The Governance Report 2018

Governance and Global Crises: Lessons from the Global Financial and Economic Crisis

Executive Summary

The global financial and economic crisis of 2008–9, or GFC for short, was the greatest economic stress test since the Great Depression of the 1920s and 1930s, and the greatest challenge to social and political systems since the Second World War. It not only put financial markets and currencies at risk; entire economies and political systems were threatened as the crisis quickly revealed major regulatory shortcomings and weaknesses in governance capacity at all levels.

Even though the GFC was felt almost worldwide, its severity and nature varied significantly across countries. Nonetheless, our analysis shows typical crisis trajectory patterns (see figure on next page). They range from protracted crisis countries such as Greece, Italy, and Portugal which experienced multiple crises, including growth crises, in both 2009 and 2012; to rebounded countries such as Iceland, Ireland, and Estonia that were hit early and hard, but found relatively stable routes to recovery; to debt crisis countries such as Japan, the UK, and the US that essentially borrowed their way out of the GFC; to largely unaffected countries such as Australia, China, and India. Most of the countries impacted by the GFC have since recovered economically, but traces of it still remain to varying degrees in terms of high public debt burdens, distrust in many institutions, including political elites, as well as other aspects.

Now ten years on, *The Governance Report 2018* offers an opportunity to tease out the implications of the GFC for governance today and consider how such financial and other global crises of similar magnitude and complexity can be prevented or better managed in the future. To do so, scholars at the Hertie School examined developments in fiscal policy, administrative capacities, institutional trust, and global governance from the period before the GFC to current times.

The Governance Report 2018, prepared by a team of experts at the Hertie School of Governance, is the sixth in a series highlighting particular governance challenges and how to approach them.

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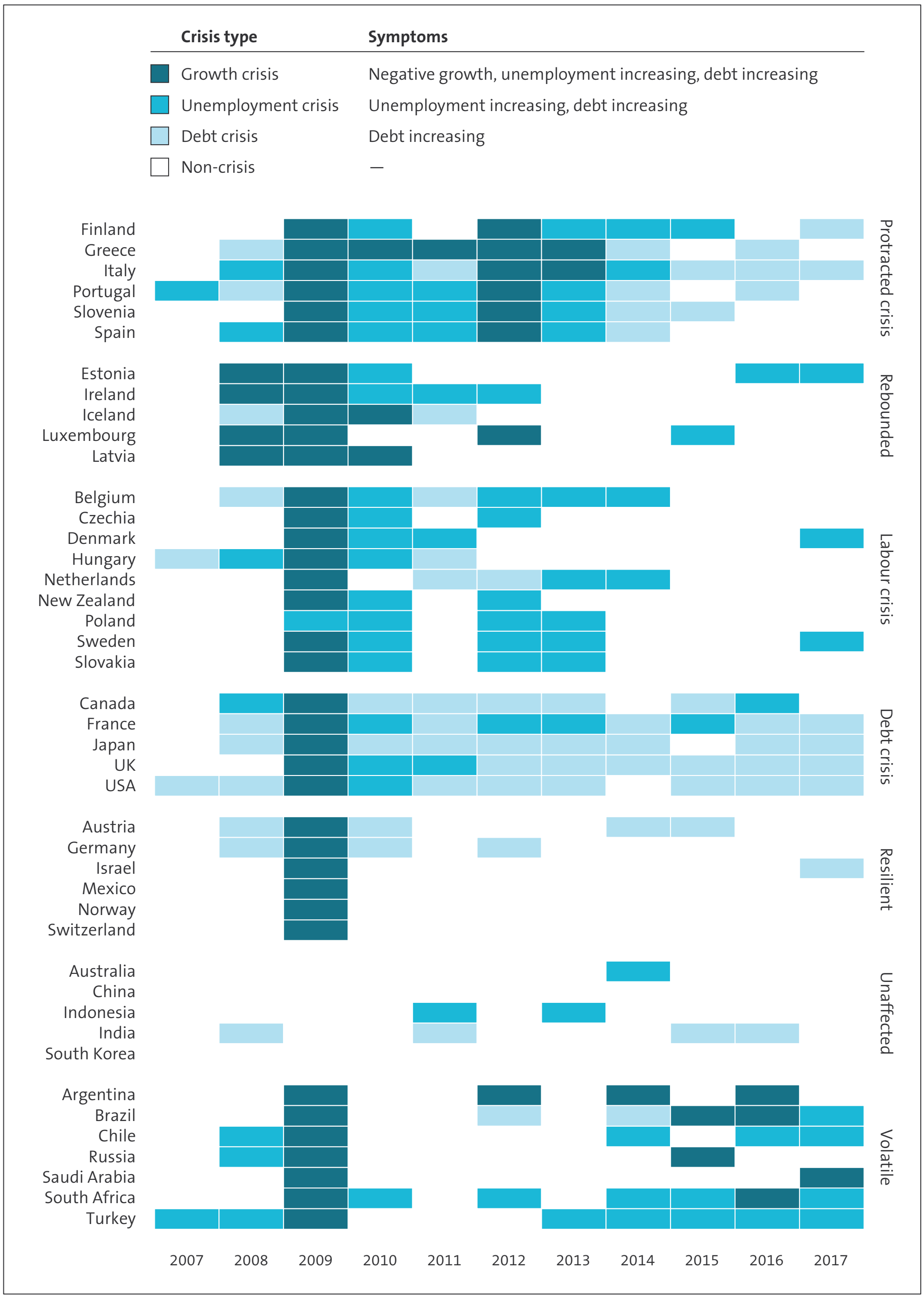

Crisis trajectories by economic crisis types, OECD and G20 member countries, 2007–17*

Explanatory note on crisis types:

Growth crisis: GDP per capita in terms of purchasing power parity decreases.

Unemployment crisis: In the absence of a growth crisis, the unemployment rate is above 6 per cent.

Debt crisis: Neither a growth nor an unemployment crisis is present, but the debt-to-GDP ratio increases to a level of 60 per cent and higher.

Non-crisis: All remaining situations, i.e. those with growing GDP per capita, unemployment below 6 per cent or decreasing, and a debt-to-GDP ratio below 60 per cent or decreasing.

Crisis types imply a ranking of severity that assumes that more severe crises comprise less severe crisis symptoms as well. Thus, a growth crisis usually also means increasing unemployment and debt, while an unemployment crisis would be accompanied by increasing debt.

*) The shading in this graphic has been corrected to show that Finland experienced an unemployment crisis in 2015, and Portugal an unemployment crisis in 2013, rather than a debt crisis in the respective years, as originally appeared in Figure 1.1 (p. 17) of The Governance Report 2018.

Has Fiscal Policy Returned to Pre-Crisis Levels?

The short answer is: no. Many of the responses to the GFC necessarily had fiscal policy at their root. Almost all G20 countries introduced one or several stimulus packages to stabilise the financial sector and the broader economy. Once some measure of stability returned, many countries were compelled to change course and turn to austerity.

In fiscal policy terms, most OECD countries find themselves in vulnerable positions, leaving them little room for manoeuvre.

The fiscal effects of the GFC are most evident in advanced industrialised countries and the eurozone, especially in terms of public expenditures and debt. There gross debt burdens have not yet returned to lower pre-crisis levels, though economic theory would expect that they should; in many places, government debt levels are much higher now. Likewise, public expenditures in relation to the economy's size increased over the crisis period, but, despite austerity measures in many countries, have not snapped back to earlier levels as they should have in theory. In fiscal policy terms, most OECD countries ten years after the GFC's peak find themselves in more vulnerable positions because of higher public debt burdens and higher social expenditures, leaving them little room for fiscal policy manoeuvre should another crisis arise.

Have Governing Capacities Been Affected?

Certain governing capacities are required for governments to provide essential public goods including the rule of law. These include the capacity to deliver (executing and managing policies and programmes at the frontline), to regulate (providing oversight of private and public organisations), to coordinate (bringing about joint action among key actors), and to analyse (providing intelligence and advice in conditions of uncertainty). Some combination of these four capacities is needed to address complex policy issues and crises, in particular.

Governing capacities have developed differently since the GFC; especially regulatory and coordination capacities have not been sufficiently enhanced everywhere.

These governing capacities have developed quite differently since the onset of the GFC. For instance, by some measures, delivery capacity in OECD and G20 countries was not demonstrably affected. However, health and education spending as a share of total public expenditures declined markedly on average in the countries that suffered protracted crisis and have only recently begun to increase again. In the group of countries that rebounded rather quickly, spending also declined significantly at the peak of the GFC, but has since recovered almost to pre-crisis levels.

In terms of regulatory capacity, the GFC should have been a wake-up call pointing to the need to regulate financial markets more effectively. However, ten years after the GFC erupted, there appears to be no clear trend towards stronger regulatory capacity. Furthermore, recent developments, for example, repeal of parts of the Frank-Dodd Act in the US and lobbying on the part of the City of London to make it more competitive after Brexit, suggest that the pendulum might start to swing back towards deregulation.

Countries that seem to have dealt well with the GFC display reduced coordination capacity for the period after 2010. While it might be understandable that the pressure to maintain or even enhance coordination capacity has subsided somewhat, more recent developments in other national and global policy areas, such as immigration, security, or trade, have again challenged coordination capacity and have highlighted continuing deficiencies at both domestic and international levels. The reduction in coordination capacity is particularly troubling given that it was precisely the ability to coordinate among the G20 economies that arguably prevented the GFC from spreading and deepening in 2009–10.

The status of analytical capacity has been the relatively good news coming from our analysis. At least some analytical tools are now being used more often in the G20 and OECD countries. Whether these analytical tools and skills are being used effectively remains an open question, but it is a question that deserves attention, especially in light of so-called truth decay and related developments challenging knowledge creation and evidence-based policy-making.

Has Institutional Trust Been Permanently Damaged?

Major economic shocks and crises have the potential to shake popular trust in key public institutions. This effect, however, was not uniform in relation to the GFC, but varied by country and individual cirumstances, especially socioeconomic status. But OECD and EU countries did experience a pronounced fall in confidence in financial institutions, and that trust has barely recovered since its trough in 2009. Public opinion clearly attributes significant blame for the crisis and its consequences on financial institutions and the elite more generally.

The combination of austerity measures and poor governance in the aftermath of economic crises is particularly damaging for institutional trust levels in the longer term. Indeed, it was in a small number of EU countries such as Greece, Portugal, Spain, and Cyprus, having to resort to bailout packages and accompanying austerity programmes, that levels of institutional trust were deeply affected. What is more, they have at most only partially recovered. It is also in this group of countries that voter turnout and satisfaction with democracy declined sharply, though satisfaction with democracy seems to be rising somewhat since.

Nevertheless, recent electoral shifts towards far-right, ultranationalist and/or Eurosceptic options cannot be traced back to the GFC alone. The political system matters, as the countries most affected in terms of declining trust levels were either characterised by political stalemate among fragmented and polarised party systems, or showed strong leanings towards left-wing populist options.

> Governance makes a difference in whether countries recover trust quickly.

There is some good news in the analysis of institutional trust. While good governance performance, in terms of rule of law, control of corruption, and government effectiveness, did not seem to immunise countries against falling institutional trust in the immediate wake of the GFC, they made a difference in whether countries recovered this trust quickly or not. Institutional trust is then, for the most part, a solid currency that is not easily undermined, and when hit, can be replenished through good governance and resilient institutions.

Is Global Governance Passé?

The scale of the GFC was such that the 1990s' globalisation process itself seemed in jeopardy, the very process that, in many ways, made the crisis possible. Despite signs that the post-Second World War international order was weakening, the G20 stepped up to act once the extent of the GFC began to be acknowledged. Indeed, the G20 could be seen as an exception to the trend and as an attempt to re-energise the multilateralism that had seemed to hold such promise in the late 1990s. The G20 is not, however, an international organisation; it is rather a political body that steers the work of numerous technical bodies that have neither decision-making nor enforcement capacity.

More generally, global governance today is having to grapple with the tension between the need for global collective action to deal with existing and looming crises, on the one hand, and the increasing reluctance of sovereignty-conscious nations to cede competences, enter into binding agreements, and abide by rules, on the other. The choices seem to be either trying to preserve the existing order to the extent possible, as in the case of the 2015 Paris agreement on climate change, or embracing flexibility and putting faith in the development of a web of ad hoc cooperative arrangements. Before going blindly down either of these paths, we need to better understand the trade-offs each involves.

> Global governance is today grappling with tension between the need for global collective action and the increasing reluctance of sovereignty-conscious nations to participate effectively.

The need for global governance is by no means passé as the problems needing attention have by no means weakened or gone away. It is the geopolitics of global governance problems that have changed as nationalism and bilateralism have gained in strength, often taking advantage of a weakened system of international institutions, many of which are in dire need of reform. The lessons from the GFC target both the limits of nationalism and bilateralism and the current weakness of multilateral institutions.

Five Lessons

Lesson 1: When regulatory and other governance tasks are not clearly assigned or are fragmented among various institutions, it may be difficult to prevent crises and may make them harder to manage when they occur. For example, once massive public monies were committed to rescuing private and public financial actors, it was unclear who was in control of processes and funds. Fuzziness of the regulatory framework in place invites gaming, shirking, and blaming–the characteristic deficiencies associated with overly complex but underspecified regulatory regimes.

Lesson 2: Policy fields become crisis-prone when they develop in such a way that national regulation can no longer provide sufficient oversight, but international regulatory systems remain inadequate, as happened with international finance before the GFC. Such a decoupling creates inherent governance weakness or institutional voids in which rules on a global scale are either declining or lacking and in which public agencies are absent.

Lesson 3: Major technological advances can lead to rapid changes in markets that can outpace institutional changes in policy fields. For example, new markets can emerge that offer huge pay-offs for early adopters or investors. These market actors not only outpace but frequently also outwit national and international regulators trying to fill the institutional void.

International regulators may not be able to keep pace with rapidly changing markets, for example when major technological advances offer huge pay-offs for early adopters.

Lesson 4: There is a need for relatively independent actors in fields that are decoupled, as international finance was decoupled from regulatory oversight before the GFC, or as other fields such as cyber-related technologies are in the process of becoming so. Without a countervailing public including watchdog groups, think tanks, activists and the like demanding transparency and accountability, the influence of private actors on legislation and regulation may remain largely uncontested, leading to normative voids.

Lesson 5: Stricter sanctions should be applied more quickly and more comprehensively to help restore trust in institutions, mainly on the part of citizens. Holding accountable those most responsible for a crisis helps minimise damage to the legitimacy of the entire system.

Recommendations

These lessons lead to a set of recommendations not only for avoiding financial and economic crises, but for preventing other crises of similar scope from emerging in the first place, for managing them in better and equitable ways, and for dealing best with the aftermath.

Crisis avoidance and preparedness

1. **Strengthen analytical capacity wisely.** Continued efforts to strengthen analytical capacity within and outside government are essential, but at least as important is determining which skills and tools are required to foresee and prevent such crises and manage them when they occur. Running crisis scenarios and having emergency plans ready, as some countries such as Australia did, are examples. Such exercises should be conducted and plans be drawn up for all policy fields showing signs of decoupling and the development of institutional voids. In addition, measures should be taken to maintain a diverse and complex set of institutional actors that support and pursue evidence-based policy-making in all sectors of modern economies.

2. **Manage debt now.** Government debt levels are clearly much higher than before the GFC across advanced industrialised economies on average. The debate about austerity focuses correctly on whether there should be any spending cuts or tax increases when the economy is already weak. But most economies in mid-2018 are relatively strong. This offers governments the opportunity to consolidate and reduce debt burdens so that they have the ability to react with more debt (or less austerity) when the next economic downturn or crisis occurs.

A systematic assessment of multilateral governance arrangements would help define a clear set of choices available to actors to prevent global problems from turning into crises.

3. **Prepare systematic assessment of multilateral governance.** Such an assessment would help categorise the problems facing existing arrangements; identify underlying interactions and structures; establish who, how many, and how diverse the relevant players are; and, on this basis, determine the effectiveness of the enforcement and monitoring mechanisms they rely on. This research should help map a limited set of governance templates onto a limited set of collective action games and a wider set of concrete international cooperation issues. The result would give actors a set of clear choices to guide them in solving global problems, preferably before they turn into crises.

Crisis management

4. **Install or enhance coordination capacity, and develop actionable, real-time governance indicators.** Coordination capacity remains the step-child of governance at the domestic and global levels, each requiring a different kind of attention because the actors involved work in distinct institutional settings. To more fully understand and therefore lay the basis for strengthening coordination capacity within national borders requires better indicators that capture institutional behaviour rather than, for example, the number of working groups established. But in order to make these indicators actionable and available to policy-makers as quickly as possible, this type of research should be accompanied by exchanges among practitioners and policy-makers.

5. **Find out what kind of global governance arrangements work in managing crises of different kinds.** Policy-makers need new tools to confront weaknesses in the system of rules and institutions around which global interdependence has been organised and managed for many decades. Such a toolkit would help them determine minimum requirements for effective collective action on a field-by-field and topic-by-topic basis. First, a minimum set of universal principles and governance institutions must be determined. Second, the channels of interdependence, the incentives and disincentives to cooperate, and the critical mass of participants for creating a bandwagon effect must be established.

In light of the potential damage to institutional trust from extended financial and economic stress, the costs of austerity should not only be considered in economic terms, but also in terms of the quality of institutions.

6. **Avoid excessive austerity measures.** Where automatic stabilisers are not built in or do not work in a crisis like the GFC, austerity may be unavoidable. In such cases, national and international actors should target budget cuts in ways that avoid the depletion of the capacity to deliver public services, using enhanced analytical capacity. This could also involve additional transfer mechanisms where appropriate. Furthermore, in light of the actual and potential damage to institutional trust that results from extended financial and economic stress, external donors and financial lenders should factor in the costs of austerity not only for the economy but also for the quality of institutions.

Crisis aftermath

7. **Identify and correct regulatory deficiencies, resist early deregulation pressures.** When recent developments suggest that some regulations introduced in the wake of the GFC (especially relating to financial firms and markets) are being loosened, it is time to look again at whether those deficiencies have been resolved sufficiently to reduce vulnerability in the future. Furthermore, we need better measures to track regulatory efforts and to assess and improve enforcement practices.

8. **Restore trust and delivery capacity.** Since individual-level factors such as age, education, and income have a significant impact on how economic shocks like the GFC affect citizens' trust in institutions, governments should focus on rebuilding trust among the most vulnerable population groups, especially the young, the low-earning, and the less educated as well as those who rightly or wrongly see themselves as the losers of globalisation. Restoring delivery capacity where it has deteriorated is one way to do this. Another way is to avoid making entire populations bear the blame and the brunt of crisis fall-out while letting many perpetrators go without punishment, as happened in the aftermath of the GFC.

Governments should focus on rebuilding trust among the most vulnerable population groups, especially the young, the low-earning, and the less educated as well as those who rightly or wrongly see themselves as the losers of globalisation.

The global financial and economic crisis, now ten years past, has taught us that we are not yet very good at handling crises quickly, especially those stemming from the conflicts and tensions arising with decoupled fields and institutional voids. While we can point to some improvements in preparing for and managing crises, we now need to become more alert to policy fields and developments that are on the verge of escaping the governance capacities of national and international institutions and which face few countervailing forces. Among these fields and developments we list migration, trade, cyberspace, and climate change, as well as rising nationalism and a growing disregard for science and fact-based policy-making. They are the harbingers of futures crises, just as global finance was and to some extent continues to be.

We now need to become more alert to policy fields and developments that may escape the governance capacities of national and international institutions and which face few countervailing forces.

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