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Rebooting Global Cooperation is Imperative to Successfully Navigate the Multitude of Shocks Facing the Global Economy

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Abstract

There have been very few moments in history when the world faced a confluence of global shocks and crises: from the lingering COVID-19 pandemic, threat of widespread food and energy insecurity, a surge in inflation, looming crises of development financing and sovereign debt, high risk of a global recession, climate crisis, to the geopolitical crisis. While seemingly unrelated, these challenges reflect shortfalls in multilateral cooperation and coordination in a world that is increasingly interdependent. As such, successfully navigating the multitude of shocks will entail considerably stronger global cooperation and radically reforming the multilateral system.

Keywords*: Rebooting, Global Cooperation, Shocks, Global Economy*

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Background to the Study

The COVID-19 Crisis

Long before the COVID-19 pandemic, the deficit in multilateral cooperation was palpable. Growing discontent with globalization has been associated with the failure of the multilateral system to stem the tide of rising inequality, social fragmentation, job insecurity associated with technological change, and offshoring in advanced countries, among others. The rising disillusionment with the multilateral approach has prompted bilateral deals or groupings of like-minded or geographically proximate countries. Just as countries were turning inward, the COVID-19 pandemic highlighted the necessity of a global effort to eradicate the virus. That necessity was largely ignored as countries implemented anti-COVID measures unilaterally, including border closures and other restrictive policies. The lack of cooperation is also reflected in the differentiated policy stimulus to manage the pandemic. While advanced economies (AEs) deployed on average 20 percent of their GDP in stimulus, that number was 5 percent for emerging market (EMEs), and a meager 2 percent for low-income countries (LICs).

The Special Drawing Rights (SDRs), which represent perhaps the single most important instrument in the global financial system's toolkit to respond to global shocks, were not approved until 18 months into the pandemic. With the distribution of the SDRs linked to country quotas, the country's most in need of support received only $21 billion or 3 percent of the $650 billion in SDRs, and the IMF is relying on the goodwill of AEs to either donate or loan their SDRs. The lack of adequate resources along with inequitable access to vaccines resulted in an asynchronized global economic recovery. Indeed, even before Russia's invasion of Ukraine, the economic recovery around the world was highly uneven. To date, while the vaccination rate exceeds 75 percent in AEs, it is only 30 percent in LICs, well below the threshold to achieve herd immunity.

The Global Value Chain and Inflation Crises

Global value chains turbocharged globalization, and economies have become highly dependent on them. An estimated 70 percent of international trade involves global value chains, as services, raw material, and parts and components cross borders often numerous times. For all the benefits, global value chains make the global economy vulnerable to disruptions or delays in production in any country participating in the value chains or in transport and shipping logistics. The uncoordinated response to the pandemic, along with the repurposing of some factories to produce essential goods for domestic consumption, disrupted global value chains. The release of pent-up demand, particularly for goods, from the nascent recovery in the advanced economies against the backdrop of shortfalls in supply due to labor shortages, continue to clog and disrupt value chains, such as obstructions to shipment and transport logistics, which generated significant price pressures and caused a broad-based increase in inflation. These price pressures emerged before the Russian invasion of Ukraine and were exacerbated with further disruptions to food and energy markets.

Global Interest Rates, Financing for Development, and Looming Sovereign Debt Crises

The increase in inflation rates to levels not seen in decades in most countries, notably in AEs where the economic recovery from COVID-19 was more consolidated, prompted major central banks to begin raising interest rates even as the recovery remains fragile elsewhere. The higher interest rates triggered large capital outflows from emerging market and developing economies (EMDEs). With one-third of low-income countries' sovereign debt contracted on variable interest rate, the increase in global interest rates is raising the debt service costs, adding to fiscal pressures and, more generally, constraining options for development financing. To be sure, the sovereign debt buildup in low-income countries precedes the pandemic. It began in the aftermath of the Global Financial Crisis of 2008/09 as fiscal balances deteriorated and countries took advantage of the ultra-low interest rate environment to issue government debt. The reach-for-yield behavior by global asset managers facilitated access to private capital markets for sovereign debt for LICs, in many cases, for the first time. However, the devastating impact on the economies exacerbated the debt buildup and, by some estimates, about 60 percent of all LICs are now either in or at risk of debt distress. Global cooperation to establish a Debt Service Suspension Initiative (DSSI) has been helpful in alleviating the fiscal pressures on LICs but it expired in late 2021, and the newly established Common Framework for debt restructuring has run into operational challenges. Although some countries Chad, Ethiopia, and Zambia have submitted requests for debt treatment, the process has run into protracted negotiations with creditors notably China and the private sector. The expiration of the DSSI will add an estimated $10.9 billion in debt service cost for LICs this year. Calls for global solidarity to extend this initiative have so far been unsuccessful.

Overseas development assistance (ODA), an important source of financing for LICs, is in jeopardy. Unplanned expenditures on defense, refugees, and other humanitarian needs in Europe, are squeezing resources for ODA from some large donors. For example, as Germany boosted its defense budget amidst the Russia-Ukraine war, it proposed a 12 percent reduction in development aid, with cuts as deep as 50 percent for U.N. agencies such as the World Food Programme. Similarly, reductions are in the offing in the U.K., Norway, among other countries. This environment presents a perfect fiscal storm for developing countries and will, undoubtedly, impact their ability to finance development agendas and sustain progress on the Sustainable Development Goals. Already, an estimated 75 million additional people have fallen into extreme poverty since the onset of the pandemic. Reductions in health and education budgets will have both short- and long-term adverse impacts on human capital development and the economies.

Geopolitical, Food, and Energy Crises

The Russian invasion of Ukraine in late February 2022 could not have come at a worse time for the global economy. It was a culmination of unresolved issues in global cooperation since the fall of the Berlin Wall and the dislocation of the Soviet Union. While it is unclear whether a "better" or more reasonable form of global cooperation could have deterred Russia from invading Ukraine, stronger cooperation, particularly on security matters, may have reduced the odds of the Russia-Ukraine crisis. It remains unclear when and how the war will end. What looks increasingly certain is that the war signals the beginning of a new world order. Many countries in the Global South are concerned about the prospects of another "Cold War" era with acute tensions between a Western bloc and a heterogenous bloc consisting of China, Russia, and a few other countries. Such concerns led the Southern African Development

Community to reaffirm its position of non-alignment, and other countries, including India, have also refrained from taking sides in the conflict. The invasion has been divisive. It has already dealt a severe blow to global cooperation. Tensions are palpable in global organizations and processes such as the United Nations and the G-20. Invasion has wreaked havoc on global energy and food markets as well as caused further disruption to the global supply chains. Consequently, countries around the world are experiencing an energy crisis that is adding to the inflationary pressures, and many countries in the developing world also face food insecurity. The difficulty in gaining access to fertilizers due to the disruption in Ukraine, a major producer alongside Russia and Belarus, portends future food shortages and higher food prices for the vulnerable countries if proactive corrective measures are not taken.

Climate Crisis

Many countries' policy responses to the higher energy cost have included relaxing restrictions on the use of fossil fuels. The relaxation of these restrictions, while understandable, challenges the global aspiration to phase out or phase down fossil fuels. Beyond the short term, it is conceivable, and even likely, that the crisis can be a catalyst for faster transition toward renewable energy. However, that is yet to be seen. The biggest blow to the climate agenda stems from the geopolitical tensions and their impact on global cooperation. The joint Glasgow declaration by the U.S. and China the world's largest emitters of CO2 to enhance climate actions in the 2020s, including the reduction of methane emission, was a welcome boost to global cooperation and ambitions. Notwithstanding some progress over the past decades, collective action to address the looming climate crisis has fallen significantly short, and there is growing consensus that the next years present a critical last-chance window of opportunity to ramp it up at all levels. Given divisions between the U.S. and China on the Russia-Ukraine crisis and, importantly, the heightened tensions surrounding Taiwan, it is unclear whether cooperation between the two countries can be strong enough to sustain their joint commitment to climate mitigation. It is encouraging that U.S. climate envoy John Kerry urged Beijing to resume talks even as geopolitical tensions escalated.

The Imperative of Rebooting Global Cooperation

Just as the deficit in global cooperation and coordination contributed to or amplified the multitude of shocks that the world is currently grappling with, restoring and strengthening global cooperation will be crucial to successfully navigate these challenges. First, the global community must sustain its efforts to complete COVID-19 vaccine distribution and ensure that a critical mass of the global population is vaccinated. As long as one country lags, the world will remain at a risk of another variant that is potentially deadlier and immune to current vaccines. In addition, global value chains remain vulnerable to additional lockdowns such as the case in China demonstrates.

Second, policymakers should prioritize cooperation and coordination to fully restore global value chains and address the transport and shipping logistics that are impeding global commerce. Supply shortages will subside as a result and, along with them, price pressures for core goods and inflation. The containment of inflation and inflation expectations will, at a minimum, slow the pace of monetary policy tightening in AEs if not outright stop or reverse the rate increases, which will help contain the debt servicing costs and the risks of sovereign default in LICs.

Third, the G-20 should reinstate the DSSI until at least the Common Framework is fully operational. The unpleasant experiences of Chad, Zambia, and Ethiopia could deter other countries from requesting sovereign debt treatment under the framework. The issue of holdout creditors has always been a thorny one in debt restructurings. With strong support from its major shareholders, the IMF has the option lend into arrears to the requesting countries, which will incentivize recalcitrant creditors to compromise.

Fourth, beyond these immediate actions, policymakers should seize the opportunity to radically reform the global governance system. One compelling proposal to fix the global financial architecture is outlined in a brief produced for the G-20 to set up a Global Liquidity Insurance Mechanism, a market-based facility that will institutionalize and broaden access to short-term foreign exchange liquidity for EMDEs. The Brookings Institution's Global Economy & Development program has also compiled essays with proposals from experts in the Global North and Global South to significantly reform the multilateral system.

Conclusion

The interconnectedness of seemingly unrelated shocks that the world economy currently faces highlight one main reality: The more interconnected the world becomes, the more likely it is that the shocks will be either global in scale or reverberate worldwide. It is time for a radical imagination of the multilateral system to strengthen global cooperation commensurately. It must be an approach that is built on strong global leadership as the U.S. exemplified in the aftermath of World War II. Will the world's leaders seize the opportunity and step up to the challenge? Only time will tell.

Reference

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