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Time to rethink the Washington Consensus

As globalisation unravels, it's time to revisit this mantra, and the current WEF would be a good place to start

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ECONOMIC globalisation, broadly defined as the reduction of economic distances between nations, has been fostered by three factors.

The first is the innovations and advances in transportation, information and communications technologies. The second is a broad global consensus that market-friendly policies are a means of rapid and sustained economic growth. The third is the push towards global economic liberalisation by the various international institutions: the General Agreement on Tariffs and Trade and the World Trade Organization (WTO) in the case of world trade, and the International Monetary Fund (IMF) in the case of global finance and capital flows. Taken in total, these factors comprise what has come to be known as the Washington Consensus.

While globalisation may be a means of promoting economic development, it has clearly increased economic insecurity and contributed to rising social discontent in many countries. Under the Washington Consensus, a simple formula guided economic policy: globalisation was good for growth, and growth is good for the poor.

With globalisation now unravelling, it is time to revisit this mantra. The 2009 World Economic Forum (WEF), which began yesterday in Davos, Switzerland, would be a good place to start.

Globalisation is usually thought of as a steady, unyielding growth of the threads that tie together the countries of the world economy. Yet we know from the period between the two world wars that this global integration process can go into reverse. The 'triple whammy' of World War I, the Great Depression and World War II effectively halted the trend towards economic globalisation.

We now stand at a similar historical juncture when the threads of the world economy are beginning to unravel. As participants take their seats at the WEF meeting in Davos, the stakes have never been higher.

The threads of the world economy include international trade and production (goods and services), capital flows (portfolio and foreign direct investment) and migration, particularly the remittances that migrants send back to their countries of origin. All early indications suggest that each of these globalisation processes is now beginning to ebb.

Statistics recently released by the WTO indicate that trade growth was slowing even in 2007. We will soon know the situation for 2008, but it is difficult to expect anything but modest growth for the past year. It is not unlikely that trade growth will disappear altogether in 2009. Risk aversion and the continuing global credit squeeze are shrinking portfolio investment, while foreign direct investment too is likely to experience a sharp decline given the contraction in the real and financial sectors worldwide. While remittances held up in 2008, the World Bank expects them to fall in 2009 by at least one per cent.

In the light of this unravelling, Davos participants must squarely face the following five considerations:

- The world is highly interdependent. Consequently, recovery is a collective good. As Australian Prime Minister Kevin Rudd recently pointed out in the Financial Times, any failure to act in concert through effective policy coordination will prolong the global unravelling. A coordinated global stimulus is needed urgently, with a focus on productive, labour-intensive investments rather than short-term consumption.

- We must reconsider the balance between financial liberalisation and regulation, and reduce the incentives to take outsized risks. (Privatisation of profits and socialisation of risks surely is unacceptable!) If there is one key result in recent microeconomic theory, it is that imperfect information matters.

And imperfect information is most relevant in financial markets. Self-policing is a distraction from reality in the realm of global finance. Restoring trust at this juncture will require new and significant attempts at oversight.

There is obviously a need for significant regulatory overhaul, though policymakers need to be aware of unintended consequences in any type of regulatory initiatives. At a minimum, we need transparent clearing houses for the more exotic derivative and securities.

- Despite the distraction of the financial crisis, the real economy - the actual production of goods and services - still matters. The financial crisis and the crisis of the real economy are reinforcing each other in negative ways.

Doha round

Consequently, the Doha round needs to press ahead with both a renewed vigour and a revised viewpoint. Given the abyss that could lie ahead, the quibbles holding up the round (the EU position on sensitive products, the US position on deep tariff cuts in manufacturing and resistance to agricultural safeguards in developing countries) now look ridiculous. We need a conclusion of the round by year's end.

- We must revisit the issue of regional and global financial coordination and what, if any, role the IMF in particular should play in future crises.

In relation to this, it is imperative that global leaders move from the current outdated G-7 group of industrial nations to at least the G-10 (including China, India and Brazil) as the central focus of future internationally coordinated financial and monetary initiatives.

- The poorest among us will need to be protected. Countless studies of past economic crises have shown that the bulk of the adjustment burden is placed on the shoulders of the poor.

The Washington Consensus was a promise that the poor would ultimately benefit from the globalisation processes, a promise that now rings somewhat hollow. As private capital flows diminish, official development assistance will need to fill the gap. A new commitment to the 2002 Monterrey Conference aid targets must be made, and quickly, with an emphasis on basic provisions: clean water, sanitation, housing, primary health care and infrastructure.

World leaders gathered at this year's Davos conference thus have a new challenge - and a new opportunity - before them: to create a new global consensus in terms of the new realities of the world economy.

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