

Viewpoints

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Active Governments Must Work Together

By Mohamed El-Erian
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I am mesmerized, concerned and hopeful by the surge in policy activism around the world. It is fascinating to see governments forced into even more unconventional policy responses.

Anxiety comes from the growing risk of collateral damage, including a new “beggar thy neighbor” phenomenon which threatens the longer-term growth and poverty alleviation potential of the global economy. Yet, as this becomes obvious, there is hope we may finally see a meaningful effort at global co-ordination.

After initial hesitations, most policymakers are now willing to do “whatever it takes” to counter today’s global crisis. Yet willingness does not equate with effectiveness. Despite bold measures, policymakers are yet to trigger badly needed “circuit breakers.” As a result, the crisis continues to morph into an even greater menace for global growth, employment and welfare.

What began in 2006 as a turn in housing has evolved into the simultaneous and disorderly collapse of three other huge sectors: global finance, industrial country consumption, and demand in emerging economies. Even the strongest are contaminated. Witness how profitable firms shed labor, the rich cut spending, and cash-rich investors retreat to the sidelines.

Understandably, policymakers are scrambling to provide an offsetting balance sheet and bypass damaged institutions. It is no longer a question of whether we will see additional fiscal stimulus packages around the world; it is how large and how fast. Governments are also in the business of bailing out “national champions,” however controversially defined. And central banks are opening new financing windows for non-banks while also helping to rehabilitate a crippled banking system.

This policy activism, while necessary, is a violent departure from the past 25 years. It is led by countries that, not so long ago, lectured others on limiting the government’s role. Yet, the shift is tolerated, if not supported across the political spectrum – understandably so as the alternative of cascading market failures is more costly and socially unacceptable.

In some cases, policy measures are made up on the fly and without the help of a master plan that imposes the internal consistency needed in such a radical shift in policy regimes. As such, we are far removed from the world of “first best”. That is why policy effectiveness has been less than complete.

Looking forward, there are two factors that suggest a high risk of additional collateral damage and limited effectiveness in the months ahead. First, it is not clear government balance sheets can carry the burden imposed on them.

Viewpoints

February 2009

Mushrooming government financing needs must be covered at a time when many holders of debt are turning from buyers to sellers. No wonder the Federal Reserve is "prepared" to buy Treasury bonds. But will the world be comfortable with two U.S. public agencies offsetting operations that ultimately must be supported by someone else?

Second, virtually every country now seeks to implement fiscal stimulus and rescue national champions. Yet those with weak initial conditions will find it difficult to keep up. Instead they face a lose-lose proposition: maintain the pace of policy activism and lose control over funding costs and, in some cases, exchange rates; or abandon it and see the economy hollowed out by the actions of others.

Fortunately, such clouds have a silver lining. As the risks become clearer, a greater degree of international policy co-ordination may emerge. This is not just about regulatory harmonization. It is also about the urgent need for policy principles that limit the risk of this new type of beggar-thy-neighbor phenomenon. Otherwise, the policy activism of some countries will undermine those of others and, by implication, the welfare of the global economy.

The U.S. is best placed to lead the effort. It should take advantage of its special relationship and team up with the U.K. which, as host of the upcoming G-20 meeting, can forge an international consensus for macroeconomic policy principles. Delay will complicate an already dangerous global crisis of no winners; just differences in the extent of loss.

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Viewpoints

February 2009

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