GLOBAL Dashboard

2009 – A Year for International Reform

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Reforming International Institutions – Meeting the Challenges of the 21st Century
A conference organized by the United Nations University and the British Embassy in Tokyo

David Steven

Introduction[1]

In the run up to November's G20, I published *A Bretton Woods II worthy of the name*, a paper co-authored with my colleague, New York University's Alex Evans.[2]

In a nutshell, our argument was that leaders needed to respond to extreme global stress by:

- Becoming *more ambitious* in their attempts to reform the international system, despite temptations to focus narrowly on fire fighting a growing number of immediate problems.

- Focusing on *the long-term* in order to increase the basis for co-operation, thinking in decades where national interests tend to converge, rather than in years where often they will not.

- Working towards *integrated solutions*, and not imagining that a 'global deal' on finance could be divorced from the other big deals that must be struck on trade, security, climate and other resource issues.

This paper, prepared for presentation to the United Nation's University and UK Foreign Office conference on International Institutions Reform in Tokyo, expands these points.

It has been written at the beginning of a critical year for the international system – a year of great peril, but also of some promise. Threats are building up globally, many of which are poorly understood and will strain our capacity for collective action. International institutions, as currently constituted, risk being overwhelmed. We could end the year confronted by a 'new isolationism'.

But there are also opportunities to carve out an effective response. After all, a crisis always provides the conditions in which desperately needed reforms can best be achieved.

But policy-makers will find it much easier to work together if they focus on the big picture, or what Wittgenstein called 'the single great problem'. Without ambition, long-term goals, and integration across issues, 2009 will go down in history as a

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[1] **An earlier version of this paper was presented to the Planet in Peril conference, held at the Institute for Environmental Security, Brussels, 15 December 2008**. Many thanks to Alex Evans from the Center on International Co-operation, Jonathan Aves from the British Embassy in Tokyo, and Tom Spencer from the Institute for Environmental Security for comments that helped shape and improve this paper.

[2] Alex Evans and David Steven, *A Bretton Woods II Worthy of the Name*, November 2008, http://tinyurl.com/9kflep

year of lost opportunities – and possibly mark the point that a short-term international crisis turned into a much more deep-seated decline.

The financial crisis

So how can we expect 2009 to unfold?

First, it is a given that the financial crisis will continue to unravel, revealing some devastating economic consequences.

Japan knows better than most how pernicious a banking shock can be – and how long lasting.[3] Her experience, however, is far from unique. On average, banking crises take around four to five years to unravel in a developed country, and cost around 12% of GDP to resolve – emerging economies tend to feel more pain, but get through the crisis slightly faster (see figure 1).[4]

	Average Crisis Length (years)	Average Fiscal Costs of Banking Resolution (% of GDP)
All Countries	3.7	18
Emerging Market Countries	3.3	20
Developed Countries	4.6	12
Banking Crises Alone	3.3	5
Banking and Currency Crises	4.1	25

Figure 1 – Cost of a financial crisis

Their economic impact is also considerable. In a review of the fallout from past crises, Carmen Rheinhart and Kenneth Rogoff find that on average:

- 35% is lost from house prices and 55% from equities.
- Unemployment rises by 7% and output falls by 9%.
- Government debt increases by 86% (see figure 2).[5]

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[3] Hiroshi Nakaso, Bank for International Settlements, *The financial crisis in Japan during the 1990s: how the Bank of Japan responded and the lessons learnt,* October 2001
[4] Michael Gomez, *Emerging Markets to Watch,* Pimco, August 2008, http://tinyurl.com/ax7akp
[5] Carmen M Reinhart and Kenneth S Rogoff, *The Aftermath of Financial Crises,* Harvard University, December 2008, http://tinyurl.com/9twvfs

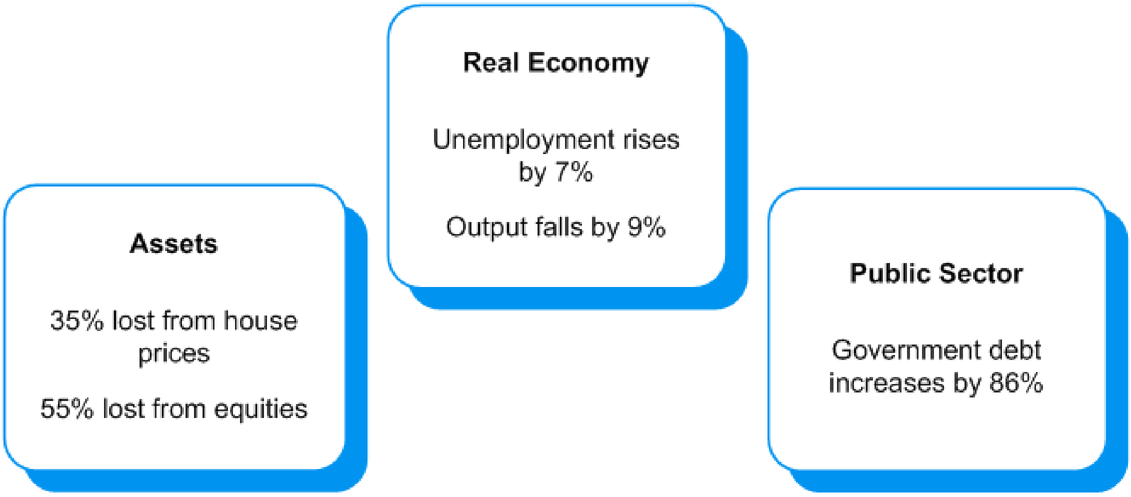

Figure 2 – Economic Impact of a Financial Crisis

The past does not predict the future, of course, but it should make us wary. The pattern, as Japan found, is for policy-makers to underestimate the seriousness of the problem and for financial institutions to spend years refusing to confront their predicament head on. The required *psychological* shift is a profound one.[6]

Throwing money at the problem is, in many ways, the easy bit. Much more demanding is the process of unpicking and revaluing the poorly-understood risks that are at the heart of the financial sector's difficulties. This is a process that has barely begun.

Back in April last year, I presented on multilateral reform to heads of state at the Progressive Governance summit.[7] Then, bold action was promised to sort out the 'bad' from the 'good' banks, but nine months' later that is only beginning to happen.

Instead, many countries have pumped money into their financial institutions, without having the tools to force these institutions to identify, value and dispose of toxic liabilities.

This mistake is likely to prove costly. As Ben Bernanke admitted last week, large quantities of "troubled, hard-to-value assets" have now become the primary obstacle to the financial system's recovery.[8] The UK and US are both now working on new mechanisms to tackle these toxic assets.

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[6] Hiroshi Nakaso, op cit
[7] Alex Evans and David Steven, *Shooting the Rapids: multilateralism and global risks,* for the Progressive Governance Summit, April 2008, http://tinyurl.com/3jft8q
[8] Ben S Bernanke, *The Crisis and the Policy Response,* speech to the London School of Economics, 13 January 2009. See also: http://tinyurl.com/7u3wu2

Meanwhile, the US Treasury's Troubled Asset Relief Program (TARP) has been subjected to some fierce criticism. The Congressional Oversight Panel, for example, identified:

- 'Significant gaps in Treasury's monitoring of the use of taxpayer's money'
- A lack of clarity in asset evaluation, making it unclear whether the Treasury is able to distinguish between 'healthy' and 'unhealthy' banks, and
- 'Shifting explanations' of the fund's purposes, leading the Panel to the conclusion that the Treasury does not have a clear strategy for spending the funds.[9]

The situation in the US is not atypical; its system is simply unusually willing to wash dirty linen in public. Stimulus packages also pose risks, as they must be assembled and dispersed at high speed. Finding productive investment opportunities is a significant challenge.

We have already seen a massive market failure. The danger is that a similarly sized policy failure will now be layered on top.

The trade challenge

The trade system is also well worth keeping a close focus on.

It offers the best early warning system we have for any widespread loss of *confidence* in global integration. Protectionist pressures are already on the rise, as happens in every serious downturn. In 2009, will they overwhelm the will of governments to contain them?

If they do so, we may rue the opportunities that were missed on trade in 2008. In April, at the Progressive Governance Summit, there was genuine enthusiasm for returning to, and completing, the Doha Development Agenda. But the talks still collapsed in July, in a row between India, China and the US.

China thought the rich countries had been 'selfish and short-sighted', while Japan attacked the emerging economies for failing to recognise their new responsibilities. They had failed to think about the world economy as a whole, while pursuing narrow national self-interest.[10]

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[9] *Accountability for the Troubled Asset Relief Program*, The Second Report of the Congressional Oversight Panel, 9 January 2009, http://tinyurl.com/7sks5g

[10] *Dismay at collapse of trade talks,* BBC News, 30 July 2008, http://tinyurl.com/a5ql55

At the G20 in November, Doha was back on the agenda, with heads of state promising a framework agreement by the end of the year.[11] By mid December, however, Pascal Lamy had decided it would be dangerous even for ministers to meet, believing that an acrimonious failure could threaten not just the round, but the WTO system itself.[12]

And the bad news spread beyond Doha. Russia, India, Indonesia, Brazil and Argentina – all G20 members, and key swing voters in the multilateral system – had announced restrictive trade measures within weeks of the G20, despite a promise to "refrain from raising new barriers to investment or to trade in goods and services."[13]

Doha, then, has become the 'zombie' trade round, staggering on, but never quite dying. Few expect that it can now be revived. But who knows? Given its resemblance to a B-movie, perhaps it will lurch back into life at the very moment when all hope appears to have been lost.

An alternative view is that the *content* of Doha doesn't matter *that* much. As Paul Krugman has argued, "World trade is already so free, we're really talking about stuff at the margins."[14]

But Doha has, at the very least, great symbolic importance. It is a yardstick for our ability to strike complex global deals; shows the extent of the world's commitment (or otherwise) to developing countries; and – above all – acts as a bellwether for global confidence in free trade itself.

Global imbalances

If the global trade system is to come under a sustained attack in 2009, this will happen as global imbalances – built up over the past decade – unravel, revealing divergent interests between producer and consumer countries, and particularly between China and the United States.

Currency may well be the main battleground, with countries tempted by competitive devaluations as export markets shrink and domestic producers beg for protection.

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[11] *Declaration of the Summit on Financial Markets and the World Economy*, The G20, 15 November 2008, http://tinyurl.com/62vs35. See also: *G20 Leaders Inject Political Will into Doha Talks,* Australian Minister for Trade, 2008, http://tinyurl.com/8h37w5
[12] *Fresh blow to trade protectionism battle,* Financial Times, 12 December 2008, http://tinyurl.com/a2pb8g
[13] *Declaration of the Summit on Financial Markets and the World Economy*, op cit
[14] *Why Barriers Don't Matter,* Newsweek, 29 November 2008, http://tinyurl.com/6v6rw2

Since the mid-1990s, we have seen:

- A 'savings glut' in Japan and old Europe, and more recently in China and the oil producing countries.

- A 'money glut' in the United States and a few other countries.

Effectively, US consumption was fuelled by a potent combination of cheap imports and cheap money, leading to a surge in consumption and debt. The causes for this were to be found both in the US and globally.

Within the US, monetary policy was lax (in part, as a response to previous economic shocks). From overseas came an avalanche of dollars, as China and other countries recycled their surpluses back into the US economy in order to stop their currencies from appreciating.

The debate as to who should be blamed for the imbalances – savers or borrowers – is a fruitless one. [15] The arrangement was symbiotic, or to borrow language from those who treat addiction, an example of *co-dependence*.

More pertinent were two questions. Were the imbalances sustainable? And if not, could they be unwound in an orderly fashion? The answer to the first was 'clearly not'. Much now depends on whether a gradual and controlled rebalancing is possible.

China is entering a critical period. The country has massive surplus capacity now the American consumer has stopped spending.[16] Its exports have fallen fast and have much further to go. It is vulnerable to falls in the dollar, which will worsen its terms of trade while devaluing its massive dollar holdings ($1.94 trillion at the end of 2008).[17]

Finally, there are signs that so-called 'hot money' may be beginning to flow out of the country, with analysts estimating that $120-140bn of capital left the country in the last quarter of 2008.[18] China's own banking system has significant weaknesses, despite recent efforts to address non-performing loans.

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[15] The debate was summarised by Martin Wolf in 2007. Wolf concluded that "The savings-glut view is far more comforting. Excess savers will learn to spend, in the end – sooner rather than later, if US spending were to weaken dramatically. But if we live in the money-glut world, the great gains in monetary stability of the past quarter century are at risk." *Villains and Victims of global capital flows,* Financial Times, 12 June 2007, http://tinyurl.com/92sr42

[16] *How will China deal with the US adjustment?,* Financial Times, 9 January 2009, http://tinyurl.com/854typ

[17] *China forex reserves exceed US$1.9 trillion,* China Daily, 14 December 2008, http://tinyurl.com/5bula6

[18] *Secrets of SAFE: A sharp slowdown in reserve growth and large 'hot' outflows in Q4,* Council on Foreign Relations, 13 January 2009, http://tinyurl.com/8d2bw6

Some of the tensions can be seen in a fascinating interview in last month's Atlantic magazine with Gao Xiqing, Chief Investment Officer at the China Investment Corporation, the sovereign wealth fund that manages the riskier part of China's foreign exchange reserves.[19]

Gao had harsh words for the Americans ("the simple truth today is that your economy is built on…the gratuitous support of a lot of countries"). He also provided an insight into how unpopular Chinese investment in the US can be at home. China's citizens 'hate' its support of rich Americans ("people eating shark fins" at the expense of "poor [Chinese] people eating porridge," he claims).

It seems unlikely that the Chinese can boost domestic consumption rapidly enough to soak up declining exports – though they must do what they can. A worrying prospect is that the Chinese government will devalue to prop these exports up. That would mean that Western stimulus dollars, euros and pounds were flowing to Chinese producers. It is hard to imagine anything more politically explosive in the current climate.[20]

The US would almost certainly react to protect its producers, with Europe tempted to follow suit. The worst case would be the emergence of a nasty zero sum dynamic in the international arena – a series of tit-for-tat measures that are *politically compelling* in the short term, but lead to a marked, and even disastrous, *loss of collective welfare* over longer time scales.

The politics of scarcity

2009 will also see the world continue to grapple with the impact of a set of scarcity issues that are perhaps the most important long-term drivers of global change.

These issues have enormous geopolitical relevance (oil), are growing causes of poverty and conflict (food, water, land), and/or demand unprecedented levels of international collective action (climate change).

Neither can they be seen in isolation, as was shown by last year's short, but pronounced, commodity boom. In the spring of 2008, oil prices spiked, reaching $147 dollars per barrel in July. Food prices also increased alarmingly, sparked to a large degree by the price of oil. Inputs such as fertilisers had risen in price, while biofuels were an increasingly strong competitor for productive land.

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[19] *Be Nice to the Countries That Lend You Money*, The Atlantic, December 2008, http://tinyurl.com/65qakk
[20] *How will China deal with the US adjustment?* Financial Times, 9 January 2009, http://tinyurl.com/854typ

In rich countries, recent analysis suggests that higher energy prices were a significant factor in turning an incipient slowdown into a deep and painful recession.[21] In poorer countries, rising commodity prices had seriously destabilising effects, with food riots across Africa and Asia.[22]

The response: a wave of *resource nationalism*, with over thirty countries introducing export restrictions.[23] Even with lower prices, countries have continued to try and protect their security of supply. Middle income food importers have signed long-term land deal with other – usually poorer – countries, while producers are re-examining the merits of self-sufficiency.

In the medium term, the drivers for commodities remain upwards. Population growth, economic development, underinvestment in supply, a lack of water, competition for land, and climate change are all likely to increase prices *and* volatility.

We therefore find ourselves in a damaging triple-bind:

- On the one hand, resource price shocks are likely when times are good, acting as a repeated challenge to economic recovery.

- On the other, political progress may prove hard in *both* good and bad times. When prices are high, national responses will be favoured. When prices are low, economies will probably be suffering too. Other priorities will thus seem more important.

Recent experience with climate change illustrates the problem. In the boom years, global emissions shot up, rising 2.9% a year between 2000 and 2006, compared to a figure of less than 1% that was assumed in the models that formed the basis of the Stern Review. Surveying this trend, analysts from the Tyndall Centre argued that “it is difficult to envisage anything other than a planned economic recession being compatible with stabilization at or below 650ppm.”[24]

Now, of course, we have that recession – though it wasn’t planned. The IEA expects demand for oil to fall by around 0.6% in 2009, though the drop could be

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[21] See *The oil shock and recession of 2008: Part 1,* Econbrowser, 31 December 2008, http://tinyurl.com/9d8lvm and *The oil shock and recession of 2008: Part 2,* Econbrowser, 2 January 2009, http://tinyurl.com/8wf6or

[22] Donald Mitchell, *A note on Rising Food Crisis* (PDF), World Bank, Policy Research Working Paper 4682, July 2008

[23] Alex Evans, *The Feeding of the Nine Billion – Global Food Security for the 21st Century*, Chatham House, 2009

[24] Kevin Anderson and Alice Bows, *Reframing the climate change challenge in light of post-2000 emission trends*, The Royal Society, 2008, http://tinyurl.com/5wkwqe

much more dramatic than that.[25] Emissions will decline roughly in line with energy demand (though probably not as rapidly given substitution by dirtier forms of fuel). In theory, this should make emissions restrictions easier to swallow.

But yet, as we saw in Poznan, the reverse is true, with many governments arguing that a tough climate deal should be delayed until the economy recovers. At the same, investment in low carbon technologies (at least from the private sector) is also suffering.

The logic is insidious and, if unchecked, will have catastrophic long-term consequences, as countries persuade each other that it's never a good time for a robust climate deal.

The security threat

Finally, with the economy on all our front pages, it is easy to disregard the potential impact of security threats on the world in 2009, and on prospects for international co-operation.

That would be a mistake. The situation in the Middle East again seems unsustainable, at a time when oil producer countries are coping with what was, for them, a very unwelcome decline in the oil price. Iran's nuclear ambitions are a threat not just to Israel, but to many of its competitors in the Arab world, and indicate the ongoing threat from proliferation.[26]

Key middle income countries, meanwhile, are experiencing extreme distress. Pakistan, for example, has been battered by fall-out from its highly ambiguous role in the Bush administrations 'war on terror'; by the commodity price crunch which pushed large numbers of Pakistanis back into poverty; and by the credit crunch, which left it needing an IMF bailout.

Many other countries are feeling similar impacts. Higher food prices in 2008 are estimated to have pushed an additional 130-155 million people into poverty.[27] That shock had barely worked its way through the system, before the financial crisis hit. The World Bank estimates that developing country growth will slow to 4.5% in 2009, well below recent levels.[28] Many analysts are significantly more bearish.

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[25] *IEA predicts further fall in oil demand,* Financial Times, 16 January 2009, http://tinyurl.com/9smf5p
[26] *More grave than Gaza,* The Globe and Mail, 10 January 2009, http://tinyurl.com/8wywn8
[27] *High Commodity Prices: impact on poor people,* in 'Global Economics Prospects 2009: commodities at the crossroads', World Bank, 2009, http://tinyurl.com/7g8qtz
[28] *World Development Report 2009: Reshaping Economic Geography,* World Bank, Washington, 2009.

2009 could see a wave of countries get into serious trouble. If so, the IMF may well struggle to cope, given that its reserves are only around $200bn.[29] It can probably respond to a handful more crises in smaller, poorer countries. If a larger emerging market were to get in trouble, it would need new money and fast. Trouble for a major developed country would quickly take us into unknown territory.

Weak growth in the developing world is likely to fuel conflict and state failure, with poor countries facing a 'demographic disaster' if they fail to provide economic opportunities for growing numbers of young adults.[30] There is a compelling link between income and civil war, while sudden income losses weaken the legitimacy of the state and exacerbate competition between groups for scarce resources.[31]

The results are countries that are a threat to themselves, to their neighbours, and – as havens for terrorists – to the rest of the world.

Now is a good time to remember that Nassim Nicholas Taleb has said that the financial crisis is *not* a black swan, because it was too predictable that it would happen.[32]

An unexpected security deterioration in one or more regions is *precisely* the kind of additional stress that could derail international efforts to tackle other problems. Terrorism is another potential threat that can be corrosive to international alliances, of course, while avian flu would see countries rush to close their borders, in a futile attempt to isolate themselves from the threat.

This, then, is not a time to lose focus on these risks. Instead, the question to ask is: how will global systems cope at a time when they are *already* compromised by a number of other serious stresses?

Lessons from Bretton Woods

Given the dramatic prospects we face in 2009, it's tempting to look at past crises to see what historical precedents tell us about what is happening today.

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[29] *IMF firepower could soon run short,* Financial Times, 27 October 2008, http://tinyurl.com/555lnz See also *IMF may need to "print money" as crisis spreads,* Telegraph, 28 October 2008, http://tinyurl.com/5fuqhg

[30] David Bloom and David Canning, 'How Demographic Change Can Bolster Economic Performance in Developing Countries', *World Economics*, 2003, Vol. 4, No. 4, October-December, pp. 1-14.

[31] Susan E Rice and Stewart Patrick, *Index of State Weakness in the Developing World*, The Brookings Institution, Washington, 2008, http://tinyurl.com/9uudj3

[32] *The Black Swan: Quotes & Warnings that the Imbeciles Chose to Ignore,* Fooled by Randomness, http://tinyurl.com/3f9jay

In the run up to the G20 last year, a number of European governments became excited by the prospect of a grand redesign of the multilateral system. Gordon Brown and Nicolas Sarkozy were particularly enthusiastic about the prospects for Bretton Woods II – and have taken this energy into the G20 process.[33]

The first Bretton Woods conference aimed, in the words of John Maynard Keynes, to find "a common measure, a common standard, a common rule" that would govern all parts of the economic system.[34]

The impetus for agreement sprang from the exhaustion of the second world war; a decade of thinking and preparatory work by Keynes and others; and the ability of the United States – in its pre-Cold War period of undisputed hegemony – to impose agreement where necessary.

Today's conditions are very different. Many policymakers are still in denial about the depth of the problems we face. There are few, if any, well-developed packages of solutions. And the United States is in no position to *insist* on a programme of global reform.

Perhaps then, a better example is the crisis that ended the Bretton Woods system – the so-called 'Nixon Shock' of 1971 when the US President broke the link between dollar and gold.

Although Nixon blamed speculators for his decision, in fact the problems were structural – global imbalances that are strikingly similar to today's. Post-war European recovery had led to large US deficits and, with fixed exchange rates, the Europeans had little choice but to recycle dollars into US government debt, of which there was plenty, given America's need to fund an expensive war in Vietnam.[35]

The result was a series of runs on US gold reserves and growing pressure to devalue the dollar. Policy was made up on the hoof. Nixon's shock decision to break the link with gold was taken with little preparation or forethought. The President spent less time on the policy itself, than he did on worrying whether he should interrupt a popular television programme to announce it to the American people, and the world.

So what happened? Predictably, the dollar went into a steep decline, losing around a quarter of its value against a basket of European currencies.[36] And

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[33] Alex Evans and David Steven, *A Bretton Woods II Worthy of the Name*, November 2008, http://tinyurl.com/9kflep

[34] Robert Skideslky, *John Maynard Keynes 1883-1946: economist, philosopher, statesman,* Pan Books, London, 2003

[35] George Cooper, *The Origin of Financial Crises,* Harriman House, Petersfield, 2008

[36] *Black Gold: the end of Bretton Woods and the Oil-Price Shocks of the 1970s,* The Independent Review, Volume 9, Number 4, Spring 2005, http://tinyurl.com/7znsq2

inflation was let loose, despite US attempts to control prices and wages. The resulting inflationary spiral was not tamed until the 1980s and only then through the 'Volcker recession'.

Natural resources were also involved. The oil shock of 1973 can be seen, in part, as a response to the depreciation of the dollar, as Arab countries protected an oil price that, when denominated in gold, had seen a three-fold decline.[37]

The Nixon shock illustrates the dangers of unilateral and reactive policy-making; and also the power of unintended consequences. In our response to a crisis, we often sew the seeds for the next breakdown, and can easily exacerbate not dampen volatility.

Stagnation in the thirties

For pessimists, however, comparison with the 1970s is not sufficiently dramatic. They prefer to reach for the stock market crash of 1929 and the subsequent 'great depression.'

A few months' ago, these were comparisons were regarded as distasteful, maybe even a little hysterical. In April last year, the IMF was predicting only a minor slowdown for Europe and a recovery in the US starting in 2009.[38]

No longer. Now, rich countries are clearly all in a deep recession. The question is whether it will be U-shaped (deep but with a gradual recovery) or L-shaped (ongoing stagnation).[39] As one economist quipped recently, it's now too late to avoid 1929. Instead, we must focus on avoiding the mistakes of 1930, 1931 and 1932.[40]

What were those mistakes? Deflation exacerbated by policy, of course. But also a tit-for-tit recourse to protectionism, as global trade came to a halt, and a series of sovereign debt defaults, leading to the collapse of the international financial system.

It is tempting to imagine that the period was a time of international policy paralysis, with policymakers simply unaware of the risks they were running. Far from it. There were plenty of attempts to tackle problems on an international level, culminating in a World Economic Conference in 1933 that brought 66 nations together.

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[37] The Independent Review, op cit
[38] *Transcript of a Press Briefing by IMF's Managing Director Dominique Strauss-Kahn, First Deputy Managing Director John Lipsky, and Director of External Relations Masood Ahmed*, International Monetary Fund, Washington, 10 April 2008, http://tinyurl.com/8pztg8
[39] Nouriel Roubini, *The Worst is Yet to Come*, in 'Foreign Policy', January/February 2009
[40] *Complacency rules as time slips away,* Financial Times, 14 December 2008, http://tinyurl.com/5s4fxb

The summit was supposed to launch a global 'new deal' – or, at least, that was what the Europeans were hoping for. But there was no shared platform to bind Europe, the UK and the US together. Franklin Roosevelt – just elected in a landslide – was focused on problems at home.

To European fury (and the discomfit of his own delegation), the new President derailed the summit with the so-called 'bombshell message', sent from a yacht where he was enjoying a vacation. It was to be the last attempt to forge a global approach to reform before Bretton Woods.

Surveying the conference's wreckage, Keynes's conclusion was a sobering one. 66 countries could never be expected to agree, he thought. Only a 'single power or a like-minded group of powers' could prevail – and only then if they were equipped with a new understanding of the world's systemic problems, and a new toolbox with which to tackle them.[41]

The first globalization

The 1930s offers salutary lessons to policy makers. However, it does encourage them to believe that our current troubles are *purely* economic in their nature – and can be solved through some deft re-regulation and a generous dose of stimulus.

This creates a real danger that other pressing issues will be kicked into the long grass for how ever long a recovery takes. This would be a mistake, especially given the strong links between economic and other global challenges.

To underline this point, it is worth looking back beyond the thirties, to the period before the First World War, when the world had its first experience with globalization and enjoyed unprecedented mobility of capital, goods and people.

It was then that Norman Angell argued in *The Great Illusion* that major wars were now almost inconceivably because of "the delicate interdependence of our credit-built finance."

For Keynes, looking back, globalization then appeared "normal, certain, and permanent, except in the direction of further improvement." But yet the forces that were to lead to war were already building:

> 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, and appeared to exercise almost no influence at all on the ordinary

[41] Skideslky op cit

course of social and economic life, the internationalization of which was nearly complete in practice.[42]

Rapid social, technological and economic development had brought about a new paradigm of 'industrial war'. Countries were enmeshed in a system of diplomacy that was intricate in its operation, but in which levels of mistrust had steadily grown.[43]

The result, in 1914, was the destruction of the European world order and a period of chaos that took two world wars and the intervening depression to resolve.

Today, the second period of globalization faces similar challenges and contradictions.

Modern economies are dynamic but unstable, as we have found out. Technological diffusion is putting unconventional weaponry in the hands of a growing number of states. Inevitably, non-state actors will also find some way of getting in on the act.[44]

Power, meanwhile, is shifting to countries where most people are still poor, at a time when resource constraints are beginning to bite. Economies must decarbonise at a speed that will make the industrial revolution look pedestrian.[45] Even so, the chances of disruptive climate change are now worryingly high.[46]

The challenge then is to use the current systemic shock as an impetus for fundamental reform. The danger is that, as in 1914, the basis for international co-operation will disappear, just when globalization most needs to be 'saved from itself'.

Signals from the future

Last year, in a paper for the United Nations University, I argued that international co-operation on climate depends on 'signals from the future'.[47]

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[42] John Maynard Keynes, *The Economic Consequences of the Peace,* Kessinger Publishing, Montana, 2005

[43] Rupert Smith, *The Utility of Force: the art of war in the modern world*, Penguin Books, London, 2006

[44] Phillip Bobbitt, *Terror and Consent: the wars for the twenty-first century*, Allen Lane, London, 2008

[45] *The Carbon Productivity Challenge: Curbing climate change and sustaining economic growth*, McKinsey, 2008

[46] Michael C. MacCracken, Frances Moore and John C. Topping, Jr., *Sudden and Disruptive Climate Change - Exploring the Real Risks and How We Can Avoid Them*, Earthscan Publications, 2008

[47] David Steven, *A Low Carbon World – pathways to a global deal,* speech to the United Nations University G8 Symposium, 4 July 2008, http://tinyurl.com/7mlrrw

Alex Evans and I have developed this work further, in a project for the UK's Department for International Development that explores the radically different *institutional architecture* that will be needed to deliver a low carbon future.[48]

One of our central arguments is that action taken on climate today is fundamentally influenced by *expectations* of what will happen in the future:

- If countries, companies and citizens expect a slow transition to a low carbon economy, then they have a strong incentive to block any climate deal, and to free-ride on carbon reduction measures implemented by others.

- On the other hand, if they expect the transition to happen rapidly, their incentive is to lead the change (in order to avoid misallocated investment, and to lead emergent industries), while supporting strong action against free-riders.

An effective climate deal, then, is something of a self-fulfilling prophecy. With strong signals from the future, policy-makers are likely to behave in a way that makes a deal easier to achieve. In contrast, weak signals will lead to a vicious cycle and intense zero sum competition (see figure 3).

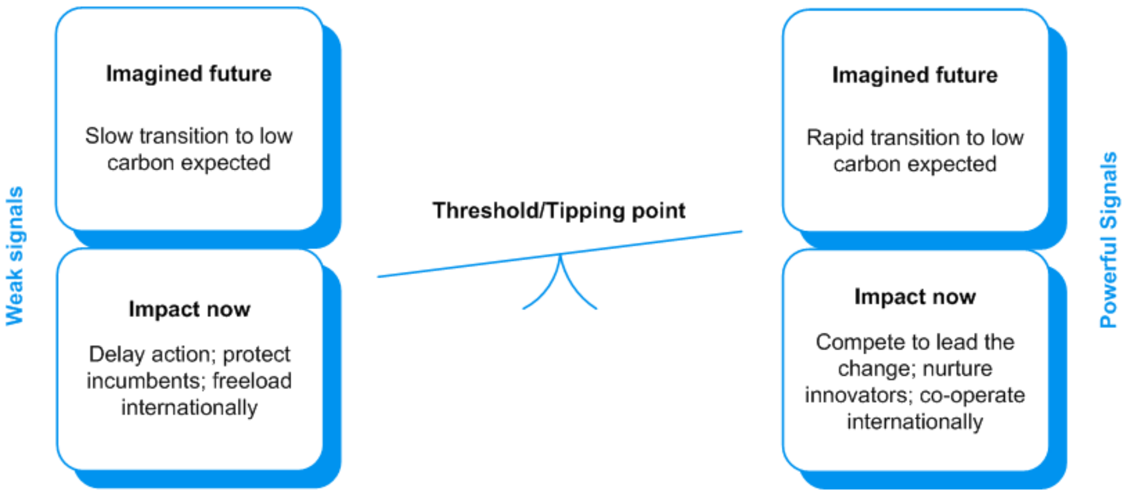

Figure 3 – Signals from the future

This argument can, I believe, be applied more generally to today's international challenges. Let us characterise current international co-operation as *medium trust*, with considerable commitment to globalization, but relatively weak institutional arrangements for controlling the global system.

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[48] Alex Evans and David Steven, *An Institutional Architecture for Climate Change*, concept paper for DFID, first draft, 12 December 2008

If we experience a long crisis (or a chain of interlinked crises), we are likely to see *either* a significant loss of trust in the system (globalization retreats), *or* a significant increase in trust (interdependence increases). The status quo is not likely to be stable over the medium-term (see figure 4).

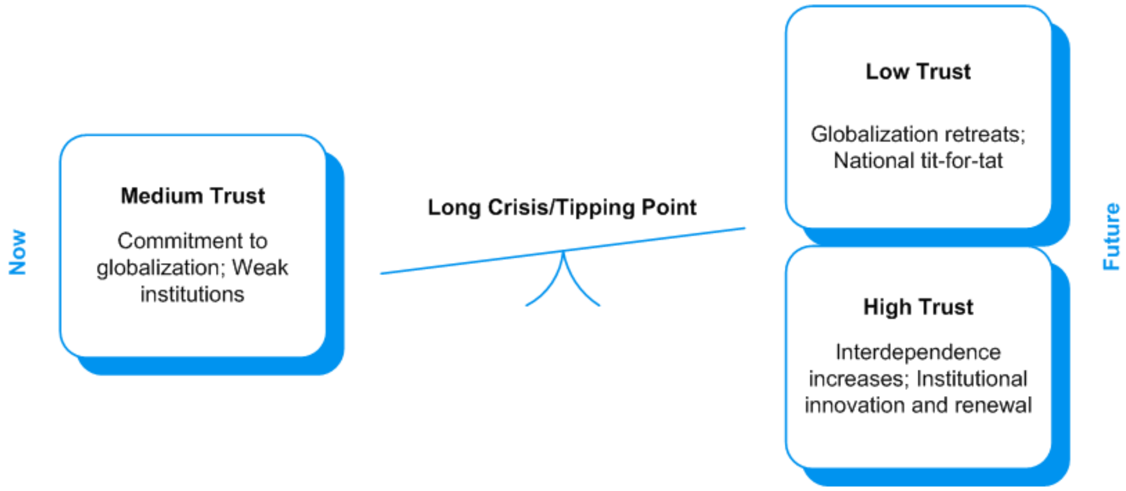

Figure 4 – International Reform: tipping point

The three 'shareds'

Lengthening time horizons requires countries to work from a comprehensive view of the risks and challenges the world faces, and its opportunities for solving them.

This is why we need a new diplomacy – one that focuses its resources not on bilateral relationships, but on multipolar responses to global threats and challenges.

This is a *diplomacy of ideas*, not one of narrow self-interest, and it should take us a long way from the old geopolitics. In the new paradigm, countries need to co-operate to build a vision for the international institutions that we need, not just today, but over the next generation. They need to identify and further shared interests.

The goals of this diplomacy, then, are to build:

- *Shared awareness* – a joint analysis of future challenges, one that is sufficiently broad to bring together economic, security and scarcity issues, and that has buy-in not just from governments, but from non-state actors too.

- *Shared platforms* – coalitions of countries that begin to harmonise their domestic policies and commitments (whether on banking reform, or climate change, or investment in agriculture), and use this as the basis for lobbying for more fundamental international reforms.

- A shared *operating system* – new global frameworks and institutions, with a mandate to deliver security and sustainable growth over the long-term (see figure 5).[49]

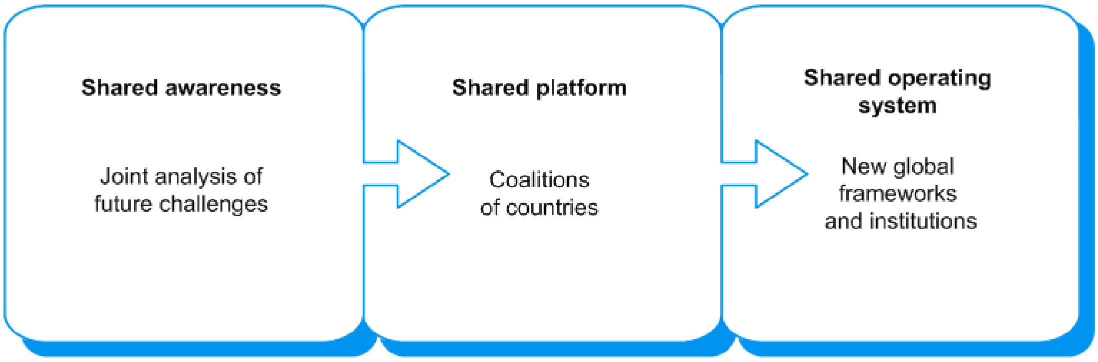

Figure 5 – The new diplomacy

As Alex and I argued in our paper for the Progressive Governance summit, we need to drive through a programme a multilateral reform that focuses on delivering results, not restructuring organisations.[50]

This means building an international system that:

- Aims, over the long term, to manage risk and increase resilience.
- Embeds national sovereignty in a deeper context, in which the need for cooperative action between states is recognised and acted upon.
- Overcomes fragmentation between silos and distributes, as widely as possible, the responsibility for creating global public goods.
- Rebuilds international organizations, making them much more flexible, responsive, and able to interface with non-state global networks.

Building the platform

So what might this look like in practice?

The first priority is for the US, Japan and Europe to start *acting* as if they have a shared interest in a more stable, equitable and sustainable future. We have been

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[49] Alex Evans and David Steven, *Towards a Theory of Influence for twenty-first century foreign policy: public diplomacy in a globalised world*, in 'Engagement – Public Diplomacy in a Globalised World', Foreign & Commonwealth Office, London, 2008, http://tinyurl.com/6k2ydo
[50] Evans and Steven, *Shooting the Rapids,* April 2008, op cit

through a period of US overreach and unilateralism, coupled with muddle and passivity from its key allies. That has to end.

The Obama administration will clearly be a breath of fresh air. It can be expected to:

- Develop the US's piecemeal and reactive bailout into something that has greater coherence and strategy.
- Signal a more co-operative and less confrontational security stance.
- Begin the process of legislating on climate change, with the US potentially matching European commitment on the issue.

This will create considerable diplomatic space – across the UN system; at the G20, of course; but also at the G8, which will have a reduced, but important, role as a caucus for richer countries.

For the rich countries, the priority is to use domestic delivery to build a basis for international agreement. This is true for financial reform, trade, and action on climate and other resource issues.

But, assuming positive moves from the US, will Europe and Japan respond in kind? Or will they take a 'wait and see' approach to Obama's overtures? The question is critical to the ongoing relevance of the post-1945 alliance.

Even united, the world's traditional powerbrokers cannot act alone. They will need China, India and the other emerging powers not as reluctant negotiating partners, but as substantive contributors to a new global order.

Broader involvement becomes more, not less, important should the BRICs find themselves in serious economic trouble as the financial meltdown proceeds.

This will require more established powers to show considerable (and uncharacteristic) humility. In East Asia, memories of the financial crisis of the late 1990s are fresh. Bailout packages then came with stringent conditions and much lecturing from the international community. Countries were told there was no gain without much pain.[51]

Things are very different today, now that rich countries are in trouble. Stimulus is all the rage, not austerity. The doctrine of deregulation has also been shattered, but it is as yet unclear what will take its place.

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[51] Paul Blustein, *The Chastening: inside the crisis that rocked the global financial system and humbled the IMF,* PublicAffairs, New York, 2003

2009 will be a year that heads of state spend more time together than ever before. This time will be wasted unless the intellectual spadework is done to prepare for their discussions.

That means creating a vision for where globalization goes from here. Built into this vision, we need a renewed emphasis on the *resilience* and *coherence* of global systems. We cannot simply ‘redraw the organogram’ – the need for reform is much more fundamental than that.

Good signs

I want to end by sketching out some sense of what would constitute progress in 2009. This is not a comprehensive agenda for the year, just some *positive signals* that countries are choosing a long term, high trust and co-operative approach, not slipping into tit-for-tat, reactive and protectionist responses.

We should expect the G20 to:

- Embed its work on finance and economy within a broader vision of global reform and not simply focus on technical issues.
- Make clear its expectations for a deal on climate at Copenhagen and set out some parameters for the ambition of that deal.
- Make a shared commitment to a *green stimulus,* with arrangements to quantify the impact of stimulus packages on carbon productivity.
- Mandate the IMF to monitor the re-pricing and allocation of toxic assets, improving cross-border visibility of the pace of financial restructuring.
- Agree that members should report, on a quarterly basis, steps they have taken to control the financial crisis.
- Begin to develop a ‘super sherpa’ system to improve the capacity of Heads of State to cope with their growing responsibility for global issues.

From the G8, meanwhile, we should expect:

- A clear signal from each member state as to what it is prepared to offer to ensure an effective climate deal.
- Equally clear signals from the ‘+5’ countries (Brazil, China, India, Mexico and South Africa) on how they plan to reduce emissions over the *long term*.
- A renewed pledge to meet development commitments, especially as poor countries suffer growing impacts from the financial crisis.

- Reporting on national delivery of key G8 commitments in area such as climate and trade.

From the United Nations, we require:

- Renewed leadership from the Secretary General on climate, especially through the SG's high-level 'Friends Group'.
- A concerted effort to explore the shape and content of a climate deal, using previous High Level Panels as a precedent.
- A process that explores the global institutions needed to deliver a post-2012 climate deal (this could build on the model provided by the Task Force on the Global Food Security Crisis).
- An exploration of how global stocks of food and other commodities can be increased, using the International Energy Agency's co-ordination of strategic oil reserves as a model.
- An initiative by the Security Council to explore the security implications of financial instability and growing resource scarcity, as part of a renewed commitment to forging a new global security consensus.

This year could be an exceptionally tough one for the Bretton Woods' institutions and the WTO. As a minimum, we should therefore look to:

- Strengthen the IMF and World Bank to ensure they can cope with the risk of a cascading series of national liquidity crises.
- Defend the current free trade system and maintain confidence in the WTO.

Looking forward, the Bretton Woods' institutions must address their lack of legitimacy in large parts of the world, while developing:

- An enhanced global surveillance function (though this must incorporate a new openness about the limits of economic forecasting).
- Tough international norms for the regulation of financial institutions.
- A framework that allows debtor countries to restructure their debts in a controlled fashion.[52]

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[52] *International Financial Architecture for 2002: a new approach to sovereign debt restructuring,* address by Anne Krueger, First Deputy Managing Director, International Monetary Fund Given at the National Economists' Club Annual Members' Dinner, American Enterprise Institute, Washington DC, 26 November 2001, http://tinyurl.com/88mw2w

- Enhanced arrangements for working with the rest of international system to improve resilience in the face of short and medium term challenges.

Finally from the WTO, we should look for:

- A renewed attempt to breathe life into Doha, perhaps as part of a broader 'grand bargain' on finance and climate.

- An analysis of the relationship between trade and scarcity issues, exploring action to discourage export barriers and related restraints to trade.

- An analysis of how the world trade system can best be integrated with a comprehensive framework for emissions control.

Human drivers

Finally, I want to close with a warning.

We will make a grave mistake in 2009 if we persist in treating the world's challenges as primarily *technical* ones, and we neglect the underlying human drivers.

The world's economic and financial problems have deep-seated psychological and behavioural dimensions. As Paul Krugman has argued, "the expectations, even the prejudices of investors, [have] become economic fundamentals – because believing makes it so."[53]

Our security challenges result from the fact that conflicts are now fought 'among the people' rather than just between nation states.

Scarcity issues, meanwhile, trigger powerful popular responses – and could easily lead to debilitating conflicts within and between countries over how limited resources can be fairly distributed.

But we live at a time when public trust in governments is being shattered.

In a recent international poll, only half of respondents believe their leaders are up to the task of designing a suitable response to the financial crisis (see figures 6 and 7).[54] Confidence was lowest here in Japan, the country that has the longest experience of financial turmoil.

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[53] Paul Krugman, *The Return of Depression Economics and the Crisis of 2008*, Penguin 2008
[54] The WIN Crisis Index – Worldwide Barometer of the Financial Crisis, World Independent Network of Market Research, January 2009

What is your level of trust in the government to manage the financial situation?

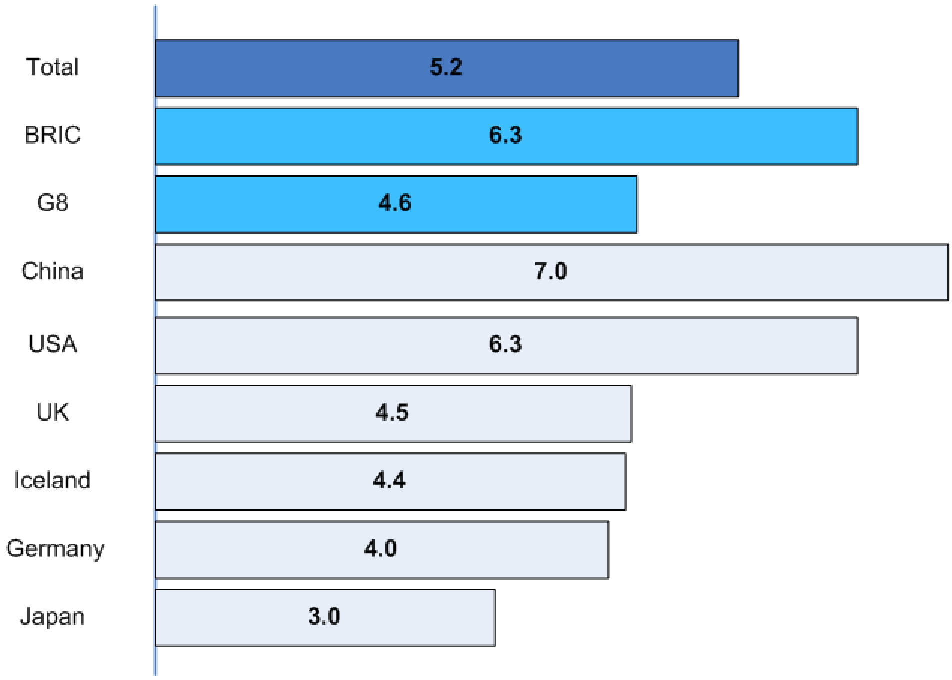

Figure 6 - Trusting the government

Most optimistic	Neutral	Least Optimistic
Brazil	Austria	France
China	Canada	Germany
India	Korea	Iceland
Netherlands	Italy	Japan
Switzerland	Russia	United Kingdom
USA	Spain	

Figure 7 – Optimism and pessimism

Source: The WIN Crisis Index

In this atmosphere, populist movements are certain to thrive. We ignore them at our peril, as they will rarely support international action and, even if they don't attain power, they may exert a blocking vote.

That makes it vitally important that reforms are designed in the open, not cooked up behind closed doors. Whatever solutions we come up with, they must emerge from a new engagement with citizens and efforts to develop domestic political conditions that allow international commitments to be made.

That means a concerted attempt to:

- Reach out to influencers and opinion formers at a national level, to debate and make the case for a new multilateralism.

- Build a narrative and vision that will communicate to a wider public the need for international approaches to global problems.

- Develop social protection systems that will insulate citizens from international volatility and instability.

Ultimately, any international reform agenda must be about the needs of global citizens. Lose sight of this fact and, however attractive new policies appear in prospect, in practice, they will fail.

About the author

David Steven is a policy analyst, strategic consultant and researcher. He is managing director of the consultancy River Path Associates, and a Demos associate, where he runs a programme on the new diplomacy.

In 2008, David was commissioned to explore the future of multilateralism by the British Prime Minister for presentation to heads of state at the Progressive Governance Summit., with New York University's Alex Evans. Subsequently, they co-authored a paper on multilateral responses to the global financial crisis.

David presented on the politics of global climate deal at the United Nations University G8 symposium on climate in July 2008. This presentation provided the basis for a study for the UK's Department for International Development on the global institutions needed to support a post-2012 global deal on climate.

David co-edits the website, Global Dashboard, (http://globaldashboard.org), which explores global risks and foreign policy responses.

Further reading

On international institutional reform:
Alex Evans and David Steven, *Shooting the Rapids: multilateralism and global risks,* for the Progressive Governance Summit, April 2008

On the G20:
Alex Evans and David Steven, *A Bretton Woods II Worthy of the Name*, November 2008

On the new diplomacy:
Alex Evans and David Steven, *Towards a Theory of Influence for twenty-first century foreign policy*, in 'Engagement – Public Diplomacy in a Globalised World', Foreign & Commonwealth Office, 2008

On climate:
David Steven, *A Low Carbon World – pathways to a global deal,* speech to the United Nations University G8 Symposium, 4 July 2008

On food:
Alex Evans, *The Feeding of the Nine Billion – Global Food Security for the 21st Century*, Chatham House, 2009

All available from http://globaldashboard.org/articles-and-publications/