After the Crisis?

Available in: Français, Español, Türkçe, 日本語, Deutsch, русский, العربية, Português, 中文

Robert B. Zoellick
President
The World Bank Group

The Paul H. Nitze School of Advanced International Studies
of the Johns Hopkins University

September 28, 2009

Great upheavals produce shock waves that widen cracks in political, economic, and security orders. Sometimes the old orders break. Yet it can be in the power of leaders and peoples to shape the directions of change.

Today, most people assume that when Edmund Burke wrote his *Reflections on the Revolution in France* he was denouncing a revolution that had already executed a King and Queen, and launched the Terror. But he published his work in 1790, before the cobbled streets of Paris echoed with the rumble of tumbrels and the roar of crowds at the guillotine.

1789 was one of the great upheavals in history. Although Burke offered wise warnings, most of his contemporaries expected France to tread an "English path" towards constitutional democracy.

The effects of momentous events can reverberate over time. When asked more than a century later about the impact of the French Revolution, China's Premier Zhou Enlai allegedly replied, "It's too soon to say."

This year is the 20th anniversary of the peaceful revolution of 1989. The upheavals across Europe of that year, so different from 1789, brought an end to the Cold War. They led to the opening of the Berlin Wall, the freedom of Central and Eastern Europe, the unification of a democratic Germany and the reunification of Europe, the break-up of the Soviet Union, and the return of Russia. To many, these tumultuous events really did feel like the "End of History," as my friend and your professor Frank Fukuyama famously put it. Yet the European narrative moved to new chapters with the widening of what became the European Union, the creation of a common currency, and the enlargement of the NATO Alliance.

While most eyes were focused on Europe in that era, new histories were being sketched around the world: NAFTA offered a fundamental reorientation of Mexico, including toward democracy and potentially deeper integration of North America; APEC implied a new "open regionalism" that could connect a rising East Asia with the Americas bordering the Pacific; and a coalition based upon UN action reversed Iraq's brutal conquering of Kuwait, opening the way for a Madrid Conference that initiated negotiations between Israel and the Arab states. These seeds of change were planted by forward-looking leaders who saw the opportunities amidst seismic shifts and shifting trends.

My experience then –and since – has reinforced my sense that events occur within a continuum. As Burke observed, there exists "a partnership not only between those who are living, but between those who are living, those who are dead and those who are to be born."

Outcomes are not predetermined. They depend on both events and purposeful actions.

In 2009, we are living through another upheaval that is changing our world. What will be its implications for the future?

Today's upheaval did not occur from nowhere. The seeds were planted earlier.

The last 20 years have witnessed a huge economic shift. The breakdown of the planned economies in the Soviet Union and Central and Eastern Europe, the economic reforms in China and India, and the export-driven growth strategies of East Asia all contributed to a world market economy that vaulted from about 1 billion to 4 or 5 billion people. This shift offers enormous opportunities. But it has also shaken an international economic system forged in the middle of the 20th Century, with patched-up changes in the decades since.

Some seeds of today's troubles were sown by the responses -- or lack of them -- to the financial crises of the late 1990s. After the Asian financial crisis, developing countries determined they never again wanted to be exposed to the tempests of globalization. Many "insured" themselves through managing exchange rates and building huge currency reserves. Some of these changes contributed to imbalances and tensions in the global economy, but for years governments muddled through amidst generally good growth.

Central banks failed to address risks building in the new economy. They seemingly mastered product price inflation in the 1980s, but most decided that asset price bubbles were difficult to identify and to restrain with monetary policy. They argued that damage to the "real economy" of jobs, production, savings, and consumption could be contained once bubbles burst, through aggressive easing of interest rates. They turned out to be wrong.

Regulators and supervisors of financial institutions were no longer grounded in reality. Financial innovation and competition vastly expanded services – including to companies and families often shunted aside in the past –but the alluringly simple design of "rational markets" theory led regulators to take a holiday from the realities of psychology, organizational behavior, systemic risks, and the complexities of markets and humans.

As in the past, the actions we take today shape future opportunities and challenges.

We need to learn the lessons from the past – without being limited by them. Too often we prepare to fight the crisis of the past rather than anticipate the crisis of the future. The one thing we can be sure about is that another upheaval will happen in your lifetimes and that it will be different from the one we are currently experiencing.

All of you at SAIS have the good fortune to be prepared to contribute, and I hope you will choose to. As you study past efforts, you may be asking: how will our world be changed by this crisis?

In 1944, the delegates at Bretton Woods seized a moment to shape a new global arrangement. They spent three weeks in New Hampshire developing a system of rules, institutions, and procedures for financial and commercial relations in the world economy.

That world has changed enormously over the past 65 years – not least with the transformations of 1989. The current upheaval is changing the landscape yet again.

Already, we can see potential shifts in power and institutions and international cooperation. In part, the shifts will depend upon how the parties adapt to new circumstances; in part, upon the rapidity of the recovery; in part, upon changes in who holds the world's capital, technology, and human resources and what they do with them; in part, upon how countries cooperate –or do not. .

What are the perceptions and realities of power after this crisis?

The current assumption is that the post-crisis political economy will reflect the rising influence of China, probably of India, and of other large emerging economies. Supposedly, the United States, the epicenter of the financial crisis, will see its economic power and influence diminish.

There are good reasons for this perception. China has responded strongly to the crisis, both in terms of stimulus and monetary policies, and it seems to have a deep treasure chest to back up its first moves. China has enjoyed a rapid recovery, which has assisted others, underscoring China's growing influence.

Indeed, today, China acts as a stabilizing force in the global economy. Together, China and India account for 8.5 percent of world output. They and other developing countries are growing substantially more rapidly than developed countries.

And yet … China's future is not yet determined. Its rapid recovery in 2009 was fueled by an expansion of credit of 26 percent of GDP in the first eight months of this year. This flood is now easing, and authorities are likely to limit it further for fear of effects on asset prices, asset quality, and eventually general inflation. China still faces big uncertainties in 2010.

China's leaders recognize these risks, including the continued dependence of China and other emerging economies on export-led growth. It will not be easy for China to shift to increasing reliance on domestic demand, especially to greater consumption that could help balance world growth while contributing to China's goal of a more " harmonious society." China's protected service sector, including financial services, limits opportunities for entrepreneurs and increases in productivity.

The United States, in turn, has been hit hard by the crisis. But America has a culture of resilience to set-backs, adapting to new circumstances and remaking itself.

The future for the United States will depend on whether and how it will address large deficits, recover without inflation that could undermine its credit and currency, and overhaul its financial system to preserve innovation while adding to safety and soundness. The United States also needs to help people adjust to change, so that it can maintain its greatest trump card: openness to trade, investment, people, and ideas. The geopoliticians will be on the watch for signs that America's economic troubles are leading to a weakening of U.S. confidence, energy and resources to project its interests globally in cooperation with others.

Japan is the first leading industrial power to experience a political upheaval in the wake of the crisis. The election of the Democratic Party of Japan could create a sustainable two-party democracy for the first time in the country's history.

Japan rose from the ashes of World War II as a "trading state," the model for export-led growth. It is not clear that the old export model of growth will be sustainable in a more "balanced" global economy that does not rely so heavily on the U.S. consumer. An aging Japan will have new consumption needs. A global economy with more poles of growth could offer Japan new markets, especially for its impressive capabilities to use energy efficiently.

The world will be deeply interested in the shape of a Japanese foreign policy that can be sustained across parties and that might assume new responsibilities. Such a foreign policy could build on Japan's experiences in development. Japan could deepen cooperation with other Asia-Pacific actors in ASEAN, Australia, China, and Korea, while maintaining its global role, especially through relations with the United States. Development opportunities in Africa, Latin America, Central Asia, and the Middle East would also enable Japan to "do well while doing good."

The European Union may have been slow to recognize that this economic crisis was the first big test of the New Europe made possible by the revolutions of 1989. But it adapted relatively quickly, and European institutions may come out stronger for it.

Central and Eastern European economies were hit especially hard by the crisis. And their problems are far from over. At least for European Union members, however, the support offered by the European Commission, the European Bank for Reconstruction and Development, and the European Investment Bank – with assistance from the World Bank Group -- has been critical. It appears that the European banks that invested in their Central and Eastern European neighbors are staying with them. The good strategic news is that the European states, for all their internal debates and negotiations, have recognized their interdependence. Under stress, this time, Europe did not splinter.

The European Central Bank played a decisive role under the able leadership of its president, Jean-Claude Trichet. The ECB walked a fine line in supporting the European financial system and even helping Europeans outside the Eurozone, while assuring the Euro's credibility. As a result, newer EU members outside the Eurozone may well strive to gain its security.

Yet, amidst tighter economic times, the European Union must still face insecurities. Its energy vulnerability feeds worries, aggravating difficult relations with its neighbors to the east, especially Ukraine and Russia. The Balkans still smolder, and inattention to Bosnia could revive apprehensions about the EU's ability to offer security, even on its own continent. The EU and Turkey have yet to cultivate a common view of their shared future. As its demographics age, Europe will also struggle with the integration of immigrants.

South East Asia may also have been given a boost by the crisis – depending on how opportunities are seized. The region lies at a geographic crossroads between India and China, two rising powers. ASEAN seems to have recognized the moment, and has taken actions to deepen its integration even while reaching out to others.

Given the sizeable weight of Indonesia and the rising influence of Vietnam, their sound performance amidst economic turmoil has stood in sharp contrast to a decade ago. But there remain questions of adjustments and political transitions in countries such as Thailand and Malaysia. There is also a question of whether others will recognize the emerging ASEAN. China and India seem to be doing so – but will North America and the European Union?

For others, the long-term impact of the crisis may depend upon commodities, especially oil prices, which, in recent years, gave high returns. When the oil price is at $100, these countries are strong. When it is at $30, most are in serious trouble. This reliance on oil and commodities is a precarious basis upon which to build an economy in a world that is struggling to reduce its reliance on fossil fuels, and in which commodity prices gyrate as investors move in and out of an “asset class.” Will countries use these returns wisely – to diversify and build broader-based economic development? These are the questions for Russia, countries in the Gulf, and some countries in Latin America and Africa.

Understanding shifting power relations is fundamental for shaping the future -- as the Bretton Woods’ delegates appreciated. The political basis for that system was forged through a shared experience in failed responsibility after World War I and a clear assessment of power after World War II. Change those power relations -- and the nature of the markets that connect them -- and the system looks out of touch. Let’s examine a few examples:

Will the U.S. dollar remain the predominant reserve currency?

The Bretton Woods currency system gave way in 1973 to floating rates, with the dollar as the world’s main reserve currency. For all the questions about the dollar’s reliability as a reserve currency, its value strengthened during the crisis as it offered investors a safe haven.

The United States is incredibly fortunate that the dollar enjoys this special status. When I work with countries struggling to pay for budgets or finance trade deficits, I reflect on how Americans do not spend a moment considering the unique advantages of being able to issue bonds and print money freely. The histories of the Napoleonic wars tell of great campaigns and battles, but the ultimate victory of Britain and its coalition depended on the dry chapter about Pitt’s restoration of Britain’s credit.

The United States would be mistaken to take for granted the dollar’s place as the world’s predominant reserve currency. Looking forward, there will increasingly be other options to the dollar.

Given the ECB’s recent performance, there is every reason to believe that the Euro’s acceptability could grow. The influence of the Euro will depend in part upon the competitiveness of European Union countries in future years, and the depth and liquidity of its financial markets. Demographics and growth prospects will also matter. But Euro financing offers a respectable alternative if the dollar is weak.

Moreover, China is moving toward gradual internationalization of its currency. China is making it easier for trading partners to do business in Renminbi – for example, through currency swaps. We are likely to see this shift in the world of investment as well: for the first time this month, China issued sovereign bonds in Renminbi to offshore investors. China recently announced that foreign companies will be able to list their stocks in China, a step toward making Shanghai an international financial center. As a major importer of commodities, one can imagine new benchmark indices established at Shanghai or other Chinese ports, eventually in Renminbi.

Chinese leaders will be cautious. Most want to retain the control that comes from a closed capital account. Financial and banking markets are likely to continue to be subject to various tools of intervention and control. Yet I expect China will be inevitably drawn outward. Over 10 to 20 years, the Renminbi will evolve into a force in financial markets.

Countries and markets may also experiment with financings denominated in Special Drawing Rights –or SDRs— which reflect a portfolio of major currencies.

Of course, the U.S. dollar is and will remain a major currency. But the Greenback’s fortunes will depend heavily on U.S. choices. Will the United States resolve its debt problems without a resort to inflation? Can America establish long-term discipline over spending and its budget deficit? Is the country restoring a healthy financial sector capacity for innovation, liquidity, and returns, without producing the same risk of big bubbles and institutional breakdown? The dollar's value will also depend on the extent to which we see the return of a dynamic, innovative private sector economy.

Power relations are being questioned within countries as well. Central Banks have played a huge role in this crisis.

Will democratic governments permit independent central banks to assume even more authority?

The U.S. Congress was surprised to learn of the scope of the Federal Reserve's authority to create funds, buy assets, devise global swap lines, and make transactions outside the usual process for expending public monies.

The Congress has had an uneasy relationship with banks and bankers since Alexander Hamilton. It took the United States until 1913 to set up a central bank. The Federal Reserve earned its hard-won independence over years of effort.

So it should not be a surprise that American democracy is hesitating about authorizing the Fed to supervise systemic banking risks as well as operate monetary policy, adding to its power.

In the United Kingdom there is a debate about the roles of the Bank of England and the Financial Services Authority. Euro-zone countries face the issue, too, with the added complexity of multiple national supervisory authorities. It is a topic for rising developing countries with increasingly developed banking and financial markets as well.

Central banks performed impressively once the full force of the crisis hit. But there are reasonable questions about how they handled the build-up, including asset price inflation and significant failures of supervision. We have yet to see whether Central Banks can handle the recovery without letting inflation get out of control.

Stanley Fischer, Israel's central bank governor and a former IMF deputy, makes a case for combining the tools of monetary policy and prudential standards supervision in the central bank, based on organizational effectiveness. Others suggest that one function will inevitably be treated as a poor cousin, or that one authority for both magnifies the risk of errors without a second opinion. Some even suggest a conflict of interest.

This debate will reflect different political traditions and attitudes towards banks and central banks. In the United States, it will be difficult to vest the independent and powerful technocrats at the Federal Reserve with more authority. My reading of recent crisis management is that the Treasury Department needed greater authority to pull together a bevy of different regulators. Moreover, the Treasury is an Executive department, and therefore Congress and the public can more directly oversee how it uses any added authority.

Another legacy of the Bretton Woods architects is our global trading system.

Is it keeping up with the demands of the global economy?

The answer is an unequivocal "no."

Looking at the positive side, the cataclysmic experiences of economic isolationism of the 1930s have cautioned most government not to risk a sequel. So far, traditional trade protectionism has been a low-grade fever. But the temperature is rising.

The political economy of trade is epitomized by the "bicycle theory": Given the local pulls of protectionist producers in most countries, the only way to counter their gravitational force is by forging forward with a liberalizing trade agenda. The potential gains of opening markets can then help mobilize interests that will counter those clamoring for barriers.

Today the pedals are hardly moving the Doha Round in the WTO. Moreover, with an agenda framed almost a decade ago, the Doha Round is fast falling behind the new challenges. We should get the Doha Round done promptly – -- and then look ahead.

The Doha Round could cut, discipline, and even eliminate some agricultural subsidies that for years were left outside the rules-based trading system. It could modestly open markets for manufacturing and agricultural goods in developed and major developing economies. It could “bind” barriers of major developing countries at much lower levels, increasing the sense of mutual contributions and limiting the risks of big jumps in tariffs. The Doha Round could also open service markets and cut developed country tariff peaks that limit basic manufacturing and value-added production in poorer countries. The Round could correct rules that have been bent to limit trade too freely. These are real gains and would demonstrate the capability of developed and major emerging economies to compromise to achieve a mutual and systemic interest.

Once Doha is achieved, we need to move quickly to a new agenda. Regional integration is part of globalization, but we need rules that enable countries to capture the benefits of deeper and comprehensive liberalization with others while encouraging an open regionalism. The WTO needs to support the climate change agenda without recourse to new carbon tariffs. We need counters against the financial and subsidy protectionism that arose out of the crisis. We need lower barriers to South-South trade. The services trade must be expanded to match the opportunities for development and growth. We need more help for the poorest countries that have been less able to seize growth opportunities from trade.

The new agenda needs to build on early efforts by WTO’s Director General, Pascal Lamy, supported by the World Bank Group, to link trade facilitation to aid for trade. To capitalize on lower barriers to trade, poorer countries need: regional integration to build bigger markets and access for land-locked countries; energy; infrastructure; logistics systems; ready access to trade finance; assistance with standards; and streamlined customs and border procedures. It used to take two days for trucks to clear the border between Kenya and Uganda. Today, a one-stop border post that the World Bank helped establish has cut down the transfer time to two hours or less.

The Bretton Woods system was forged by 44 countries at a time that power was concentrated in a small number of states. The great waves of decolonization were just stirring; the few developing countries were seen as objects, not subjects, of history. That world is long passed. The new realities of political economy demand a different system.

What will be the role of developing countries after the crisis?

The crisis has underscored the growing importance of the large emerging economies, especially China and India, but others as well. In effect, the world economy is being “rebalanced” toward the relative shares of some two hundred years ago, before the industrial revolution, plus a new North America.

The rising developing economies should play a key role in the recovery. Most forecasters expect demand to be tepid, with a pullback by the U.S. consumer. Many developing countries could expand demand if they can get access to financing. They have fiscal space to borrow, but cannot get the volumes they need at reasonable prices without crowding out their private sectors. Moreover, the middle income countries are home to 70 percent of the world’s extreme poor. The World Bank Group and the regional development banks can assist.

Looking beyond, a more balanced and inclusive growth model for the world would benefit from multiple poles of growth. With investments in infrastructure, people, and private businesses, countries in Latin America, Asia, and the broader Middle East could contribute to a “New Normal” for the world economy.

Over time, Africa can also become a pole of growth. The messages I hear in most African countries are the same: Africans want energy, infrastructure, more productive agriculture, a dynamic private sector, and regionally integrated markets linked to open trade. It is a message one might have heard in a devastated Europe 60 years ago.

Prior to the crisis, the growth rates of a number of African countries were achieving impressive levels with consistency. Coming out of the crisis, there could be a new opportunity. Some Chinese manufacturing firms, with government support, are considering shifting their basic production to Africa. The World Bank Group is working with China to explore the development of new industrial zones that match infrastructure, energy, and training with these ventures.

China’s African prospects -- which include resource development and infrastructure -- are likely to be complemented by others. Brazil is interested in sharing its agricultural development experience. India is building railways. These are the early days of a trend that will build.

The World Bank Group can offer a counterweight to financial and trade protectionism by supporting this development globally: We have launched a new Asset Management Corporation, through IFC, our private sector arm, to invest in banks, equity, infrastructure, and debt restructuring. We have a parallel effort to support and invest in the development of local currency bond markets. Longer term investors –such as sovereign and pension funds—now recognize that developed markets pose risks, too, and developing markets can offer good growth prospects.

Conclusion

Coming out of this crisis, we have an opportunity to reshape our policies, architecture, and institutions. We have an opportunity to craft a new global system for a 21st Century of "Responsible Globalization" – one that would encourage balanced global growth and financial stability, embrace global efforts to counter climate change, and advance opportunity for the poorest. It means expanding the benefits of open markets and trade, investments, competition, innovation, entrepreneurialism, growth, information – and debates on ideas. It must be a globalization that is both inclusive and sustainable – expanding opportunity with care for the environment.

Yet it won't happen by itself.

At the G-20 Summit in London in April, leaders stared into an economic abyss. The danger today is not freefall, but complacency. As the crisis wanes, it will be harder to press countries to cooperate in "building back better." Peer review of a new Framework for Strong, Sustainable and Balanced Growth agreed at last week's G-20 Summit is a good start, but it will require a new level of international cooperation and coordination, including a new willingness to take the findings of global monitoring seriously. Peer review will need to be peer pressure.

Climate change poses as early test. A key task at Copenhagen in December will be to create incentives for developing countries to participate in low carbon growth. The decision-makers will need to frame an ongoing process that cuts greenhouse gases while encouraging technological change, adaptation, and growth.

We need a system of international political economy that reflects a new multipolarity of growth. It needs to integrate rising economic powers as "responsible stakeholders" while recognizing that these countries are still home to hundreds of millions of poor and face staggering challenges of development. It needs to engage the energies and support of developed countries, whose publics feel the heavy burdens of debt, competitive anxieties, and feel that the new powers must share responsibilities. It needs to help offer a hand to the poorest and weakest countries, the 1.6 billion people who still live without electricity, and the "Bottom Billion" trapped in poverty because of conflict and broken governance.

Global finance and currencies. The trading system. Inclusive and sustainable development. Climate change. States struggling with fragility and conflicts. And a host of other security issues. Each topic is important on its own. But each interconnects with the others.

The countries of the world will never deal effectively with this agenda unless they cooperate. The economic multilateralism of another age does not reflect today's realities. We need to modernize Multilateralism and Markets.

As agreed in Pittsburgh last week, the G-20 should become the premier forum for international economic cooperation among the advanced industrialized countries and rising powers. But it cannot be a stand-alone committee. Nor can it ignore the voices of the over 160 countries left outside.

The G-20 should operate as a "Steering Group" across a network of countries and international institutions. It could recognize the interconnections among issues and foster points of mutual interest. This system cannot be hierarchical, and it should not be bureaucratic. If given a push, the topics could be pursued through other negotiating groups, international regimes, or global and regional institutions. The IMF, World Bank Group, WTO, Financial Stability Board, and UN bodies could alert countries to issues, provide analyses, build cooperative solutions, and help execute the policies.

To be effective and strengthen their legitimacy, the international institutions must also evolve. Their voting shares should reflect the weights and new responsibilities of emerging powers, while assuring a voice for the poor. They need the transparency and agility to work within networks of private businesses, foundations, and civil societies, as well as with one another.

The old international economic order was struggling to keep up with change before the crisis. Today's upheaval has revealed the stark gaps and compelling needs. It is time we caught up and moved ahead.

The question is whether leaders can cooperate in steering the changes. They will be drawn to the interests of the national publics they represent, as they should. Yet they also will be challenged to recognize and build common interests, not only case-by-case, but through institutions reflecting a "Responsible Globalization."

Bretton Woods is being overhauled before our eyes. This time, it will take longer than three weeks in New Hampshire. It will have more participants. But it is just as necessary. The next upheaval, whatever it may be, is taking form now. Shape it or be shaped by it.