GLOBAL Dashboard

A Bretton Woods II worthy of the name

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Introduction

With “Bretton Woods II” now imminent, it’s a good moment to take stock of preparations for the summit – and to ask what chances it has of matching the achievements of its illustrious predecessor.

The summit will be held in Washington on 15 November 2008, with G20 leaders, the UN Secretary General, and the heads of the IMF, World Bank and Financial Stability Forum in attendance.[1] Its aim is to:

> Review progress being made to address the current financial crisis, advance a common understanding of its causes, and, in order to avoid a repetition, agree on a common set of principles for reform of the regulatory and institutional regimes for the world’s financial sectors.[2]

It’s a clear remit. The worst of the crisis is seen as already past (as Hank Paulson puts it: “we have taken the necessary steps to prevent a broad systemic event”).[3] The clean-up now proceeds apace. Leaders should thus turn their attention to the bigger picture, learn tough lessons from what has gone wrong, and rejig the world's financial architecture to ensure that we never again tread so close to disaster.

Many are relishing the challenge. Nicolas Sarkozy and Gordon Brown, in particular, are having the time of their lives, as they oscillate between playing as a team and jostling over the limelight.[4] For Brown, this is vindication of a long interest in international financial reform – and a chance to slip back into the role of economic sage that he enjoyed so much while Chancellor of the Exchequer.

Sarkozy’s enthusiasm is more recent, but this has not stopped him from ramping up the rhetoric. He has been busy dancing on the grave of laissez-faire, and calling for ‘whole swathes of financial activity’ to be brought under state control. The chance to trample all over George Bush – now more unpopular at home than Nixon after Watergate – was an added bonus.[5] “Europe wants the summit before the end of the year,” the French President told the media as he set off to meet his American counterpart. “Europe wants it. Europe demands it. Europe will get it.”[6]

But now the Europeans have got their way, can the summit live up to its billing? Are leaders correct to assume that the worst news is now in the past? And do they understand the problem well enough to be able to implement viable solutions?

Be careful what you wish for

The answer to all three of these questions is 'no', we believe.

US support for the summit is grudging at best. Its officials are refusing to play along with the Bretton Woods II moniker, and instead stick resolutely to referring to it as a G20 summit. They're of course keen to hit ‘pause’ while waiting for the Obama team to make its intentions known. The President-elect, meanwhile, is keeping a low profile, with little to gain by meddling before he has the power to ensure his interventions count.

The IMF is equally cautious. Written off by many, it is now back in the ascendant and has a growing queue of countries looking for bailout finance. But its head, Dominique Strauss-Kahn, has been busy dampening expectations of what the summit can achieve:

> Expectations should not be oversold. Things are not going to change overnight. Bretton Woods took two years to prepare. A lot of people are talking about Bretton Woods II. The words sound nice but we are not going to create a new international treaty.[7]

The US and the IMF both argue that the summit is just the beginning of a process, and that leaders should use the get-together to set up a programme of work that can roll out over the next year or two. This, of course, is closer to the model provided by the original Bretton Woods. John Maynard Keynes (whose reputation is one of few commodities to thrive in a bear market) was hard at work thinking about the shape of a future global settlement more than a *decade* before anyone travelled to New Hampshire.

Can we say that we're at the same stage today? Of course not. At present, we not only lack a clear consensus on what Bretton Woods II should try to achieve; we don't even have consensus on the major areas of disagreement, and where we should look for trade off and compromise.

Serpent in paradise

Perhaps, though, the problem is more fundamental than a lack of shared awareness.

The success of the original Bretton Woods was built on what the geopolitical blogger, Fabius Maximus, has described as the “exhaustion and steely resolve of the world's people following the twin disasters of the Great Depression and WWII.”[8]

The observation that institutional or social renewal usually follows moments of breakdown (indeed, may actually depend on them) isn't new. Thomas Homer-

Dixon made the same point last year about the emergence of the Federal Reserve system following the San Francisco quake of 1907.[9] But it should force us to ask a simple question: have we suffered a sufficiently arduous trial by fire to force us to think the unthinkable?

At this stage, it would seem not. A few weeks back, during the shock and awe that followed the Lehman breakdown, the unthinkable was certainly being thought. Now, though, we have entered a period of phoney warfare, in which we know that dire economic impacts are on the way, but the pain hasn't yet been felt. Neither exhaustion nor steely resolve are terms that spring to mind to describe the mood of the global body politic.

So perhaps we are indulging in wishful thinking when we imagine that we have arrived, once again, in 1944. Maybe we are still stuck in a grimmer period of global history –1914, when the first phase of globalization was drawing to a painful close.

As Keynes himself later remembered, the 'internationalization' of social and economic life was then regarded as:

> Normal, certain and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable. The projects and politics of militarism and imperialism, of racial and cultural rivalries, of monopolies, restrictions, and exclusion, which were to play the serpent to this paradise, were little more than the amusements of his daily newspaper.[10]

Perhaps the serpent is still at play in our paradise – in which case, the challenge becomes a more fundamental one. Not 'how do we pull off BW II in one fell swoop?' – rather, 'how do we get from 1914 to 1944 without the disasters that disfigured and disgraced the first half of the twentieth century?'

Shifting plates

Let's consider some reasons for believing that we are yet to hit rock bottom.

First, there's the fact that the extent and depth of the crisis has been persistently underestimated. Six months ago, many experts assumed the worst was over and predicted recovery by 2009 – with hindsight, an incredibly rosy assumption.[11] History suggests that optimism may be similarly misplaced today. On average, past banking crises in developed countries have taken four to five years to unravel, have cost around 12% of GDP to resolve, and have led to a cumulative loss in output of almost a quarter of GDP.[12] In Japan, it was around eight years before policy makers even *found* the right policy levers.[13]

Given that we now face what Gordon Brown has described as “the first truly global financial crisis of the modern world”, our bet would be that it takes *as long as a decade* to bring it fully under control.[14]

At the same time, it is important to pay close attention to the broader power shifts that are likely to coincide with, and be embodied in, any major renewal of the global international architecture. At the heart of BW I was the eclipse of the UK by the US. While Keynes chaired the summit, it was the Americans who called the shots – as the balance of quota votes in the IMF attests.

Today, the tectonic plates are on the move again. Their destination is as yet unknown, but presumably we are headed towards some kind of more or less fractious multipolarity. Yet for all the talk of a global settlement at BW II, emerging economies are only beginning to come to the forefront (whether as victim of the crisis or knight in shining armour). Admittedly, China's stimulus already dwarves that applied by the West, at 16% of GDP compared to the US's 1% – but China has made it clear that it interprets its international role primarily in terms of boosting growth, not as a leading player in fashioning or implementing a collective response.[15]

China's dramatic action shows that only one of the legacies of the debt binge has come home to roost: the toxic liabilities that have clogged up formal and the ‘shadow’ banking system. Another, though, has yet to do so: the global imbalances between debtor and creditor nations that have most notably led to China sitting on dollar reserves that, at last count, came to nearly two trillion (leading to a fresh burst of worry about whether China might exercise its economic ‘nuclear option’ if it were to come under hard pressure from the US to revalue the yuan).[16]

Concern over these imbalances has led Paulson to call for BW II to take on much more than the banking crisis. Fail to tackle them now, he warns, and the pressure “will simply build up again until it finds another outlet.”

The bigger picture

Paulson is right to signal the need to widen the BW II agenda. This, of course, was a lesson from the first Bretton Woods summit, whose focus spanned the whole international economic waterfront, taking into account banking supervision, foreign exchange and currency valuations, trade, countries’ balances of payments and other areas besides. Moreover, Keynes sought explicitly to *integrate* these various considerations in his elegant proposal for an International Clearing Union (subsequently blocked at BW I by the head of the US delegation, Harry Dexter White).[17]

Today, integration needs to go much further than it did in 1944. In an interconnected world, the boundaries between issues are as blurred as those between countries. Leaders will make a big mistake if they attempt to tackle finance in isolation from the other big challenges of our age.

The first thing they should be alert to are non-financial shocks – the wild cards that could conspire to make the financial crisis much worse. The United States is already entangled in two expensive overseas conflicts. What would be the impact of a further deterioration in global security, as Pakistan finally implodes, Iran and Israel tire of shadow boxing, or Al-Qaeda pulls out another spectacular? Or there's the long-heralded avian flu epidemic, which (even if it proves on the mild side of estimates) will bring economic chaos as countries rush to shut their borders. These examples are indicative of course; any 'black swan' would suffice. As the IMF's Jaime Caruana has put it, "it is obviously also the case that when financial systems are more fragile and they are under stress, other shocks can have a higher effect."[18]

Resource scarcity, meanwhile, will have an inevitable impact over the next twenty years, as population shoots up by 20% or so, and we find it ever harder to meet the expectations of the world's burgeoning middle classes.[19] The choke points are land, water, food, energy, and, of course, the right to emit greenhouse gases. The International Energy Agency appears to be the latest convert to peak oil, while Chatham House predicts a $200 oil price may be nearer than we think.[20] Oil now drives the food price, as was shown by the spike that peaked earlier this year, and both are major threats to security, especially in fragile states.[21]

Over the coming years therefore, competition for resources between major powers is likely to become a dominant driver of change in the international system, as concerns over security of supply grow. Poor countries, meanwhile, risk being destabilised, either through the 'resource curse' in the case of exporters, or as they are priced out of the market in the case of import-dependent countries. Either way, this will increase pressure in some of the least stable parts of the world.

At the same time, we face the challenge of climate stabilization, which will require a complete retooling of the global economy to be underway within the next decade. Global emissions will need to drop by at least 50% by mid century (and by much more than 80% in developed countries, assuming an equitable deal), even as population and living standards grow too.[22] This is primarily an *economic* and *institutional* challenge, much of which will have to be confronted internationally. It is simply *impossible* to imagine a new global financial architecture that does not take into account this change – a change that McKinsey has compared to the Industrial Revolution, but at three times the pace.

Recalibrating globalization

The biggest challenge, though, will be to take a new look at what we expect from globalization. Recent debate has been sterile – split between those who are 'for' and 'against' further global integration. Reality, on the other hand, has been much more nuanced – some things have become *very* global, while others have stayed national or even become more local.

To illustrate the point, imagine a globalization 'graphic equalizer' with different slides for different variables:

- The 'capital' slide would in recent years have shifted all the way up to 9 or 10; the slide for 'labour mobility', by contrast, would be down at 4 or 5.
- 'Trade in high value added manufactures' would be up at 7 or 8; 'trade in agricultural goods', on the other hand, would be more like a 5 or a 6, given developed country protectionism and the fact that most trade in food is regional rather than global.
- Emissions trading is today probably only a 2 or a 3 (limited as it is to just one major region, the EU) – but a successful global deal at Copenhagen could push it up to a 7 or an 8 in one go, and even higher if developing countries start to take on emission targets.

In each of these examples and numerous others, the question is: is this an area in which globalization has gone too far, too fast? Or, conversely, is it an area in which it's *more*, not less, globalization that we really need?

These are *exactly* the questions that were preoccupying Keynes in 1933, as he wrote his essay on 'National Self-Sufficiency'.[23] He believed that the interdependence of the first half of the 20th century was as much a cause for worry as for celebration.

> I sympathize … with those who would minimize, rather than with those who would maximize, economic entanglement among nations. Ideas, knowledge, science, hospitality, travel – these are the things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible, and, above all, let finance be primarily national.

A wholesale retreat into nationalism, or even worse localism, is simply not possible – not if we want to support 6, 7, 8 and 9 billion people. But at the same time, we are building a fiendishly complex global system whose workings we do not understand, and which thus has the potential to occasionally career out of control (how far we never know, until it's over). For that reason, BW II – seen as a long-run process of renewal, rather than a meeting or two – can only make an impact once we have had a serious debate about subsidiarity. What function is best discharged at what level? And which checks and balances are needed to keep it healthy?

The chances are that leaders will duck these questions in Washington and in the meetings that follow. If they do, then it will be worth recalling Milton Friedman's advice to his fellow monetarists during their long wait in the wilderness:

> [This], I believe, is our basic function: to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes the politically inevitable.[24]

Extend horizons

All this should discourage us from holding out too much hope for quick solutions. This weekend's summit may start a useful process, but it will surely disappoint those who have elevated expectations.

Leaders must therefore extend their horizons in (at least) five directions.

- First, they need to look **further ahead**. The challenge is not to patch things up sufficiently to get leaders through their next domestic election, but to work towards an international architecture that will last for a generation at least. This will take time, vision and the patience to develop a common understanding of both problems and solutions.

- Second, they need to look far **beyond financial regulation**. Economic imbalances probably cannot be ignored. But resource scarcity may be put aside for another day, especially with short-term declines in prices as the economy suffers. That would be a mistake. Eventually, these highly volatile bulls will *demand* attention. Leaders would be wise to focus on the problem before it spurs a stampede away from multilateral co-operation.

- This should encourage them to **reach into other international processes**. It is staggering to realise that there are two tribes, each hoping for a far-reaching global deal in 2009 – one on finance, the other on climate. The prospects for achieving either are slim, but non-existent if we persist in believing that either can be treated in isolation from the other.

- Fourth, leaders need to **widen the circle** and get much more serious about the rising powers. Rich countries currently have an unhealthy obsession about being displaced by China and the rest. If only they would devote even half the energy to listening to what emerging economies *want* from multilateralism, and then using that intelligence to strike the ‘grand bargains’ that can secure long-term mutual interests.

- Finally, of course, governments need to **look beyond other governments**. Robust deals are no longer struck in the ‘bubble’ where diplomats meet their peers (though both climate and financial insiders act as if they are). What matters are the political conditions that each government faces at home and, increasingly, the flow of ideas and sentiment across borders. BW I relied heavily on one man's thinking. BW II, on the other hand, will only succeed if built on a platform that brings consensus to a network that stretches across countries and sectors.

About the authors

Alex Evans is a Non-Resident Fellow at the Center on International Cooperation (CIC) at New York University, where he runs CIC's work on climate change and global public goods. He was seconded from CIC to the United Nations from June to October 2007 as part of the team charged with planning and executing the UN Secretary-General's High Level Event on climate change. His current areas of work include a project on the international implications of rising food prices (a joint project between CIC and Chatham House) and acting as a senior adviser on climate change to International Alert, the international peacebuilding organisation.

From 2003 to 2006, Alex was Special Adviser to Hilary Benn MP, then UK Secretary of State for International Development, where he worked across DFID's policy agenda, including UN reform, governance in fragile states and the Middle East Peace Process. He focused particularly on climate change, including working as a member of the cross-Whitehall team charged with working up the Prime Minister's climate change agenda for the 2005 G8 summit at Gleneagles.

David Steven is a policy analyst, strategic consultant and researcher. He co-founded River Path Associates in 1997 and is now Managing Director. His work there focuses on international policy, strategic communications, and responses to cross-cutting global risks. He has led projects for clients including the Department for International Development, the Foreign & Commonwealth Office, the World Bank, the World Economic Forum, and the Harvard School of Public Health.

David's research on international development has been published by a number of leading journals such as Science and World Economics, while his book chapters have been published by Routledge and Oxford University Press. His work on foreign policy reform was published by Manchester University Press in Autumn 2007. Recent presentations have been made to RUSI on resilience and the United Nations University on the politics of a global deal on climate.

Alex and David have worked together on numerous projects since 2006. Their joint publications include:

- *Shooting the Rapids: Multilateralism and Global Risks* (2008), commissioned by Prime Minister Gordon Brown, who subsequently asked them to present the paper to heads of government at the 2008 Progressive Governance summit;

- *Towards a Theory of Influence for 21st Century Diplomacy* (2008), commissioned by FCO Minister Jim Murphy for inclusion in the Foreign Office book Engagement: Public Diplomacy in a Globalised World;

- *Beyond a Zero-Sum Game on Climate Change* (2008), commissioned by the British Council for inclusion in their publication Talking Trans-Atlantic;

- *Climate Change: the State of the Debate* (2007), commissioned by the London Accord (a major climate research initiative led by BP, the Corporation of London and investment banks including Citigroup, Morgan Stanley, HSBC and Merrill Lynch); and

- *Fixing the UK's Foreign Policy Apparatus: an Open Memo to Gordon Brown* (2007) which was adapted for publication in the Guardian and led to an invitation to meet with the FCO's Permanent Secretary to discuss the paper's arguments.

They are currently jointly heading a Demos project on public diplomacy, due to culminate with the publication of a major pamphlet in autumn 2008, and preparing a paper for the UK Department for International Development on multilateral reform needs arising from the challenge of climate change.

They jointly edit GlobalDashboard.org, the foreign policy and global risks blog, and their publications can all be downloaded from www.globaldashboard.org/documents

This paper has been written by Alex and David in their personal capacities.

[1] G20 members are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union. See www.g20.org.

[2] Statement by Press Secretary Dana Perino, 22 October 2008, http://tinyurl.com/6r82cm

[3] Remarks by Secretary Henry J Paulson Jr. on Financial Rescue Package and Economic Update, 12 November 2008, http://tinyurl.com/5rq4nu

[4] For example, http://tinyurl.com/6zkk9a

[5] A recent poll showed Bush with a 76% disapproval rating, compared to Nixon's 66% on resignation, http://tinyurl.com/6xulga

[6] Sarkoy calls for revamping of capitalist system, Washington Post 17 October 2008 http://tinyurl.com/5oyn9l

[7] Bretton Woods II unlikely to emerge from G20 Summit, Financial Times, 13 November 2008, http://tinyurl.com/57ke6v

[8] A Look Ahead to the End of This Financial Crisis, 30 October 2008, http://tinyurl.com/63h95b

[9] Summer Reading: the upside of down, GlobalDashboard.org, http://tinyurl.com/6gnptg

[10] John Maynard Keynes, 'Chapter II Europe Before the War', in *The Economic Consequences of the Peace,* 1920, http://tinyurl.com/5t33nk

[11] See, for example, this press briefing by Dominique Strauss Kahn from April 2008 http://www.imf.org/external/np/tr/2008/tr080410.htm

[12]PIMCO: see http://is.gd/7lt8

[13] Bank for International Settlements, *The financial crisis in Japan during the 1990s: how the Bank of Japan responded and the lessons learnt*, October 2001 http://tinyurl.com/6q7q4e

[14] PM concludes Progressive Governance Summit, 5 April 2008, http://tinyurl.com/5nhnsj

[15]Caveats should of course be applied until we see how fast each country spends the money, and the extent to which expenditure is actually additional to that planned. See: http://tinyurl.com/5r9rsj

[16] China forex reserves exceed US$1.9 trillion, China Daily, 14 October 2007, http://tinyurl.com/5bula6; China threatens nuclear option of dollar sales, Telegraph, 10 August 2007, http://tinyurl.com/3r2w8t

[17] James M Boughton, *Why White, Not Keynes? Inverting the Postwar International Monetary System,* IMF Working Paper, March 2002, http://tinyurl.com/6yjb3b

[18] Transcript of a Press Conference on the Spring 2008 Global Financial Stability Report by Jaime Caruna, 8 April 2008, http://tinyurl.com/65t434

[19] World Population Prospects: The 2006 Revision, World Population Database, http://esa.un.org/unpp/

[20] *Executive Summary*, OECD/IEA, 2008, http://tinyurl.com/5l59ud; The Coming Oil Supply Crunch, Chatham House Report, August 2008, http://tinyurl.com/6gdslv

[21] Alex Evans, *Rising Food Prices*, Chatham House, April 2008 http://tinyurl.com/6y96bz

[22] *Contribution of Working Group III to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change, Summary for Policymakers*, IPCC, May 2007, http://tinyurl.com/33944o

[23] John Maynard Keynes, 'National Self-Sufficiency', in *Yale Review*, Vol 22, no 4 (June 1933), pp. 755-769, http://tinyurl.com/5lhrsh

[24] Milton Friedman, *Capitalism and Freedom*, University of Chicago Press, 2002