The Making of a Mess

Who Broke Global Finance, and Who Should Pay for It?

By Harold James

From *Foreign Affairs* , January/February 2009

Fixing Global Finance . Martin Wolf . London : Johns Hopkins University Press , 2008 , 230 pp. 24.95 .

Summary: The current economic crisis may have one winner: the Chinese financial model, which -- together with the IMF -- holds the keys to fixing the problem.

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The current financial crisis poses a fundamental challenge to globalization and to its many analysts. All are now considering what the recent meltdown means -- the euphoric globalizers, few of whom are left; the tragic globalizers, who see the benefits of interdependence but worry about a great crash ahead; the managerial globalizers, who would like a better way of controlling the process; the critical globalizers, who are pushing for radical reform; and, of course, the antiglobalizers. Which global institutions might manage the international economy, and how? they all wonder. European leaders, for example, have called for a new Bretton Woods Conference to reconsider the architecture of the international financial and trading systems.

What kind of crisis is this, and what are its likely implications? Some crises are cathartic and push policymakers to take corrective measures; others, like the Great Depression, are radically destructive. Over recent decades, there have been blowouts at the financial center and storms at the periphery. After the meltdown in Latin America in the 1980s came a decade of stock-market and housing booms in the United States that eventually went bust. The Asian financial crisis of 1997-98 was also followed by a run on U.S. assets, causing a bubble (and the dot-com boom) that then burst. Is the latest financial collapse a first step on the road to a profound backlash against globalization? A decade ago, after the Asian financial crisis, Washington and various international financial institutions held up the U.S. system as a model to Asian governments. Today, it is Asia, especially China, that may be entitled to give Americans a lecture.

MASSIVE FAILURES

Martin Wolf, the Financial Times' chief economics commentator, has been a persistently insightful analyst. He has not forecast that financial globalization will necessarily end in disaster, but he has warned of its dangers and tried to address its shortfalls. Most recently, he has done so in Fixing Global Finance, an extremely helpful guide to the origins of today's problems and to possible solutions.

The book was completed before the financial turmoil hit this past fall but was released in its midst, and in some respects this awkward timing makes for peculiar reading. Wolf seems to have been offering an eloquent defense of financial globalization even as it was being execrated -- not only by the usual church leaders and moralists, the French president, and the German finance minister but also by the candidates in the U.S. presidential election, who were calling for less greed from investors and more regulation by the state. Mostly, however, the book's timing is an advantage. Written before the crisis, it is unhindered by minutiae about the crescendo of ad hoc measures that several governments took throughout the fall: injecting liquidity, purchasing toxic assets, capitalizing banks, and, finally, nationalizing entire banking systems.

Fixing Global Finance begins by surveying the achievements of finance-driven economic integration over the past two decades and the vulnerabilities caused by the system's periodic crises. In a previous book, Why Globalization Works, Wolf devoted a great deal of attention to the benefits of globalization. He argued then that it was "on balance highly desirable" and that it reduced poverty, enhanced prosperity, and promoted peace and democracy. There has been no

fundamental change in his main argument. In this new work, Wolf expertly relays the debates that followed the Asian financial crisis of 1997-98 and the extraordinary ballooning of the U.S. current account deficit in the first years of this century -- debates that asked whether the global imbalances that had prompted these crises were extraordinary threats or permanent features of the world economy. For Wolf, these imbalances are extraordinary, and it is they, rather than globalization itself, that threaten the stability of both mature and emerging markets.

In a move that may seem odd today, given the current talk about the end of capitalism, Wolf's book casts the American model of financial liberalization as a hero and Chinese mercantilism as a villain. Wolf argues, for instance, that China's "inordinately mercantilist currency policies" have caused dangerous imbalances. In order to maintain its exports' competitiveness on the world market and keep a vast (and potentially restive) work force occupied, Beijing prevented the Chinese currency from appreciating against the dollar and thus from driving up the price of China's exports. The result was a vast trade surplus. A byproduct, largely unintended, was the piling up of reserves of U.S. dollars, which Beijing then placed mostly in U.S. government securities. (It also invested in quasi-state institutions, such as Fannie Mae and Freddie Mac, thereby indirectly enabling their recklessly aggressive lending.) This is Wolf's international spin on Alaskan Governor Sarah Palin's explanation for the crisis -- "Darn right, it was the predatory lenders" -- only his predators are the Chinese.

As it happens, Beijing's decisions have also turned out to be more of a mixed blessing for China than is generally understood. Since 2000, Chinese assets abroad have earned very poor returns -- and with the depreciation of the dollar, by some measures they have even performed negatively. As Wolf points out, because the U.S. government was -- as it still is -- at liberty to print as many dollar bills as it wanted, it could always in effect expropriate assets denominated in its currency. The rapidity of U.S. monetary expansion in the era of Federal Reserve Chair Alan Greenspan made this more than a theoretical risk. China, or rather its citizens, paid a high price for Beijing's mercantilism.

Wolf's narrative blaming China may seem remarkable now that everyone is excoriating the U.S. financial system, the U.S. Federal Reserve, and Greenspan in particular. With the Federal Reserve effectively acting as the Chinese central bank, one argument goes, an overly lax U.S. monetary policy was threatening the world with inflation. But Wolf contests this view, arguing that the Federal Reserve did roughly what central banks are supposed to do, namely, keep inflation in check. In his opinion, growth in the U.S. money supply in the early years of this decade was "not unreasonably high." At the time, the Federal Reserve insisted that its job was to look at price levels generally, not to puncture bubbles in some asset prices. For Wolf, "The United States is at least as much the victim of decisions made by others as the author of its own misfortunes." It was only natural, perhaps even inevitable, in Wolf's view, that the United States would emerge as the borrower of last resort, with its perceived reliability as a debtor fueling global growth.

But instead of quietly expropriating assets held by the Chinese by gradually devaluing the dollar, the borrower of last resort got into trouble itself. Even though the global financial system melted down after Wolf completed his book, his first chapter already warned that the world of finance was "a jungle inhabited by wild beasts." As the subprime mortgage crisis of 2007 mushroomed in 2008, a profound flaw at the core of the U.S. financial system was revealed. Partly due to a glut in global savings, assets had been repackaged so thoroughly and resold so often that it became impossible to clearly connect the thing being traded to its underlying value.

The $700 billion bailout announced by the U.S. Department of the Treasury in late September was designed to remove from banks' balance sheets mortgages and other securities that in some way corresponded to real houses. But it is still unclear today how these assets are to be valued or how that valuation might wind up benefiting or hurting their new owners. In the United States and in Europe, the hope is that governments will assume many of the risks inherent in this uncertain valuation -- and tame the wild beasts of the financial jungle through state-backed and state-run banking systems. To some, this is profoundly ironic. As Russian President Dmitry Medvedev put it in September, the experience shows that "the move from self-regulating capitalism to financial socialism is only one step." American free-market capitalism was not supposed to look like this.

FREE FALL

Wolf himself predicted the dramatic turn of events months before the worst of the crisis. In a Financial Times column last March, when U.S. government efforts to rescue the investment and brokerage firm Bear Stearns seemed to indicate that everything would soon be all right again, Wolf wrote, referring to the day of the bailout, "Remember Friday March 14 2008: it was the day the dream of global free-market capitalism died." Just six months later -- and a decade after it lectured Asian governments -- Washington seemed to adopt a Chinese-style solution to its

escalating financial problems: greater state intervention to restrict the movement of capital.

But there are dangers and limitations inherent in this approach, too, especially given that, as Wolf warns, instability and vulnerability will not be confined to the United States and that "financial crises are most significant when they are international." This crisis may have originated in the United States, but it has rapidly become global.

Some emerging markets are highly vulnerable to financial implosion. Collapses have begun to happen in Brazil, Hungary, Iceland, Indonesia, Pakistan, Russia, the Baltic republics, and Central Asia, as investors stampede away from risky assets. And with these failures comes the risk of major geopolitical instability, because many of these vulnerable countries and regions lie on political fault lines. Such crises help promote anti-Western reactions, including militant forms of Islamic fundamentalism. These threats should be taken very seriously.

The possibility of geopolitical turmoil is all the greater because so far the bailouts have been handled in a purely national context, while international institutions have been nervous and hesitant. The discussion has been entirely domestic in the United States and, more surprising, in Europe, too. In fact, the failure to find a supranational mechanism for dealing with Europe's large and internationally active banks is rapidly developing into the Achilles' heel of the continent's ambitious project to build a monetary union. The European Union's governing bodies can only leave bank bailouts and their fiscal implications to national authorities. Germany and Ireland each tried to create what the German finance minister, Peer Steinbrück, has called an "umbrella" over their national banking systems. But in these days of high capital mobility, this appears to be a very poor solution. It is likely only to prompt a wild rush of fund transfers as governments try, in their own idiosyncratic ways, to prop up their banking systems and as depositors move their assets away from countries at risk of needing bailouts. Every state for itself, and every depositor for him- or herself.

Meanwhile, international financial institutions have largely stood on the sidelines of the meltdown. Since the end of World War II, there has been a belief that international cooperation can tackle major problems. But that faith is now being tested. The current financial collapse is the first international financial crisis since the 1944 Bretton Woods Conference in which the International Monetary Fund has played no role at all in tackling the causes of the problem and only a secondary part in managing its consequences. In addition, the current financial crisis threatens to trigger trade protectionism precisely at a time when the sputtering of the Doha Round of multilateral trade negotiations has weakened the World Trade Organization. Institutions such as the IMF and the WTO have become largely ineffective and irrelevant because of a general shift away from the belief in a rule-based international order and toward a Machiavellian view of the world in which power is all-important. Critical decisions about an international response to the financial crisis have been left largely to the G-7 (the group of highly industrialized states), a patently unrepresentative body that excludes major new centers of global savings and trade surpluses, such as China.

A NEW BRETTON WOODS

It is thus both bold and constructive for Wolf to see current financial problems as global issues requiring global answers. In a late chapter, "Toward Global Reform," he calls for the big emerging markets, especially those, such as China, with large savings ratios, to abandon capital controls, allow their exchange rates to float, and begin borrowing mostly or entirely in their own currencies. There have been substantial steps in this direction. Several major emerging countries, including Brazil, China, and Mexico, have already developed their own capital markets and thereby overcome what the economists Barry Eichengreen and Ricardo Hausmann term the "original sin" of dependence on foreign currency borrowing (which tends to increase vulnerability to crises by creating a dangerous mismatch between liabilities in a foreign currency and assets in the domestic currency).

But Wolf rightly argues that international action is also required. In his view, the IMF should better represent the new centers of global growth: its voting rules should be altered accordingly, and its managing director should no longer be a European appointment. Wolf also proposes that the IMF more actively manage currency reserves. He advocates greater pooling of assets in order to establish funds that could be tapped promptly in times of crisis.

The logic of these proposals is sound, but they should be extended: as the economist Michael Bordo and I argued in an article for VoxEU.org last June, under the present circumstances, the IMF should take on the role of asset manager. The conditions that created the global savings glut -- especially insecurity in emerging markets -- still exist, and so an important question for the future is, Who should manage these assets? Are governments and existing international institutions doing a good job? If the IMF were to manage some part of the vast global savings pool, it could act much more effectively as a crisis manager. If it oversaw a significant part of the

reserves of countries with surpluses, it would be in a strong position to take bets against speculators or stabilize markets when prices moved in a disorderly way.

When the IMF was created, in 1944, there were few major private capital flows in the world; states dominated international transactions. Today, private flows play a preponderant role, and extending the IMF's mission would be a way of responding to that reality. And the need to do so has become much more urgent since Wolf finished writing his book, in the very early stages of the current crisis.

Stabilizing action by the IMF would benefit both the global economy and the reserves' owners, which, simply by virtue of their accumulated surpluses, share an interest in the world's financial and economic stability. Many previous financial crises have been resolved only by the actions of massively powerful financial players, sometimes private ones (such as J. P. Morgan in 1907) but more frequently states (such as the U.S. government with the New Deal in the 1930s and the Swedish government in the 1990s). Financial giants can make bets on stabilization and recovery and reverse the momentum of the global market.

There is a further advantage to IMF action. Bringing reserve assets under the management of an internationally controlled entity would also remove suspicions about governments' use of assets for strategic political purposes. Such concerns were bedeviling discussions before the outbreak of the financial crisis; in fact, the geopolitical use of finance was one of the ills that the Bretton Woods Conference was supposed to remedy over half a century ago. The current meltdown has only magnified these fears. In October, Russia sprang in with money to assist Iceland -- a move that was interpreted as an attempt to buy greater influence over the Arctic -- and China has been gaining influence across the world through strategic investments in poor countries.

In the course of developing new functions for the IMF, it would be important to distinguish between day-to-day transactions and crisis management, much as central banks and national regulators do. Placing large stocks of assets under the routine management of the IMF could stave off speculative attacks and stem irrational panics: with the IMF in a situation to intervene preemptively, possibly at the request of targets of speculation, speculation itself would become more costly. The IMF's enhanced asset base would also enable the fund to switch into crisis mode without long discussions and formal negotiations. It could respond quickly and, like other asset managers, without setting off a geopolitical debate about the strategic implications of the investment.

Given widespread suspicion in emerging markets about the IMF's motives and standards, expanding the IMF's power would require reforming governance at the organization. Wolf's suggestions for new voting and appointment rules are steps in the right direction, but they do not go far enough. Industrial states, especially European ones, are overrepresented; the United States has too much influence; and new centers of wealth, which have accumulated massive savings, are underrepresented. If the IMF were to become a reserve manager, it might be possible to substantially reform the organization's voting rules: for example, a country's voting clout on the IMF's executive board could be partly determined by the amount of convertible currency it voluntarily deposited at the IMF. A new mechanism for calculating votes along these lines would immediately give greater voice to emerging-market economies. It would make the IMF both more representative of the real balance of economic power in the world and more legitimate.

In this new role, the IMF could directly provide crisis-stricken countries with a lot of support. In situations in which the fund's managers believed a crisis was entirely or predominantly caused by speculation rather than fundamental problems, it might also be able to intervene directly in currency markets. A decision to do so would be made not by governments or the IMF's executive board, but by the IMF's managers, who would ultimately be accountable to the board and to the governments that fund the IMF. Some might object to giving the organization such an activist role. The best way to address their concerns would be to set strict criteria for long-term performance, including regular benchmarking, and ensure oversight by the IMF's executive board.

A BEIJING CONSENSUS

A crisis with global origins cannot be adequately tackled in purely national settings, even in a country as large as the United States. An effective international financial system is needed, as well as strong incentives for powerful states to act within it. Without such an international order, countries are left to act on their own. Big countries might do a better job of this than smaller countries with more open and more vulnerable economies. But since even geopolitical giants are likely to resort to the solutions that appeal most to their domestic constituencies, they will tend to insulate themselves from the rest of the world. And that protectionist reflex could return the world to the misery of the 1930s.

The need for managed international action raises the question of which country should be its main driver. Like the United Kingdom during the Great Depression, the United States today is unwilling, and probably unable, to act as the world's stabilizer. Meanwhile, China, the preeminent holder of global savings, may now be in a position comparable to that of the United States in the 1930s, when isolationism at home stymied any chance that Washington would take action abroad. Like the United States back then, China today cannot hope to stabilize the world on its own. It would need to work through an institutional framework. But Beijing is unlikely to take on a key role in reconstructing the global financial system without guarantees that its interests would be recognized in the new order.

The response to the Asian crisis of 1997-98 was the reinforcement of the American model of financial capitalism, the so-called Washington consensus. The response to the contagion caused by the U.S. subprime crisis of 2007-8 will be the elaboration of a Chinese model. One can only hope that this new approach will not reflect an autarkic or nationalist policy, whereby the Chinese stand by and continue to save (and suffer) while the world's financial order collapses. That would really spell the end of globalization -- and of the prospects for a peaceful world order.

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