Similarly, a conglomerate may put up its own bank to establish some form of direct payment facility for its clients. These linkages make the financial system function like the circulatory system of the economy. Thus, a problem in the financial system affects the whole body.

Unlike the real sectors of the economy, the financial system has direct linkages to all parts of the economy. In the case of the United States financial crisis, companies lent to each other but turned a blind eye on the unusual situation: no one actually had enough money to pay all the obligations. It was generally thought that nothing unusual was happening because, again, competition was extensive. Then the bubble burst, the "house of cards" built with housing mortgages fell apart, and a major heart attack to the financial system occurred incapacitating the United States. As the repercussions in the real sector manifested, the financial sector found that it did not have enough money to support the untangling of debts.

The linkages within the United States also serve as the conduit for extending the United States mess to the global economy. With the retreat of capital to the advanced economies for security, the real sector of developing economies will suffer as economic contractions ensue following reduced capital and trade flows. This way, the Global Crisis is like the Asian Crisis because in the latter, capital fled the region to seek safer places, especially the United States.

The Global Crisis is similar to the Asian Crisis because of the linkages across the financial and real sectors. The problem in the United States hit the European and Asian financial systems as they were unable to recover their exposures. As their financial system stalled, their real sectors were compromised in the end. Because economies are now rather tightly linked to each other, the slowdown resulted in secondary effects on other economies as well. Thus, as advanced and developing economies slowed down, the world fell into economic trouble.

During the Asian Crisis, capital pulled out from the region and shifted to the advanced economies to start another bubble, so the amount of capital in the end remained intact or, at least, capital was able to recover the losses from the Asian Crisis rather quickly. In fact, the same general process could be observed with the Mexican Crisis in 1994, Brazil and Russia Crises in 1998, Turkish Crisis in 2000-2001, and Argentine Crisis in 2001–2002. Even the United States dot-com bubble in 2001 came from the same cycle of boom and bust.

This time, the Global Crisis hit capital in its core. Capital was vacuous because it did not have (enough) value to support or back up its expansion with securitization. Thus, when the bubble erupted in 2007, asset evaporation ensued. Large write-offs and write-downs have continued since 2008, creating a downward spiral of valuation and sentiments. The effect is that capital will now have much difficulty reconstituting or restoring itself in the post-crisis period. This time, bubbles will not be quick to emerge. Besides, the amount of capital will not be enough to start another bubble, at least during the mediate post-crisis period. The failure of another bubble will therefore be problematic for reviving global economic growth.

Of course, there will be subsequent problems, especially in developing economies, where capital is already scarce. In fact, some of them already had difficulties repaying their debts before the Global Crisis. Poor ones will face a much tougher problem in meeting their debt obligations. If debt problems emerge, certainly, there will be another layer of complications to the Global Crisis.

Nobody Saw "It" Coming

The Global Crisis emerged in the heart of the world. It did not occur in some developing economy with faulty financial institutions or broken politics, but in the United States, the richest, arguably the most democratic, country with the most advanced financial system in the world. While serious crises occurred in advanced economies in the past, like the 1980s United States savings and loans debacle, the 1990s Scandinavian banking crises, or the 1990s European Monetary System breakdown, none of them actually threatened the world. Perhaps this is because there is something odd with the present-day variety of United States capitalism, or the Global Crisis came out in the United States that it was not expected.

Contrary to popular perception, the Global Crisis was actually foreseen by a number of analysts. Nobel Laureate Joseph Stiglitz and economists like Robert Shiller and Nouriel Roubini noticed the alarming trends before 2007. There are other analysts who raised the alarms, of course. The United States Federal Bureau of Investigation warned, in 2004, of problematic and unhealthy financial practices linked to securitization. Warren Buffet warned of the dangers of derivatives, as early as 2002, calling them "financial weapons of mass destruction" (c.f., Berskshire Hathaway 2002). What is incomprehensible is that precautionary measures were not adopted despite these early warnings, including in the United States. It seems that the world was content to dismiss these analysts as doomsayers (c.f., Greenspan 2007), or, as in the case of Asia in the 1990s, authorities did not want to let go of the vision that global economic performance was heading to a higher level of advancement. Perhaps, authorities and their analysts operated within a setup that predisposed them to take self-serving analyses which rule out the possibility of a brewing problem. If their analyses succeed in identifying the problem, the setup is such that it precludes them from taking actions because doing so risks the loss of confidence and produce panic.

Of course, there is the matter that the Global Crisis, like earlier crises, is a systemic problem inherent in capitalism. That is, while no economic system is free of crises, it is argued that only capitalism is genetically structured to fall periodically into crises. But people find it difficult to accept that capitalism is fundamentally flawed. As such, it is better to forget about the flaws. It is relaxing to believe in the infallibility of capitalism and to dismiss dissenters as doomsayers. The onslaught against alternative proposals has been successful because the notions that the capitalist system will eventually sort itself out if crises occur and that competition will temper it dominated policy and analysis and so crises are unimportant dominate the analysis of the Global Crisis. The situation is unfortunate because the collapse of capitalism today is an occasion to engage in a serious fundamental analysis of the capitalist system.

3. Another Declaration of Interdependence[1]

What are the policy directions to revive economic growth and prevent the occurrence of another crisis? Five considerations for the post crisis period are presented below.

Economic Growth

The first policy challenge in the wake of the Asian Crisis was reigniting economic growth in the region. The same applies to the economies adversely affected by the Global Crisis. As in the Asian Crisis, sustaining growth over the long term across the world will, in fact, be the bigger challenge in the post-Global Crisis period. Recall that after the Asian Crisis growth trajectories of the crisis-affected economies did not return to their previous path.

[1] This heading is an adaptation of Rubin and Weisberg (2003)

This pattern need not reoccur if outputs, incomes, and jobs expanded in the post-crisis period.

In the interim, the world is seeing the advanced economies on a downward spiral. The contractions have adverse impacts on the economic performance of developing economies that, in turn, can aggravate the conditions of the poor who comprise more than half of the world's population.[2] The collective decline of economies will be problematic because global economic welfare will fall, too. With the bottom of the Global Crisis not yet in sight there are serious concerns about the depth of the dive and, accordingly, the magnitude of the damages. Recovering these costs will be a huge challenge to economies in the post-crisis period.

It is imperative therefore to prevent the Global Crisis from escalating into global collapse. The scenario of a depression must not be allowed to happen. As such, stimulus programs are needed to pull economies out of the crisis. Put simply, aggressive spending is needed to improve the outlook in the succeeding years. The purpose is not only to realize an improvement today but also to reinvigorate the economy for the future. To have profound effects, the stimulus programs need to emphasize complementarities, exploit scale economies, and minimize duplication so that there will be generalized expansion across sectors and economies.

Stimulus spending is crucial during a crisis because it is quick to stimulate economic growth. But it needs to be timely so that spending will actually contribute to the expansion of production, generation of jobs, and increase in incomes. Enlarged income, in turn, creates successive expansions that materialize into larger gain than the initial outlay.

Stimulus spending needs to be coordinated so that demand will be spread out across economic sectors. The challenge is more difficult in the case of the Global Crisis because the spending also needs to be coordinated across economies to see improvements in global economic performance. At the same time, it is important that stimulus spending is sustained in the medium term to avoid an economic relapse.

Depending on the domestic capacity, a meaningful stimulus spending needs to be

[2] This statistics is based on the US$2.50 daily benchmark to be classified as international poor. With the US$10 threshold, however, 80 percent of the world is poor.

between 2 and 5 percent of gross domestic product (GDP) over a four- to five-year period, with gradual reductions midway into the program.[3] A conservative determination is to first obtain the total contraction as a share of GDP at the bottom of the crisis, then divide the figure by four or five years to get the size of a stimulus program for each year.[4] For example, if the total contraction reached, say, 10 percent of GDP at the end of the crisis, then the stimulus spending needs to be in the range of 2 to 2.5 percent each year. Recall that this approach could bring an economy back to its pre-crisis trend. To recoup the costs, however, stimulus spending needs to exceed the calculated low-end amount.

Of course, downgrading economic growth targets is inevitable during crises; but it is precisely because of this that stimulus spending needs to be introduced quickly and to be as decisive as possible in order to reverse the distressed scenario swiftly. In the ideal scenario, reduction in spending is done once the economy is back on track to its original growth trajectory. At this stage, it is important to institute counter-cyclical spending. Thus, there is a need to set up a mechanism that will enable interventions to manage growth fluctuations via spending. Because of the Asian Crisis experience, there is consciousness that improving the economic performance of crisis-affected economies is a priority concern before going into the structural changes.

Opportunism and Hesitation

A major mistake during the Asian Crisis was the misdiagnosis of the crisis and, because of that, the wrong prescriptions. The Asian Crisis was thought to be a current account problem, forcing the crisis-affected economies to execute current account measures. In actuality, the Asian Crisis was more of a capital account crisis which affected the current account, since economies suffered from liquidity as capital flows ran out.

Recall that the Asian Crisis was attributed to cronyism, corruption, and so forth, so the prescriptions focused on structural changes and other reforms that were not directly related to the liquidity problem faced by the crisis-affected economies. Of course, entrenched interests were upset. Elites did not support the reforms, resulting in the mere

[3] Two percent of total output is a generic IMF prescription for stimulus programs.

[4] Obviously, the calculation assumes perfect foresight to determine the bottom of a crisis. In the absence of perfect information, historical analysis will be useful.

token acceptance of the prescriptions handed by the IMF and others. In the end, there was default on the reforms. If the liquidity problem were addressed head on (i.e., with access to funds to stabilize the situation), a bitter crisis could have been avoided. There were other mistakes, of course. But, again, the Asian Crisis escalated the way it did because of the incorrect analysis and prescriptions.

In a way, the Global Crisis started out as the result of incorrect analysis and prescriptions. As mentioned earlier, as early as 2004, warnings pointed to unhealthy financial market practices. Warnings in 2006 pointed to an impending crisis in the United States housing sector. It is unlikely that the United States Federal Reserve did not see the unhealthy trends. Recall, for instance, how the United States stock market adjusted in December 1996 after then Federal Reserve Chairman Alan Greenspan marginally commented in a speech that the 1990s stock market boom exhibited "irrational exuberance." In due course, the dot-com bubble burst.

In other words, if United States authorities wanted to act to deal with a potential problem, they did so with binding threats of intervention and regulation. The fact of the matter is that the United States Federal Reserve refused to intervene in the 2000s. To the Federal Reserve, the brewing problem was merely froth in the financial system that would just disappear when competition fixed the exuberance. Accordingly, the Federal Reserve did not acknowledge a housing bubble problem. It even went on to relax its monetary policy and maintained loose policy for too long. It also supported the removal of the remaining safeguards against speculative activities. In a way, the Federal Reserve acquiesced to the financial markets.

Market players, in turn, were emboldened to engage in more speculative activities. There were also implicit promises that government would lend a hand in the event that help was needed, strengthening the notion that market players were too big to fail. In short, not only were structures and institutions weakened with deregulation and financial liberalization; the incentives were also unsound and the environment encouraged speculation.

Moral hazard was part of the problem. On one level, there was hesitation to say that there was a problem in the financial system despite the deregulation and financial liberalization. If the Federal Reserve made such declaration, panic, and thus a crisis, would break out. If it did not do anything, however, a crisis would still occur. In these alternative scenarios, the latter was easier to pursue.

The above argument avoids the issue of the roles of financial regulators, which are, necessarily, to ensure the soundness of the financial system and make it resilient against shocks, ascertain the veracity of financial products sold in the economy or elsewhere, check market players if they engage in financial casinos or prey on people or fool everyone else to consume financial products that are unsafe for the economy in the end, avoid situations which will bind the government to bail out those who acted irresponsibly, impose the burden on those who acted carelessly, and, more importantly, discipline capital so that it supports the economy. In addition, there must be effective regulation and capacity to discipline market players. Apparently, when the situation was ripe for a financial crash, Federal Reserve did not and could not act to extinguish a crisis.

The bailout and rescue activities comprised the first phase of the effort to resuscitate the financial system, and the stimulus programs are the next steps. Institutional reforms are, without a doubt, desperately needed to address the source of the problem, but they are to be done in the appropriate fashion and timing.

An important lesson from the Asian Crisis is that fundamental reforms should be introduced once the crisis-affected economies are on a steady course to economic recovery, which in itself is important to sustain the reforms. Some measures could be urgent, like strengthening the rule of law and apprehending culprits, which signal the seriousness of government and convey the message that things would not go back to the way things were before the crisis. Safety nets are needed to minimize the adverse impact of the crisis on the poor and the vulnerable. In such cases, actions need to be creatively introduced by the authorities to convey the correct message that government defends public interest not private interests.

It is apparent when reviewing past major crises, like the Great Depression of the 1930s, that urgent measures were done without delay and reforms were introduced in due course.[5] The Federal Deposit Insurance Corporation, the Securities and Exchange

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[5] There were also policy mistakes. In 1937, the Roosevelt administration decided to balance the budget. The result was a recession. Realizing the mistake, the Roosevelt administration changed direction and embarked on a stimulus program to revive economic growth.

Commission, and other agencies, as well as social security, wage and labor standards, and so forth, were introduced by the mid-1930s. An alphabet soup of regulatory agencies was prepared between the 1930s and the 1960s.

Together with regulatory reforms, the United States government raised taxes on the elites. Naturally, such measures were objectionable. In the end, however, the policy transformed the United States society. In particular, taxes on the elites and, subsequently income taxes as well, produced the great compression in wealth and inequality, creating the middle-income American society that attracted many people to the United States (c.f., Piketty and Saez 2003 and Krugman 2007; for the experience of advanced economies, see Piketty and Saez 2006). Regulatory agencies produced a managed economy. Eventually, there were parallel growths in wages, profits, and accumulation which sustained expansions in production, consumption, and economic welfare. Thus, the United States experienced the longest expansion in the post-World War II period ending in the 1970s.

At the broader level, reforms are needed to repair the capitalist systems that were damaged by unbridled deregulation and financial liberalization. Equally crucial are measures to take care of the frightening challenges to society caused by mindless capitalist expansions, namely, climate change and environmental destruction. Reforms are likewise necessary to shift attitudes from focusing on corporate profitability to emphasizing public safety and security.

Measures that penalize those that funnel resources into useless and destructive activities have to be enacted in the post-Global Crisis period. Those who engage in speculation need to be liable for their mistakes. In the meantime, governments must institute caps on irresponsible and callous actions that seem insensitive to the Global Crisis. Reforms that encourage and reward productive activities, initiative, and good business need to be enacted, too. At the same time, reforms like redistribution and income and wealth taxation have to be revisited.

Lastly, research and development needs to be stressed in order for societies to devise context-specific measures, strengthen regulatory institutions, and improve bureaucracies. It is also necessary in finding alternative routes to economic progress so that rapid economic growth will not compromise environmental sustainability and the global economy. In areas where agriculture plays a key role in terms of employment and income, there needs to be greater attention to, say, enhancing agricultural and technical services to improve farming and harvesting techniques, as well as explore viable off-farm livelihood programs, especially during the growing season. Obviously, free public education and health services and employment must be guaranteed to anyone who wishes to attend school, needs medical care, and wants work. Skills improvement and training, together with technological research and advancement, are key components of an invigorated capitalist system. Their availability — both the quantities and qualities — will bring about sustained growth. They are all needed in the post-Global Crisis period in order to recoup quickly the lost opportunities.

Managing International Flows of Capital and Trade

The challenges learned from the Asian Crisis with regard to capital and trade flows are even more relevant to the Global Crisis. Deregulation and financial liberalization without the corresponding regulatory reforms to strengthen institutions and respond to the new conditions, together, were the preconditions for the Asian Crisis. In the end, with the virulence of the crisis, massive capital flowed out from the region while trade contracted, eliminating the source of funds for debt financing, and pushed economies to very difficult and painful experience.

By 2000, capital had started to flow back to developing economies. More funds returned to Asia. However, globally, these flows remained predominantly within the advanced economies. A fraction of global flows actually went to the developing economies, albeit to a dozen of high-performing developing economies. The other areas, like Sub-Saharan Africa, received very little capital flows and did not have access to capital to support economic growth.

With the crises in the late 1990s and earlier 2000s, capital was reluctant to flow to the developing economies without guarantees or privileges, like tax breaks or safe passage if it wanted to take the exit. Meanwhile, unrecorded flows intensified as capital flowed in because there were few regulations in place. Any adverse development amplified the rush to the exit. At the same time, capital could circumvent the remaining regulations because the infrastructure was weak for the administration of the remaining regulations.

Moreover, capital flows became more short term in character. The composition of flows also turned out to be increasingly liabilities rather than assets and green-field investments. The consequence was that capital did not take root in the domestic economy, nor did it contribute to enhancing productive economic activities. In short, capital was only after profits then quickly left to search for other profitable opportunities.

As Asia started to stabilize, efforts toward further deregulation and financial liberalization were revived. The view changed from deregulation and financial liberalization as preconditions for the Asian Crisis to being indispensable measures in the post-crisis to pull the region to higher growth trajectories. Indeed, the latter view was the argument in the early 1990s as Asia had enjoyed uninterrupted expansion since the 1980s. With governments instituting financial measures and other reforms like capital adequacy and accounting standards, confidence was raised that even if deregulation and financial liberalization were pursued the old way, the safeguards introduced were already sufficient to forestall another crisis. Of course, governments were cautious with embracing capital flows but more amenable to the removal of regulations.

Even today, capital flow management remains weak. In regard to the capacity to control capital flows, such as directing capital into the productive sectors, affecting the composition of the flows from short-term to long-term capital, or preserving capital in the economy, developing economies in general remain weak. Malaysia removed its capital controls in 1999 and, thus far, there is no comparable capital management setup in place there. Not surprisingly, when capital controls were removed in 1999, Malaysia experienced a massive outflow of capital. As the world gathered economic momentum in the early 2000s, capital management techniques became more difficult to introduce in developing economies; capital became stronger and launched a capital strike against an economy that contemplates regulating capital flows, causing problems to the economy.

There also remain problems in trade flows management. Global trade continues to be predominantly within advanced economies. The developing economies, on the other hand, take part in a small portion of global trade, albeit high-performing economies like those in Asia are able to participate more than others economies. Trade access and facilitation and coordination continue to be difficult challenges to overcome despite solid convictions of the advanced and developing economies that greater trade is good for economic performance and the international community.

An associated problem concerns the composition of trade flows from the advanced and developing economies. What remains consistent is that developing economies trade mainly in primary or low- to medium-technology goods, which are easily absorbed by the advanced economies. There have been improvements, but these are seen only in the high-performing developing economies. In general, though, developing economies cannot easily absorb the flows in high-value manufactures or high-technology goods, which differentiates the trade in the advanced economies. The latter's goods are more expensive relative to those of the developing economies, which therefore creates an imbalance in trade financing.

The asymmetry of global trade flows happens partly because investments into the developing economies do not often allow transfer of technology or even permit adaptation to help ignite the drive for the formation of domestic industries. Trade flows management has focused on the protection of intellectual property rights and the standardization of production that little attention is given to how to utilize existing technologies to create industrial diversity across economies. Developing economies are thus forced to specialize in diminishing returns intensive production that fails to not only bring in large returns because the prices of their goods decline with greater production but also generate large employment opportunities for workers. Participation in global trade turns out to be limited and potential for economic growth is constrained.

Trade management techniques that result in solid industrialization and trade deepening are important in transforming the developing economies. Each economy needs the policy space to be able to design industrial policies that account for local characteristics and conditions. The setup may include industrial protection coupled with the appropriate incentives for competition and the weaning of industries from protection as industrialization takes root. For instance, protection may be linked to utilizing local resources and labor or attaining bigger shares of the global markets, and so forth. Since industrial deepening is a long-term endeavor, adequate domestic capacity is crucial to succeed in this complex engagement. As with the capital management techniques, trade management techniques require the integrity of policy space to have the control to set a course of development that is appropriate to the economy.

There are reemerging challenges that the Global Crisis brought to the surface. The first concerns the reversal of capital flows as the Global Crisis intensified. Because economic contraction continues and the turning point of the advanced economies is not yet in sight, capital flees the developing economies to seek safety in the advanced economies. Meanwhile, developing economies face more difficulties in getting financing to meet present obligations because capital flows have significantly slowed down, if not stopped, the cost of financing has markedly increased, or investments are already withdrawing from the rest of the world and are consolidating in the advanced economies. Rating agencies also downgrade the investment appraisal of developing economies. These changes actually began in 2007 but have worsened since 2008.

With the intensifying capital outflows, developing economies are facing grave difficulties in sustaining their economic performance because of trade flows contraction. With the Global Crisis escalating in 2009, there is lower demand from advanced economies for goods from the developing economies, which complicates foreign exchange constraints that deepen the external debt financing problem and the ability to obtain inputs of production. As above, there is negative feedback that ultimately reduces economic growth. There are added complications, like the currencies and stock markets get battered and then international reserves are depleted. The negative feedback from this side of the economy accelerates the fall in growth.

Naturally, reduced capital flows, coupled with the hesitation to extend credit to the developing economies, add risk. With remittance flows decreasing because jobs and wages fall during crises, developing economies have fewer options in terms of accessing credit or rolling over existing debts. The most serious risk that the Global Crisis places on the developing economies is debt defaults which, if they materialize, will transform the Global Crisis into a depression. Therefore, capital and trade management techniques are actually more pressing today than in the late 1990s.

The above issues concerning capital and trade flows management deal with the macroeconomic dimensions. But the Global Crisis has brought forward the microeconomic dimensions concerning capital and trade flows. On the former aspect, there is a need to reemphasize the microeconomic aspects of regulating the domestic financial system that encompasses banking, securities, insurance, and other institutions to manage risk and direct resources to productive economic activities. As explained in the first part of the postscript, deregulation and financial liberalization facilitated the removal of the setup that compartmentalized the financial system to avoid speculative and unhealthy activities. Re-regulation of capital flows is now needed to put the economy back in shape, with capital supporting domestic productive activities onto smooth economic expansion, thereby contributing to the improvement of public welfare rather than the other way around.

Obviously, capital and trade flows management in developing economies needs to address both resource direction and supervision of risk to avoid crises. In advanced economies, on the other hand, the task is more on regulation to take control of risk rather than direct resources, since their financial markets are more developed than elsewhere. What needs to be stressed is that capital and trade flows management entails separate but complementary policies. In this regard, governments have even more important roles to play today in balancing strategies with respect to both domestic objectives and international cooperation because, if mismanaged, either one can be deleterious to economic growth.

Role of Government

In fact, one of the encouraging developments because of the Global Crisis is a marked shift from market fundamentalism that had characterized economic management since the 1970s toward more active government participation. Governments need to be steadfast in their task to protect their societies. They are once again reminded that they can actually lessen the frequency and severity of crises if they fortify their economies with solid institutions, inoculate themselves with reasonable regulations and vigorous supervision, and, at the same time, institute changes to respond to changing conditions. There is no doubt that markets can be efficient if they are efficiently regulated as well. And there is also no question that more competition is possible with more rules (c.f., Helleiner 1994, Vogel 1996, and Yeung 1998).

Of course, governments need to build capacity so that they are able to fairly govern and quickly move to deal with threats to economic growth and institutional integrity at the initial stages rather than after a crisis erupts. That is, they need to assume a precautionary rather than reactionary stance in economic management. Governments also need to enhance their bureaucracies in order to have a base on which to launch a strategic course for stable economic performance. They likewise need to be able to achieve a balance of competing demands coming from beneficiaries and learn when to withdraw support because it is no longer needed, unleash competition at the right time and amount, or return intervention when needed. While the role of government is contingent on the prevailing trends that are likewise changing, governments cannot, under any circumstance, forego their regulatory responsibilities over their economies. Needless to say, regulatory capture and corruption emasculate governments from doing their job.

Principled leadership is of the essence during crises. What the Global Crisis revealed is that corporate interests have captured the government and transformed the economy to fit their interests. For instance, as the Global Crisis evolved, the United States did not throw its weight to discipline capital. In fact, as pointed out in the first section of this postscript, the United States government progressively removed regulations to respond to the demands of capital. It was a long process of transformation, but eventually, government was dominated by capital when elites entered government to run it. In the end, public interest was tossed out and capital defined change as it pleased. Capital was therefore not deployed to support the economy; rather, the economy was made to serve capital. The US government, for example, embarked on massive bailout and rescue operations to save the bankers (not the banking system) because they were unable to reign on capital.

With the Global Crisis, governments resolved to salvage their position, strengthen their capacity, and embed once again in the economy, so that they would regain their positions as key agents of transformation. It is worth noting that, in the history of the advanced economies, their governments creatively intervened in the economy to promote and manage advancement. The interventions came in different forms like industrial policies, regulations, preferential treatment of the domestic sector while pushing it to engage the external sector, capital flow management to maintain economic stability, and other similar actions. With governments of advanced economies repositioning to undertake these roles once again, these roles need to be allowed to governments of developing economies as well so that real transformations will be realized there as well.

It is worthwhile to point out the argument made for the Asian Crisis and reapply it to the Global Crisis: the way reforms were executed in the past created opportunities that ultimately undermined the economy, made it vulnerable to crises, and thus damaged the purpose of having governments manage the economy. As such, if governments let go of regulation and remove regulatory structures, they lose control over their economies, resulting in diminished sovereignty. What is needed is a government that works and is intelligent enough to be able to navigate successfully through the challenges today and still produce results. The Global Crisis is yet another reminder that focus and success are consequential, for they mark the future path of governments and, by extension, of their economies as well.

The last item concerns the need for governments to be involved in international cooperation but not compromise their sovereignty. More is discussed below about the first part, but at the national level, the challenge is how to achieve democratic control and maintain identity, given the reality of economic integration and globalization. In other words, the reasons for regulation within national borders are clear, but the imperative for international regulation is apparent with the present realities. Governments need to bring to bear efforts to enhance their capacities and bureaucracies for domestic management as well as to engage effectively in international cooperation. It is the whole package that guarantees efficient market operations and the attainment of robust economic performance.

International Cooperation

The construction of an environment that can engender global economic expansion of all economies while enhancing economic welfare within individual economies remains a very important objective of international cooperation. This end was emphasized in the late 1990s, as the Asian Crisis caused havoc in the region and threatened the advanced economies. There was a consensus that undertaking structural reforms in the international economic architecture was needed to stop the recurrence of crises, a position that was aggressively pushed by the advanced economies, particularly the United States.

The existing setup was dominated by the Group of Seven as the global steering committee for economic cooperation. The conclusion was that the structure forged in the 1940s was no longer adequate for the twenty-first century. It could no longer avoid the recurrence of crises, and much less stop a crisis in one area from spilling over to other. It sustained unequal economic relations, and so it facilitated the creation of economic imbalances that were not easy to solve. With deregulation and financial liberalization proceeding to open economies, capital and trade carried on without a meaningful management of cross-border flows and the consideration of their impacts. There were policy responses within individual economies as each grappled with the flows, especially when they became volatile and massive to adversely impact economic growth; but at the international level, no one actually cared if capital or trade flows from one area had adverse effects elsewhere.

Since the Asian Crisis, various schemes have been established, like the Chiang Mai Initiative for some bilateral currency swap arrangements to respond to short-term requirements if economies in the region face difficulties with liquidity (i.e., to avoid reliving the experience of the late 1990s); and the Basel II, which deals with the international standards for banking regulation, such as capitalization requirements. However, nothing significant has happened since the issue of international economic architecture reform was raised in 1999. Instead, there appears to be a desertion from the conviction to change what was already considered an obsolete setup. Once the Asian Crisis — and the subsequent crises, like Brazil and Russia in 1998, Turkey in 2000–2001, and Argentina in 2001–2002 — was contained, the issue of reform was moved into the backstage and, in the end, evaporated from the discussions. Talks about the international architecture became passé, even misplaced with the supposed recoveries.

Rather than grapple with the difficult task of how to execute reforms in the international economic architecture, the debate was refocused on the reasons for the quick turnaround of the economies affected by the Asian Crisis. These economies were considered to have already recovered because they were deemed robust. The difficulty in the late 1990s was merely an anomaly to their overall growth trajectories. Further debates on what to do in the post-crisis period needed to focus only on how to sustain the progress of the Asian crisis-affected economies, as if the crisis did not alter growth trajectories. Of course, the advanced economies rode with the trend because they were not willing to give up the existing setup. There was no need to continue with the proposal as the Asian Crisis no longer threatened the advanced economies.

The reawakening today of discussions to change the international economic architecture suggests that previous efforts were not an intention to change the setup but were merely token responses to the clamor for reform. But notice, too, there is again downplaying in the present discussions with the rhetoric that crisis-affected economies are already showing signs of imminent turnaround and economic recovery is therefore forthcoming. Let the setup be and it will reconstitute itself in due course. What is apparent in the debates is that, as before, attention is being moved to a stance on how to muddle-through with the present setup with the least reforms in the international architecture.

The silver lining, so to speak, with the Global Crisis is that the economic performance of the advanced crisis-affected economies is expected to exhibit an L-shape growth pattern similar to that of the Asian crisis-affected economies. Such is the case today because the Global Crisis destroyed a lot of capital. In other words, the amount of capital would no longer be intact when the bottom of the Global Crisis is reached. As explained earlier, this disappearance of capital is attributed to vacuous investments (i.e., not backed up by real values), and the write-offs and write-downs that led to a downward spiral of valuation, making it difficult for capital to rekindle an economic expansion. With the slump and the phobia toward unleashing capital, global economic performance would be moribund for some time. Ironically, and sadly enough, the situation would be a valuable opportunity to push once more the long-postponed reforms in the international economic architecture because, with the Global Crisis, the advanced economies would want changes in the setup as this time they got seriously hurt.

Accordingly, the recent development that supplants the Group of Seven with the Group of Twenty (G20) as the alternative global steering committee for economic cooperation is an encouraging step because the latter provides a valuable opening for greater participation of developing economies in the international economic architecture reforms. Regardless of the issues about membership, legitimacy, representation, and so forth, that the G20 has to address, the main problem that the globe faces today is how to reignite economic growth. As suggested above, changes have to be made in the international architecture once the crisis-affected economies stabilize and growth is revived. That is why, in the interim, stimulus spending is of high priority in the G20, including forging international cooperation in global spending in order to distribute effective demand across all economies. Desperate moves, like wayward currency devaluations and similar actions, need to be avoided by cooperating economies because they not only undermine collective action but also generate protectionist responses from the affected economies, ultimately destabilizing global spending and prolonging global economic recovery. This is also why the success of the G20 is crucial to the realization of international architecture reform in the medium term. For these reasons, the G20 needs to define the short- to long-term goals and convey to the world how the outcome of reforms and interventions will look like and, ultimately, what will be the benefits to each economy.

The G20 needs to take decisive steps and not to justify inadequate actions with explanations that global economic performance was reinvigorated because the Global Crisis was contained. It has to focus on four emerging broad themes in order to solve the Global Crisis and carry out reforms to transform the international economic architecture into something that will finally make the global economy a better environment for all.

The first item that the G20 needs to be concerned about is the institution of changes in the conditions that make crises recurring problems. It basically means that changes in the international economic architecture have to provide a framework for policies adopted by individual economies. The global imbalances, which partly underpinned the Global Crisis, are now straightforward to be unhealthy states for long-term economic growth, and need to be avoided in the future. For this change to materialize, appropriate regulations at the macro (i.e., capital and trade flows management) and micro levels (i.e., prudential regulatory controls and supervision of the domestic financial system) must be pursued.

With economic integration and globalization, the task is more difficult because economies need to forge cooperation by making each one commit to cooperation over the long term. Added to this, the regulations need to operate within the domain of capital and trade at various levels. That is, if the concern is about cross-border flows, then the domain of regulation needs to be supranational; or if the concern is securitization, the domain is more domestic management of capital. Obviously, the core of the problem is that economies do not want to give up on their sovereignty. Again, as long as the "rules of the game" are made clear and enforcement is fair and transparent, global cooperation will benefit all economies in terms of stable economic growth and collective improvements in economic welfare. In the end, economies need to experience the gains of cooperation so that each one commits rather than opts out.

The second item for the G20 covers two things. One is crisis management. Clearly, no capitalist economy is immune from crises. Thus, if a crisis happens, there must be sufficient international liquidity to extinguish the problem at the quickest time and in the least costly way. Decisive action is necessary; otherwise, the costs would mount and, as shown in the Asian Crisis, economic recovery would be extended. The IMF needs to be strengthened with additional financial stock that is ready for deployment. Of course, there might be objections to the IMF taking a bigger role in crisis management, but it is the only international institution designed for that purpose. As the G20 proceeds to define the changes in the international economic architecture, it has to look into the role of the IMF, the World Bank, and the Bank for International Settlements (BIS), and see how they could be put together in an overarching organization that constitutes a supranational regulatory agency (see below). In the meantime, modifications have to be made in the way IMF approaches crisis management because, in the past (and specifically during the Asian Crisis), it became part of rather than the solution to a crisis.

The other item in the second theme is the possibility of having debt standstill and orderly debt workouts, especially for developing economies. All past major crises, including the Global Crisis, were about indebtedness. Developed economies do not have problems with debt rollovers because they hold reserve currencies and could embark on debt workouts. Developing economies, on the other hand, do not enjoy such command over creditors. If they go on unwelcome debt standstill, for instance, they face the risk of capital sudden stop and flight, which worsens their problem. What might have been a manageable fiscal difficulty could turn into a major liquidity problem and then a crisis. Debts of developing economies need to be reviewed, too, because corruption or dodgy activities could have funneled the borrowed funds into private pockets, in which case debt standstill or workouts might be constructive to finance the developmental targets like the Millennium Development Goals. Or, at least, the G20 must define a mechanism that alleviates the burden of debt financing during crises.

Third, the G20 needs to deal with issues about development financing. Access to finance remains a major challenge to developing economies despite international agreements supporting development financing. The circumstance is especially serious with regard to the poor economies. Because they are poor, they are considered risky areas from the point of view of capital, do not get access to capital, and, in turn, realize only limited economic growth, which further restricts their access to capital, thereby aggravating economic performance. Because they are poor, their industrial capacity is limited and does not allow for diversified exports. The problem can be addressed if the international economic architecture is changed in a way that it is not only open but extends considerable support that will pull out the poor economies from their difficulties. During crises, when the sources of capital dry up and trade shrinks, the international architecture needs to guarantee financing to developing economies so that they will not be derailed with economic shocks. Access to capital is also crucial in the post-crisis period to facilitate recouping of costs.

Finally, the G20 needs to work toward a global social contract between advanced and developing economies. For the advanced economies, there has to be stronger commitment and action that support the aspirations of developing economies for real progress and transformation. Moreover, advanced economies need to be steadfast in efforts to shape a global environment that is conducive to global economic growth and able to pull everyone up the economic ladder. Global imbalances therefore need to be avoided. If adjustments are necessary in the advanced economies, they must be done in such a way that they will benefit both advanced and developing economies. If relief from indebtedness is needed, developed economies must be ready to cancel debts especially if it could not be demonstrated that the funds were used as intended or were misused or cornered by a privileged few or diverted into private accounts or money havens. Accordingly, prudence calls for the advanced economies to initiate appropriate action to correct such unacceptable situation and, if established, the burden needs to be imposed on those involved in the offense.

For developing economies, they must work hard to develop their own economies. Sound policies are important; as such, expanding and enhancing their policy space will be crucial to success. At the same time, developing economies need to be confident that, as they pursue reforms, they will not be exposed to volatile and massive flows of capital or unfavorable trade flows from advanced economies. At the same time, they need to have access to financing during the transformation process to sustain economic progress but, at the same time, avoid the accumulation of illegitimate or odious debts. Those that take part in such activities are accountable for the unfavorable outcomes and must not impose the burden on their societies nor have the legitimacy to seek redress for their problems. Indeed, prudence requires that appropriate actions be first taken in the economy to correct an unacceptable situation. Obviously, as development takes shape, developing economies need to face up to tougher competition and thus engage the developed economies in a less privileged playing field. Accordingly, developing economies need to be ready for this inevitability.

Finally, international cooperation has to move to the next stage of international control and commitment to global economic management with the creation of a supranational agency like a World Financial Organization (WFO) — a necessary response to bring that which is outside the system into something that is part of the system (c.f., Eatwell and Taylor 2002, and Griffith-Jones and Ocampo 2003).[6] The WFO will be a body with surveillance powers over banking supervision and settlements-related issues akin to the BIS, securities matters like the International Organization of Securities Commission, insurance activities as in the International Association of Insurance Supervisors, and stabilization, payments, and related transactions similar to the IMF.[7]

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[6] The classic argument for a supranational agency to control capital flows is in Keynes (1980). Recent discussions on the Keynes Plan include Iwamoto (1997), Harcourt and Turnell (2003), and Constabile (2007).

[7] There needs to be parallel supranational organizations for other cross-border flows like trade and labor and transboundary issues such as climate change and environmental sustainability. For trade, there is already the World Trade Organization, but it needs major adjustments in its operations to function as a supranational regulatory agency for trade flows management. In the case of labor, there is no supranational agency as yet. The International Labor Organization could evolve into a World Labor Organization to focus on trade flows, among others. Similarly, there is no supranational organization for climate change and

The World Bank, with strengthened linkup with regional development banks, could be brought into the WFO setup to focus on global developmental goals. Furthermore, there is a need for a financial audit agency to meet evaluation and assessment requirements, a financial products safety agency to look into the substance of capital flows, and an international credit regulatory agency to cover ratings practices, and so forth, to complete the supervisory functions of the WFO. The G20 may have to look into bringing together existing institutions into one structure with a single framework for the international economic architecture but with each branch focusing on specific operations and services that are relevant to accomplishing global economic objectives. Comprehensiveness is thus essential in setting up a WFO.

As a supranational organization, the WFO needs to pursue at least the following two important tasks. One is to build shared management of cross-border risks. The purpose is straightforward: policy mismanagement in one location may spill over to another place as a crisis, which in the process may evolve into a bigger problem that affects a bigger area. Because of economic integration and globalization, the transmission of risks is faster and more profound. To have effective risk management, the WFO may impose binding regulations covering facets of on-shore and off-shore as well as on-balance and off-balance sheets transactions. Consultations with member economies on how to proceed with regulations are crucial. At the same time, the WFO needs to provide guidelines for the management of currencies and interest and inflation rates, which are relevant to capital flows. Additionally, the WFO has to function as the global lender of last resort and be able to mediate problems in regard to debt standstill and workouts. A sizeable capital base is thus needed for the WFO to embark on emergency operations and provide guarantees to creditors as debt problems are being managed.

For such activities to succeed, however, the WFO needs to provide the overall direction for member economies, say, what the desirable global economic expansion and advance look like. Such a vision will bring everyone in solidarity with global targets. At the operations level, though, it is crucial that the WFO has solid technical capacity to

environmental sustainability. A supranational body may be called World Environmental Organization. These are necessities to meet the challenges of economic integration and globalization. Certainly, a lot needs to be done in terms of research and dialogue to come up with functioning supranational organizations.

embark on sound global regulation and supervision, given that capital will necessarily find a means to stay ahead or avoid controls. It is important that the WFO possesses institutional integrity so that its interventions will be effective. It is also important that the WFO works promptly to not only respond to challenges like global imbalances and crises but remain fully engaged with other global players like large transnational companies.

The second task of the WFO is to engender collective action in the management of domestic risks, which may arise from various sources like information asymmetries, market imperfections, and elite capture of regulations. At this level, however, the WFO needs to assume the indispensable supporting role to its member economies because domestic regulation still remains the responsibility of governments. Accordingly, technical assistance to governments in all aspects of domestic regulation is crucial not only for capacity building but also for parallel international regulation over capital flows. In short, there needs to be a relatively tight correspondence between domestic and international capital flows management. Of course, the big hurdle is with the developing economies that are at various levels of development, both in terms of the state of their economies in general and the financial systems in particular. What is important, though, is that all economies contribute toward global regulation and supervision and are willing to allow intervention in solidarity with the global goal of mutual economic growth and enlargement of economic welfare. Needless to say, the implementation of domestic regulations remains within each economy.

The formula for success is the WFO's building a track record in the effective management of capital flows, a rather difficult item to fulfill, since there is no comparable organization existing to date, with the possible exception of the IMF and BIS. Of course, the IMF and the World Bank have been attacked for disastrous interventions. The BIS, on the other hand, does not enjoy an extensive clout, unlike the IMF or the World Bank. If the G20 proceeds with creating the WFO, it is highly important that the WFO is embedded in the global economy at the outset, that is, unaffected by the demands of capital or captured by the interests of a small group of economies. It is necessary that the WFO is able to demonstrate, at the beginning, that it can ingenuously navigate the competing demands, maintain legitimacy, and take fair and transparent actions to safeguard global economic balance. There will be no debilitating concerns about the effectiveness of interventions during volatile conditions or in the post-Global Crisis period if the WFO can demonstrate success during normal conditions. If the G20 instead pursues small scale versions to the WFO, like a regional organization approach, the expectations will be the same. Certainly, with multiple regional organizations, there will be challenges with regard to coordinating regional actions. In any case, global- or regional-cum-domestic coordination of policies can lead to sound global economic growth and tangible improvements of global and domestic economic welfare that are long overdue. As long as economies come to an agreement on the basic principles of cooperation, their articulation into codes and procedures, including their interpretation and application, and the modes of participation at the global or regional level — again, the "rules of the game", the WFO may be a major step toward the construction of a global economy that succeeds in balancing increases in incomes, wages, profits, and economic welfare and a healthy environment for all.

4. Conclusion

Whether or not crisis-affected economies will recoup their losses is an important issue that needs to be grappled with if it is to demonstrate that the current international economic architecture can cope with the problems that come with, say, regional integration and increased economic globalization. At the same time, how well the economies recover is a benchmark for assessing the overall health of the system to promote and support economic expansion.

It is important to stress that unless policies in the crisis-affected economies move in a positive direction — that is, reviving strategies that have proven effective to get robust economic expansion going, and then employing new ones to meet current challenges — future economic progress will likely be limited and punctuated by crises. Full economic recovery from past crisis will be difficult, and the adverse consequences from it will linger. Complacency with a seemingly stable economic environment will be misplaced as long as massive and volatile capital and trade flows continue to characterize the international financial system, and most economies remain ill equipped to deal with the challenges produced by these flows. So if the international financial system is the culprit in creating and propagating crises in the international economy, it is reasonable to demand changes not only in the nature of policies but also in the fundamental structure of the system if only to address the threats and thereby obtain stability and sustain economic expansion.

Decisive actions are needed from governments so that they can accomplish their economic and political goals. Together with dynamic performance and sound government interventions to produce the needed structural transformation, the complementary actions for international cooperation and policy coordination for capital and trade flows management are equally important. Other concerns like environmental sustainability, including climate change, must not be forgotten. The effectiveness of policies will largely depend on political willingness and the courage to proceed with rather unpopular measures, especially in the eyes of the private sector, as well as the skillfulness of government in forging cooperative arrangements that draw out timely actions directed toward obtaining desirable outcomes that will benefit everyone in the end

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