

# THE ROLE OF INTERNATIONAL COORDINATION TO SUSTAIN GLOBAL RECOVERY

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## Özet

Bu çalışma ekonomik krizin yarattığı sorunları aşmak için küresel koordinasyonun temel bir öneme sahip olduğunu göstermeyi amaçlamaktadır. Ekonomik krizlerin tarihi büyümeyi başlatabilmek için uluslararası koordinasyonun gerekliliğini açık bir şekilde ortaya koymaktadır. Bu çalışmada öncelikle 1929 büyük buhranından dersler çıkarılmaktadır. Daha sonra 2008 krizinin başlangıcının Çin'in 2001 yılında dünya ticaret örgütüne dahil olmasına kadar gittiği öne sürülmektedir. Dünya ticaretindeki büyük artış, düşük enflasyon, gevşek para politikası, tasarruf bolluğu, cari açıklar ve fazlalar, varlık fiyatlarındaki balonlar krizin arkasındaki temel faktörler olarak görülmektedir.

Kısaca yaşanan krizin global olduğu, çözümün de global olması gerektiği tartışılmaktadır. Koordinasyon ülkeler arasında dengeli bir işbirliğine dayanmalıdır. Bu çerçevede yapılabilecekler detaylı bir şekilde çalışmanın son bölümünde tartışılmaktadır.

## Abstract

This study aims to show why global coordination is essential to cope with the problems of crises. History of economic crises clearly shows us the importance of international coordination to rebalance and to initiate the recovery of economies. Having discussed the lessons of the 1929 great depression, this study argues that the beginning of the current economic crises goes back to the participation of China to WTO in 2001. Huge increase in world trade volume, low inflation, and loose monetary policy, glut of savings, current account deficits, surpluses and rising bubbles in asset prices are thought to be the basic factors behind the current crisis.

Thus it is argued that the source of the crisis is global and the solution must be global. The coordination should be based on delicate rebalancing acts across countries. What is to be done as a part of coordination efforts and rebalancing acts are discussed in detail in the final section of the study.

**Key Words:** Economic Crisis, International Cooperation, Economic Policies

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## **1) Introduction**

History of economic crises clearly shows us the importance of international coordination to rebalance and to initiate the recovery of economies. The major example is the 1929 Great Depression. History of pre-crisis, crisis and post crisis period of the great depression clearly shows us why international coordination is essential to cope with the problems if the contractionary cycle is global by its nature.

Current economic crisis has similarities with the great depression. Some lessons can be drawn from that depression to direct the global economy to growth path rather than to another historical depression. Indeed, some lessons seem to be drawn so far increasing the probability of sustained recovery in the world economy. In the first section of this study, there will be a short analysis of the 1929 crisis and lessons to be drawn from that crisis to the current 2010 crisis. In the second section, sources and some features of the current economic crisis will be discussed. In this section, the focus will be on the incorporation of China to world economic system and its dramatic effects in the world economy after 2001. Why those features of the world economy necessitate international coordination to cope with the current economic crisis is discussed in the following section. Indeed, section three aims to link the previous two sections. What is to be done as a part of coordination efforts and rebalancing acts are discussed in detail in this section of the study. In the conclusion part, there will be an overall assessment of the study.

## **2. Lack of international coordination during the 1929 great depression**

At the end of the first world war, gold standard as a means of international monetary system has terminated. Money supply has substantially increased in many western countries compared to gold standard period. As a result, most of those nations have entered a hyperinflation period. Instability has increased. High inflation came up with high interest rates and contracting output. By mid 1920s, England turned back to gold standard by fixing pound to gold at an overvalued rate. The desire to be the leading country was probably be the main reason for the preference of strong pound. However, strong currency has caused deterioration at the current account balance of England adversely affecting the growth potential. Great

mining strikes were also undermining the growth potential of the country during the same period. (Temin,1991,1-39)

Meanwhile, other western countries like France and Germany were turning back to gold standard but mostly at an undervalued rate. The natural outcome of this structure has been the current account surpluses for those countries whereas the deficit of the England was rising. This unsustainable structure led England to ask other countries having surpluses to reevaluate their currencies. That has been rejected. After a while, England asked USA to lower interest rates to attract some capital to finance its deficits. Considering the importance of English economy, USA started to lower interest rates. That was one of the main reasons behind the rising bubbles at the stock exchange market of USA. At last, the bubble burst in October 1929 and the economy has started to move a deep contraction. It is transmitted to many countries through by financial and goods markets. (Kindleberger,1973)

The brief story that has been summarized so far is one of the main sources of the great depression. This pre-crisis period gives us the first lesson for the current crisis. Instability at international monetary system and lack of coordination across countries would create more imbalances leading to unavoidable crises. A very similar story that has been experienced just before the current 2008 crisis. Despite the rising imbalances across countries in terms of current account deficits and surpluses, no delicate rebalancing act was taken.

Once the contraction has started, initial reaction in many countries was protectionism. The real collapse of the stock exchange markets realized just after the imposition of customs called Smooth – Hawley in June 1930. With Smooth-Hawley act, customs of more than 20.000 goods has substantially increased. The rate of fall at Dow-Jones stock exchange index was 26 percent between October 1929 – June 1930. It has been 83 percent between June 1930-July 1932. The real shock in financial markets and depression has started after the Smooth-Hawley act. (Yardeni, 2009-a). Retaliation by other nations has increased trade wars across countries and significantly reduced the trade volume by early 1930s. Depression intensified in all over the world. This is the lesson two from the great depression. Protectionism would be a temporary solution for individual countries. It causes long lasting problems for the global economy.

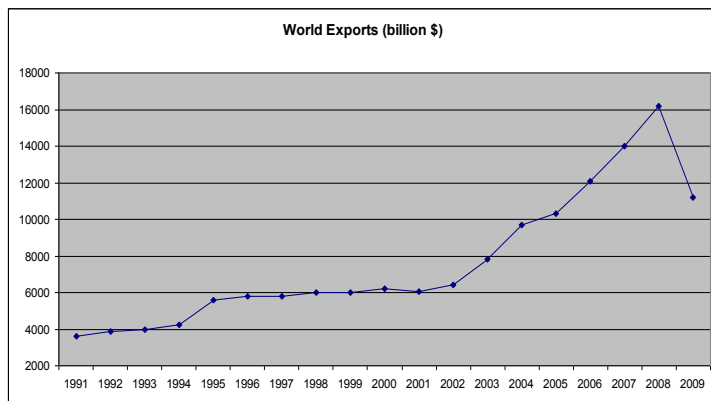
USA economy has subsequently contracted 46 months during the great depression. Unemployment rate has increased to 25 percent and output has contracted more than 30

percent in real terms (Kindleberger,1973). The picture was not so different for many countries. However, economies have started to move a modest recovery period after 1933. It was really modest. Economic growth has started but unemployment rate remained at historical high levels for long period of time. The picture has triggered political and geo-political risks leading to second world war. For example, unemployment rate in USA in 1939 was just below 20 percent. The world economy has started to move a sustained growth path just after the establishment of new international monetary system with its institutions like IMF and World Bank at Breton Woods (Yardeni, 2009-b). This is the lesson three from the great depression. There should be a well defined international monetary system (Bernanke, 1983, 259-261). Up until the end of the first world war, gold standard was the essential monetary system. Once the system has reached its limits at the end of the first world war, a new system needed to replace the gold standard. But there was not. Global problems can not be solved locally. Unfortunately. It took years for the world economy to reach that point.

Hence, it is obvious that pre-crisis –crises and post-crisis periods of great depression is full of examples that why global coordination is essential both to prevent huge crises and to channel the economies to sustained growth path if the crises once appears.

### **3) Sources of the 2008 Crisis**

The world economy has entered a new phase just after the membership of China to World Trade Organization (WTO). This country has got the opportunity to sell its products at a competitive rate to all over the world. World trade volume has substantially increased since then. Annual volume of world exports was around 4 trillion USD by early 1990s. It has reached to 6 trillion USD by 2000s. Then it has dramatically increased and reached to 16 trillion USD by early 2008. (WTO)



Source:WTO

If exports rise, imports must rise too in the world economy. If some countries give higher and higher trade surpluses, others must give more and more trade deficits. This is exactly what happened in the world economy through by 2000s. On the one hand, there were countries like China, India and other Asian countries that have had high output, more savings, less consumption and rising trade surpluses. Increasing world trade and output stimulated the demand for energy. Major exporters of energy like Russia and Middle East countries have also benefited from this structure and gave high trade surpluses. On the other hand, there were western countries having low output, low savings, and high consumption and hence rising trade deficits. USA, UK and Spain are the major examples of this group of countries. Middle and eastern European countries have followed that group. (Blanchard and Ferretti, 2009;4-5))

Within this framework, while China was the main exporter, USA was the main importer. Current account deficit of the USA has reached about 1 trillion USD just before the 2008 crisis. USA has mostly financed this deficit by printing money. That was the basic source of the liquidity in the world economy reflected in the FX reserves of main exporters. Accordingly, China as one of the biggest exporter has accumulated FX reserves mostly in USD. China has used those reserves to buy USA Treasury bonds and bills to finance the deficits of this country. USA economy did not face with a financing problem for its budget and current account deficits. That has allowed the USA economy to enjoy both from high consumption and high growth rates despite the persistence of fundamental problems in the economy.

Another source of the liquidity in the world economy was the expansionary monetary policy of Bank of Japan (BOJ) due to deflationary conditions in the economy. Despite the risks of liquidity trap. BOJ has kept policy interest rates around zero percent and provided high

liquidity into the markets pushing down the cost of credits to minimum levels. Expectedly, that has stimulated the carry trade from Japan to all over the world, particularly to emerging countries with rising current account deficits.

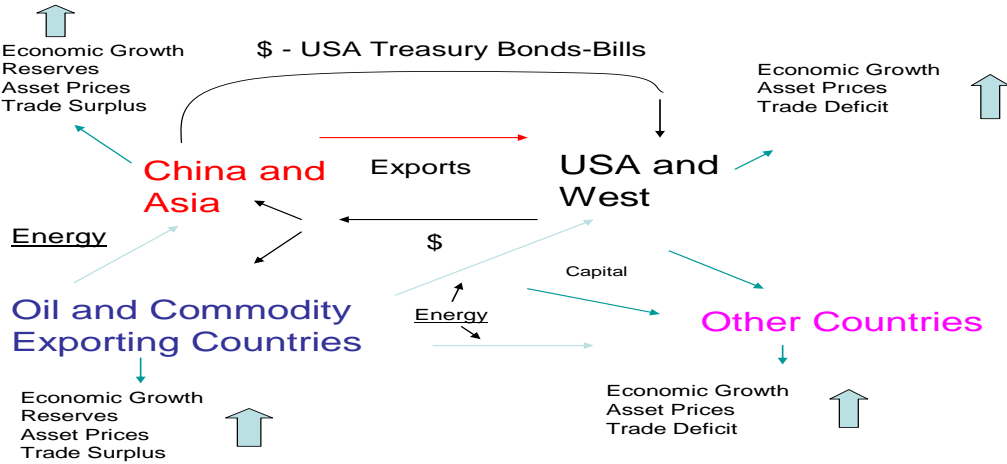
All these developments contributed to the disequilibrium in the world economy. Countries having high trade surpluses accumulated their reserves. As central banks bought foreign currencies, local money supply in terms of domestic currency has substantially increased. Most of the Asian countries, Russia and some Middle East countries were within this group. Under normal conditions, this excess money supply is expected to create demand pull inflation. However, it did not. Chinese goods with very competitive prices brought a downward pressure on inflation in all over the world. Average annual inflation has significantly decreased in the world economy. Headline inflation did not increase. Central Banks could have reached their inflation targets easily without tightening monetary policy. Excess supply of domestic currencies mostly remained in the markets. Loose monetary policy allowed the abundance of liquidity in the markets. Though headline inflation did not increase, this excess money supply increased the demand for assets and pulled the prices of them up and up. The prices of houses, stocks and commodities have substantially increased in all over the world. 'The price of the object of speculation goes up. Securities, land, objects d'art and other property when bought today are worth more tomorrow. This increase and the prospect attract new buyers: the new buyers assure a further increase. Year more are attracted, yet more buy, the increase continues. The speculation building on itself provides its own momentum' (Galbraith, 1993;1-6)). This is what John Kenneth Galbraith calls 'Financial Euphoria' or in today's terminology 'bubbles'.

Globalization came up with the liberalization at goods and financial markets. Membership of China to WTO has intensified this process. Volume of trade and capital flows has dramatically increased. On the one hand, China and other South East Asian countries has increased their exports to USA and in general to western countries. That has allowed China other Asia high economic growth, rising trade surplus and FX reserves and bubbles at asset prices. This high growth rates in China and Asia boosted the demand for energy and raw materials. Countries that export energy and raw materials have benefited from this structure, they enjoyed high growth, reserve accumulation and trade surpluses. However, they could not escape from the asset price bubbles. The other group of countries known as emerging economies mostly in Central and Eastern Europe and Latin America have been affected from

this structure as well. Abundance of liquidity in the world economy allowed those countries to attract significant capital. This capital inflow stimulated growth and asset prices in those countries but their trade deficit has also increased. (Blanchard and Ferretti, 2009;10-12)

Following diagram summarizes the cycle briefly mentioned above. High economic growth and high asset prices have been observed in all over the world in the first half of the 2000s. That was the convergence, the divergence is observed at trade balances. While a group of countries enjoyed rising trade surpluses, others suffered from high trade deficits. That was an unsustainable structure.

**Globalization – Liberalization at Goods and Financial Markets.....Wrong Inflation Target !! – Loose Monetary Policy....**



Hence, the main features of the globalization period can be summarized as follows. There was an abundance of liquidity, high growth rates, rising asset prices and wealth effect stimulating consumption, rising capital flows, easy lending and borrowing by countries and firms. The structure of trade has also changed in this period. Vertical integration replaced the principle of comparative advantage in shaping the exports. As is well known, a country was supposed to specialize in the production of goods it has comparative advantage and export those goods. Globalization has started to change this structure. Various parts of a good have started to be produced by different countries. For example, a car would be assembled in Mexico but its different parts would be produced for example in four countries within this region including USA. Therefore, if demand for cars falls in USA, not only exports and production of Mexico falls, exports and production falls in at least four countries including USA. There is a growing

interdependence in the world economy due to vertical integration (The Economist, March 2009)

Financial liberalization and deregulation came up with extensive use of derivative products like CDOs (Collateral Debt Obligations) and CDS (Credit Debt Swaps) particularly in USA and Western European countries. Those products have been widely used in the provision of mortgage credits. Volume of market transactions and asset prices, particularly house prices have tremendously increased. However, that has paved the way to a major risk. Rising commodity prices finally reflected in headline and core inflation figures by mid 2000s. That made central banks to raise interest rates. Fed has raised its policy interest rates from about 1.5 percent to almost 6 percent. Rising interest rates had two adverse effects on the economy. First of all, high interest rates has increased the delinquencies at mortgage credits. Problems in mortgage credits has increased the concerns on the default risk of mortgage based Collateral Debt Obligations (CDO). Falling demand for CDO's has lowered their prices and damaged asset side of the balance sheets of financial institutions holding such securities and their derivatives. The problem soon turned to a complete banking sector problem. Second, rising interest rates have adversely affected economic growth through by consumption and investment channel. Both the falling growth rates and rising default risks of mortgage based credits negatively affected the provision of credits crowding out private investments and consumption (IMF, 2009).

Thus, the initial symptoms of the 2008 crises have been as follows; falling liquidity, rising volatility, decreasing foreign trade volume, falling credits, contracting economies, rising unemployment, rising credit risks, decreasing wealth, falling capital flows and rising debt rollover problems (IMF, 2009)

#### **4. The problem is global, the solution must be global**

Both the historical experiences like in 1929 and the characteristics of the recent crisis strongly suggest that the solution must be global or coordinated. It seems that there was a failure of coordination for the pre-crisis period of the recent crisis. Though the imbalances in the world economy has accumulated, there was no significant effort to rebalance and to prevent the likely problems in the world economy. Lessons from the pre-crisis period of 1929 seem not to be drawn for the current crisis.



As is discussed in the first section, one of the major lessons to be drawn from 1929 crisis was to prevent the protectionism as much as possible. Though there were some attempts, this time protectionism seems to be prevented to a great extent. The group of biggest 20 countries G-20 which also composes almost 80 percent of world output and trade replaced the G-7 of 1970s. Meetings of this group seems to be productive during the crisis period. Members committed to support free trade. Recent trade figures imply that the volume of world trade started to rise again in the second half of the 2009 after a drastic fall in by late 2008 (IMF, 2010). This should be considered as an achievement though there is no guarantee that the risk of protectionism is over.

Avoiding protectionism is not the only reason for global coordination. There are some other factors. One of them is the default risks of public and private sector in developing countries. In a recent striking book called `This Time is Different, Eight Centuries of Financial Folly`, Rogoff and Reinhart argues that “after a wave of international banking crises, a wave of sovereign defaults and restructurings often follows within a few years” (Rogoff, 2010;1-2). We have started to see the examples from the world economy since the last quarter of 2008 like the case of Dubai and Greece. The list is likely enlarge in the coming months if the history is right. In order to reduce the damage of those developments, international cooperation is necessary to successfully manage some unavoidable defaults and debt restructurings. G-20 countries have decided to raise the funds of International Monetary Fund from 250 billion USD to 1 trillion USD in April 2009 meeting. This fund is supposed to be used to minimize the public and private sector default risk in various regions of the world economy. However, raising the funds of IMF would not be enough to cope with the likely default and restructuring problems in the world economy. International cooperation across countries, regions and institutions would be necessary in the next few years to cope with the default and restructuring problems.

Simple macroeconomic theory suggest that effective demand is the main source of the recovery of the economies in the short term. If there is a demand, there will be a production. If there is a production, there will be an income. If there is an income, there will be a new demand. Hence, the cycle goes as new production, new income, and new demand and so on.



As has been discussed, USA and mostly western countries consumed more than saved, heavily borrowed to finance that consumption and thus gave substantial current account deficits in the last decade. During the same period, China and mostly Asian countries produced more, saved more than consumed and gave substantial current account surpluses. The current crisis seems not to allow to repeat this scenario soon in the world economy. Unemployment rate has significantly increased in USA and western countries. Consumers are heavily indebted. Falling house prices are negatively affecting purchasing power of consumers through by wealth effect. Those countries can not be the engine of the world economy in terms of the consumption demand (Blanchard and Ferretti, 2009;15-20). However, there must be a consumption to sustain high economic growth in the world economy. A country, a region should replace the consumption demand of USA and West.

It seems that the structure of the last decade should be reversed in the next decade. While the countries having high savings and current account surpluses should start to consume more save less, others should save more and bring down the deficits to more sustainable levels. That is the message given in all occasions of G-20 meetings and at the meetings of international institutions (IMF, 2009). This means that China and some other emerging countries (basically good at goods, energy and commodity exports) should be the source of the consumption. If the consumption demand of millions of people in China and other emerging countries could be stimulated by the expansionary fiscal and monetary policy of those countries, gradual recovery of the world economy would be more likely. The question is whether China and those other developing countries would successfully manage this change or would they really want this. For the second part of the question the answer should be mostly yes. Because if those countries would not stimulate their domestic demand, they can not sustain high growth rates preventing high unemployment. In the past, they could sell to rich countries. Now, there is no such strong demand. For example, if China could not sustain high growth rate exceeding eight percent annually, unemployment rate rises. The higher the unemployment rate, the more instability arises in the domestic political system of this country. There were several examples of street protests, riots in China in the past. Hence, those

emerging countries should stimulate their domestic demand even if they do not want. However, whether they could manage this process should be main question mark for the post crisis period. There would be many economic and non-economic factors making difficult to manage the process. That is why international cooperation is necessary to cope with those likely economic and non-economic factors in the post crisis period.

Finally, it could be argued that the exit strategies from the expansionary fiscal and monetary policies should not be unique for all countries and that requires coordination as well (Graue, 2009, 1-4). As is discussed above, China and some other emerging countries should continue expansionary policies for some time for the sustained recovery of the world economy. However, the other group of countries having high budget and trade deficits should soon start to exit from the expansionary policies. As is argued previously, deficits of some countries have been rising tremendously. If it goes like that, default risk would be reality. That is why those expansionary policies should stop soon in some countries. We argue that the exit should start with the monetary policy. For example, Fed has dramatically reduced the policy interest rates to almost zero percent by late 2008. With so low interest rates, credit markets are expected to function properly and credit volume to rise to support economic growth. But it did not happen. Credit markets are not functioning properly and credit volume in USA has decreased by almost 400 billion USD in the past one year rather than increase. This seems to be a version of liquidity trap that can be observed at times of deflation. There are similar examples in many countries including Turkey. Economic history books of the next decade would call the monetary policy in 2008-9 crises as a Liquidity Trap. 2.0.

This could be considered as monetary policy paradox. Again take the example of Fed, zero interest rates policy stressing that this policy will continue for an extended period of time guarantees market player's high bond prices with limited risk of capital loss. Due to uncertainties related to growth prospects, willingness of banks to give credits are very low. Hence, zero interest rate does not encourage banks to give credits. In contrast, it allows banks to stand far from risk taking. If Fed stops to emphasize that zero interest rate policy will continue for an extended period of time and starts to raise interest rates gradually to for example, one percent, this will increase the risk of capital loss of banks from holding T-bills. This is likely to encourage banks to take some risks and shift their portfolios from T-bills to credits in the asset side of the balance sheet. It is of course risky to raise interest rates too

fastly and to very high levels. Gradual increase at interest rates is likely to help the normalization of financial markets.

We argue that the exit strategies from the expansionary policies should start with the monetary policy. As is argued above, the risk of liquidity trap is decreasing the effectiveness of monetary policy at such deflationary cycles. Fiscal policy either in the form of government expenditures or tax advantages should be the major policy instrument and should continue for long period of time if there is no sign of sustained recovery in the economy. It is obvious that fiscal policy would negatively effect economic growth in the long run as public deficit and debt accumulates. Therefore, governments should have long-term credible plans to lower the deficits. On the other hand, higher deficit means rising liability of the government,. If government expenditures are directed to investments, this would be an asset for the government. Those investments would help to create both growth and employment. In the long run, the government can sell those assets.

Thus, exit strategies should start with monetary policy. In the medium term, there will definitely be a need for contractionary fiscal policy. At that time, monetary policy need not need to be contractionary. It would again be expansionary to accommodate the fiscal policy. This is what the fed has done when the Clinton administration in 1990s was trying to reduce budget deficits. This is known as Greenspan-Clinton mix. USA and many countries may need such mixed policies in the medium term (Blanchard, 2006,103). That can be achieved with cooperation as well.

## **5) Conclusion**

This study has basically two aims. One is to draw some lessons from the 1929 Great Depression for the current 2008 crisis. The other one is to analyse the dynamics of current crisis and propose some policies to move the world economy to sustained growth path and successfully exit from the expansionary monetary and fiscal policies.

In the first section, the dynamics of the 1929 great depression has been summarized. Main lesson that has been derived from this section is that coordination is essential to cope with the adverse effects of global crisis. The following section has discussed the sources of the 2008 economic crisis. The role of China has been emphasized in shaping the world economy in the

first decade of 2000s. It is argued that the world economy need to be re-shaped in the post crisis period allowing China and other major developing countries to be the source of demand for the world economy to ensure its sustained growth. In the final section, exit strategies from the global crisis have been discussed. The main argument is that the exit strategies should start with tight monetary policy and continue with tight fiscal policy. When the fiscal policy is tightened, monetary policy should be eased to sustain at least the modest growth during the transition period.

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