

Dieter, Heribert; Higgott, Richard

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1944 or 1933? The Drawbacks of the World Financial Summits

Heribert Dieter / Richard Higgott

Since the world financial crisis gained momentum in recent weeks, politicians have developed a surprising level of activity, considering that OECD-countries have been ignoring the problems in international finance for years. Neither the large capital flows to the United States nor the weakening position of the International Monetary Fund were given serious consideration. Financial crises used to happen elsewhere, not in the core of the capitalist world. A series of conferences on international finance shall contribute to both the solution of the crisis and to making the international financial regime more robust and less crisis-prone. The first of these will take place on 15 November in Washington. At face value, the desire to learn from the current crisis looks convincing. But the risks are substantial. Without having a concept for the restructuring of the international financial architecture, these conferences may not yield the expected results. Moreover, they may even contribute to a further deterioration of global financial governance.

In the last three decades, the world has seen a number of financial crises in various parts of the world. The Asian crisis of 1997/98 in particular could have served as a reminder that liberalised financial markets can lead to vicious crises if not properly tamed by regulation. However, the United States and, to a degree, the European Union insisted that markets do not need a strict regime of supervision. Of course, the American government and the Federal Reserve Bank under Alan Greenspan were leading the debate. But European governments did not show any substantial

resistance against the American push for ever more deregulation.

But the reluctance of the USA and the EU was not limited to the national regulatory sphere. The main institution of global financial governance, the International Monetary Fund, remained largely untransformed. Neither its crisis management nor the influence of large emerging economies was changed significantly. After the financial crises at the end of the 1990s, there was some discussion on the need to reform the IMF, but no substantial change followed. The transatlantic powers saw no

need to improve the position of emerging countries in the IMF and continued to view the fund as their institution, primarily serving the foreign economic policy interests of the United States. As a consequence, emerging economies gave up the expectation that the IMF would be reformed into an institution that serves their, rather than American and European, interests. Emerging economies created their own last-resort-lending facilities and piled up unprecedented foreign reserves.

The end of inertia

Today's financial crisis has ended the inertia of western politicians. The immediate result is the first World Financial Summit, to be held in Washington on 15 November. There is a consensus on the need to do something, but it is unclear what the precise aims of the grand conferences are. Of course, the hopes are high for the Financial Summits. But policy makers, wishing for a repetition of the successful conference of Bretton Woods in 1944, may end up with a failure. More precisely, there is a considerable risk that the World Financial Summit of 2008 will be akin to the London Monetary and Economic Conference of 1933, one of the greatest failures of economic diplomacy. The parallels are striking.

The London Monetary and Economic Conference of 1933

Just like today, the global economy was in bad shape in 1933. After a financial crisis that had started in the United States and that had spread around the globe, both trade and production were in sharp decline. And just like today a new President had been elected. When Franklin D. Roosevelt was inaugurated on 4 March 1933, international economic relations were in a chaotic state. More than 30 countries had abandoned the previous monetary regime, the Gold Standard. The USA adhered to the old monetary regime, and this policy of the

Hoover government was one of the few pillars of stability. But the new President changed this immediately and took the USA off the Gold Standard, which deepened the global crisis. Roosevelt declared in his inaugural address:

»Our international trade relations, though vastly important, are in point of and necessity secondary to the establishment of a sound national economy. I favour as a practical policy the putting of first things first. I shall spare no effort to restore world trade by international economic readjustment, but the emergency at home cannot wait on that accomplishment« (Franklin D. Roosevelt, Inaugural Address, 4 March 1933).

The London Monetary and Economic Conference opened on 12 June, 1933. Representatives from 66 nations convened at the Geological Museum in Kensington, London, trying to re-establish a monetary regime. Roosevelt withdrew support for the goals of the conference and ordered his Foreign Minister, Cordell Hull, to make no concessions. Effectively, Roosevelt's rejection destroyed the conference (Morrison 1993: 312).

Of course, one could argue that the next American President will be more sophisticated than Franklin D. Roosevelt and will not repeat those mistakes. But in the American discourse on international economic relations, we have often observed a tendency to blame foreigners for America's economic ills. In recent years, China was blamed for America's trade deficit, and there was little discussion on the lack of competitiveness of American companies. This could of course happen again. It would be a fatal mistake to ignore the possibility that the newly elected American President could reject a comprehensive regulation of financial markets.

Hasty preparation

In addition, the coming conference appears to be hastily prepared. This is another parallel to 1933 and a big difference to 1944. The

former was organised in the middle of a severe crisis, the latter after three years of careful planning. The intellectual leadership for the Bretton Woods conference was provided by John Maynard Keynes, representing the empire in decline, and Harry Dexter White, the envoy of the new hegemon. Bretton Woods was a meeting of treasury officials, who had carefully studied the available options for a new international monetary and financial regime. In 2008, heads of state and government will meet for one day in Washington after just a few weeks of discussion. In such a context, it will be difficult to produce more than a statement that something ought to be done.

But even if those twenty heads of state or government that meet in Washington agree on policy measures, this will not be sufficient. At the level of banking regulation and supervision, the twenty countries may be able to find some consensus on how to organise financial markets in the future, which would be no mean achievement. But as long as international capital flows remained unrestricted, a consensus within the OECD-World will not be enough. Once the dust of the current crisis has settled, financial markets and the innovative people that drive them will explore new loopholes. The history of financial regulation provides numerous examples of such behaviour. Consider, for example, the Eurodollar markets, which grew in the 1960s as a consequence of strict financial regulation in the United States. Following the Great Depression, the American government had introduced caps on interest rates, the so-called regulation Q, and by creating dollar accounts outside the United States banks could by-pass that regulation. The cap on interest rates should have provided stability, but this curbed the profits of banks, which reacted by creating dollar denominated accounts abroad. The Eurodollar markets were born. Subsequently, the existence of these dollar accounts outside the United States undermined the ability of American authorities to control

their monetary policy, which eventually contributed to the demise of the Bretton Woods regime.

Consequently, the agreement on regulatory standards will not be sufficient. Governments will have to address the potential undermining of the new regime. Initially, as we could observe after the last crises, banks and other participants in financial markets tend to be more cautious and operate within the regulatory regime that governments provide them with. Inevitably, financial markets will return to their normal mode of operation, which is characterised by a desire for so-called innovation and greed. Of course, this coming period of calm may last a little longer after the current, global crisis will be overcome. But even this crisis will not change the behaviour of participants in financial markets for good.

Is there already a consensus?

Even within the world's most successful integration project, the European Union, the diverging regulations that continue to exist between the various national financial markets continue to provide regulatory arbitrage, i.e. banks opt for the financial markets with lower regulatory or tax requirements. Banks explore loopholes in the regulatory regime *within* the European Union. If governments have not been able to agree to a level playing field inside the European Union, it appears to be a gargantuan task to achieve this within the group of countries that is invited to the Financial Summits, let alone globally. Furthermore, even after it has become clear that national approaches to crisis management are risky indeed, European policy makers are not discussing a unified European approach for the World Financial Summit and prepare the summit in the national capitals. It is not unlikely that in Washington they will argue with each other, rather than present a consistent position.

What has the USA learnt from earlier crises?

The current crisis does have a number of predecessors in the USA. Consider, for example, the experience of the United States with so-called junk bonds. In the late 1970s and 1980s, these high-yield, high-risk bonds changed the way takeovers were financed in America. One Wall Street investment bank, Drexel Burnham Lambert, pioneered this financial innovation and paid its staff enormous bonuses. Its best paid manager, Michael Milken, earned 550 million dollars in 1986, even by today's standards a substantial income. Four years later the investment bank Drexel Burnham Lambert no longer existed and Milken had been sentenced to ten years in jail. The effect on America's financial system was negligible. Regulation was not tightened. Instead, in 1987 the era of Alan Greenspan began, who repeatedly bailed out Wall Street after managers had, once again, engaged in reckless business practices.

The close connection between Wall Street, the American central bank and the American government has been criticised many times, but there has not been any substantial change. Back in 1998, the American trade economist Jagdish Bhagwati criticised the "Wall Street Treasury Complex". Despite some support for Bhagwati, policies in the USA remained unchanged. The question is why the close links between Wall Street and Washington should be severed as a consequence of the current crisis. Unless this structural change will occur, any hopes for a reversal of American policy regarding the regulation of the financial sector could be premature.

How to handle blockades?

The probably most important question, which should be answered before heads of state and government meet in Washington, is the reaction to potential blockades. The EU should be prepared for a blockade by a big country. What should the EU do if the US refuses to cooperate? More explicitly:

Does the rest of the world have an idea what to do in case the United States refuses to support a new multilateral regime for international finance? Not only the experience of 1933, but also the importance of the financial sector for the American economy and the reluctance of American policy makers to re-regulate after previous crises suggest a cautious approach. One possible solution would be that a group of countries willing to harness financial markets would go ahead and hope for a later expansion of this group, a method that has predecessors in the agreements on climate change.

Opposition in Asia?

Another big problem, however, will be the policies of Asian countries. After the crisis of 1997/98, economies in Southeast and East Asia piled up large amounts of foreign reserves, some of which were then lent to the United States and other countries with current account deficits. Asian economies produced the goods America wanted and provided the credit for it, a regime termed "vendor finance" by the Bank for International Settlements in 2004. America drowned itself in a sea of Asian liquidity, as one Chinese observer called it. Asian countries have been contributors to the build-up of the crisis, and they will have to be contributing to its resolution. Any new regime of international financial governance will have to be attractive to Asian economies.

This is where the current proposals of European policy makers are far too timid. The often heard call to make the International Monetary Fund the key institution for financial governance fails to consider the lasting resentment in Asia about the Fund's performance in the Asian financial crisis. If the IMF were to become the platform for financial governance, it would have to be a structurally different institution. It could and should no longer remain in Washington, but its headquarters should be transferred to an Asian country. This does not solve all problems of the IMF, but it would make it clear that the USA and the

EU are accepting the enhanced importance of Asian economies and are willing to support fundamental change in global financial governance.

In essence, both the European Union and the United States have to make proposals that go further than improving banking supervision and transparency. However, if the efforts to strengthen the global financial architecture will fail, regions will intensify their cooperation.

In the crisis of 2008, we already witness a much enhanced role for regional monetary cooperation. In Europe, the ECB has been providing liquidity not only for private banks within the Euro zone, but has thrown a lifeline to both Hungary and Denmark, which have initially received five and twelve billion euro respectively. Despite continuing tensions, Japan, China and South Korea have agreed on establishing a joint financial regulatory regime aiming at the stabilisation of financial markets. In America, the Federal Reserve has been providing liquidity not only to its own financial sector, but has lent 30 billion dollars each to Mexico, Brazil, South Korea and Singapore. Without significant result in Washington and in the subsequent conferences, regional cooperation in monetary and financial affairs will most probably gain significance.

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SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3-4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

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