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DEFENDING A FRAYING ORDER

The Imperative of Closer U.S.-Europe-Japan Cooperation

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STRENGTHENING TRANSATLANTIC COOPERATION

3 The Liberal International Economic Order: Toward a New Architecture

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In the summer of 1944, delegates from 44 Allied nations gathered at a remote mountain resort in Bretton Woods, New Hampshire. Even while World War II raged in Europe and the Pacific, they met to sketch the framework of a new and more liberal post-war economic order. Their goal: to avoid the mistakes that led to the Great Depression, the rise of militarism, and conflict among nations. Instead, they would ensure a shared and equitable prosperity by encouraging trade, supporting financial stability, and financing development. While the Soviet Union eventually opted out of the Bretton Woods framework, and certain aspects (such as the dollar-gold peg) did not stand the test of time, much of it — including the three pillar organizations: the World Trade Organization (WTO, successor to the initial 1947 trade and tariff agreement), International Monetary Fund (IMF), and World Bank — not only survived and shaped the post-war world, but continue to stand at the center of the global economy more than 70 years later.

In the wake of the 2008 global financial crisis, calls were heard for a "New Bretton Woods." What this meant, exactly, was often unclear, and one suspects it was invoked more as a talking point, or an excuse for more high-level summitry, than as a concrete agenda. Nevertheless, the calls reflected a growing sense that the old answers had grown stale, and required a rethink. Dissatisfaction with the so-called "Washington Consensus" has given rise to a new fascination with China. In recent years, China's growing influence, and its desire to play a larger role in existing institutions — as well as establish new ones — has given new direction and urgency to the conversation about what the future economic order will look like, and what values and priorities will shape it. If Europe, Japan, and the United States do not provide an updated blueprint for the global economy, perhaps China will. Recent developments suggest that Western and Japanese leaders would be discomfited by such an outcome.

What would such a U.S.-European-Japanese blueprint for a 21st-century liberal economic order rooted in and supportive of political and economic freedom look like? How can Europe, Japan, and the United States cooperate to turn it into reality? What place should China and other emerging economic powers have in that vision? To answer these questions, it helps to begin by looking at the original Bretton Wood framework: what did it aim to achieve, how did it evolve, and where has it fallen short? It is clear that leading countries need to work together to unlock demand from chronic surplus economies and increase global economic balance, and, when it comes to China, Japan, the European Union, and the United States need to be active and find ways to be inclusive without being lax.

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Shaping the Global Economy

When the Bretton Woods conference took place, the Great Depression was a fresh memory. The framework that emerged was a direct response to that experience, aimed at fixing the flaws and mistakes that, the delegates firmly believed, had deepened the Depression and helped sow the seeds of world war. Their solutions centered on three main themes: free trade, financial stability, and economic development.

Free Trade

Many countries responded to Great Depression by trying to protect their domestic markets by raising tariffs and other barriers to international trade. These moves — including the infamous Smoot-Hawley Tariff enacted by the United States in 1930 — proved self-defeating, causing the global economy to shrink even further. The delegates at Bretton Woods were determined to go in the opposite direction. While the International Trade Organization (ITO) they proposed did not immediately come into being, it did inspire the General Agreement on Trade and Tariffs (GATT), starting in 1948. Over the next 50 years, in a series of seven negotiating rounds, GATT grew from 23

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to 123 nations and substantially reduced tariffs and preferences for trade in most goods on a uniform, multilateral basis. The formation of the World Trade Organization (WTO) in 1995, not only as a forum for further trade negotiation but as a tribunal for judging disputes, along with China joining WTO in 2001, represented important new landmarks in this process. The WTO now has 162 member states accounting for 97 percent of global GDP.

Nevertheless, the achievement is in many ways incomplete. Significant barriers to trade in agriculture and services remain, even as services have grown to a dominant share of developed economies. Protection of cross-border investment and intellectual property are imperfect and not necessarily binding. The Doha Round, which has the goal of addressing many of these issues, has been essentially stalled since 2008. In its place, the world has seen a proliferation of bilateral and regional agreements, like the North American Free Trade Agreement (NAFTA) or the Association of Southeast Asian Nations (ASEAN), which may signify progress, but many worry could distort as much as encourage trade, and could even give rise to rival trading blocs. In the meantime, many complain that the WTO dispute resolution process moves so slowly that violators can capitalize on blatantly protectionist policies for years, with lasting effects, before being brought to account.

Financial Stability

The Great Depression saw a breakdown in the system of international settlements as one country after another abandoned the gold standard and devalued its currency in a destabilizing race to gain competitive advantage at each others' expense. By the end of World War II, nearly all of the world's gold reserves had flowed into U.S. hands, making a return to the gold standard — even if desirable — simply impractical. Instead, Bretton Woods created a replacement in which each country's currency was pegged at a fixed exchange rate to the U.S. dollar, which in turn was pegged to gold. Nations used their accumulated reserves of U.S. dollars to settle accounts, with the newly created International Monetary Fund (IMF) stepping in to lend more dollars and coordinate restructuring if the imbalance could be rectified, or overseeing an orderly currency devaluation if it could not. In order to stabilize the rate of exchange, most countries initially imposed controls on capital inflows and outflows.

Over time, countries gradually lifted these controls to facilitate efficient allocation of capital in an increasingly global economy. At the same time, rising U.S. fiscal deficits (to pay for the Great Society and Vietnam War) and a shift in the U.S. trade balance from surplus to deficit put downward pressure on the dollar, forcing the U.S. off the gold peg in 1971. The world shifted from a system based on fixed exchange rates and strict capital controls to one of floating exchange rates and unrestricted, often volatile, flows of cross-border capital. To many people's surprise, the U.S. dollar remained dominant, although it now had to compete with other major currencies as a means of exchange and store of value. Ironically, even as U.S. fiscal and trade deficits continued rising to unimagined heights, the sheer size and liquidity of U.S. debt markets actually reinforced the dollar's dominance, and the world's willingness to finance those deficits.

The ability and willingness of the United States to consume more than it produced, on a seemingly endless basis, was a boon to emerging economies that turbo-charged growth by ramping up export capacity. But the volatile flows of global capital that funded this expansion could be a double-edged sword, creating a boom one year and a bust the next. Far from being hailed for cushioning the resulting adjustments, the IMF was blamed for imposing restructuring on the suffering victims. After the subprime and Euro crises, many wondered aloud whether the United States and Europe — which

played the lead role in directing the IMF — were in any position to be dispensing either money or advice. They asked — with growing boldness or trepidation, depending on who was asking — whether another system, or another currency, like China's, could serve as a more stable foundation for a very different kind of economic order.

Economic Development

In the wake of World War II, there was a widespread conviction — particularly in the United States — that many pre-war problems could be traced to the selfish and short-sighted competition among the Great Powers for exclusive control of colonial markets. U.S. policymakers were resolved that the post-war world would be a post-colonial world, characterized by more even and equitable economic development. To assist in financing this development, the delegates to Bretton Woods proposed what eventually became the World Bank.

To be sure, many of the projects funded by the World Bank contributed positively toward this goal. But other projects were misconceived or poorly executed. All too often, while Western contractors got paid, and local elites thrived, the broader populace benefited little and was left with large "development" debts to pay back. When the World Bank and similar institutions like the Asian Development Bank (ADB) learned from their experiences and raised their lending standards, they were accused of getting bogged down in red tape and failing to address critical needs.

In recent years, a new funding source has appeared: China. Starting in 2007, China Development Bank (CDB) and China Export-Import Bank have together provided more development financing on an annual basis than the World Bank. Last year, China played the lead role in founding the New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB) as all-but-declared rivals to the existing institutions seen as dominated by the United States, Europe, and Japan. China also announced an ambitious "One Belt, One Road" (OBOR) program to finance and construct new trade routes worldwide. Many countries — including several of the founding nations at Bretton Woods — find China's new initiatives intriguing, at the very least, and have signed up to participate.

Toward a New Architecture

The Bretton Woods accord was a repudiation of mercantilism, whether in the form of trade barriers, currency manipulation, or colonial subordination. At the same time, it took place in an era when confidence in the "visible hand" of governments to manage the economy was at its height. In later years, the framework evolved to reflect a renewed appreciation of the "invisible hand" of markets, and the costs of excessive regulation. That experience — of a more deeply interdependent global economy, driven by deregulated, self-directed markets — gave rise to an entirely new set of challenges and concerns. Each of the objectives of the Bretton Woods framework — free trade, financial stability, and economic development — has taken on a new meaning. A "new Bretton Woods" for the 21st century must do more than fix what was flawed in the old framework, it must respond to these new realities.

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Free Trade

The global economy is no longer about making a product in one country, and shipping and selling it somewhere else. It is about complex supply chains that weave together activities all over the globe, supported by investment, technology, and skills that know no borders. Creating an even playing field is no longer just about reducing external tariffs and quotas, but about coordinating and sometimes revising what have traditionally been seen as domestic policies to "stabilize" agriculture, promote national culture and identity, encourage innovation, protect health and safety, and ensure citizens a certain minimum quality of life. Critics of the

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Trans-Pacific Partnership (TPP) argue it is no mere "trade" deal, and they are right: more accurately, it is a package of integrated economic policies that will increasingly fuse several national economies into a single marketplace.

Developing the consensus to support this level of fusion is not easy, which is one reason the WTO process is stuck. Understandably, countries that don't share the same experiences or perspectives won't necessarily agree on the way forward, leaving the process at the mercy of the most recalcitrant partner. Signing bilateral agreements, or putting together broader coalitions like TPP or the Transatlantic Trade and Investment Partnership (TTIP) between the United States and Europe, should not be seen as abandoning a more multilateral approach, but instead as laying the foundation for its eventual success. Far from excluding potential partners like China, India, and Brazil, TPP and TTIP are about a self-selected group that can agree, demonstrating the advantages of closer cooperation and higher standards — as well as the costs of standing to the side and missing out.

Ratifying TPP and getting TTIP off the drawing board should be top priorities. Undoubtedly, both will fall well short of the ideal. With any agreement as large as these, among so many parties, a determined critic is certain to find something to dislike. However, as with each round of GATT before them, the point is not to achieve perfection but to make incremental progress in the right direction, and lay the foundation for further progress. TPP and TTIP should be seen not as one-off deals, but as ongoing works-in-progress, stepping stones rather than a final destination.

Cyber security is one topic that should be added to this agenda. When governments use the internet to steal billions of dollars in intellectual property, hijack sensitive data, or disrupt business operations in order to gain "competitive advantage," their actions have real and damaging consequences for their trading partners. Engaging serial offenders like China and Russia is vital, but unlikely to produce much helpful agreement in the short run. In the meantime, Europe, Japan, and the United States must not wait on their cooperation, but should take the initiative in defining international standards of behavior, and establishing mechanisms to identify and punish cyber perpetrators. That includes highlighting, clearly and repeatedly, the long-standing distinction between (unwelcome but expected) intelligence activities for reasons of state security and (unacceptable) spying and sabotage for illicit commercial advantage.

The WTO will remain an essential forum for refereeing trade disputes, but it can be improved. The settlement process should be strengthened to expedite the review of new (as opposed to long-standing) policies that may put trading partners at a disadvantage, and allow the board to issue injunctions to halt actions that may do long-lasting damage in the time it takes for a ruling to be made. Europe, Japan, and the United States should also press China to join the Agreement on Government Procurement (GPA), as it promised to do when it joined WTO over a decade ago.

Financial Stability

When, at the height of the 2008 global financial crisis, French President Nicolas Sarkozy called for a "New Bretton Woods" to contain the cross-border contagion ripping through banks and capital markets, he was reacting to a subtle but profound change in the international financial landscape. At the time of the original Bretton Woods agreement, that landscape was like a chain of separate islands (national financial markets) linked by ferries (the international payments system). Eventually, those ferries had been replaced by superhighways, creating a single, interconnected global market for capital, in which "hot money" could pick up and move at any time, and national currencies were

just another commodity to be traded. The first disturbances triggered by these liberated flows of capital were attributed to the instability intrinsic in emerging markets, but the 2008 meltdown revealed that the fragility was, in fact, global.

Reimposing capital controls would be impractical and undesirable. It would only, as in China, distort domestic savings and investment decisions. A more plausible solution is to require a higher ratio of committed long-term capital, especially for financial institutions, to reduce sensitivity to both losses and more fickle forms of financing. The torchbearer on this front has been the Bank of International Settlements (BIS), established in 1930, which actually predates (and to some degree rivaled) the Bretton Woods framework. However, the so-called Basel rules rely heavily on somewhat arbitrary categorizations of risk that can be gamed or give rise to distorted outcomes, and on models that may not adequately measure the kind of tail risks most likely to prompt a crisis.

Sarkozy's call — as vague as it was — for a more comprehensive supra-national financial regulatory regime fell largely on deaf ears. To begin with, it was hardly clear, from their performance in the subprime and Euro crises, that bureaucrats were any better equipped than markets to foresee and prevent financial catastrophe. Moreover, each country's banking system, even in the developed world, continues to be based on different traditions and philosophies. Countries might be willing to make their own efforts to bolster stability (Dodd-Frank in the U.S., the Banking Union in Europe), but they often rested on different assumptions and pointed in different directions. If anything, most are inclined to see regulatory reforms in a competitive rather than cooperative light, hoping that the imposition of onerous requirements elsewhere might give their own financial sector a competitive advantage.

One proposal that merits discussion is the idea of establishing a "bankruptcy" process for restructuring unpayable sovereign (national) debts, which does not currently exist. While informal coordinating groups such as the Paris Club and the London Club, and the introduction of innovative instruments such as Brady Bonds, have provided ad hoc solutions in many specific situations where external debt has grown out of control, the recent examples of Argentina and Greece illustrate how, without more formal coordination and a clearer blueprint, negotiations can break down and unresolved debt burdens can hang like a dark cloud over an economy's recovery prospects for years. The advantages of a framework where the risks and resolution options, short of outright default, are more clearly known at the outset are clear, but the risks of encouraging moral hazard and imposing one-size-fits-all rules must be carefully weighed as well.

Perhaps only two things are clear: that the discussion about how to restore international financial stability has barely begun, and that it is essential to the credibility of any liberal economic order — based on free trade, supported by free capital flows — in the 21st century.

Economic Development

The founding of the World Bank was a response to entrenched imbalances in the global economy. Today, the imbalances that threaten a shared and sustainable prosperity are very different than they were in 1944. That may sound like a simple, and perhaps obvious, observation, but it carries profound implications.

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For much of the 20th century, the United States served as a supplier of both goods and capital to the rest of the world economy. Like Britain in the 19th century, it ran trade surpluses and invested the proceeds abroad. Now China appears intent on stepping into the same role. That is the core

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idea, spoken or not, behind initiatives like AIIB, NDB, and OBOR. But the world has changed, significantly. Imperial Britain and 1916-1970 United States both faced global economies that were fundamentally supply-constrained — Britain because the rest of the world had not yet industrialized, the United States because the world was rebuilding from two devastating wars. Today, the global economy is fundamentally demand-constrained. The world is so awash in excess savings that one-third of all government bonds are returning negative interest rates. What the world needs from China is not more goods and money, but consumer demand.

The shift of the United States from surplus to deficit, from creditor to debtor, first enabled global prosperity, and now imperils it. For a time, it turbo-charged growth in emerging markets, while allowing (most) Americans to enjoy an elevated standard of living. But relying on the United States to go deeper and deeper into debt to serve as the world's consumer of last resort is not sustainable. Unfortunately, persistent trade imbalances are usually discussed in terms of what is "fair," not what is sustainable, giving the impression there are "winners" and "losers." Contrary to popular belief, though, such imbalances are not, at their heart, about competitiveness, but about savings. For relatively poorer countries like China to be lending inordinate sums to the United States, in order to drive external demand for their own output — rather than spending it on their own well-being — is perverse, to say the least. It is also damaging to the long-term prospects for global growth.

John Maynard Keynes, one of the key architects of Bretton Woods, bemoaned that the agreement placed the whole burden of adjustment on debtor/deficit countries (like his native Britain) and had no means to encourage complementary rebalancing by chronic surplus/creditor nations (like the United States at that time). The problem grows even greater when, as now, the dominant role of the U.S. dollar provides U.S. borrowers with a nearly limitless well of credit. In 1985, the top five industrialized nations (United States, Japan, West Germany, Britain, and France) tried to rectify this, and reduce the U.S. trade deficit, by signing the Plaza Accord, in which they intervened in currency markets to push the dollar down against the Yen and the Deutsche Mark. The experiment was only partly successful, reducing the U.S. trade gap with Europe, but not with Japan, where imbalances were more deeply entrenched. Today the G20 should study the lessons of the Plaza Accord, both positive and negative, with an eye toward opening a serious discussion on how countries can work together to unlock much-needed demand from chronic surplus economies that can most afford it, and put the global economy on a more balanced path.

Role of China: Incentive, not Exclusion

A few concluding words need to be said about China in particular. China is the 800-pound gorilla in the room: now the world's second-largest economy, some of its recent initiatives, and rhetoric, suggest it might wish to replace the liberal economic order led by the United States, Europe, and Japan with its own agenda. Certainly, many of China's domestic policies are overtly mercantilist in intent and — despite frequent paeans to market openness and reform — it would not be unreasonable to conclude that China has actually grown less open, politically and economically, under Xi Jinping. That said, the fact remains that in recent years, no nation has benefited more from being welcomed into the existing liberal economic order than China, and it has much to gain from cooperative efforts to tackle the issues discussed above.

The United States, Europe, and Japan should not be shy about holding China to account for the commitments, such as to WTO rules, that it has already made. When there is disagreement, as on cyber security or the requirements for joining TPP,

U.S., European, and Japanese officials should keep the lines of communication open, while forging a path that encourages China's leaders to rethink the costs and benefits of continuing in a different direction. When the Chinese government makes its own proposals, the democracies must not object merely for the sake of objecting — as the United States was perceived as doing in response to AIIB — but by presenting an attractive and viable alternative. The goal should not be to exclude China, but to present it with real and serious choices. The only way to do that — and this is the crucial point — is to not wait on China in moving ahead.

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