Coordinating Global Economic Action: Globalization's Great Recession Requires Extraordinary Leadership

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The world's political leadership meets today under very unusual circumstances. Summits of this kind generally involve the ratification of understandings or agreements worked out in some detail long before the leaders meet in the public spotlight. This time, they convene in the midst of the worst global economic crisis in 80 years. Not only have they not yet agreed to a set of responses; they and their advisors haven't come to a common view of what the problem is. Instead, much of the value of this meeting will come from President Obama, Prime Minister Brown, President Sarkozy, President Medvedev, Chancellor Merkel, and President Hu listening to each other. They can learn how each of them sees the crisis affecting their own countries, what they understand as its causes, who or what they blame, and what they're prepared to do. Last weekend, German officials leaked a communiqué drafted by Gordon Brown calling for coordinated stimulus – leaked it in order to knock it off the table. Thus far, the United States, China, and Spain are the only nations that have initiated significant stimulus, in part because other major industrial countries have such extended safety nets that there's less political pressure to stimulate. But as global demand sinks, global stimulus us called for. Even so, it's clear that the summit is unlikely to produce a coordinated response in this area.

This is a real loss, because the crisis demonstrates the extraordinary degree to which globalization integrates the economic trajectories and fates of the world's major economies. Part of this reflects the most highly-globalized sector of all, finance, where the products created in New York – mortgage-backed securities and credit default swaps, for example – are traded furiously around the world. It may be that the European banking system incurs as much damage as our own. At a minimum, the steps we've taken to bail out our own large banking institutions have been taken, in part, to protect the major institutions of our allies. This was particularly clear in the early takeover of Fannie Mae and Freddie Mac, after the Chinese and European governments informed the Bush Administration that their own central banks held large quantities of Fannie and Freddie paper.

This deep integration is not limited to finance. Under globalization, the share of everything produced in the world that's traded across borders jumped from 18 percent in 1990 to 30 percent in 2007. The result is that a severe economic shock like the one shaking the world today can produce the main result of protectionism -- a sharp drop in global trade – without any new protectionist laws. Compared to the year before, exports in January of this year were down over 20 percent here , down about 30 percent in Germany, France, Mexico and Britain, down 30 to 40 percent in Korea, Italy, Canada, Japan, Argentina and – here's the big one -- China, and down by more than 40 percent in Russia. And one early result is rising unemployment in virtually every nation.

So, the world finds itself in not only a systemic crisis, but a cascading one as well: That is, a systemic crisis that becomes more and more serious through feedback effects, and a cascading one that also spreads across sectors and countries.

In short, this is not an ordinary business cycle or an ordinary recession. And the normal steps to bring a country out of an ordinary recession don't work. The chief conventional response, easy monetary policy, has failed: We're running nearly zero interest rates; we've doubled the monetary base in four months – something that usually happens over a period of four to five years. Yet, the sectors that are supposed to be most sensitive to monetary policy – housing, consumer durables and business investment – all continue to fall. The fiscal stimulus will help some starting in the fall and early next year, but only on a limited and temporary basis.

There are two fundamental reasons why this recession is so different. First, much of the core of the nation's financial sector – the whole system for distributing capital to businesses and people – is unable to operate normally. That's because they're bankrupt or nearly so, or because they're trying to protect themselves against the next set of shocks – and new shocks are what has to be planned for in a systemic, cascading crisis. That's the supply side of the crisis.

Conditions are no better on the demand side. Here, what's unique in this crisis, compared to every other business cycle in the lifetimes of everyone in this room, is that people aren't holding back simply because their incomes are down, or they've lost a job or fear they might soon. That happens in every recession. What's different this time is that people are also suddenly and starkly poorer. Over the last year, this crisis has evaporated some $14 trillion in personal wealth in America – split nearly evenly between falling housing values and falling stock values. That's about 20 percent of the value of everything in the American economy. In economic terms, the shock isn't just in flows – how much income you're taking in – but also in stock – what you're worth, apart from your income. The result is a fast rising saving rate, and faster-falling consumption and business investment.

That's why fiscal stimulus and monetary ease can't do the job alone. That's why this downturn will likely last three years, compared to the 12 to 14 months of an average recession. And that's why it's vital that we implement effective programs to address the two critical, underlying sectors in this crisis, housing and finance.

That brings us to the same conundrum facing all the leaders in London this week: What's economically necessary is very difficult politically. We won't stop the wealth drain until we can stabilize housing – and, closely related, we can't stabilize banking until we stabilize the mortgage-backed security market. That won't begin to happen until we can bring the foreclosures driving down the value of both housing and those securities back to normal levels. But how do you help those in danger of defaulting on their mortgages and facing foreclosure, without igniting a political firestorm from everyone else with mortgages? So far, the Administration's housing plan mainly addresses the availability of mortgage refinancing; but banks are unlikely to refinance a homeowner facing foreclosure, because they're by definition bad credit risks. It's not likely to be enough.

This crisis also won't abate until we can normalize the foundations of the financial system. And that can't happen so long as that system remains dominated by institutions that are insolvent or nearly so. So far, the Administration's main plan is to create markets for those institution's bad assets, by guaranteeing loans to private partnerships that want to buy those assets. But the sick institutions holding those assets today have already written down their value on their books. So unless these new buyers pay a lot more for the assets than the banks have already valued them on their books, the plan won't make them any more solvent than they are today.   It's not likely to be enough.

So, just like the foreign leaders in London, our own leadership is still learning how this crisis is unfolding and what the options are. It promises to be an extended process, and that means a protracted crisis. It will take leadership of the kind not often seen to grasp the problem, accept the solutions, and sell them to the public. Extraordinary leadership is precisely what Barack Obama has promised the American people. Whether or not he can deliver on that promise will be the test that history will most likely remember him for.