Solving the Global Financial Crisis - What Would Alexander Do?

More than four years after the collapse of Lehman Brothers, which unintentionally triggered the worst financial crisis since the 1930s, the global economy remains extremely fragile. Structural reforms to prevent another crisis have not been implemented and a double-dip global recession is still possible, as the EU struggles to resolve its sovereign debt crisis, the U.S. tries to avoid a suicidal drive off its own "fiscal cliff", and China's growth rate has slowed significantly in recent months. And even if another global recession is narrowly avoided this time, a prolonged period of stagnation is likely, unless coordinated corrective action is taken soon.

Unfortunately, none of the principal actors in this slowly unfolding drama – The EU, US, and China – has the economic and political decision-making degrees of freedom required to do what is needed domestically, let alone abroad. It is as if the global economy is tied up in a gigantic Gordian knot from which it cannot untangle itself.

The immediate challenge is that the ability of the EU and the US to revive their economies through additional fiscal and monetary measures is disconcertingly limited, due to already low interest rate levels and their weak fiscal and debt positions. China still has some room for additional stimulus measures, but can't afford to overreact the way it did a few years ago, and is certainly in no position to jump-start the global economy all by itself.

An even greater challenge is each economic superpower's inability to make much progress in developing and implementing the structural reforms necessary to avoid long-term global stagnation, further financial instability, and, possibly, a return of protectionism accompanied with widespread social and political unrest. What's especially frustrating is that their inaction isn't rooted in the underlying economics, but in each country's political environment, which, albeit for very different reasons, makes structural change difficult to even contemplate, let alone implement.

The EU's impotence stems from its reluctance to accept the unavoidable trade-off between political independence and stagnation versus further economic integration and prosperity. The EU's existing governance structure may thankfully have been successful in ending centuries of almost continuous warfare – implausibly earning its citizens the 2012 Nobel Peace Prize – but it can't provide the strong oversight required to effectively manage the highly divergent, yet increasingly interdependent, group of economies that are now included in the Euro zone. Europeans will simply have to come to terms with the fact that their union needs greater economic, fiscal, and political integration to remain competitive and avoid similar crises in the future.

The U.S. also seems to have lost much of its ability to make sound economic policy adjustments, struggling to make even straight-forward tactical decisions, such as raising the debt ceiling a few years ago. As in the EU, the issue is political gridlock, in this case caused by decades of opportunistic gerrymandering, which have reduced America's cherished "government of the people, by the people, for the people" to one where its Presidential elections are now actually decided by a mere handful of people in a few swing states. In addition, media fragmentation has had the unwelcome side effect that many Americans live in ideological cocoons, where they feed on partisan news, wishful thinking, and economic nonsense. As a result, the two main political parties are increasingly locked into irreconcilable positions by the extreme fringes of the political spectrum.

Finally, the seemingly omnipotent Communist Party of China is far more restricted in its decision-making freedom than is commonly believed in the West. In reality, the CPC is trapped by its own post-'89 Faustian bargain with the country's middle class into having to deliver annual GDP growth of 7-8% for the foreseeable future, or risk potentially regime-ending social unrest – either through runaway inflation and asset bubbles when inadvertently overheating the economy, or, conversely, by not improving the people's living standards fast enough when economic growth falls below target. In addition, the central leadership actually only partially controls its own state-owned enterprises and local governments, and is also far too entrenched in the status quo to willingly risk major structural reforms.

Alexander solved his Gordian knot by simply slashing the rope with his sword. Is there a similar Alexandrian "out-of-the-box" solution for the global economy? Probably not, but what has become painfully obvious is that the answer won't be found at the national level. Instead, a new international system for supra-national coordination and governance is urgently needed, as the global economy has become so interdependent that the actions of individual governments are insufficient to ensure global stability, and, worse, can often even be harmful. Cross-border capital flows have simply become too large for regulation at the national level only, and the management of large integrated economic zones, such as the EU, can't be left to each of its twenty-some individual countries. At a minimum, a better global response mechanism for managing future financial crises will have to be created. In addition, the G20 and its supporting institutions must work hard to improve monetary and fiscal policy coordination and mitigate the impact of potentially destabilizing forces, such as asymmetrical exchange rate regimes, state banks, and sovereign wealth funds.

So what will the future hold? Fortunately, true doomsday scenarios are still less likely than the various muddle-through scenarios; the U.S. will no doubt avoid jumping off its fiscal cliff through another nail-biting last-minute political deal, the EU will in the end not collapse after all (although the Euro zone may not survive in its current form), and China will continue to grow at 7-8% one way or another. But we probably won't see a strong recovery for a while either, and the risk of another global financial risk remains uncomfortable real. Unfortunately, the pre-crisis boom days may have been as good as it gets for some time to come.