Global finance still stands on imaginary foundations*

The world economy is on the brink, not unlike in November 2008 when the G20 first met in Washington. Then it was the financial meltdown triggered by the implosion of the sub-prime mortgage scheme and the collapse of Lehman Brothers. Now it is a sovereign debt crisis and the spectre of stagnation in advanced economies.

Meeting in Seoul in November 2010, the leaders of the group of 20 largest economies defused the immediate threat of currency and trade wars but failed to create the conditions for a sustained recovery. By agreeing in principle to curb «persistently large imbalances» in trade, saving and spending without taking concrete action until next year, the G20 has done little to avert another global crisis.

What has changed is that cooperative globalism is superseded by economic nationalism. In 2008, the G20 agreed on unprecedented monetary and fiscal expansion to prevent the recession from turning into a depression. In 2010, the group is deeply divided over public spending, financial reform, exchange rates and trade. The disappointing compromise of the Seoul summit will do nothing to reverse the sharp slowdown in US and European growth that increases the global imbalances between deficit countries like the US and surplus countries like China.

The core disagreement left unresolved by the G20 meeting is about how to reduce those global imbalances. Last month the US treasury secretary Tim Geithner floated the idea of capping trade surpluses and deficits at 4 per cent of national output. The Chinese deputy foreign minister Cui Tiankai immediately dismissed the proposal, saying that it harkened back to «the days of planned economies». When communist China defends the free market against capitalist America, you know that the global balance of geo-economic and geo-political power has decisively shifted.

Caps on international trade surpluses and deficits were first suggested by the British economist John Maynard Keynes at the 1944 Bretton Woods conference. That conference created the post-Second World War international financial and monetary order, with fixed exchange rates and the dollar pegged to gold. But when in 1971 the US president Richard Nixon took the dollar off gold and abolished capital controls, he helped unleash the forces of global finance that have destabilised the international economy ever since — the mark of Bretton Woods II that failed so conspicuously during the global recession.

The fundamental problem since the 1970s has been that governments have printed too much money in relation to the total value of goods and services. This excess liquidity and mobility has facilitated the casino capitalism of banking conglomerates that speculate in real estate and commodities. Being «too big to fail», they are bailed out by taxpayers' money when it all goes horribly wrong. That's why the financial crisis is of a piece with the sovereign debt crisis.

Now the real task for the G20 is to lay the foundations for Bretton Woods III — a monetary and financial system that can channel free-floating capital into productive, growth-sustaining activities instead of short-term speculation.

Mr Geithner's proposed cap on trade surpluses and deficits is a first, modest step. Robert Zoellick, the president of the World Bank, has gone further. In November 2010 he called for a modified international monetary arrangement with gold as an indicator to guide currency movements, thereby reducing global imbalances. Already in April 2009, Zhou Xiaochuan, the governor of the Chinese central bank, advocated the creation of a «super-sovereign reserve currency». This new currency would be modelled on Keynes's proposal to establish a new international reserve asset called «bancor» (short for «bank money»).

But the trouble with all these policy ideas is that they are ineffective. Mr Geithner's 4 per cent limit is arbitrary, and there are no sanctions for countries that fail to meet this cap, especially the G2 (China and the US). Mr Zoellick's international gold-pegged monetary arrangement guards against currency wars by stabilising exchange rates. But, like Mr Geithner's proposal, it fails to resolve the fundamental problem of excess liquidity.

Keynes's proposed International Clearing Bank would reduce global imbalances by imposing an escalating set of penalties on repeat offenders who refuse to reduce their trade and capital surpluses or deficits. But such a system requires a double agreement that is politically unrealistic: one on global capital controls to regulate the export or import of money; the other on a single reserve asset that replaces a national currency — currently the US dollar but perhaps in future the Chinese yuan. Nor do Keynes's proposals provide positive incentives for the US to live within its means or for China to boost domestic demand.

Thus, the G20 must devise wide-ranging reforms that rebalance the global economy. First would be counter-cyclical reserve assets held by a new global bank (or the IMF) that build up during economic booms and can be spent to offset the worst effects of downturns. Instead of either printing more money or accumulating trillions in foreign currency reserves, countries would have a stronger incentive to achieve a balance over a full economic cycle.

Second, reduce the excess liquidity and mobility of capital by linking finance much more closely to the real economy. This is best done by creating conditions so that global capital is channelled and retained within nations and regions. The G20 could promote global investment in local economies, notably in infrastructure and social capital.

Currency and trade wars might be averted but the recovery is far from secure. The world economy requires a new financial and monetary system that promotes real investment and growth instead of debt-financed speculation.

© Adrian PABST

Lecturer in politics at the University of Kent, Canterbury, UK

* Originally published by "The National" (06.11.2010) at: http://www.thenational.ae/the-national-conversation/comment/global-finance-still-stands-on-imaginary-foundations?pageCount=0

№11(49), 2010