Working toward the next economic paradigm

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For decades, the Western world put its faith in a well-defined and broadly accepted economic paradigm with applications at both the national and global levels. But, against a background of declining confidence in the ability of "experts" to explain - let alone predict - economic developments, that faith has deteriorated. With a new paradigm having yet to emerge, the world economy faces a heightened risk of fragmentation, with already-vulnerable countries being left even further behind.

The paradigm that, until recently, dominated much of economic thinking and policymaking is embodied in the so-called Washington Consensus – a set of 10 broadly applicable policy prescriptions for individual countries – and, at the international level, in the pursuit of economic and financial globalisation. The idea, simply put, was that countries would benefit from embracing market-based pricing and deregulation at home, while fostering free trade and relatively open cross-border capital flows.

Deepening the economic and financial linkages among countries was viewed as the best way to deliver durable gains, enhance efficiency and productivity, and mitigate the threat of financial instability. This approach was also deemed to yield collateral benefits, from enhancing internal social mobility to reducing the risk of violent conflict among countries. And, it promised to support the positive convergence of developing and developed countries, thereby reducing both absolute and relative poverty and weakening economic incentives for illegal cross-border migration.

Supported by the traditional economic theories taught at most universities, this approach was energised after the fall of the Berlin Wall and the disintegration of the Soviet Union, when the former communist countries, together with China, joined the Western-dominated world order, boosting total production and consumption.

But, at a certain point, confidence in the Washington Consensus turned into something like blind faith. The resulting complacency, among policymakers and economists alike, contributed to the world economy becoming more vulnerable to a series of small shocks that, in 2008, culminated in a crisis that pushed the world to the brink of a devastating, multi-year economic depression.

Suddenly, the advantages of globalisation paled in comparison to the risks. It didn't help that the crisis originated in the United States, which had hitherto been the main advocate for the Washington Consensus and unbridled globalisation, including through its role in multilateral organizations like the G7, the International Monetary Fund, the World Bank, and the World Trade Organization.

Analytical failures were partly to blame for this. The economics profession did not go far enough to develop a comprehensive understanding of the connection between a rapidly growing and increasingly deregulated financial sector and the real economy. The impact of major technological innovations was poorly understood. And insights from behavioral science were inadequately regarded – if not shunned altogether – in favor of analytically elegant microeconomic underpinnings that were model-friendly, but unrealistic and overly simplistic.

Meanwhile, policymakers overlooked the economic, political, and social consequences of rising inequality – not just of income and wealth, but also of opportunity – thereby allowing the middle class gradually to be hollowed out, a trend that was exacerbated by both technological and non-technological developments. They also underestimated the risks of financial contagion and surges in migration flows. As a result, behavioral norms and rules lagged far behind realities on the ground them, and political polarisation intensified.

At the international level, the established post-war order was increasingly challenged by a rising China, whose sheer size, in terms of both geography and population, enabled it to achieve systemic importance, despite a relatively low per capita income and a political system that seemed at odds with a liberal market-based economy. The major global economic institutions struggled to adapt quickly enough.

In fact, notwithstanding a few tweaks, the governance structure of the IMF and the World Bank remained more reflective of past realities, with Europe, in particular, maintaining disproportionate influence. Even the G20, which emerged when the G7 proved too narrow and exclusive to support effective economic-policy coordination, failed to change the game. A lack of operational continuity, together with disagreements among countries, quickly undermined the G20's effectiveness, especially after the threat of a global depression had passed.

Given all this, it should come as no surprise that enthusiasm for economic and financial globalisation has faltered. Indeed, both advanced and emerging economies have long balked at the notion of strengthening regional and international institutions by delegating more national authority to them.

Now, some countries are adopting a more inward-looking approach and/or shifting their focus to bilateral and, in Asia, to regional linkages. Such shifts give larger economies like the US and China a distinct advantage, while some economies and regions – particularly in Africa – face increasing marginalisation.

Building consensus around a revised unifying paradigm will not be easy. It will be an analytically challenging, politically demanding, and time-consuming process that will probably entail the consideration and rejection of a few bad ideas before good ones take root. It will also be a more multidisciplinary and intellectually inclusive process – more bottom-up than top-down – than the one that preceded it. It will need to adapt intelligently to innovations in artificial intelligence, Big Data, and mobility.

In the meantime, both economists and policymakers have an important role to play in improving the existing situation. At the international level, the concept of "fair trade" – not to mention social displacement – should be a bigger part of policy discussions. And economies – especially Europe – need to work actively to reform a tired system of multilateral governance that increasingly lacks credibility.

Moreover, feedback loops between the real economy and finance need to be examined in greater depth. Distributional issues, including pressures on the middle class and the predicament of population segments vulnerable to slipping through stretched social safety nets, need to be better understood and addressed. This demands deeper comprehension of technology-driven structural changes, with Big Tech recognising and adjusting to its growing systemic importance in step with government.

Complacency was a central reason for the last economic paradigm's loss of credibility. Let us not allow it to do any more damage than it already has.

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