'A vital account of the history and likely evolution of the international financial system.' **Niall Kishtainy**

PAOLA SUBACCHI

THE COST OF FREE MONEY

How Unfettered Capital Threatens Our Economic Future

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Paola Subacchi
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manque les parties barrées

PREFACE

As this book is going to press the world is grappling with the Covid-19 pandemic that originated in the city of Wuhan in the Hubei province, China in late 2019. The pace of contagion is fast; in March 2020 alone, the number of confirmed cases increased eightfold and, on the 26th, the United States overtook China to become the new epicentre of the pandemic. But it is Italy where the mortality rate has been at its highest (around 13 per cent). By 21 April, there were 797 deaths in my home city in the north of the country, the area from which the outbreak of Covid-19 in Italy, and therefore that in Europe, originated.

Europe went in to lockdown in mid-March and the United States gradually followed suit. Spain, France, Germany and the United Kingdom, like Italy, banned public gatherings and shut bars, restaurants, theatres, cinemas and holiday resorts. The United States blocked all travel from China and Europe, while the British government advised against all unnecessary travel. Border controls were reinstated within the European Union and, in a small number of countries police were out on the streets to ensure that people were staying in their homes except when strictly necessary.

As citizens and policymakers are confronted with the impact of the pandemic on day-to-day life, the world economy is in freefall. All economic indicators point to a global recession worse than the one that followed the global financial crisis in 2008. The measures unveiled so far – a mix of monetary policy and fiscal policy – have been spearheaded by the US Federal Reserve, and the Bank of England and the European Central Bank have followed. Monetary policy aims to underpin business and consumer confidence, to support the banking sector at a time of potential stress, and to encourage lending to businesses. Fiscal policy measures, in turn, are designed to support those who are experiencing economic hardship as a result of the lockdown, although in a patchy and rather uncoordinated way. In Europe, Germany, France and Italy have expanded public spending to help firms – especially the small and medium-sized – get through the crisis. The British government has put a halt on its long-standing conservative fiscal approach and announced £30 billion worth of measures to face the crisis. But the largest fiscal stimulus is in the United States, where a $2 trillion support package approved by Congress includes extensive unemployment benefits, income support for people earning less than $75,000 a year, funds for badly hit sectors, loans to small businesses and $150 billion of aid to hospitals. Short of showering banknotes from the sky – the so-called 'helicopter money' – it looks as if money has suddenly become free.

There is, however, no such thing as free money. The current generosity is motivated by the need to prop up economic activity and avert a collapse of the banking and financial sector by putting a floor under it (and plenty of guarantees). The pandemic demands that drastic measures be taken to help many individuals, households and businesses get through the crisis without falling into destitution. But, although the veil of fiscal austerity has been lifted, it has not been removed. So who will end up paying the cost? Will the impact of trying to recoup these funds haunt our society for decades to come?

We still don't know when the contagion will subside, but it feels like the world as we know it – in which the mobility of people, goods and money are the defining features – has evaporated overnight. The pandemic has put vital resources in short supply, and nations are spreading blame. Nationalistic calls to repatriate supply lines of emergency and non-emergency goods have become more widespread. In Europe, countries seem reluctant to overcome their national interests and help one another.

In this book I ask what happens when competition for markets and resources, especially among contrasting systems led by states determined to pursue their own domestic interests, spreads into open rivalry. The question is made even more urgent by the Covid-19 crisis. Will countries cease playing by the rules of the international order and no longer seek to cooperate with one another? The leaders of the G7 and the G20 have come together (via videoconference, of course) in a pledge to support the economy and coordinate recovery policies, which includes safeguarding the flow of critical medical supplies and agricultural products across borders and the suspension of bilateral government loan repayments from poor countries. The International Monetary Fund and the World Bank, in turn, have committed to deploy more than $1.2 trillion in various types of financial support.

This is good news. As at the time of the global financial crisis, in November 2008 and then again in April 2009, it is critical that the importance of multilateral cooperation is reinforced and the world is reassured that 'somebody is at the steering wheel'.[1] If we are to have any chance of fighting both the pandemic and a global recession, we need coordinated international action and strong multilateral institutions. Only with this framework in place can we enact measures that ensure that our world is prevented from falling into such a crisis again.

The pandemic is expected to put more strain on the international order than the global financial crisis did, so what will the world look like once it is over? As I discuss throughout this book, a peaceful and prosperous world cannot be sustained without the provision of development finance and a global financial safety net to be deployed in moments of crisis. And as long as the dollar remains the key international currency and the main source of liquidity, the global economic order will continue to revolve around the United States.

But the United States has lost interest in playing the role of leader and is becoming a force of disruption. Tensions with China, rather than subsiding in view of the pandemic, have become more acute. Even more than in the aftermath of the global financial crisis, the world now needs a resilient and robust institutional framework. The Covid-19 crisis should offer the opportunity to strengthen and even reform the existing international system on the basis of a progressive, fair and green agenda. However, the indications are that this will not happen, just as it didn't happen in 2008 when countries were more willing to cooperate than they are now – and the United States was more willing to lead. And if this proves to be the case, there will be a significant risk of the international order breaking down into competing blocs, making the world much more fragile than ever since the end of the Cold War.

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During my time as a visiting fellow at the Crawford School of Public Policy, Australian National University in Canberra in late 2018, I explored Asian regionalism and, especially, the Chiang Mai Initiative. I am grateful to Peter Drysdale for inviting me. Peter's warm hospitality coupled with many conversations about Japan, China and of course Australia made my stay truly remarkable. Shiro Armstrong and Joel Rathus guided me through the complexity of East Asian economic integration and the role played by Japan within it. Susan Travis, Adam Triggs and all the researchers at the East Asian Bureau of Economic Research offered invaluable inputs and practical support. Mike Callaghan, Paul Gretton, David Gruen, Paul Hubbard and Barry Sterland were generous with their time and expertise, and helped me to navigate through many aspects of trade and financial arrangements in Asia-Pacific.

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Philip taught me a great deal about Russia, more than he would like to admit; Stephen supported me through this project and kept me sane.

As many friends and family in Italy's first red zone are gripped by the devastating impact of the pandemic, my heart and gratitude are with those who have been working incessantly to help, assist, console and mourn. I dedicate this book to all doctors, nurses, hospital workers and volunteers that every day risk their lives on the frontline of the Covid-19 outbreak.

ABBREVIATIONS

ADB	Asian Development Bank
ADBC	Agricultural Development Bank of China
AIIB	Asian Infrastructure Investment Bank
AMRO	ASEAN+3 Macroeconomic Research Office
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam)
ASEAN+3	Association of Southeast Asian Nations Plus Three (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam plus China, Japan and Republic of Korea)
BRI	Belt and Road Initiative
BRICS	Brazil, Russia, India, China and South Africa
CDB	China Development Bank
CMI	Chiang Mai Initiative
CMIM	Chiang Mai Initiative Multilateralization
ECB	European Central Bank
ECU	European Currency Unit
EEC	European Economic Community
EFSF	European Financial Stability Facility
EMS	European Monetary System
EMU	Economic and Monetary Union
EPU	European Payments Union
ERM	Exchange Rate Mechanism

ESM	European Stability Mechanism
EU	European Union
Exim Bank	Export–Import Bank of China
FDI	Foreign Direct Investment
Fed	Federal Reserve System
FOMC	Federal Open Market Committee
G7	Group of Seven (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States)
G8	Group of Eight (Canada, France, Germany, Italy, Japan, Russia, the United Kingdom and the United States)
G10	Group of Ten (Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States)
G20	Group of Twenty (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union)
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNI	Gross National Income
IBRD	International Bank for Reconstruction and Development
ICE	Intercontinental Exchange
ICSID	International Centre for Settlement of Investment Disputes
IDA	International Development Association
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IP	Intellectual property
IPO	Initial public offering
MIGA	Multilateral Investment Guarantee Agency
MP	Member of Parliament
NAFTA	North American Free Trade Agreement
NATO	North Atlantic Treaty Organization
NDB	New Development Bank
NHS	National Health Service (United Kingdom)

OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
OMT	Outright Monetary Transactions
OPEC	Organization of the Petroleum Exporting Countries
PBoC	People's Bank of China
PPP	Purchasing Power Parity
QE	Quantitative Easing
RCEP	Regional Comprehensive Economic Partnership
RMB	Ren Min Bi (renminbi)
SDR	Special Drawing Rights
SEZ	Special Economic Zone
TPP	Trans-Pacific Partnership
TPP-11	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
TTIP	Transatlantic Trade and Investment Partnership
UN	United Nations
USMCA	United States–Mexico–Canada Agreement
VAT	Value Added Tax
WTO	World Trade Organization

INTRODUCTION

If understanding is impossible, knowing is imperative, because what happened could happen again.

Primo Levi, *If This Is a Man*, 1947

Early in life we all become aware that there is no such thing as free money. Our parents lecture us when we are kids to make sure we understand that money doesn't grow on trees, and that even Santa and the Tooth Fairy have a budget. So when something seemingly does come for free – or perhaps at a discount – there is always somebody paying for it down the line. And yet, it appears that in the last three decades, money has become freer. Not only is credit cheaper but many goods and services are much more affordable than they have been before. Take the fashion industry. Clothes have become so cheap in relative and historical terms that many people regard them as disposable – think of the garments that you can buy for the price of a cup of coffee or less such as the infamous £1 bikini.[1] The apparent trade-off is with quality, but who cares if their clothes don't last a lifetime when fashion changes every season?

Money can now move freely around the world to chase cheaper goods and investment opportunities. Americans, for example, buy 20 billion garments a year; over 40 per cent of this trade comes from China and the bulk of the rest from other developing countries – only a tiny percentage is still made in the United States.[2] Innovations in IT and telecommunication have allowed inventive companies to link consumer demand in advanced economies with a supply of cheap goods from developing countries; in doing this, they have changed consumers' habits and moved money across international boundaries. Take the case of Amazon. A customer may place an order and pay for it in one country, which is then processed in a warehouse located in another, only to be dispatched to a third, as could happen in the case of a gift, for example.

Having become one of the largest companies in the world, with a value over $1 trillion, Amazon attracts capital from investors from everywhere – those who bought Amazon shares in the late 1990s have seen the value of their investment grow enormously.[3]

As money moves around, it binds the global economy together. Developing countries have enjoyed strong economic growth in the last thirty years by becoming more integrated in the world economy through trade and investment – a process that is referred to as globalisation. We, as consumers, have all benefited from lower prices – but only if we don't include environmental and human costs in our calculations. But what happens, then, when the world enters into a phase of transition where economic growth no longer lifts all boats,[4] where rules become confused, confidence evaporates and politics becomes conflictual?

In the recent critiques of globalisation, almost everyone – and especially Donald Trump – posits economic integration pushed by a cosmopolitan elite of international organisations and corporations as the main offender, citing the displacement of industries and people that it has caused. 'It's a global power structure that is responsible for the economic decisions that have robbed our working class, stripped our country of its wealth, and put that money into the pockets of a handful of large corporations and political entities',[5] Trump declared in a campaign advert released just days prior to the US presidential election in November 2016. The same ideas were echoed on the other side of the Atlantic in Britain, where, in the same fateful year, Boris Johnson and the other Brexiteers were advocating 'taking back control' from the 'rogue European Court'.[6] For the Vote Leave campaign, the European Union (EU) – the largest customs union and single market in the world where member states trade with one another without any tariff or other non-tariff barriers – epitomises the constraints on national sovereignty imposed by 'the Brussels bureaucrats' in exchange for trade liberalisation.

So far, all eyes have been on trade, but this is not where the sickness lies. It is in fact free-flowing capital – 'free money' – that is at the root of the string of financial and economic crises that have strained our political systems, corroded our dialogue and worn down the global economic order. With the possibility of making a buck always present, we have become both greedy and short-sighted.

Let's be clear here. Capital is critical at any stage of economic development. Developing countries, in particular, can accelerate the pace of their catch-up by accessing international capital markets. However, because of their intrinsic fragilities many countries struggle to adapt their economies to cope with unfettered capital movements[7] when their relative position in international markets changes. As a result, for many of them, capital flows have been difficult to deal with at best, and extremely disruptive at worst.

Unconstrained capital movements and the associated financial instability – with the related excessive risk on the back of light-touch regulation – have distorted the allocation of resources and the distribution of income between labour and capital. Thus they have generated arduous inequalities, spurred price bubbles, promoted rent-seeking, spread instability and constrained domestic policy choices. Electorates have been driven into the hands of populists and have increased the demand for enhanced national sovereignty, while the once perceived benefits of openness have been cast by the wayside. The United States – the largest economy in the world – has publicly questioned the value of openness. The cracks in the global order can no longer be ignored.

When the international financial system breaks down, tensions arise and chaos ensues. Conflicts that have been brewing for decades rise to the surface and can no longer be mitigated. Competition for markets and resources, especially among contrasting systems led by states determined to pursue their own domestic interests, spread into open rivalry. Tensions become especially rife when financial benefits resulting from playing by the rules within the international order cease to exist. Countries no longer work together to restore stability. This is especially true when the country that has been leading the international order for many years, the United States, not only refuses to lead, but becomes a force of disruption. What will happen next? Will a new system emerge? And, if so, will China lead it?

In this book, I argue that while the dollar remains the key international currency it will be difficult for other countries, including China, to play a more significant role in the international economic and monetary order, let alone to build an alternative one. Their currencies simply lack the financial depth held by the dollar. So what is the solution? I make the case for a rules-based international monetary system and discuss the forms of cross-border cooperation that are required to sustain it. A well-functioning system allows countries to adjust their relative competitive positions through the exchange rate without resorting to protectionist measures that disrupt international trade and are a lightning rod for tensions. Drawing on the experience of the Bretton Woods conference in 1944 where the postwar international economic and monetary order was established, I maintain that building resilience around the existing institutional framework is necessary to provide a safety net to support and reset the current economic and monetary system when it short-circuits. This is a second-best solution when compared to a thorough reform of the existing system based on a progressive, fair and green agenda, but one that is dictated by the fact that there is no scope for establishing a new framework of international cooperation because the political fragmentation led by the United States provides little room for manoeuvre.

A more resilient institutional framework should enhance regional cooperation, help to better integrate market economies with a strong private sector such the United States and Europe, as well as economies where plan and market work together, such as China, and foster the development of regional institutions. These and the further development of China's renminbi as an international currency are the steps forward in shaping the future international economic and monetary order. Regional cooperation should help countries to manage or even limit the extent to which capital may be mobile.

The system that came into place after 1971 – when the United States unilaterally called off the dollar convertibility to gold and put an end to Bretton Woods – has been based on the idea that robust economic growth can only be generated when markets and market interaction are not constrained by regulations and public policy interventions. 'Free money' became the main feature of the economic order post-1980 – a drastic turn from Bretton Woods, which advocated an active role for the state in the economy and controls on capital movement. The belief in the market's capacity for self-regulation removed any need for international policy cooperation or coordination, until financial instability generated by unfettered movement of capital destabilised the system in 2008.

After the global financial crisis President Sarkozy of France and other political leaders called for the reform of the international economic and monetary order, but to little avail. The clock was set back and the system was tweaked around financial regulations and monetary policy, effectively leading to more 'free money'. What has not been questioned is the relative roles of government and market. And indeed, the policy response to the crisis in many countries has been through more flexibility, effectively translating into lower taxes, cuts in social and welfare benefits, capped wages, precarious labour conditions and increased inequality. The capture of social discontent by populist movements and the rise of a nationalist narrative in the countries that have been at the core of the postwar economic order are undermining the very system in which such countries have flourished.

DEFINITIONS AND WHAT TO EXPECT

Like any other book this one inevitably reflects the vantage points of its author. No matter how rigorous and fact-based the underlying analysis is, my approach and narrative are of course affected by where I look at the world from. Hence here my focus is on the advanced economies of Europe and the United States that have been at the core of the international order that has lasted, with ups and downs, from the end of the Second World War to the present. It is an order that revolves around the advanced countries of the west, but it has also driven the development of the rest. The rise of Asia, and China in particular, has been helped by their integration within this order.

Another caveat for the reader is that this is a book about the dynamics within the world economy, mainly capital flows, monetary adjustments and currencies. As such, and regardless of my own vantage point, it revolves around the largest economies that have a systemic impact on the world economy and shape the trends within the economic and monetary order. These are the United States, Europe – the EU and its subset, the Economic and Monetary Union (EMU) – China and Japan. Smaller advanced economies and large developing countries – with the exception of China – are on the receiving end of the effects of policies applied by and coming from large countries. They are 'innocent bystanders', but they can get their voice heard if they club together and cooperate.

Another point of caution is that this is not a book about the history of financial crises, so the reader won't find all episodes of financial instability over the last seventy years, nor a detailed account of recent crises. I have selected significant episodes of financial instability – a choice that some readers may disagree with – to show how free movements of capital destabilise the system and have significant political impact. These episodes illustrate how the cost of free money is not only in economic and financial terms, but spills over and corrodes domestic politics and international cooperation. Because these crises tend to repeat themselves through a rather defined pattern, I look at episodes that are critical for the narrative, even if this means making a choice that is partial and inevitably reflects my own judgement. Thus I take the liberty not to follow events along a chronological sequence, but along a narrative that is consistent with the book's argument.

Last but not least, this book touches upon monetary policy, but it is not exclusively about monetary policy. Since the implementation of the extremely loose monetary policy embraced by the United States and other advanced economies in the aftermath of the global financial crisis, it has become common practice for people to refer to money as being 'free' because interest rates – i.e., the cost of borrowing – are historically low. Although this is an aspect of free money, it is not the only one.

Throughout the book I refer to the international order as the framework that includes the political and security system and the economic and monetary system. These two elements are related as they overlap and support each other. Since the Bretton Woods conference the economic and monetary system has underpinned the world economy through trade and financial transactions. The political and security system is the alliances that support international security and political stability, with the United States at its core. The dollar as the key international currency underpins this system and the status of the United States as an international power.

The Bretton Woods conference in 1944 focused on building a postwar economic and monetary order that revolved around the idea of a rules-based international monetary system to buttress a rules-based international trade system. Its implications, however, transcend the economic and financial sphere and include international security. In other words, it is difficult to have a peaceful world when countries compete for markets and resources. Thus, 'Bretton Woods' – and the 'Bretton Woods system' – is broader than the international economic and monetary order that prevailed between 1945 and 1971.

WHAT THIS BOOK IS ABOUT

The book is organised as follows. In Chapter 1, I set the scene for the subsequent discussion by exploring the many ways in which the establishment of a new rules-based international order provided the context for the postwar golden age. By underpinning an exceptional combination of economic growth, improvements in health conditions, demographics and geopolitics, this order raised the well-being of many people. Under the postwar agreements, there were constraints on the movement of capital, but this all changed when the world started to open up after the end of the Cold War. Indeed, it is unfettered capital that provides the dividing line between now and then.

To understand where we are going, we must understand where we came from, and so Chapter 2 fleshes out the details of the economic and monetary order that emerged from Bretton Woods and the 'non-system' that was born out of its collapse. The Bretton Woods monetary system was designed to limit the scope for domestic policies that are detrimental to other countries, indeed 'beggar-thy-neighbour' policies – such as securing an unfair advantage for one's own country through a competitive devaluation of the exchange rate, at the expense of another country. It also aimed to establish a level playing field for international trade, while at the same time providing the flexibility to pursue domestic interests such as full employment. Under these arrangements, the dollar came to replace sterling as the key international currency and the United States came to replace Great Britain as the leading global power, rendering it responsible for the provision of public goods: finance for development and the global financial safety net.

In Chapter 3, I discuss how liberalised capital movements that came into place after 1971 driven by the blind belief in the market's ability to smoothly adjust and the consequent deregulation led to a string of devastating banking and financial crises. Among others, crises in Mexico (1994), Asia (1997) and Argentina (2001) were shrugged off by critics who claimed that the developing world had simply failed to adjust to financial globalisation. When the global financial crisis hit in 2008 – the worst since the Wall Street Crash of 1929 – it proved just how wrong this line of thought was and made a serious dent in the credibility of the US leadership.

The post-1971 non-system put an end to capital controls, but it did not do the same for the dominance of the dollar. In Chapter 4, I examine the intrinsic contradiction in having a domestic currency – the dollar – at the epicentre of the international monetary system. In desperate need of exchange rate stability, many developing countries have anchored their currencies to the dollar, but in doing so they have tied themselves to the monetary and policy decisions of the United States and consequently run into a whole heap of problems. This chapter shows that 'America first' is not as new as some might think.

In Chapter 5, I look to the EU to show how the lack of an adequate response to the 2008 global financial crisis created a time bomb at the heart of the international order. Although regulations and firewalls were strengthened, they failed to address the buildup of financial instability. I argue that the depth of global financial integration and free-flowing capital have created a situation in which no country is ever truly shielded from financial contagion. Indeed, in one way or another, all economies are exposed to it. Focusing on Greece and Italy, this chapter further examines how the measures considered necessary to manage debt and continue to attract capital have created a pull between sustaining the international order and catering for the wants and needs of domestic electorates. This has spurred public discontent and caused nationalistic reactions in the countries at the heart of the Bretton Woods system.

Chapter 6 expands on Chapter 5 to show that the international order is now in a state of political crisis and the possibility of its collapse must be taken seriously. The benefits of market-based rules-light capitalism once provided an incentive to play by the rules of the international order, but the global financial crisis has discredited this model. Against this context, we have seen the re-emergence of state-based security threats from countries such as Russia. Ultimately, this chapter shows that a world in which countries are in a power struggle and compete against one another for markets and resources may not be as far away from our current reality as we think.

So where does China stand in all of this? In Chapter 7, I explore the rise of China and how this, as well as the growth of the other large emerging markets, has tipped the balance of the global economy. China's economic growth has been nothing short of exceptional, but it would not have been possible without the country's 'opening up' coinciding with the liberalisation of international trade and the inflow of foreign direct investment. This chapter also looks at the ways in which China is still constrained by its model of growth as well as its currency, the renminbi. This is a critical point, as I go on to argue that China's monetary limitations and its immaturity as a lender hinder its ability to provide development finance and a financial safety net – the public goods that it is necessary for the world's leading country to provide – and so challenge the United States' leadership.

Chapter 8 shows that the international economic architecture is now outdated because it has failed to adjust to the changing dynamics of the global economy. For the Bretton Woods institutions to remain credible and relevant, they need to be strengthened to adequately cater for the problems caused by unfettered capital. They also need to be reformed to properly account for new economic powers such as the BRICS countries (i.e. Brazil, Russia, India, China and South Africa). This chapter concludes that the ambivalence of the US Congress means that it is unlikely that these much needed reforms will occur.

What would happen if China felt that its best option was to break free from the international order, given the United States' open hostility and Europe's ambiguity? In Chapter 9 I discuss the notion that institutions such as the Asian Infrastructure Investment Bank (AIIB) are the first steps of China trying to establish a new international order. Looking at the development of a handful of Asian institutions, I argue that these are only intended to cater for Asia and are designed to work alongside the existing Bretton Woods institutions.

Finally, in Chapter 10, I pull together the key points that I have discussed throughout the book and conclude that the United States is unwilling to lead the international order, while China is still unable. As the dominance of the dollar is not going to fade anytime soon and the rise of the renminbi will be gradual, the transition to a multipolar world with a multi-currency monetary system is likely to be long and slow. Whether this transition is peaceful and the new multipolar world inclusive depends on the large economies and whether or not they can blend their rivalries within new and existing regional institutions. If two world wars have taught us anything – and I most certainly hope that they have – it is that the sanctity of international cooperation must be upheld above all else. Whether or not this will happen, however, is currently hard to tell. The clear lesson that was learned in the interwar period and built into the subsequent response at Bretton Woods is that 'free money' has a high cost.

1
WE'VE NEVER HAD IT SO GOOD

For many children of my generation, growing up in the 1960s meant living out the dream conceived by the interwar generation. These men and women had worked and fought hard to establish a peaceful world – a world that was democratic, progressive and prosperous. After the horrors of the Second World War, life for many people could only get better and tangible improvements did emerge in many different areas. For us – the youth – it was even better. Compared to older generations, we grew up with better food and better clothes, were healthier and received a better and longer education. Healthcare was free, in Europe, anyway, as was education – including university. Food was becoming cheaper and ever more widely available. Our parents had secured jobs for life, along with the guarantee of a decent pension when they retired. Unlike today, housing was both available and affordable.

I grew up in a not too big, not too small city in northern Italy, where the winters are rigid as a thick fog enfolds everything – a key factor, apparently, in the production of local delicacies such as cheese and wine. We were four children, affording a good middle-class lifestyle on my father's salary. My mother, following the norm at the time, had given up her professional job when she got married – a decision that she came to regret in later life. We weren't unusual; disposable income was increasing for everyone, while mass production was making many consumer goods affordable. We were the first generation to be exposed to mass consumption of goods – something at which our parents would marvel, but also recoil. Having been raised during the war, they couldn't get on board with the intrinsic wastefulness of non-necessary ephemeral goods.

In the meantime, my husband – also one of four – was growing up in Manchester in northern England. Like us, they had a solid middle-class lifestyle that was supported by their father's salary. Compared to us they had more gadgets – a full train set on permanent display in their playroom, for example – and they also travelled more. Their diet contained more processed food, the quintessence of modern life in the 1960s. By today's standards it was inferior to my family's diet, which still revolved around fresh produce. We were, however, thrilled to welcome the arrival of processed food to Italy, gorging on fish fingers once they finally became available.

Despite growing up roughly 1,500 kilometres apart, then, my childhood and that of my siblings was not fundamentally different from that of my husband and his. Nor was it far from the experiences of many of our contemporaries across Western Europe and the United States. We are the baby-boom generation of children, born in the two decades after the end of the Second World War. Many of us still lived in pretty dire conditions, in insalubrious houses without plumbing, heating or indoor toilets. But things were changing for the better, and we grew up and came of age under an exceptional set of circumstances. Indeed, never before in human history have demographics, improved health conditions, economic growth and geopolitics come together to create a golden age for all.[1]

Compared to the previous generations that had experienced war and displacement, ours was – and still is – a world of peace, democracy and rule of law. The context was that of personal freedom and freedom of expression – a remarkable departure from the world known by our parents. Growing up in Italy, my parents' early years were tainted by Mussolini's fascist regime and the German occupation and civil war that ensued after his fall from power in 1943. Meanwhile, my Jewish mother-in-law had her childhood disrupted by events that were unfolding miles away from her home in Manchester. In 1940, the risk of Britain being defeated by Nazi Germany was too serious to be ignored and so she, together with her mother and sister, left behind a very comfortable life in England to flee to Canada. To this day, she still remembers her shock upon returning to a war-devastated Britain in 1945.

Furthermore, the postwar era looked like the ideal world of linear progress, where the trend in living standards and economic conditions was an upward one. Our children's world has remained peaceful and democratic, and their living standards are higher on average than those of earlier generations, but their opportunities and prospects are starkly different from ours. Today's young adults face more precarious jobs, more debt, fewer benefits and unaffordable housing. Many young families struggle to make ends meet, even when both parents work full-time. The burden of debt from student loans and mortgages chain people to jobs that they dislike, or to areas with limited scope for professional or personal development. In the United States, families can easily end up bankrupt if they lose the medical insurance that comes with good jobs and face a medical emergency. For the first time since the end of the Second World War, many children are likely to be worse off – socially and economically – than their parents' generation. Until the end of the 1970s, living standards in the United States grew in line with the growth of the economy, but between 1980 and 2016, 90 per cent of the population's income grew at a pace that was slower than the national average, with that of workers in the bottom 40 per cent of the income distribution growing by 0.3 per cent a year. Over more than three decades, pre-school teachers and carers saw their annual income grow from $26,400 to just $29,800. On the other hand, those in the top 0.1 per cent of the income distribution – for example, an investment banker or a corporate lawyer – almost quadrupled their post-tax income.[2]

Even if many young adults may not see their income increase at the pace experienced by their parents and grandparents, and face more precarious labour market conditions, they can still maintain a lifestyle that is not radically dissimilar from that of the previous generation. The savings that have accumulated in the advanced economies over the last seventy years have created a stock of wealth that has been transferred from one generation to the other, helping preserve the living conditions of the younger ones, even if in both the advanced economies and developing countries wealth has accumulated at a much stronger pace and therefore concentrated in the hands of the top 0.1 per cent.[3] Despite the overall sense of 'being squeezed', the lives of our children are much better than the lives of their peers in many areas of the world. Although living conditions have substantially improved everywhere, 8.6 per cent of the world population still live in extreme poverty on less than $1.90 a day.[4]

In the postwar years there was broad-based progress in the western world. We had peace, stability, health, education, social mobility, steady jobs, access to the housing market and decent pensions. Not even the recurrent and inevitable tensions on the international stage, such as the nuclear scare, detracted from the sense of confidence and opportunity. But we have become too complacent. The generation that experienced the horrors of fascism and warfare in Europe is almost extinct, and we now risk losing the memory of just how exceptional the post-Second World War international order was.

THE POSTWAR GOLDEN AGE

The post-Second World War golden age was the result of extraordinary economic and political conditions. These conditions supported the expectations that progress could only be linear and ascendant – that is, that social, economic and physical conditions could only improve. In the opening of this chapter I identified four trends – demographics, health conditions, economic growth and geopolitics – that, through their interplaying, came to shape the golden age. Between 1950 and 1975, the population in Western Europe grew by almost 20 per cent, while that in the United States increased by almost 40 per cent.[5] This was not the first time that the world had seen large increases in population, but the interplaying of these factors meant that this population size could now be sustained.

The establishment of universal or affordable healthcare systems in Europe, medical discoveries, the development of affordable drugs and the creation of public health programmes, all resulted in significant improvements in a broad base of health conditions and ultimately contributed towards extending the life span of the average person. Britain's National Health Service (NHS), for example, was created by Clement Attlee's Labour government in 1948 and is now praised as being the most ambitious postwar welfare effort. The baby-boomers were the first generation to see a drastic drop in child mortality rates, which more than halved in Italy in the two decades after the end of the war.[6] In the early 1950s, polio was still afflicting the lives of hundreds of thousands of children across the globe, often leaving them paralysed or dead. But the discovery of the polio vaccine in 1955 – together with a swiftly implemented mass immunisation plan – meant that instances of the disease in Europe had dropped by 75 per cent by the early 1960s.[7] By 1979, the disease was completely eradicated in America, and Europe was declared polio-free in 2002. By 1944, the first true antibiotic, penicillin, was in mass production. Penicillin was put to an array of uses, tackling illnesses such as rheumatic fever and pneumonia. It effectively treated wounds that previously could have led to amputation – or even septicaemia and death. This made surgery much safer than it had ever been before, while new medical technologies paved the way for procedures such as open-heart surgery and organ transplants as we know them today.

The food supply also drastically improved in the golden age, so the fact that people were better nourished is another factor in the overall improvement of health conditions. By the 1980s, young men in Europe, for example, were on average 11 centimetres taller than their counterparts a century earlier.[8] All of these advancements, together with the development of social welfare policies, radically changed the lives of many families who no longer feared destitution in the case of ill health and disabilities. Although the United States was intellectually at the forefront of many of these medical innovations, it is well known that their healthcare system, by following a private insurance method, diverged from the universal path chosen by Europe.

As child mortality rates plummeted, the 1960s saw populations that contained a higher percentage of young people than it had ever been the case before – a trend that was soon to be reversed, thanks to prolonged life expectancy and a drop in fertility rates. In order to support the growing number of children, reforms in education soon became necessary. For many children of the previous generations, childhood ended when they left primary school and work began at the age of eleven – or at the latest, fourteen. But by the 1950s, educational reforms meant that an education beyond elementary literacy and numeracy skills was no longer the reserve of the privileged few. Indeed, the baby-boomers were the first generation to be in compulsory full-time education during childhood and adolescence. Subsequently, tertiary education boomed. In Italy, universities were opened up to all with the abolition of entrance exams in 1965. By the end of the 1960s, roughly 14 per cent of young Italians were attending university, almost triple the figure from a decade earlier. Although the number of students in the United Kingdom did increase, the system remained selective, and only 6 per cent of the youth population were in tertiary education by the late 1960s.[9] In the United States, few industries grew as rapidly as that of higher education in the decades after the Second World War. Between 1950 and 1990, the number of colleges and universities in the United States almost doubled. By 1970, the number of Americans attending university hit 8 million – over three times the number of attendees in 1950.[10]

The postwar years were blessed with exceptional economic activity that resulted in strong and sustained economic growth. In the two decades after the war, the advanced economies, including Western Europe and the United States, saw their annual real gross domestic product (GDP) grow at a steady average rate of 5 per cent.[11] Unemployment was low. By the mid-1960s, the average unemployment rate across Europe was 1.5 per cent – effectively a situation of full employment. The United States also saw a significant improvement, with the unemployment rate dropping to around 4 per cent at the same time.[12]

Along with this increase in employment came the increase in labour productivity, especially in Western Europe where, in the three decades after 1950, productivity increased by three times the rate that it had done in the previous eighty years. GDP per hour worked was higher than GDP per member of the population, reflecting improvements in health and living conditions, as well as better skills.[13]

The overlapping of these trends meant that, for the first time ever in human history, people who were not endowed with wealth and capital, exceptional talent or even just sheer luck, could aspire to a decent life for themselves and their children. For many people from blue-collar backgrounds, a white-collar middle-class future was no longer a wild dream. They could aim for a life that wasn't a constant struggle to make a living against adverse circumstances, hostile environment, poor nutrition, disease, coercion or exploitation. With better education, health, job security – and innovations such as oral contraceptives – came a change in the way that society and families were organised. More women began to take part in the formal labour market, challenging the notion that their role was to stay at home as full-time carers.

It is important to remember that the successes of this period would not have been possible if countries hadn't cooperated with one another in the way that they did. The nations that had fought against one another during the two world wars put aside their differences and worked together to prioritise the greater good. The context of the golden age was provided by a new international order, where economic and financial conditions overlapped and interacted with international security. The United States, together with Great Britain, had won the war and took the lead in the subsequent peace talks. Unlike Britain, which had been physically and economically devastated by the war, the United States emerged in a position of strength. As such, they became the new international leader – the *primus inter pares* – and the guarantor of the postwar order.

A BAG FOR CASH

Although still far from the choices available today, the ever increasing variety of consumer goods in shops and supermarkets epitomised the achievements and aspirations of the postwar middle class – as did family holidays. For the first time ever, those other than the very wealthy were taking time off during the summer. Like many of our friends and contemporaries, my family and I used to spend our holidays in a small town on the Ligurian coast (in the northwest part of Italy along the border with France) where we would spend our days lazing in the sun and snacking on fresh focaccia. My best friend at the time was a local girl called Silvana. One day, circa 1979, Silvana's mother invited us to accompany her on a trip 'abroad' to Nice, France – some 45 kilometres down the road. The purpose of the excursion was to visit the Louis Vuitton boutique to purchase the iconic Speedy 40 handbag.

Like today, Louis Vuitton goods were the object of desire and the quintessence of luxury for Italy's rampant middle class. Cheap and well-made counterfeits were available at every weekly market along the Ligurian coast. French tourists on holiday on the Côte d'Azur used to descend en masse during market days to buy the fake Louis Vuitton goods. Because of the strength of the French franc – a hard currency – against the Italian lira, they could snatch some amazing bargains. In those days, the world was not yet globalised and those Louis Vuitton counterfeits were made in Italy by Italian craftsmen, often the same people who produced the actual stuff. Even if the differences between real and fake were allegedly unnoticeable, buying the real thing in France set the cognisant apart from the *hoi polloi*.

When we arrived in Nice at the Louis Vuitton boutique, Silvana's mother meticulously examined the Speedy 40 bag, enquired about the price and agreed to proceed with the purchase. She then asked to use a changing room while the shop assistant was busy wrapping the bag. She emerged with a handful of francs that she had retrieved from its hiding place – her bra. When we arrived back at the car, she took the Speedy 40 out of its glossy carrier bag, emptied it of the paper used to keep it in shape and discarded all of the wrappings. She then laid the Speedy 40 flat on the back seat of the car and asked Silvana and I to sit on it during the trip back to Italy. She did this to hide the evidence – to avoid attracting the attention of the Italian customs and duty officers. The risk was to be caught and charged the difference between the value added tax (VAT) rate in France and the much higher one levied in Italy.

I tell this anecdote, of course, because it describes the nature of goods and markets in the pre-globalised world. Cross-border mobility was considerably reduced and many goods were produced locally; markets appeared almost self-sufficient in comparison with the many purchasing opportunities that we have today. Goods that are now ubiquitous were once rare and difficult to acquire. Nowadays you could traverse the globe, from Bogotá to Ulaanbaatar, from department store to major airport, ticking off Louis Vuitton outlets on your way – although no one would take the trouble when their products are just a few clicks away online.

Silvana's mother had to hide her cash in her underwear because those were the days of restrictions on how much money could be moved across borders. All currency transactions were forbidden, unless they were explicitly allowed. Firms that imported and exported manufactured goods and raw materials, for example, were granted special licences to move funds in and out of the country to pay for those transactions. But Italians travelling for tourism were not allowed to take more than 500,000 lira out of the country – approximately 260 euros. In the late 1970s this equated to about two-thirds of the net average salary, but the unfavourable exchange rate left Italian tourists with little cash to splash on overseas trips.

Italy was far from being the only country to apply capital controls, nor were they anything new. Capital controls have a long history, but their prevalence was cemented in the post-Second World War era, as they became a structural element of the global economic order – as I'll discuss in the next chapter. The fundamental weakness of the lira, however, made the Italian authorities particularly inclined to restrict capital outflows. Politically, the country was unstable – there were widespread concerns that the Communist Party would gain a majority in the Italian parliament and take power from the centrist Christian Democratic Party. This persuaded many wealthy individuals to transfer significant chunks of their money abroad. Fearing a haemorrhage that could further weaken the lira and undermine economic growth, the Italian authorities increased interest rates and tightened financial controls. These were particularly severe at two key points along the extensive and exposed Italian border. The first, Ventimiglia, was the gateway to France, located roughly 20 kilometres from Monte Carlo – an offshore financial centre and tax haven. The second, Como, was close to the Swiss border, similarly close to another tax haven, Lugano.

In 1979, Italy's VAT on luxury goods was set at 38 per cent.[14] Currently, it is 22 per cent, with a similar rate across the rest of Europe. The high tax rate in 1979 was a way for Italy to protect one of its key industries, high-end fashion, against competitors – in particular, the French. Even allowing for the unfavourable exchange rate and other transaction costs, buying the Speedy 40 bag in Nice was approximately 25 per cent cheaper than buying the same product from the Louis Vuitton boutique in Milan.

There is another interesting feature of life in the pre-globalised world highlighted by this anecdote. Although it did of course play a big part, this expedition was not solely a question of acquiring a luxury product at a reduced price. For, despite the emergence of the annual family trip to the coast or countryside, for most people, mobility was restricted. In leading this expedition, then, Silvana's mother broke away from the norm, as not many would have had the confidence to travel abroad to make a significant purchase. For her, as well as a handful of other conveniently located fashionistas, the thrill of crossing the border, smuggling cash and luxury goods, was worth the risk.

A DEEPLY INTEGRATED WORLD ECONOMY

The world today is strikingly different from how it was in the late 1970s. If my friend's mother wanted to buy the Louis Vuitton Speedy 40 today, she would not need to smuggle cash out of Italy. In the 1980s and 1990s, capital controls were abolished in most European countries in preparation for the single market and single currency, so individuals and companies are no longer constrained in how much money they can take abroad. Financial technology has also come a long way since then. The advent of debit cards means that now many people purposefully choose not to carry cash when travelling abroad. Cards issued by Italian banks are accepted everywhere in France – and not only France – to pay for purchases and withdraw cash from ATMs. However, it is most likely that, in the present day, my friend's mother would have used a credit card. Credit cards facilitate international payments, as they are widely accepted and used everywhere around the world – especially online. For tourists, they have come to replace the traveller's cheques as a secure and convenient means of payment abroad. Credit cards and debit cards have fundamentally changed how we deal with money. In 1979, cash was king, but today 'plastic' dominates. Although cards are the most common method of payment, it is not even necessary to carry them with you anymore.[15] Advances in contactless payment technology mean that you simply need to link your card to a payment app on your smartphone, and you are ready to shop – and travel – around cities such as London and Hong Kong.

Following monetary unification in 1999, Italy and France are now part of Europe's monetary union and share the euro as their common currency. Louis Vuitton goods in their Nice boutique are now priced in euros and cost a similar amount, if not exactly the same, as the goods in their Milan boutique. Relatively speaking, Louis Vuitton goods are cheaper for Italian consumers than they were forty years ago, as they no longer have to exchange cheap lira for expensive francs. Deeper economic integration in Europe and the creation of the single market (as I'll discuss further later in this chapter) have also led to the harmonisation of tax and duties. VAT rates have converged and today the difference among rates applied in EU member states does not exceed a couple of percentage points. The only exception is Hungary, where the VAT rate is at 27 per cent. Scope for duty and tariff arbitrage within the EU has therefore been considerably reduced.

In addition to the free movement of money, people can now also move freely between the countries that adhere to the Schengen Agreement. This agreement came into effect in 1985, abolishing internal border checks and sowing the seeds of a borderless area within the EU.[16] As Italy and France are members of the Schengen area, border controls between the two countries were removed – although France did reinstate some checks in 2015 to constrain the flows of illegal migrants and refugees.[17] (In March 2020, the EU decided to temporarily suspend free movement across all Schengen borders in response to the Covid-19 pandemic.[18])

Louis Vuitton is now one of many global luxury brands. Brands have become global because the world economy has become global. The world has changed beyond recognition in the last forty years; it has become larger, 'flatter'[19] and more connected. The reduction or removal of trade barriers (as in the case of Europe's single market), the opening of new markets and the integration of transnational supply chains have become the defining stories of our time.

We buy, for example, food produced in Africa, flat-screen TVs manufactured in China – and there is a good chance that the system that manages our personal banking was developed in India. We wear inexpensive but trendy clothes that imitate the latest fashions seen in Paris, London or Milan. These clothes are designed and marketed by companies headquartered in Spain, Sweden or Japan; are manufactured in places such as Turkey, Bangladesh, Tunisia, Albania or Vietnam; and then distributed in mono-brand shops all over the world. We are avid users of electronic gadgets that are similarly designed in one country, assembled in another and sold all over the world.[20] We now travel frequently for work and for pleasure, and travelling is both cheaper and faster than it used to be. Airfares have dropped since the early

1990s when the deregulation of EU airspace enabled the creation of budget airlines such as easyJet and Ryanair.[21] In 2018, about 80 million passengers passed through London's Heathrow, the largest airport in the United Kingdom, on their way to or from more than 200 destinations.[22] International hubs are now connected to regional airports through an extensive network of routes.

Never before in the history of humanity has there been as many people living in a country other than their own as there are now. The non-UK population of the United Kingdom (those who were not born there or who are not British nationals) has increased year-on-year since 2004 when reporting began. Currently 37 per cent of London's population is non-UK.[23] More than 485,000 students from all over the world study in British universities.[24] At Peking University, China's elite institution, international students have come to account for 15 per cent of the student body.[25] It is not an exaggeration to say that the world has undergone a radical transformation since 1979, as goods, money and people are now more mobile than ever before. We can see that it is the economic and financial integration – or globalisation, as it is universally known – that serves as the dividing line between then and now.

OPENING UP

The limited mobility of the postwar world was solidified by the fact that the world's two largest countries, the Soviet Union and China – the former being the biggest in terms of geographical extension and the latter the most populous – were both on the other side of the 'iron curtain', making them virtually unreachable. The iron curtain seemed like a permanent division between democracy and authoritarianism, between market economies and plan-based economies, but critically between freedom and repression.

Barriers to mobility started to crumble around the time of the fall of the Berlin Wall in 1989, which marked the end of the Cold War and the beginning of an intense period of trade and financial integration. With the barriers to mobility removed or reduced, markets opened up, fostering innovation in technology, information, ideas, governance and institutions. This in turn created the conditions for more cross-border business, shaping the development path of many countries and underpinning the transformation of the world economy. These dynamics are reflected in the dramatic increase in international trade flows over the last three decades. In 1990 the value of world merchandise exports was $3.5 trillion, but by 2018 it had risen to $19.6 trillion. Trade in commercial services grew even faster, from $830 billion in 1990 to $5.8 trillion in 2018.[26]

As a result the world economy has experienced strong and rapid growth. In 1990, GDP was approximately $24 trillion in current prices; in 2019 it was over $86 trillion.[27] This rapid expansion is often compared to the growth of trade, relative to population and income, that happened during the course of the nineteenth century – the period referred to as the first wave of globalisation. This was driven by technological changes that substantially lowered shipping costs and a reduction in tariffs. Trade measured by exports expanded by 305 per cent per year between 1815 and 1914, while income grew at 2.7 per cent.[28] Although the trade growth of the late twentieth century did broadly emulate this growth, its pace was unparalleled and could not be matched.[29]

What really differentiates the later phase of globalisation, however, is not the speed of integration within a relatively short space of time, nor the rate at which international trade grew. It instead lies in the fact that the countries that had, for the last seventy years, largely remained at the periphery of the world economy, are now key components. These include China, India, Russia and Brazil, with South Africa added at a later stage – the BRICS as they have become known (as I will discuss in chapter 7) – but also Mexico, Indonesia, Thailand, Vietnam, Nigeria and Turkey. All of these countries have come to epitomise the broadening of the world economy both in terms of the increase in the share of the world GDP they currently produce (about 40 per cent at current market prices) and their contribution to global growth (approximately 60 per cent).[30]

There are two elements in this 'weighted' convergence between developed and developing countries – or the shift in the relative weight of these two groups. The first one is determined by the catch-up factor that has allowed the latter to narrow the development gap with the former through the participation in international trade, access to international capital, and exposure to innovation, technology and skills transfer. This catch-up factor is reflected in the rate at which an economy grows year by year (or quarter by quarter). Since 2000, developing countries have grown at an average annual rate of almost 6 per cent while the advanced economies have grown at 1.9 per cent. In the previous twenty years, from 1980, the latter had grown at the annual rate of 2.9 per cent and the former at 3.4 per cent.[31]

It is not that the advanced economies have considerably deviated from their growth trend – even if some countries in this group did, for instance Italy. It is that the developing countries, on the aggregate, have shifted to a more dynamic pattern of growth. Consequently – and this is the second element in the convergence story – developing countries have increased their share of global GDP. Since 2000 the aggregate size of the advanced economies almost doubled from $26.8 trillion to the current $52.2 trillion while that of the developing countries has grown five times from $7 trillion to over $35 trillion. All together, developing countries now account for over 40 per cent of the world economy.[32] Back in 1990 the economies of North America and Western Europe together accounted for more than half of the total world economy.[33] Over roughly thirty years, the aggregate weight of North America, Western Europe and Japan has fallen to just below 50 per cent. In 1990 Asia-Pacific was approximately 23 per cent of the world economy, with Japan contributing the most – about 13 per cent of the total. In 2018, the Asia-Pacific region accounted for 35 per cent of the total world economy, with Japan's global share having dropped to approximately 6 per cent and that of China having risen to roughly 16 per cent.[34]

China is the key element in the expansion of the world economy and its changing dynamics, for it accounts for the majority of the expansion of the developing and emerging countries. Its share of the world economy has jumped from less than 2 per cent in 1990. The other large emerging markets such as Brazil, Russia and India have also seen their share grow. They now rank among the world's ten biggest economies.[35] However, their size is comparable to that of China only in the aggregate; together they account for about 7 per cent of the world economy.

China has managed to close the gap, in terms of size of its economy, with the largest economies, regaining the position that it held in the world economic ranking at the beginning of the twentieth century. In 1910 China held almost a 9 per cent share of the world economy. Western Europe – roughly the countries that are now members of the EU – was then the largest economy in the world, with almost a 28 per cent slice. The United States, which was in the most intense phase of its development, held about 17 per cent of the total at the time – although this had grown to about 26 per cent by 1990. Russia was 8 per cent, and Japan accounted for a mere 2 per cent.[36] Fast forward to our days, the EU accounts for approximately 21 per cent of the global total and the United States accounts for roughly 25 per cent.[37] The shift of economic weight

– and the influence that inevitably comes with this weight – from developed to developing countries is one of the most critical aspects of the world's recent economic development.

MONEY CONNECTS THE WORLD

Capital flows, even more than trade, have grown robustly since 1990. This is true of both portfolio investments and foreign direct investments. At its peak in 2014, the overall value of international merchandise trade was $19 trillion – double what it was ten years before and quintuple what it was fifteen years before that.[38] Over the same period, capital flows have expanded at an even greater pace, despite a temporary drop during the global financial crisis. In the mid-1990s, gross cross-border capital flows accounted for approximately 5 per cent of world GDP; at their pre-crisis peak in 2007 they were about 20 per cent. Capital flows, then, increased at a pace approximately three times faster than that of world trade flows.[39] Nowadays, foreign direct investments account for around 1.4 per cent of the world's total GDP.[40] (Foreign direct investment are a type of investment that reflects lasting interest and control by a foreign investor, such as when an investor who resides in one country buys or establishes a firm in another country.) In 1990 this figure was much lower, at approximately 0.9 per cent. Portfolio investment – such as when an investor buys shares in a foreign company or a portion of a country's or a company's debt such as stocks and bonds – are by far the bulk of the overall investment activity. They account for approximately $58.7 trillion – approximately 68 per cent of global GDP.[41] Since 2001, when the data series began, they have increased by four times their level.

Money, then, glues the world together.[42] It facilitates international trade, allows migrant workers to support their families back home, and lubricates the setup of international development projects and cross-border technology transfers. Capital flows are a positive force for the economy as they support economic activity and growth. If they are directed towards activities that increase productivity and add value, they can – directly or indirectly – create new jobs and have a long-term impact. However, when international capital flows are directed towards speculative activities without any intrinsic value creation, they can often end up feeding speculative bubbles or excessive and unstable credit growth, generating significant risks for financial stability. When this happens the recipient countries can make themselves hostages to fortune and vulnerable to external shocks. Not only do these developments make it difficult to manage the domestic economy – for instance, by creating inflationary pressures – but they make countries vulnerable if money inflows suddenly reverse. The Organisation for Economic Co-operation and Development (OECD) has estimated that after large capital inflows, the probability of a banking crisis or a sudden stop increases by a factor of four.[43]

There is also another downside of international capital flows, for they aid international crime networks, funding activities such as illegal arms sales, trafficking and terrorism. The presence of such things in a country can cause social unrest, political instability and, in turn, economic instability. Because of the covert nature of money laundering, it is difficult to give an exact figure, but it is estimated that somewhere between 2 and 5 per cent of annual global GDP is money laundered. Even at the lower rate of 2 per cent, this puts the estimated figure of money laundered in 2018 at over $1.7 trillion.[44]

The United States is, without a doubt, the largest hub for international capital. In 2018 it received $258 billion in net foreign direct investment, followed by China with $203 billion and Germany with $105 billion.[45] It is, however, portfolio investments that set the United States apart from all other countries. In 2019, $11.6 trillion in portfolio investment flew into the US market – a fourfold increase from 2001. The second largest recipient, the United Kingdom – with London as the key international financial centre – trails far behind with a mere $4 trillion in portfolio investment.[46] In 2019 the United States invested in the rest of the world approximately $12.4 trillion in portfolio investment.[47]

The position of the United States in relation to international capital is consistent with the size of the American economy – the world's largest – and with the role that the dollar plays as the key international currency within the international monetary system. Indeed, when we talk about international money, we implicitly mean the US dollar. Regardless of where capital originated from or where it ends up, approximately two-thirds of these flows are dollar flows. Not only are dollars easily available, but they are accepted almost everywhere in the world. Because there are enough of them to satisfy demand at almost any time, the dollar is the most liquid of all the international currencies. The dollar is thus the quintessence of international money, as I will discuss further throughout the book.

Like all other international currencies the dollar is fiat money. What this means is that the government of the United States, like all other governments that issue fiat currencies, declare it legal tender within its jurisdictions. It is based on credit and its value is unrelated to the value of any physical good such as gold or silver (again, more on this point in the next chapter). Without the backing of a physical good, it is vital that foreign holders of dollars – being individuals, businesses, foreign central banks and governments – have trust and confidence in the policies and institutions of the United States.[48] Indeed, if the US government pursues policies that diverge from upholding the stability of the dollar's purchasing power, then foreign dollar holders could decide to switch to another, more stable international currency instead. In practice, however, the dollar's broad circulation, high liquidity and network externalities (i.e., dollars continue to be used around the world because everybody extensively uses them) help maintain its de facto position of prominence in international markets. No matter how reckless the US policies may be, then, the dollar tends to be the currency of choice. As the Secretary of the US Treasury John Connally Jr put it, speaking in 1971 to the European finance ministers who were concerned about the rising US inflation, 'The dollar is our currency, but your problem.'[49]

MERCURY VS MARS[50]

Many globalists, or 'citizens of the world', maintain that the mobility of goods, money and people, along with the emergence of global markets, all contribute towards peaceful international relations. Put otherwise, they believe that economic interdependence underpins peace and prosperity. The thought dates back a long way, as it was a central tenet of the nineteenth-century liberal economic thinking. In *Principles of Political Economy*, published in 1848, British philosopher and economist John Stuart Mill defined international trade as 'the principal guarantee of the peace of the world'.[51]

In the nineteenth century, the industrial revolution and the growth of international trade relations fostered deeper economic and financial integration. Such integration, which was centred on Britain, 'the first industrial nation',[52] made countries so interdependent that it was believed that there was no commercial or political advantage from war. In the early twentieth century, the British pacifist, Labour Party MP and Nobel Prize laureate Norman Angell wrote of the 'optical illusion' that territorial expansion, which was dependent on warfare, could increase the wealth of a nation and remove the demographic pressure on resources.

Indeed, in his hugely influential *The Great Illusion*,[53] published in 1910 just before the First World War, Angell recalls the anecdote about a beggar who, during the Jubilee Procession, sang: 'I own Australia, Canada, New Zealand, India, Burmah [*sic*], and the Islands of the Far Pacific [. . .] I am a citizen of the greatest Power of the modern world [. . .] and I am starving for want of a crust of bread.'[54]

The outbreak of the First World War, however, showed that geopolitical rivalries and even personal antagonism could overcome commercial and economic considerations.[55] Despite this, the call for a sound international economic order that promoted cooperation and minimised 'beggar-thy-neighbours' actions remained embedded in the intellectual debate of the interwar years. The 'delicate interdependence of the financial world (an outcome of our credit and banking systems)', wrote Angell, 'make the financial and industrial security of the victor dependent upon financial and industrial security in all considerable civilised centres. So that widespread confiscation or destruction of trade and commerce in conquered territory would react disastrously upon the conqueror. The conqueror is thus reduced to economic impotence which means that political and military power is economically futile.'[56]

British liberalism and idealism, which stressed economic paths to greater international harmony and peace, was perhaps naive, and surely too infused with paternalism and elitism – the trademarks of the nineteenth-century brand of capitalism. After the First World War, this idealism was combined with – and developed into – an articulated set of ideas that posited institutions as the repository of the rules that underpin the economic order. A well-constructed economic order that avoided pitting countries against one another to compete for markets, revolved – it was believed – around international multilateral institutions responsible for managing international economic interdependence. John Maynard Keynes, the British economist who led the economic thinking during the interwar years and played a leading role in establishing the postwar order (as I'll discuss in the next chapter), fostered the idea that international organisations could be developed as a means of international cooperation, including in economic affairs.

In *The Economic Consequences of the Peace* (published in 1919), Keynes identifies trade as the key driver of prosperity which, in turn, was believed to promote domestic order and moderation, resulting in international stability and peace. He further argued that obstructions to trade lead to impoverishment, which then fosters domestic extremism and disorder, and eventually international conflict. By the same token, those who identify their interests with trade are more likely to pursue peace than those who do not, and those who recognise that their well-being depends on trade will be much more likely to pursue policies of international 'peace and amity'.[57]

In *The General Theory of Employment, Interest and Money* (published in 1936), Keynes suggested that the 'competitive struggle for markets'[58] within an international monetary system that put countries in competition with one another was the main economic cause of war. This, he argued, could be eliminated and 'unimpeded' trade could be a 'mutual advantage' if countries could pursue national policies for full employment within an international monetary system designed to avoid achieving the external balance through deflationary domestic policies. The Second World War was soon to provide the opportunity for some of the countries involved to come together to construct an economic order based on cooperation and underpinned by a multilateral institutional framework. International organisations were to be developed to reconcile international trade and monetary conditions. Policies shifted to recognise the need for putting all countries in the position to develop their economies, informing the building of the new international order. This new, non-competitive rules-based international monetary system was to become – together with trade – a pillar of the new cooperative and non-competitive international order. There were two things that needed to be restored by this order: the partnership between Europe and the United States that had been disrupted by the war, and a new international equilibrium. This preoccupation remained central to Keynes's work until his death in 1946.[59]

A FRAMEWORK OF RULES FOR INTERNATIONAL TRADE

In a memorable scene of the postwar British film *The Red Shoes* one of the leading characters, the impresario Boris Lermontov of the Ballet Lermontov, is served half a melon for breakfast, meticulously placed in a silver bowl. He enjoys this with what we would consider today by our standards an unhealthy portion of sugar. This scene is no coincidence; in 1948 Britain, basic goods were still rationed. The exotic melon and generous helping of sugar showcase the social status of Lermontov as such luxuries were only available to a lucky few. Nowadays, melons can be bought for a small price in almost all supermarkets. This availability is due to the fact that trade barriers – tariffs and non-tariff barriers such as transportation costs, transaction costs such as legal and regulatory costs, and custom clearance procedures – have been significantly reduced, a key element in explaining the growth of international trade.

Negotiations to reduce barriers on international trade began immediately in the years following the Second World War, as fifty countries sought to establish the International Trade Organization, which would fall under the remit of the United Nations (UN). This charter, however, proved to be too ambitious, and the plan was put on hold after it was rejected by the US Congress after some strong lobbying from large American businesses.[60] At the same time, fifteen countries had initiated discussions regarding a treaty on customs tariffs. This began to attract more attention, and in 1948 the General Agreement on Tariffs and Trade (GATT) came into effect in twenty-three countries. This agreement was only ever intended to be temporary, as the establishment of a further reaching international organisation was always the ultimate goal.

The GATT was established to support economic recovery after the Second World War. It aimed to increase and liberalise international trade by requiring states to reduce tariffs and other barriers to trade. These changes in tariff and non-tariff barriers were framed within the principle of 'most favoured nations' which compels countries to treat all their trading partners equally. This means that no country adhering to the treaty may grant privileges, concessions or immunities without granting them to *all* other participating countries.

Between 1947 and 1994, the GATT underwent eight trade rounds. The first five rounds, which culminated in 1961, focused solely on the issue of tariffs. The first round of negotiations, implemented in 1948, secured tens of thousands of tariff concessions, affecting roughly one fifth of the world's total trade. Throughout the 1950s and the 1960s, these initial trade rounds served to boost world trade which grew on average at 8 per cent a year, resulting in some of the highest growth rates that international commerce has ever seen.[61] The sixth and seventh GATT trade rounds, which took place between 1964 and 1979, continued the implementation of tariff concessions, but also reached further. The sixth round, for example, brought in the Anti-Dumping Agreement, an initiative to curb predatory pricing policies; and the penultimate round introduced a code on subsidies, declaring a number of practices to be unacceptable.

The eighth and final round – the Uruguay round – was held between 1986 and 1994 and included 123 countries. When this final round closed, the average tariff rate was roughly 5 per cent. In 1947 it had been significantly higher, at around 22 per cent.[62] The topics covered during this round extended far beyond tariffs, as it was then recognised that the state of international trade had changed so much that their significance had somewhat diminished. The Uruguay round instead focused on issues such as intellectual property, and specific industries and sectors such as textiles, agriculture and services. Above all, this round negotiated the creation of the World Trade Organization (WTO), which came to absorb the GATT.

The WTO was established in 1995, marking the most significant reform in international trade since 1945. Its main objective is to ensure that global trade flows as smoothly as possible. It therefore protects and promotes the interests of producers, importers and exporters. Importantly, it established the Dispute Settlement Process, a formal procedure for resolving disputes between its member nations – currently challenged by the government of the United States that has accused it of 'judicial overreach'.[63]

The WTO currently has 164 members, representing over 98 per cent of international trade – it initially included 123 countries, accounting for roughly 90 per cent of the world's trade.[64] Nearly all decisions are taken by consensus among the members, who then ratify the results in their own countries. Its highest decision-making body, the Ministerial Conference, meets every two years. Like the GATT, the WTO does not allow discrimination between its members, unless there are exceptional circumstances such as environmental protection.

The GATT and the WTO have transformed the landscape of international trade; in 1960 international trade accounted for just over 24 per cent of global GDP, but by 2000 it had reached over 51 per cent and is currently at 59 per cent.[65] It is worth mentioning, however, that not all see it as a positive development. Low tariffs can result in foreign imports being more competitive than domestically made goods. This can have a negative impact on domestic industries, causing disruptions in the labour market such as high unemployment rates in those industries. The textiles industry in the United States, for example, has been hit particularly hard by international trade. In the 1960s, the United States produced approximately 95 per cent of its clothing, but nowadays roughly 97 per cent is produced overseas.[66] New industries have been created and so have new jobs, for example that of web developer.[67] But the anti-trade rhetoric has stirred discontent and caused many to disregard the overall achievements of the WTO – and other multilateral organisations – in favour of more domestically oriented, not to say openly protectionist policies instead.

EUROPE BUILDS ITS INSTITUTIONS

The successes of the first phase of GATT trade rounds highlighted the importance of free trade and paved the way for other trade agreements as well as further economic integration. For, at the same time as those initial rounds, the seeds of what would later become the EU were sown with the signing of the Treaty of Rome in 1957.[68] This established the European Economic Community (EEC), the founding members of which were Belgium, France, West Germany, Italy, Luxembourg and the Netherlands. The EEC members agreed to trade among themselves without tariffs or quotas and to adopt a common tariff on imports from non-member states (i.e., a customs union). In addition to this, the EEC promised free mobility of workers, capital market integration and free trade in services as well as a range of common policies. The treaty further established a set of supranational institutions including the European Parliamentary Assembly (forerunner of the European Parliament), the European Court of Justice and the European Commission.

The trade liberalisation promised by the Treaty of Rome rapidly came into effect in the 1960s and the lowering of the intra-EEC trade barriers had an immediate and significant impact on trade patterns. During the formation of the customs union, the EEC's share in its own trade grew from roughly 30 per cent to 50 per cent,[69] while the share of EEC imports remained unchanged, reducing only from 8 to 7 per cent.

The Single European Act (a later amendment to the Treaty of Rome) came into force in 1987, giving the EEC's ultimate objective – the creation of a single market – a new lease of life. Prior to the Single European Act, European firms benefited from duty-free access to each other's markets, but this didn't amount to free trade. There were a number of different barriers impeding trade within the EEC, including capital controls, preferential public procurement, and divergences in tax rates, administrative formalities, and technical, industrial and transportation regulations. Some of these policies might not sound so important, but their combined impact was significantly inhibiting.

The main changes in the Single Market Programme were intended to reinforce the main tenets of the Treaty of Rome, i.e. the free movement of people, capital, goods and services. It set the date, midnight on 31 December 1992, as the deadline for when these things needed to be achieved by. Concrete measures focused on things such as the elimination of border formalities, the harmonisation of VAT rates within wide bands and the mutual recognition of technical standards. Capital mobility, however, was the most notable aspect of the Single Market Programme. Some member states had unilaterally liberalised capital mobility but many – especially those with weak currencies – had resisted. The Single Market Programme ruled out all remaining restrictions on capital movements among EEC residents by 1988. This was a key step towards the creation of Europe's single currency and monetary union.

By the time the Berlin Wall fell in 1989, Europe had already made significant steps towards economic integration. With the wall gone, the natural next step was the unification of West and East Germany. With a population of 80 million and an economy that accounted for roughly 30 per cent of Europe's total, a unified Germany would be significantly larger than France, Britain or Italy. There were concerns that this could tip the balance of power within Europe and cause a resurgence in German militarism, but ultimately most Europeans believed that a unified Germany would be best in conjunction with an increase in the forces tying member states together.[70] The formation of a monetary union signalled a radical increase in European economic integration that, it was believed, would eventually lead to political integration also. The EEC thus committed itself to forming a monetary union by 1999 and adopting the single currency – the euro – by 2002.

This commitment was formalised in February 1992 with the signing of the Treaty of Maastricht – the most significant advancement in European integration since the Treaty of Rome. The treaty was signed by twelve countries – Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom. It committed the signatories to transferring sovereignty over monetary policy to the European Central Bank (ECB) and to replacing their national currencies with the euro. (During the negotiations of the Maastricht Treaty, the United Kingdom secured an opt-out from the euro and so it didn't have to join EMU.) It laid out a three-step plan for transitioning towards the single currency – first the participating countries would establish the total free movement of capital, then they would increase the cooperation between their central banks and align their economic policies and finally the ECB would introduce the euro under a single monetary policy. The ECB identified its main objective as price stability – i.e., making sure that the euro maintained its value.

In addition to this, the Maastricht Treaty created EU citizenship which was to be granted to every citizen of all of the member states. This provided individuals with the right to live in any EU member state (whereas the Treaty of Rome only provided the right to work in the EU), as well as the right to vote in European and local elections in their country of residence. It also established a common foreign and security policy. The Treaty of Maastricht was far-reaching and was met with some stiff opposition – the signatories of the treaty had to ratify the agreement, and some countries had to hold referendums before being able to do so. The treaty was ratified in November 1993. Since then, sixteen more countries have joined the EU, and one has left.

MANAGING THE INTERNATIONAL ECONOMY

Although for some the answer to this question might seem obvious, it is worth asking: why exactly do we need rules and institutions to manage international trade? And, more broadly, why do we require a system to govern the world economy? It is evident that a highly integrated world economy needs to be managed for a number of reasons. First of all, global markets need rules to develop a level playing field and so avoid unfair advantages for some. Rules ensure that the scope for regulatory gaps is considerably reduced, limiting the scope for unfair practices and regulatory arbitrage. Institutions, in turn, uphold the rules, ensuring that all market participants play fair.

The second point, related to the first, is that a framework of rules and institutions is needed to ensure that the interaction of national economies within global markets does not result – by accident or by design – in policies that have a 'beggar-thy-neighbour' impact. That is, they ensure policy cooperation and prevent countries from acting in such a way that brings a clear benefit to themselves by penalising neighbouring countries. Policies should be directed towards avoiding individual states' protectionist impulses, taking into account the external negative impact that some domestic policies can have. This occurs in particular in a few large 'systemically important'[71] countries, such as the United States and China – their policies matter for the rest of the world.

The third reason why we need rules and institutions is to reconcile global markets with nation states. If they do not operate in tandem, then all sorts of distortions can occur. An example of this is the taxation of digital services that companies with one domestic headquarter and several international branches provide to consumers in several countries. For, which is the jurisdiction in charge of levying the corporation tax? Is it that of the country where the company is domiciled? Or is it one of the ones where the services are provided? And, given that digital services tend to be cross-border, how should the tax be apportioned? Cooperation and coordination among national tax authorities should ultimately help to reduce the scope for unfair competition and avoid citizens – and the taxpayers – in some countries being left with the burden of transnational business activities.

Playing by the rules seems to work better when economic conditions are symmetric, such as when the countries in Western Europe were rebuilding their economies at the end of the Second World War. Asymmetric economic conditions – in terms of economic growth and domestic welfare, for example – prevail when some countries experience stronger activity and better labour market conditions than others, as is currently the case in Europe. Even within Europe's monetary union, divergent economic and financial conditions indicate that some countries (such as Italy) find it more difficult than others (such as Germany) to play by the rules and reduce public spending in order to rein in the public debt. As I will discuss in Chapter 5, this risks antagonising voters and corroding the domestic political dialogue.

Since the end of the Second World War multilateralism has been the default option for managing the world economy – as well as global capitalism. Through international institutions, such as the WTO, but also the International Monetary Fund (IMF) and the World Bank (as I will discuss in the next chapter), policy cooperation and multilateral dialogue have become the key instruments to address – in a very imperfect way – the governance of the global economy. Indeed, multilateralism is the essential tool for reconciling the needs and the agenda of sovereign states with the dynamics of the global market. This has worked well so far. Despite repetitive crises and tensions, the world economy has remained remarkably open.

Multilateralism delivers tangible results when nations recognise the need for – and see the benefits of – working together. However, cooperation tends to materialise when the urgency to correct a critical situation is evident. In addition, the decision-making process that goes with multilateralism is slow and time-consuming. Voters, especially among those who feel attracted to populism and economic nationalism, and their political representatives, feel increasingly frustrated by what they perceive as 'the democratic deficit' of the multilateral international organisations. This is because representatives of member states are nominated by their governments, rather than being directly elected. On the back of this frustration nowadays many feel that multilateral consultations are ineffective. They are not apt to help during a time of crisis, when decisions need to be swift and policy measures require quick implementation. At the same time, when non-governmental actors and non-elected 'technical' bodies are empowered with the task of crisis resolution, there are concerns about the interference in domestic affairs by international organisations.

For instance, three supranational institutions – the European Commission, the ECB and the IMF, otherwise known as the Troika – played critical roles during the resolution of the sovereign debt crisis that affected Greece between 2010 and 2015. As I will discuss in chapter 5, the urgency of the crisis and the need to minimise the risk of financial contagion to other economies in Europe – especially Italy with a public debt far larger than that of Greece – put the Troika, i.e., unelected public servants, in charge of crisis resolution. This raised the question of whether the management of global capitalism – of which crisis resolution and crisis prevention are important components – transcends the traditional model of democracy, possibly even making it impracticable.

We are left with the question, then, of who gets to decide the rules that govern global markets – and who enforces and monitors their implementation. I'll put this question aside for the time being, to revisit it in chapter 5. I now turn instead to the creation of the postwar international rules-based order at Bretton Woods.

2
EVERYTHING STARTED AT BRETTON WOODS

The global economy needs stable currencies and a balance of power that guarantees peace.

Karl Polanyi, *The Great Transformation*, 1944

In July 1944, when 730 representatives of all 44 allied countries met at the Mount Washington Hotel in Bretton Woods, New Hampshire, the world was in tatters.[1] The war had spread from Europe to Asia, leaving once vibrant cities reduced to rubble and millions of people, soldiers and civilians alike, dead. The Western Allies, led by the United States and Great Britain, had successfully landed on Normandy's beaches the month before and the war was finally coming to an end.

The Bretton Woods conference – formally known as The United Nations Monetary and Financial Conference – was held under the auspices of the United States 'for the purpose of formulating proposals of a definite character for an international monetary fund and possibly a bank for reconstruction and development'.[2] The proceedings were led by the British economist John Maynard Keynes and US Treasury Undersecretary Harry Dexter White. Preparations had been underway since June 1943 when representatives of 18 countries met in Washington, DC, followed by a preparatory drafting conference, hosting representatives of 16 countries, held in Atlantic City a year later.[3] The final location, Bretton Woods – a mountain range roughly 800 kilometres from Washington – was purposely chosen so that the delegates could focus on the issue at hand, free from the usual pressures and distractions. The remote rural location was also thought to be preferable for security matters. The conference consisted of a series of intense negotiations spanning three weeks, with many of the participants working round the clock. Towards the end of the conference, Keynes, who was hardly in peak physical health, suffered a mild heart attack causing him to collapse on the stairs. German newspapers were quick to publish his obituary even though he was well enough to sign off on the final proposal just a few days later.[4]

The idea that underpinned the Bretton Woods conference was that the war had changed the international order and so the economic order needed to be changed too. The focus, therefore, was on building a new economic system, closing the loophole that had been left in 1919 after the First World War, when the world switched back to the pre-1914 order.[5] In a document that the British government had published in 1940 in response to Nazi Germany's plan for a 'New Order' in international economic relations,[6] Keynes made it clear that the mistakes of 1919 could not be repeated; a return to the Gold Standard – the monetary arrangements in place until the First World War and reinstated from 1925 to the early 1930s – was not a viable option.[7]

Both Keynes and White were adamant that the new system should promote world peace and avoid the mistakes of the interwar period. Keynes in particular viewed the conditions that the winning powers imposed on Germany at the end of the First World War as the seeds of the economic and political instability that eventually led to another world conflict.[8] It was clear that there was a need for a well-designed economic system – as well as institutions – with a smoothly functioning monetary system based on stable exchange rates and cooperation, and a limited scope for 'beggar-thy-neighbour' policies. The experiences of the interwar period – during which unemployment rates peaked at roughly 20 per cent in Great Britain and roughly 25 per cent in the United States – had also shown the need for a system that could accommodate domestic policy objectives, such as full employment, as well as the objective of maintaining the external balance. The risk, otherwise, was to again undergo a competitive struggle for markets – the key economic cause of war.

For Keynes, there was no question about the fact that the combination of laissez-faire systems in investment and international trade during the interwar years had resulted in difficult labour market conditions, unemployment and a general worsening of economic conditions for many. Things needed to change; the international order could no longer self-regulate along with the informal 'rules of the game'[9] of the Gold Standard. Going forward, it needed to hinge on a robust framework of rules and institutions, where a multilateral monetary order could coexist with more interventionist economic practices, as they had emerged from the Great Depression.[10] Trade needed to be liberalised within a framework of rules that considerably reduced the scope for 'beggar-thy-neighbour policies'.

Keynes wanted a system where countries could pursue external adjustment – meaning, they could, for example, expand their exports by reducing their relative prices – only if other countries were prepared to absorb such exports, i.e., they were not protectionist.[11] Trade liberalisation, together with the removal of the automatic exchange rate adjustments of the Gold Standard, made policy cooperation the default option and the distinctive feature of Bretton Woods.

To this day, Bretton Woods symbolises the peak of international cooperation in economic and financial matters. Over the years, there have been attempts to replicate its spirit, but none have been successful. In 2008, amid the worst financial crisis that the world had seen since the Wall Street Crash in 1929, the French president Nicolas Sarkozy called for a 'new Bretton Woods' to no avail.[12] This is hardly surprising, for his appeal was more of a wake-up call than a thought-through proposal. More so than anything else, Sarkozy failed to recognise that Bretton Woods had not come out of the blue, nor was it the result of a single conference. It was built over many years – a process, rather than a moment, that emerged out of the intellectual backdrop of the time.[13]

Many of the ideas that subsequently informed discussions at Bretton Woods were anticipated by Keynes's 1936 *The General Theory*, which promotes the idea of managing an overall macroeconomic framework to underpin the new economic order.[14] Another contribution was Ragnar Nurkse's *International Currency Experience*,[15] which was published in 1944 just before the Bretton Woods conference. Here, Nurkse makes the case for introducing capital controls to prevent destabilising speculation, and allow some degree of domestic policy autonomy. Like Keynes, Nurkse was concerned that the need to level the balance of payments during the Gold Standard took priority over the need to balance the domestic economy.[16]

The intellectual debate that emerged throughout the Great Depression and up until the early 1940s provided the context that incubated new ideas and policy practices.[17] New policy thinking such as the New Deal, that predicated an active role for the state in the economy, ended up influencing much of the work at Bretton Woods in an effort to create a 'New Deal in international economics'.[18] This intellectual background, however, was far from the only factor contributing to the unique conditions that made Bretton Woods possible. By nationalising and centralising several industries strategic in the supply of weapons, equipment and food, many governments had strengthened the state system and concentrated its power. The conditions of war had also forced cooperation among the allied forces, as the need to agree on a plan for reconstruction became urgent.

But above all, Bretton Woods was possible because of the decision made by the United States – by then the strongest and richest country in the world – to abandon its isolationist policies which had been prevalent throughout the 1930s, to take an active role in setting up and leading the postwar economic order.[19] The US government recognised that they could be the ones to pave the way for a more open and stable world economy – and at the head of this, they would prosper.

Over the years, the Bretton Woods conference has come to epitomise the post-Second World War economic order where the new power, the United States, displaced the old power, Great Britain – and symbolically the nineteenth-century order. Bretton Woods was a success in bringing together a shared vision and solidifying a consensus around economic internationalism. But despite this, its achievements should not be overstated. In the rest of this chapter, I'll explain why.

THE PROBLEM WITH MONETARY STRAIGHTJACKETS

The delegates at Bretton Woods aimed to produce a well-designed international economic and monetary order that limited the scope for 'beggar-thy-neighbour' policies. And what better to focus on than the exchange rate, often the lightning rod for 'beggar-thy-neighbour' actions and 'currency wars'?[20] Flexible arrangements allow adjustments of the exchange rate to boost the competitiveness of a country's exports without the need for economically and politically difficult measures, but they can have an adverse impact on other countries' trade. Ideally, exchange rates should be structured in such a way that secures a level playing field for international trade, limiting the need for 'beggar-thy-neighbour' policies and actions.

Throughout the second half of the nineteenth century and until the First World War – recall, this was a period of great integration of the world economy – and briefly again from 1925 to the early 1930s, the Gold Standard was the main monetary arrangement that assured the stability of the exchange rate of the main international currencies – the pound sterling and the dollar.[21] It did this by anchoring (or pegging) their values to that of gold. This meant that a unit of each of these currencies could be converted into a fixed weight of gold. This secured the value of paper money and in turn facilitated international finance and commerce, as the fixed parities provided a common ground for pricing transactions.

The system worked as long as wages and prices were flexible enough to allow adjustments and maintain the external balance. In the event of a deficit in the trade balance, for instance, domestic prices and wages would drop, making exports more competitive and imports more expensive relative to domestic prices. Restoring the trade balance thus ensured that gold reserves were maintained to back national currencies – having too low gold reserves increased the risk of a convertibility crisis, i.e., when countries were unable to convert their outstanding liabilities into gold at the fixed parity.[22] The system, however, was not suitable for an expanding world economy. There simply wasn't enough gold to support the economic expansion of the late 1890s and early 1900s, for example, and it was difficult for domestic prices to adjust during this period.

The Gold Standard more or less worked well until it was suspended during the First World War. Being reinstated in 1925 as the Gold Exchange Standard,[23] it came under pressure during the Great Depression that followed the Wall Street Crash in 1929, when the commitment to gold convertibility proved to be an impossible stranglehold for the countries that adhered to it. As countries in the euro area know all too well (I'll discuss this in Chapter 5) attempts to restore the external balance in a situation where the exchange rate is fixed lead to an undesirable dilemma. In these circumstances, labour productivity – that is, the output produced given a certain amount of labour force – needs to increase for the balance to be restored. As productivity increases, the cost per unit goes down; exports then become cheaper and therefore more competitive, helping to restore the required balance. Output per worker can be increased through improvements in skills – due to education and training – and in technology and innovation. But both these routes take time to deliver the desired effect and so are of little use when the situation requires urgent action. In this case, there are two options. The first one is to decrease wages, either by paying less for the hours worked or getting people to work for longer for the same pay; the second is to decrease the number of workers, leaving the remainder to pick up the slack. The internal adjustment therefore requires an internal devaluation that in turn is conditioned on an increase in unemployment and/or a cut in wages; neither option is fair or politically feasible.

In many countries, especially in the United States and Britain, wages and prices no longer responded to changes in market conditions as flexibly as they had done before the First World War. New institutionalised forms of labour relations and the rise of trade unionism had significantly narrowed firms' ability to cut workers' wages. In September 1931 a combination of high unemployment rates, domestic unrest, 'the menace of Bolshevism' and further international instability due to the central European banking crisis persuaded the British government to suspend gold convertibility.[24] It had become clear that there was no other way to reduce Britain's chronic deficit in the balance of payments and stop the haemorrhage of gold reserves on the back of speculative attacks by capital holders. By 1932 the international monetary system had fragmented into three blocs: the Gold Standard, the sterling area and the central European countries.[25] These blocs were led respectively by the United States, Britain and Germany, in a sort of anticipated geopolitical division that would, some years later, lead to military confrontation.

FLEXIBILITY AND DISCIPLINE: THE BRETTON WOODS SYSTEM

Having experienced the adjustment problems inherent in a monetary straightjacket like the Gold Standard, Keynes and White wanted to build a new system with the flexibility to pursue domestic full employment policies, strengthen domestic economies and reduce the vulnerability to external shocks (both monetary and real) that could spread from other parts of the world by way of the balance of payments. At the same time, the Bretton Woods architects wanted the discipline of a fixed exchange rate system so as to retain the exchange rate stability inherent in the Gold Standard.

To combine rules with flexibility, the new system had to focus on achieving the two objectives of internal and external balance – rather than subordinating one to the other as was the case within the Gold Standard. Fiscal policy and adjusting exchange rates when they came to differ from their 'fundamental equilibrium exchange rate' values became the key policies of the new system.[26] Fiscal policy would be used to manage domestic demand to ensure full employment and contain unemployment and the consequent downward impact on wages. At the same time, the cooperative approach to the exchange rate adjustment would restrain governments' discretionary power of pursuing competitive devaluations and their potential 'beggar-thy-neighbour' impact. The way to achieve this was through an adjustable peg system of fixed parities that could be changed only under exceptional circumstances.[27]

Gold continued to provide the anchor for international currencies – like in the Gold Standard – but only the dollar was convertible into gold, making it the key reserve currency. By fixing the price of gold at $35 per ounce and pegging their currencies to the dollar, the countries that adhered to the Bretton Woods system fixed their price levels to that of the world. By using the dollar as the 'buffer' they avoided the problem implicit in the Gold Standard, i.e., deflation linked to the supply and demand of gold. And, unlike in the Gold Standard, the exchange rate of the currencies pegged to the dollar could be adjusted. All member countries had to set a par value and keep it within a 1 per cent band on either side of parity. Put otherwise, the amount by which their currencies could appreciate or depreciate against the dollar was capped at 1 per cent. There was scope for more flexibility, as the parities could be changed. However, significant changes were allowed only in the wake of a fundamental payments disequilibrium. The IMF – as I'll discuss later in this chapter – also had to be consulted first.[28]

As before, governments remained committed to current account convertibility, but unlike before, they could now control the movement of capital in and out of their economies. Governments sought to use these capital controls alongside domestic monetary and fiscal policies to maintain full employment and the external balance.

In designing such a system, both Keynes and White expressed different approaches and concerns that were those of their national governments. Britain was coming out of the war with a decimated economy, considerably fewer resources and a mountain of debt after borrowing heavily from the Commonwealth and to a lesser extent from the Unites States. It couldn't afford to be exposed to the deflationary policies of its main ally, as had happened after it returned to the Gold Standard in 1925, and needed to focus on the objective of full employment and reconstruction at home. The United States, on the other hand, was comparatively unscathed by the war and its affluent middle class created a growing demand for consumer goods. As such, it was much more focused on exchange rate stability. This is a story worth remembering, for it deeply influenced the construction of the Bretton Woods system and its institutions.

There was another problem that kept the Bretton Woods architects busy during the planning phase: adjustment and how to redistribute this burden between deficit and surplus countries. By 1924, for instance, the United States and France had surpluses in their balance of payments and so accounted for 53 per cent of the world's monetary gold reserves combined.[29] Britain, on the other hand, suffered from a deficit in its balance of payments and was exposed to a gold drain and thus to tight monetary conditions.

In an attempt to prevent the deficit countries from being overburdened, at Bretton Woods Keynes suggested a symmetric approach to adjustment where countries with a large deficit and those with a large surplus would be charged interest. He went further to propose that the deficit countries should be required to reduce the value of their currencies and vice versa for the surplus ones. This was to discourage countries from holding large surpluses, while simultaneously preventing other countries from falling into large deficits. However, this idea was rejected and the delegates at Bretton Woods instead decided that all participating countries would subscribe a quota to an international credit union which would provide temporary credit to countries when they suffered a deficit. (I will discuss this further later in this chapter.)

Having finally agreed on the arrangements for the new economic order, the delegates at Bretton Woods faced one final hurdle – convincing their countries to adopt it. As Keynes said in his last speech at the conference: 'We have sold all this to ourselves. But the world at large still needs to be persuaded.'[30] The implementation phase proved long and difficult. Even the United States and Great Britain – that had led the negotiations – struggled to push the Bretton Woods agreements through their domestic constituencies and get them ratified. The system was of course eventually accepted, thanks to the prolonged large-scale economic and political support provided by the United States.[31]

In the end, the international order that began after the Second World War didn't completely match the system that the Bretton Woods architects originally envisioned. The transition from war to peace was difficult and it took longer than anticipated, with two interrelated problems – bilateralism and the dollar shortage – dominating the decade after the war. The major industrial countries only managed to reach full convertibility at the end of 1958,[32] although the system had been more or less functioning since 1955. By then, the currencies of Western Europe were virtually convertible against one another and their current accounts were generally in surplus, with the United States running a current account deficit.

Bretton Woods' full convertible phase lasted a bit more than a decade, from 1959 to 1971. Overall, Bretton Woods lasted a quarter of a century, from

December 1946, when thirty-two countries set their par values, to August 1971 when the gold window closed.[33] But having sealed the shift in the international economic order – from Britain and sterling to the United States and the dollar – its legacy is much more enduring.

THE DOLLAR SETS THE STANDARD

Within the Bretton Woods system, the United States ended up providing global liquidity by allowing the convertibility of national currencies into dollars while maintaining gold reserves – stored at the famous Fort Knox Bullion Depository in Kentucky and the Federal Reserve Bank in New York – to underpin the value of the dollar. The result was a monetary regime that revolved around the dollar, just as the nineteenth-century classical Gold Standard had done so around sterling.

The dollar encapsulates the three features of an international currency – it acts as a unit of account, a means of exchange, and a store of value. The first two features are exemplified by the fact that the dollar is used internationally to price manufactured goods for exports, as well as to invoice and settle imports and exports. Many foreign firms use dollars for their trade with the United States and with various other countries as well. Indeed, there are many cases where a country's total volume of trade invoiced and settled in dollars is larger than that country's total trade with the United States. For example, more than 80 per cent of the exports of respectively Korea, Malaysia and Thailand are invoiced in dollars, while the United States accounts for at most 20 per cent of these countries' exports. The dollar is also used to invoice almost the totality of the United States' exports and imports. Contrast this with the euro or the Chinese renminbi; only half of the exports and about 40 per cent of imports from countries in the euro area are invoiced in euros and only 16 per cent of China's trade is settled in renminbi.[34]

Network externalities ensure the extensive use of the dollar. For instance, the prices of oil and gas, as well as most other commodities are denominated in dollars. This is no coincidence. In February 1975 the United States made an agreement with Saudi Arabia to ensure that all oil exports from the Organization of the Petroleum Exporting Countries (OPEC) would be both invoiced and paid for in dollars, regardless of which country was buying. Similarly, contracts for commodities such as gold, silver, aluminium, corn and wheat are denominated in dollars.[35]

Emerging countries with a large export sector – especially those in Asia and the Middle East – also use the dollar as the main interbank currency used for clearing international payments and short-term capital flows. Moreover, they often choose to peg the value of their currencies to that of the dollar. Pegging allows countries to reduce the exchange rate volatility and avoid currency appreciations that would undermine the competitiveness of their exports, so it is a common resort of countries that suffer from exchange rate volatility. Countries also peg their currencies when other countries in their region do so, which enhances the impact of each of the pegs. As the fast-growing economies in Asia peg to the dollar, it is inevitable that an increasing number of other countries in the region will follow suit, growing the effective dollar area.[36] In total, roughly 20 per cent of pegging countries anchor their currencies to the dollar, de facto adhering to a fixed-exchange regime.[37] Central banks keep the bulk of their official reserves in dollars. Indeed, about 62 per cent of total foreign exchange reserves are held in dollars.[38]

The extensive and broad use of dollars results in low transaction costs, higher liquidity compared with other currencies and inertia in international monetary relations. So long as everybody adheres to it, then, there is no incentive to change the system. The creation of the euro has increased the possibility of multiple major international currencies coexisting, as it offers both the necessary levels of liquidity and stability. Roughly 13 per cent of pegging countries anchor their currencies to the euro and the euro accounts for roughly 20 per cent of the total foreign exchange reserves.[39] The euro has established itself as the world's second reserve currency and has managed to maintain this position, even in the wake of recent crises, without, however, posing a serious challenge to the supremacy of the US currency.

ASCENDING AND DESCENDING CURRENCIES

The dollar is the dominant currency in the international monetary system and it has been for the last seventy-five years or so, much in the same way as the United States has been the largest economy and dominant power. This power structure is so entrenched that it is difficult to imagine a different one. However, before the Second World War, it was Great Britain at the heart of the international order and sterling at the centre of the economic and monetary system.

Britain held the largest economy at the time, accounting for roughly 8 per cent of the world's GDP; as an industrial nation with a growing middle class, it consumed over 20 per cent of the world's exports between 1860 and 1914.[40]

Much like the dollar is now, sterling was the key international currency of the time. Circulating widely within the British Empire, it was the currency used to invoice and settle the largest share of the world's trade. Between 1860 and 1914 roughly 60 per cent of the world's trade was invoiced and settled in sterling.[41] Quoting prices in sterling was an effective way for foreign firms to build their shares within the British market. Non-British companies also used sterling for trade with other non-British companies. As well as the absolute size of its international trade transactions, sterling's international status was tied to the dominance of London's financial centre and a whole range of sterling-denominated financial activities were developed, such as debt securities, trade-related funds and deposit accounts. The majority of internationally owned assets were also denominated in sterling, and foreign suppliers to British firms opened and held deposit accounts in London. Apart from gold, the largest share of official reserves was held in sterling.

By 1870, the United States had overtaken Great Britain in terms of total national income, but it took almost another sixty years for a serious challenge to the status of sterling to arise. By 1880, Britain was also second to the United States in terms of industrial power and was further pushed back to third place in 1905 by Germany.[42] By the 1920s, the United States held the world's largest economy and was the largest exporter – it had achieved fiscal credibility and created the Federal Reserve System (the Fed). Despite these demotions, the pound sterling kept Great Britain at the centre of the world's economy and finance, as the dollar struggled to attain international status.

Even when Bretton Woods marked the end of sterling's dominance, market forces, network externalities and inertia contributed towards keeping it going for quite some time. The existence of the British Empire, even if it was in its last days and in the process of being dismantled, maintained sterling at its core. The sterling area grouped together thirty-five countries and colonies that pegged their currencies to sterling and primarily held sterling reserves. It accounted for no less than 50 per cent of the world's trade. In 1947 the share of sterling holdings in world foreign exchange reserves was still about 87 per cent; a few years later, in the early 1950s, it was lower, but still significant at more than half.[43]

Despite the support provided by the sterling area, sterling was an intrinsically weak currency issued by a country in economic distress. In the years immediately after the Second World War, Britain accumulated a large balance of payments deficit with the other European countries, which was denominated in both gold and dollars. It also had an outstanding sterling debt of 3.7 billion that it had amassed during the war – mostly with countries in the sterling area.[44] Meanwhile, the British Empire was crumbling under the strain of national independence movements and Britain was struggling to restore economic stability at home. The credibility of the British currency was steadily declining.

During the Bretton Woods negotiations, the United States pushed the restoration of convertibility for current account transactions on Britain.[45] When it came into effect in 1947 it triggered a run on sterling and in just a couple of weeks, Britain had depleted $3.5 billion of newly acquired funds. Convertibility was suspended on 20 August 1947 and exchange controls were put back in place.

In September 1949, sterling was devalued by 30.5 per cent to $2.80 with the approval of the IMF. Twenty-three other countries devalued their currencies shortly after, most of which did so by a similar amount. Sterling's lower parity helped ease the United Kingdom's current account deficit and the balance of payments (in both gold and dollars) but it proved to give just a temporary respite and ultimately further undermined the currency.[46] In the weeks leading up to the devaluation, the then Chancellor of the Exchequer, Sir Stafford Cripps, had stubbornly denied that a devaluation was on the cards, so when speculators finally had a run on sterling – managing to evade capital controls – its credibility completely collapsed. The run on sterling and the reverse current account convertibility was further evidence that leadership – both in terms of economic affairs and global security – was consolidating in the hands of the United States. The weakening of sterling as a reserve currency was parallel to the strengthening of the dollar, a powerful reminder of the strength and influence of the United States in comparison with Britain.

By the 1950s the dollar had emerged as the main international currency, as well as the primary intervention currency. It served as a unit of account to define the parities of the IMF member countries, who bought and sold dollars to maintain these fixed parities. In 1955, the dollar became the most held currency in world reserves. This definitively downgraded sterling, although it managed to cling onto its status as the second most held reserve currency for another fifteen years.[47] The final blow came in 1973 when the oil crisis hit – sterling's commercial role rapidly declined relative to the dollar and its share of reserve assets drastically dropped as well. Rising international liquidity, inflation, geographical redistribution and international cooperation were the cornerstones of sterling's retreat from international to national status.[48] Even so, it took a long time for sterling to reflect the new international order. This is a story to bear in mind for Chapter 9 when I'll discuss the possibility of the current monetary order being replaced by an alternative system.

THE POSTWAR INTERNATIONAL INSTITUTIONS

What emerged at Bretton Woods was the idea that the new economic order needed an institutional framework that could support and promote international financial cooperation. Institutions are what sets the Bretton Woods system apart from the pre-1914 order and its replacement in the interwar period. Unlike the Gold Standard, which was a 'spontaneous order',[49] the Bretton Woods system was predicated on rules and institutions that would monitor and enforce those rules. Balance of payments adjustments through the exchange rate, as I have discussed earlier, and short-term balance of payments finance were tasked to the IMF. Long-term development lending, which was critical for postwar reconstruction and development, was tasked to the International Bank for Reconstruction and Development (IBRD), otherwise known as the World Bank. These two intergovernmental organisations were assigned the task of upholding the rules of membership – ensuring that each nation fulfilled their responsibilities.[50] The dollar, being at the heart of the Bretton Woods system, would underpin the setup and the operations of these organisations.

The IMF and the World Bank were the products of intense negotiations and compromise between two competing plans put forward by the British and the Americans – the Keynes plan and the White plan.[51] Eventually, this compromise led to the *Joint Statement by Experts on the Establishment of an International Monetary Fund*, which in turn led directly to the *Articles of Agreement of the International Monetary Fund*.[52]

The Keynes plan reflected British concerns about creating a system that could withstand the expansion of trade without being intrinsically deflationary and acting as a brake on economic activity. Simultaneously, it needed to be able to shield the domestic economy from foreign shocks. It therefore hinged on the creation of a supranational central bank, the International Clearing Union, which would issue a new international currency, bancor. The value of bancor would be defined by a peg to gold and the value of all member nation currencies would be defined by a peg to bancor. The central banks of all member nations would hold accounts with the International Clearing Union and settle their balances with one another at par in bancor. Countries with a surplus could hold interest-bearing credit balances and countries with a deficit could obtain overdrafts.[53] This plan was met with an outright 'no' from the United States.

The White plan was not so concerned with international liquidity and much more focused on exchange rate stability. This approach was reflected in the institutional design that hinged on the creation of a United Nations Stabilization Fund. Each member was to contribute a quota to the fund, consisting part of gold and part of its own currency. In the Keynes Plan the approach to adjustments was symmetric, but in the White Plan it fell solely on the deficit countries, as they were expected to sell their currencies for those of other members to draw from the Stabilization Fund.[54]

The IMF was set up as an international credit union to which each member would subscribe an initial quota, in gold or dollars, in order to provide temporary credit to members suffering a current account deficit. Put otherwise, the IMF was designed as a financial safety net – an insurance policy that member countries could turn to when they could no longer control the exchange rate. Its goals were to help countries maintain full employment, support rapid economic growth, keep exchange rates stable and avoid competitive devaluations. In addition, the IMF was tasked with creating a multilateral payments system, eliminating exchange restrictions and supplying funds to backstop and contain balance of payments disequilibria.[55] Initially, the member countries were entitled to withdraw credit without restriction, but over time the IMF implemented increasingly stringent conditions.

The delegates at the Bretton Woods conference ultimately decided to give the IMF markedly less power over the domestic policies of its members than was initially envisioned by both architects.[56] It was, however, given substantial control over the international monetary system. The IMF was granted the authority to approve or disapprove discriminatory practices. A change in parity, for example, would need the approval of the Executive Board, which contained Executive

Directors representing the member countries. In order to prevent 'beggar-thy-neighbour' depreciations, the approval would not be given unless there was deemed to be a 'fundamental disequilibrium'. The IMF was also empowered to issue warnings to countries whose actions increased the chance of a crisis, declare currencies scarce and members ineligible to use its resources.[57]

As for the World Bank, the idea of a multilateral commitment to economic development through the provision of good-sized loans with accessible credit conditions had emerged from the debate in the 1930s about the need for international action to help countries to develop.[58] In those years, the United States had experimented with public international loans to Latin American countries, with the intention of creating currency stabilisation as well as for development purposes. This experiment resulted in a charter for the creation of an Inter-American Bank, but the US Congress refused to back it. However, it later provided the template for the initial US plans.[59]

The World Bank was originally founded as a single multilateral development institution, the IBRD. Nowadays, the World Bank consists of the IBRD along with the International Development Association (IDA), which was founded in 1960 to provide softer loan conditions to the poorest countries. These two divisions together with the International Finance Corporation (IFC), the International Centre for Settlement of Investment Disputes (ICSID) and the Multilateral Investment Guarantee Agency (MIGA) make up the World Bank Group. These three institutions were founded in 1956, 1966 and 1988 respectively. The expansion of the World Bank into the World Bank Group shows its shift of focus from reconstruction to development. The World Bank Group not only works with national governments but also with the private sector, regional development banks and policy institutes, as well as other international institutions. The bank's current goal is to eradicate poverty and promote prosperity. It intends to achieve this by focusing on a range of issues from trade and food standards, to climate change and conflict.

The World Bank began operating in June 1946 with an authorised capital of $12 billion, although it had already received several loan applications prior to it officially opening its doors. The bank approved its first loan in May 1947, granting $250 million to France for reconstruction and modernisation (although France had applied for twice the amount).[60] The World Bank announced France's loan application in October 1946, around the same time that Iran requested $250 million to raise its general standard of living, health and welfare. This application was rejected and the World Bank would not grant Iran any funds until 1957.

Even if it is not strictly speaking a part of the Bretton Woods institutional framework, the Marshall Plan was conceptually and historically a component of the postwar economic order that contributed towards the shared goal of global peace. Established in 1948, the ultimate aim of the plan was to ensure political stability via economic stability, which was to be achieved by restoring Europe's export capacity and fostering economic growth. In addition, the plan set up a commission to offer advice, ensuring that the funds were put to effective use. The Organisation for European Economic Co-operation (OEEC) was established the same year to oversee the allocation of aid, which would be determined by the size of the members' current account deficits.

Between 1948 and 1952, the Marshall Plan managed roughly $13 billion in aid to Western Europe which was issued as grants and loans to fund necessary imports and enabled countries to build up their international reserves.[61] Each recipient government committed themselves to match the funds in their national currency, which would then be invested back into industry, agriculture and infrastructure. The plan granted aid to the countries that offered bilateral credits to other members to encourage international trade. In 1950, the OEEC set the ground for multilateralism and simplified bilateral lending by establishing the European Payments Union (EPU). With the addition of the United States and Canada in 1961, the OEEC expanded into a worldwide body, the OECD.

The Marshall Plan was a resounding success. The combination of capital and advice increased productivity and stimulated demand, resulting in a permanent increase in growth rates. By 1952, the OEEC countries enjoyed a current account surplus; their industrial production had increased by 39 per cent, exports by around 50 per cent and imports by roughly 33 per cent.[62]

'OUR CURRENCY, YOUR PROBLEM'

Keynes's towering figure granted Britain the role of intellectual leader at Bretton Woods, but it was the United States that offered political leadership and financial backup. Although Britain's future trajectory was not entirely clear at Bretton Woods, it had emerged from the war physically and financially devastated and so it was evident that the United States would be playing the leading role in the new international order.[63] The dominance of the United States in the international monetary system, along with the emergence of the dollar as the key international currency and sterling's relative decline, were not features that the two architects of Bretton Woods had envisioned. It became apparent, however, that there was no other option; only the dollar could underpin the speculative short-term capital movements that emerged in the 1950s – short-term capital mobility would end up undermining capital controls in most countries, making it difficult for monetary authorities to uphold a parity far apart from the fundamentals.

Thus the whole international monetary system relied on the ability of the United States to maintain liquidity in the system – that is, its ability to supply dollars 'on demand'. As the economy of Western Europe was expanding on the back of the postwar reconstruction, the private and official demand for dollars was growing too. Dollars were supplied through private and official long-term capital outflows in excess of a current account surplus. The establishment in the late 1950s of the offshore 'eurodollar' market – dollars that circulate overseas outside of the Fed's jurisdiction – was a consequence of this excess that further contributed to expanding dollar liquidity.[64]

By the late 1950s, Bretton Woods was in full swing as all European countries had declared current account convertibility in order to ease trade transactions. The French franc, for example, was now free from restrictions to be converted into German marks or Italian lira. Japan followed suit in 1962 in order to settle its current account balance. The system was fairly successful in supporting robust economic growth in real terms, expanding trade and keeping inflation low. However, it was also incubating the seeds of its own destruction. There were three issues that were undermining the Bretton Woods system and would ultimately result in the American decision to unilaterally unravel it.

The first problem concerned the adjustment of countries with a persistent deficit in the balance of payment, as was the case for Britain. Like in the 1920s, deficit countries were bearing the burden of adjustment, facing a cut in wages and rising unemployment. They were de facto constrained and could not implement expansionary policies to support growth and the creation of jobs, as this risked a currency crisis and a bailout from the IMF. Sterling was clearly struggling to adapt to this system and maintain its value against the dollar. But increased short-term capital mobility made exchange rate adjustments difficult as they could lead to speculative attacks. A series of currency crises ensued throughout the late 1950s and 1960s, resulting in increasingly larger rescues. Eventually, in 1967, the British Labour government led by Harold Wilson bowed to the American pressures and announced a 14 per cent devaluation of sterling against the dollar. Financially and economically, this was the right move to make – but politically, it was humiliating.

The second problem consisted in an increased risk of a run on the dollar. Although the dollar convertibility outdid the Gold Standard in creating liquidity, the link between the dollar and gold had been exacerbated by the perceived gold shortage – even more so than it had been the case in the past. As the United States provided dollars to the fastest growing economies, such as those of continental Europe and Japan, they ran persistent deficits in the balance of payments. The result was that the outstanding dollar holdings increased relative to the US monetary gold stock, ever widening the gap.

The third problem, related to the second one, was brought to light by economist Robert Triffin in his 1960 testimony before the US Congress. He heeded that the 'dollar overhang'[65] was growing larger than America's gold stock. The persistent deterioration of the United States' net reserve position would ultimately undermine confidence in the value of the dollar. Lacking this confidence, the dollar would lose its standing as the world's leading reserve currency. The so-called Triffin dilemma came to express the choice that the United States faced. On the one hand, they could improve confidence in the dollar by embracing contractionary policy that would have a deflationary impact on international liquidity. Alternatively, they could support liquidity by embracing expansionary policy, but in doing this they would risk undermining dollar-holders' confidence.[66] Put otherwise, the United States could retain confidence in the dollar by reducing the deficit, but only at the cost of reducing liquidity in the global system and constraining the growth of the domestic economy.

Throughout the 1960s, and especially after 1965, international confidence in the US economic policy was wobbling on the back of expanded government spending on social programmes at home and the intensifying war in Vietnam. Because of the large balance of payments deficits accumulated by the United States, European governments began to ponder the risk of being left with dollars that couldn't be converted into their gold equivalent. During this period, almost two thirds of the United States' cumulative deficit was transferred in the form of gold, mostly to Europe. By 1966 the US gold reserves had shrunk to the equivalent of 13.2 billion dollars, but only 3.2 billion of this was available to cover foreign dollar holdings as the remainder was needed to cover domestic holdings.[67] Foreign central banks and governments held more than \$14 billion that could, in principle, be converted into gold. The official dollar reserves, then, had grown larger than the US gold stock at the fixed gold–dollar parity.

Concerns quickly materialised among the partners of the United States and strains in economic diplomatic relations soon followed. The catalyst was the US administration's decision, on the back of domestic political pressures, to make foreign aid conditional for foreign governments to revoke discriminatory barriers targeting US exports.[68] France was particularly incensed by this; it already resented the hegemonic role of the United States and its ability to finance deficits in its own currency. This 'exorbitant privilege', as described by France's finance minister, Valéry Giscard-D'Estaing,[69] allowed the United States to issue the world's dominant reserve currency in quantities considered to be in line with its own agenda. In addition, it was free from the constraints of external payments to spend as much as it deemed necessary to bolster objectives of national interest.[70] As the use of the dollar had increased substantially in both the private and public sectors throughout the 1950s and 1960s, the French were concerned that the international monetary system no longer resembled the symmetrical system designed at Bretton Woods. Indeed, the value of the dollar no longer reflected the parity agreed on at Bretton Woods and the international monetary system had become a dollar standard dominated by the United States.[71]

From 1965 to 1968, France's policy of converting its dollar holdings into gold contributed to the weakening confidence in the US currency. In 1965, the United States embraced an inflationary policy that triggered global inflation and put Europe and Japan – the surplus countries that sided with France in opposing the US monetary hegemony – under increasing pressure. In the same years, the international financial markets began to bypass capital controls and so the possibility of a currency crisis with the dollar at its core became very real.

THE UNITED STATES NO LONGER PLAYS ALONG, 1971

The Bretton Woods system relied on the tacit and mutual agreement between all member nations that they would refrain from claiming the conversion of their dollar reserves in gold.[72] This de facto non-convertibility allowed the system to provide liquidity throughout a period of strong growth in the world economy without falling into a gold shortage, as had happened during the Gold

Standard. So, by accepting this tacit agreement, all participants kept the system in balance. But this only worked if all participants held confidence in the United States and its commitment to uphold the value of the dollar, and trusted that all others would play by the rules. When US domestic policy objectives began to negatively impact on the economic outlook in the 1960s, the countries that had signed up to the Bretton Woods system needed reassurance that their dollars did in fact reflect the conversion value that was agreed in 1944. Thus they scrutinised the economic policies of the United States to ensure that they weren't undermining the value of the dollar and, in turn, the world's monetary stability.

The deterioration of confidence in the United States vis-à-vis the dollar indicates the fundamental problem within the Bretton Woods system that eventually resulted in its dismissal. Indeed, once confidence was damaged, governments and central banks began to question what they should do with their large dollar holdings and whether they would be better off converting them into gold before the dollar is devalued. If the Bretton Woods countries had requested to convert just a quarter of their dollar holdings at the same time, the United States would not have been able to meet its obligation. This was due to the shortfall in their gold reserves vis-à-vis the amount of dollars that the western European countries and Japan held in reserves. If these countries did decide to run on the dollar, it would trigger the breakdown on the dollar–gold parity and possibly widespread financial instability.

While the central banks of France and other large dollar-holders were considering what to do, tensions were rising in the United States. Both Congress and the public felt the burden of providing liquidity to the world. Since the end of the war and throughout the 1950s, the United States had helped to rebuild the economies of Western Europe and Japan, and supported their exports by way of a relatively open market for foreign imports. European countries benefited from preferential trade and agreements, even though their practices were intrinsically discriminatory against the United States. Japanese exporters similarly benefited from access to the US market despite the fact that the Japanese market was essentially closed to foreign imports. The Marshall Plan, in turn, ensured long-term loans and grants to Western Europe and Japan, and as a result, the US balance of payments deficit provided $7 billion of an $8.5 billion increase in world liquidity.[73]

Many in Washington felt that the western European countries – Germany, in particular – and Japan could make some effort to reduce their surpluses and, indeed, many expected them to act. (This is a critical point to bear in mind given that trade and financial imbalances among countries have continued to inform the international policy discussion to this day, as I'll discuss later.) For example, they could have inflated the value of their currencies in order to reduce the competitiveness of their exports and narrow the trade surplus. More spending, and so more demand for exports by Germany and Japan, would have helped the United States to narrow its trade deficit. As public opinion in the United States was becoming more hostile towards the war in Vietnam, it was also becoming increasingly aware and less tolerant of the cost of putting the needs of foreign allies before domestic policy objectives. In particular, there was a growing concern over the commercial threat posed by Europe and Japan.

Governments and central banks in Europe and Japan, in turn, were growing increasingly uneasy about holding dollars. The Europeans and Japanese had just one critical tool to hand that could rein in the monetary policy autonomy of the United States – the right to demand to convert their dollar holdings into gold. As each side accused the other of being uncooperative, the cracks in the Bretton Woods system deepened even further.

By the beginning of the 1970s, the situation for the United States was rapidly deteriorating and soon became unsustainable. Protectionist sentiment was spreading through the US Congress and the system seemed increasingly unable to endure the broadening payments imbalances. Pressure was mounting from speculators eager to bet on devaluations of the dollar, or revaluations of the European or Japanese currencies. In the end, US President Richard Nixon decided to fold the system on 15 August 1971 and, without consulting the European or the Japanese governments, he suspended the convertibility of the dollar into gold. The 'gold window' was forever closed and the dollar was now free to find its own level in currency markets. The United States had brought the Bretton Woods system to an end, unilaterally changing the rules of the game – a move, of course, that only they as the monetary hegemon could make. Ultimately, Bretton Woods failed because it was inconsistent with short-term capital movements, which had significantly increased in the 1960s. Indeed, countries failed to make the required adjustments to the exchange rate because they knew that in doing this they risked speculative attacks.

In the two years that followed the dismissal of the Bretton Woods system, there were continuous high-level negotiations on the IMF's proposal to realign the exchange rates of the key international currencies and devalue the dollar.

The Group of Ten (G10) industrial countries (Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States[74]) were fundamentally divided but they finally agreed to restore the par value system in December 1971. The United States devalued the dollar, and Germany and Japan revalued their currencies accordingly. The renovated system didn't last long; the countries at the heart of the system abandoned their Bretton Woods pegs after a string of currency crises culminated in the spring of 1973. The world permanently shifted to an inconsistent framework – or non-system[75] – where fixed and floating exchange rates coexist. The fundamentals of growth and inflation would now determine the exchange rate and central banks, which would acquire operational independence over the years, would be the ones to intervene to smooth volatility.

THE POST-BRETTON WOODS 'NON-SYSTEM'

When Bretton Woods came to an end there was little consensus around the position supported by economists such as Milton Friedman who advocated flexibility within the exchange rate system. However, the international community's inability to reach an agreement regarding what to do next made floating exchange rates the default position.[76] At the time many policymakers and politicians welcomed the change as a way to acquire flexibility and adjust the exchange rate in line with their policy objectives – an argument not dissimilar to that of the anti-euro politicians nowadays in the weakest economies of the euro area such as Greece and Italy. Back in the late 1960s, the Bank of England had advocated floating exchange rate arrangements on the back of sterling's intrinsic weakness against the dollar and the deutsche mark, arguing that it was better for the exchange rate to take the strain, than depleting the foreign exchange reserves to defend the parities. The switch, however, exacerbated sterling's old problems and created new ones for domestic monetary management. In 1974 – the year of two general elections – the inflation rate was over 15 per cent, the balance of payments deficit was significant and the budget deficit was growing. In 1976, after years of dwindling confidence, sterling fell approximately 25 per cent against the dollar, forcing the government – a Labour minority at the time – to borrow £2.3 billion from the IMF. This resulted in a huge loss of confidence in the Labour Party's ability to manage the economy, and the subsequent attempt at reining in the double-digit inflation and capping wage increases set them against the trade unions. Without the support of their main ally, the outlook for Labour was bleak. The final straw came in the form of public sector strikes during the winter of discontent in 1978.

Voters were calling for change and Margaret Thatcher became Britain's prime minister in May 1979. Britain's economic policy approach suddenly changed from state intervention to a laissez-faire market-driven approach instead. Unlike the demand-management framework of the Keynesian era, the new conservatism of Thatcher – and Ronald Reagan in the United States – regarded state intervention as damaging because it exposed the state to risk and promoted self-interested behaviour such as rent-seeking. They thought that, given the intrinsic capacity of the new non-system to adjust itself through market mechanisms, the international cooperation that had underpinned the Bretton Woods system was no longer necessary.

Thus the end of Bretton Woods was more than just the end of dollar convertibility; it ushered in a new light-touch policy framework focused on deregulating domestic financial systems and limiting fiscal policy so to minimise political discretionality and attempts to manipulate the economy. As a result, monetary policy became the main policy tool for managing domestic demand. Alongside floating exchange rates, monetary policy can manipulate movements in the exchange rate which can result in the required changes in demand. Indeed, demand can be stimulated by cutting interest rates, which will in turn support growth and boost employment rates. Part of this stimulus happens through the depreciation of the exchange rate, as a reduction in the interest rate curbs demand for financial assets denominated in the domestic currency. A weaker exchange rate helps increase exports while making imports more expensive. As such, it was concluded that all that was needed in terms of active policies was flexible exchange rates, disciplined fiscal policies and government budget deficits that are balanced in the longer term.

Another tenet of the new economic policy framework is the liberalisation of capital movements to facilitate the allocation of capital and boost the adjustment through the exchange rate. Individuals, firms and countries with excess savings have access to international capital markets where borrowers look for capital to fund – in theory, at least – long-term profitable projects. In the aggregate, floating exchange rates adjust to enable a country to repay what it borrows. Compared with the mechanics of the Bretton Woods system, the adjustment implicit in the new non-system looked very attractive.

The importance of the external factors – that is, exchange rates and capital flows – for domestic growth and full employment made the new non-system more interconnected than before. Starting in the 1980s, the advanced economies and many developing countries removed capital controls to stimulate international trade and expand output. It was the beginning of the financialisation of the world economy. Thatcher liberalised Britain's capital movements in 1979 – one of her government's first moves. This was followed by the French socialist government's 'tournant de la rigueur' in 1983, which paved the way for more financial liberalisation within Europe.

As a result, capital has accumulated globally and the global economy has developed strong interdependencies, trans-border linkages and global networks; compared with earlier versions, its scale and scope are both wider and deeper. This has translated into bigger markets, lower labour costs, tax cuts, less regulation and new opportunities for accumulating wealth through intangible assets such as information and knowledge.[77] This process of financial integration has considerably delinked money and finance from territorial space.

The post-Bretton Woods economic policy approach found a sort of experimenting ground in developing countries and countries in need of financial support from the IMF and the World Bank. Independent central banks, prudent fiscal policy, flexible labour markets, free trade and the liberalisation of capital movements came to make up the toolbox of these institutions through their stabilisation and structural adjustment programmes. The general idea behind the Washington Consensus, as this approach was then popularised,[78] was that developing countries would benefit more from supply-side structural reforms than they would from grants and loans alone. In the practice of development, export-driven growth and inflows of foreign direct investments came to replace import-substitution measures (i.e., when tariffs and quotas are applied to imports, so that domestic industries can develop instead) and state-driven investments, while capital controls were rapidly dismantled.

At the time, it was thought that financial liberalisation would enable banks and financial institutions to allocate credit based on the profitability of the underlying projects, and thus on the capacity of the borrowers to repay the loan. In addition, it was believed that market mechanisms could ensure efficiency in credit allocation via market-determined interest rates. Put otherwise, money was thought to go where the prices – that is, the interest rates – reflected the equilibrium between supply and demand. However, the assumption that the market could allocate credit via a mechanism stripped of all other allegedly arbitrary factors – such as, for example, public policy considerations – proved not only to be disingenuous but also fundamentally wrong.

In addition, many countries were going to find out that access to international capital does support economic development, but fundamentally limits the scope for domestic policies. Although the limitations don't end here, this is particularly true for monetary policy. Think of cases where a country – normally a developing one – experiences large capital inflows that will result in a financial bubble if not carefully managed; thus the policy response often requires a considerable divergence from domestic policy objective. For example, a cut in interest rates may become necessary to stymie capital inflows, but at risk of excessively stimulating domestic demand, creating inflationary pressures and fuelling excessive credit growth. The difficulty in handling capital mobility and a fully independent monetary policy poses a huge challenge to the decision-making process in democratic countries. And the issue is not that key policymakers such as central banks are not directly elected – the independence of central banks from elected governments is one of the postulates of the post-1971 policy framework. It is that domestic policy outcomes are jointly determined by internal conditions as well as external factors,[79] and this places the non-system at direct odds with democracy and sovereignty.

Just like the previous era of financial globalisation at the end of the nineteenth century, the high international capital mobility in the new wave of financial liberalisation was going to result in a series of financial and banking crises.[80] In hindsight, it is clear that financial liberalisation should have been supplemented with the creation of appropriate rules and international policy coordination to regulate market action. But any attempt at coordination post-1971 was directly obstructed by the belief in the market's ability to self-adjust. The damaging effects of this belief ultimately engulfed many developing countries, but the crises were shrugged off, attributed either to these countries' inability or unwillingness to embrace the necessary reforms. By confusing causes with effects, the problems eventually compounded and became explosive in the financial crisis of 2008.

In the next chapter, I will discuss how unfettered capital movements – the result of the blind belief in market's ability to smoothly adjust and the consequent deregulation – have resulted in several episodes of financial instability between the 1980s and 2000s, with the mother of all financial crises erupting in 2008.

3

A WORLD OF CRISES

Every August since 1978, the Federal Reserve Bank of Kansas City gathers economists, financial market participants, academics, government representatives and the media in Jackson Hole, Wyoming, to discuss pressing economic issues. Jackson Hole, another mountain range, is just as remote as Bretton Woods – although the Jackson Lake Lodge is far less grand than the Mount Washington Hotel. Over the years, the Jackson Hole Economic Policy Symposium has become one of the key events in the diaries of policymakers. At the 2005 symposium, Raghuram Rajan, an unassuming professor of economics from the University of Chicago serving as Chief Economist and Research Director at the IMF, warned the central bankers in the audience of the systemic risks facing the global economy.[1] Disintermediation, deregulation and skewed incentives: the topics were all broached. Rajan's warning, however, was unfortunately not heard.

The evidence was there for those who wanted to see it, but was conveniently disguised for those who didn't. Those who saw it recognised that limited regulation, historically low interest rates and the high returns attached to risky assets had shifted investors' appetite for risk, which had consequently built up in the financial system. The repeal of regulations, notably the Glass–Steagall Act of 1933 that separated investment banking from retail banking, and the legislation that shielded markets from federal supervision during the Clinton presidency added to the mix. During those years, the banks were selling the risk of default on their loan books 'repackaged' as complex securities – such as subprime mortgage-backed bonds – that didn't need to be displayed on their balance sheets. This repackaging of risk was thought to have made the financial system more resilient to shocks as the impact would be scattered. Just like if you break a brick down into gravel before throwing it at a window; the glass may get scratched, but it will not shatter.[2] The widespread belief that systemic risk to the economy was a thing of the past gave a free hand to the proliferation of complex and opaque instruments that were paying relatively high yields, while borrowing was underpinned by leverage, using the inflated values of assets as collateral. Ultimately, many thought that the banks were too big to fail. Indeed, some financial institutions were so large that it would've been impossible for them to fail without triggering a systemic crisis. HSBC, for example, reported a pre-tax profit of $20.9 billion in 2005.[3] Compare this figure against countries ranked by GDP for the same year and HSBC falls comfortably within the largest eighty economies (with the likes of Lebanon and Costa Rica).

Everyone in the financial sector was making money so nobody wanted to stop the very lucrative trading. As the chief executive of Citigroup put it in July 2007: 'As long as the music is playing, you've got to get up and dance.'[4] And indeed, the music was still playing when Rajan made his appearance at Jackson Hole. His presentation went down like a lead balloon. The American economist and then president of Harvard University, Lawrence Summers,[5] attacked Rajan as an anti-market 'luddite'. Further, many branded Rajan a killjoy for spoiling the last 'dance' for Alan Greenspan, who was attending his last Jackson Hole before stepping down as Chairman of the Fed the following year. During his tenure, Greenspan had shifted the Fed's approach, reversing the view of many of his predecessors, notably Paul Volcker, that central bankers' responsibility is the enforcement of the regulations necessary 'to protect the core of the financial system from the recurrent bouts of speculative excesses and frightful contractions that have marked financial markets from time immemorial'.[6] Concerned by the risk of moral hazard that could arise if market participants expected to be bailed out, Greenspan heavily advocated the idea that financial markets 'can reliably be self-stabilizing' and so central bankers should never act to burst a financial bubble. Yet here was Rajan declaring that 'while all interventions can create their own unforeseen consequences, these risks have to be weighed against the costs of doing nothing and hoping that somehow markets will deal with these concerns'.[7]

Greenspan's era was that in which the belief in globalisation turbo-charged by large capital flows triumphed. Reliance in market rationality came to replace government intervention and international policy cooperation – the main features of the Bretton Woods system. Moderate inflation – indeed this period became known as the Great Moderation – reduced long-term interest rates and so the cost of borrowing. Finance came to dominate the global economy. In

2005, the overall value of financial assets worldwide was approximately $165 trillion, the equivalent of about 331 per cent of annual global GDP – whereas in 1980 it had equalled only 120 per cent.[8] Total financial assets, as an aggregate percentage of world GDP, had also grown from roughly 227 per cent in 1990 to 343 per cent in 2007 when their total value reached a peak of almost $200 trillion.[9] The old capitalism was mutating at an unprecedented speed, meaning that its economic, financial and political impact was largely untested.[10] This was ultimately the sense of Rajan's warning.

I am telling the story of the frosty, not to say hostile reception to Rajan to emphasise a key point of my argument, namely that despite several episodes of financial instability since the 1980s, many policymakers, business leaders, journalists and academics were blind to the enormous risk that the banking and financial sector had taken up. Because the non-system was still generating high returns for those at the centre of world finance, i.e., Wall Street, many wanted to believe that 'markets knew better'. For years, crises seemed confined to the developing world – with the exception of the crisis in Europe in 1992. Thus they were disregarded as specific to some particular country or group of countries whose policies were diverging from the mainstream framework and were unable to modernise their economies. The underlying questions about the relative competitive position of individual countries, and the impact of 'free money' on such positions, were never considered.

In this chapter I'll present some examples of crises that were generated by a combination of market failure, wrong interventions and the belief in the automatic adjustments, and explore how the world economy came close to the brink. I maintain that the liberalisation of capital movements that followed the breakup of Bretton Woods, coupled with the belief that markets should be left to their own devices with little intervention and limited regulation, resulted in recurrent episodes of financial instability. These, in turn, have eroded the rules-based international order as I'll discuss in Chapter 6. Here I'll shift from the 'classic' developing countries' balance-of-payment crises to the Asian financial crisis of 1997 to discuss how excess leveraging on the back of soft regulations added more fuel to an already incendiary situation. In fact, grappling with capital flows becomes even more daunting when foreign capital is underpinning the domestic banking sector; the necessary adjustment of the exchange rate to support the real economy can trigger speculation and eventually capital outflows. This can result in the collapse of domestic banks, as happened in Asia in 1997 and then in Argentina in 2001. The British and Italian 'Black Wednesday' of 1992, which I also discuss, seems like an odd choice, but it is here to show the risks of embracing a monetary straightjacket while keeping free movements of capital – exactly the opposite of Bretton Woods.

Despite all these crises, lessons were not learned, and financialisation continued until debt levels reached breaking-point in 2007 and asset prices across the board started to plummet. The collapse of the US bank Lehman Brothers in September 2008 almost brought down the US banking sector and ushered in a global crisis. What followed was a series of policy mistakes in crisis resolution, and the myopic approach by policymakers and private sector alike. The non-system was reset rather than reformed or overhauled. Losses were absorbed by the public sector through the bailout of banks, and the costs were eventually pushed on the general public. International financial institutions like the IMF were on the front line of crisis resolution, stirring popular discontent towards unelected bureaucrats – mistakes made in Asia and in Argentina had cemented the IMF's reputation as the implementer-in-chief of the Washington Consensus. These years saw the beginning of a deep political malaise that was then channelled into the crisis of traditional politics in many countries in the world, especially those, like the United States and Britain, that had been at the helm of the Bretton Woods conference. This malaise is fatally undermining the global economic order we inherited from Bretton Woods, as I'll discuss throughout the rest of the book.

MEXICO'S 'TEQUILA CRISIS', 1994

The year 1994 was a turbulent one for Mexico. On New Year's Day the government ratified the North American Free Trade Agreement (NAFTA), which, together with long-term marginalisation, caused the indigenous Zapatista Army of National Liberation to ignite a rebellion in the state of Chiapas the same day. A ceasefire was called after eleven days and more than 300 deaths – but the fight for economic and social rights for Mexico's indigenous population was far from over. Instability persisted and, in March, the presidential candidate for the Institutional Revolutionary Party, Luis Donaldo Colosio, was assassinated at a campaign rally. This was the man that most Mexicans believed would have become their president at the end of the year. The so-called Tequila Crisis hit in December.[11] A combination of high external indebtedness, policy mistakes and exogenous factors, such as an anticipated reversal of the accommodative monetary policy in the United States, culminated in a sudden devaluation of the peso, which triggered a massive interest rate crisis. The crisis spread across the region, hitting Argentina particularly hard, and affected financial stability even in developed countries.

In the lead-up to the Tequila Crisis, Mexico – along with many other developing countries still recovering from the 1980s debt crisis[12] – was struggling with a significant debt burden. Although the restructuring of the debt under of the 1990 Brady Plan had helped, it was not enough to ensure that it could be successfully managed. Despite a series of domestic economic reforms enacted throughout the 1980s that appeared to be sound, the Mexican economy had been stagnant for some years.[13] Attracting foreign capital was therefore critical and the government unveiled a deliberate strategy oriented towards foreign investors. Two notable and highly visible strategies were the privatisation of the banks, announced in May 1990, and the intention to negotiate NAFTA with the United States. After the 1990–91 recession in the United States, the Fed responded to high and rising unemployment rates by reducing the federal funds rate from 6 per cent in mid-1991 to 3 per cent by October 1992, where it stayed until February 1994.

These Mexican and US policy decisions resulted in large amounts of capital flowing into Mexico in the early 1990s, as many mutual funds and other financial intermediaries were chasing higher returns. As a result, portfolio capital inflows became a critical source of foreign savings for Mexico. This, however, came with an increased vulnerability to sudden changes in the sentiment of foreign investors, as portfolio capital – compared with direct investment – typically responds much quicker to changes in the environment.

Like many other developing countries, Mexico was also grappling with the exchange rate. With a growing manufacturing sector and the policy goal of liberalising external trade, the question of which arrangement could best achieve stability and facilitate international trade became critical. The other issue around the exchange rate was how to use it as a tool to manage inflation. Several attempts were made to manage the exchange rate, from a fixed peg to a crawling one and then to an adjustable band – but achieving a stable rate that was consistent with the country's economic growth proved to be difficult.

The large amounts of capital that were flowing into Mexico did not help. The appreciation of the exchange rate worsened even further as the supply of domestic non-tradables – for example, services such as hairdressing that need to be performed locally – came under pressure, undermining the policy of containing inflation. This caused actual inflation to again be higher than the target, even though the Mexican government's reforms had overall contributed to reducing it.

Savings fell in line with an increase in investments, and widened the savings-investment gap. Private investments increased on the back of positive expectations about Mexico's future economic performance; the Mexican government's market-oriented reforms (which began in the mid-1980s) complemented its stabilisation efforts and turned investors' sentiment. However, the growth of both investments and consumption were driven by an expansion of credit that got out of control in the absence of regulation (as shown by the increasing levels of nonperforming loans since 1993). In addition, the inadequate regulatory framework, lack of transparency and weak enforcement capacity made the financial system vulnerable.

The real exchange rate appreciation penalised exports and encouraged imports, resulting in a widening gap between what was produced and what was consumed, and a growing disequilibrium in the current account. There is an important point here that is worth stressing. The fixed exchange rate system embraced by Mexico could be sustainable, but only if the growth in productivity was fast enough to impact on the real exchange rate. Otherwise, the economy would experience sluggish growth or – at worst – if imports continued to be stronger than exports, Mexico would fall into a balance of payments crisis yet again. Such a crisis could be held off for as long as the current account deficit was financed by foreign capital inflows.

And foreign capital did continue to flow into Mexico. But, despite the worsening of the current account deficit, the necessary policy change – the depreciation of the peso – did not happen because the government was committed to price stability and, above all, did not deem it feasible to take up a measure that would rock the capital inflows. Furthermore, the depreciation would have required some cuts in public spending. Thus, the government preferred to believe that the growing current account deficit was just temporary.

The lack of policy action meant that the real exchange rate appreciation intensified even further on the back of capital inflows. This, combined with the savings-investment gap, exacerbated the current account deficit – exactly what Mexico needed to prevent. For a while, Mexico's current account deficit was 'overfinanced'; there was so much capital flowing into the country, that its central bank was able to build up its reserves. This strategy, however, was not sustainable. The low domestic savings rate meant that Mexico was vulnerable to problems in debt servicing and subsequent swings in international investors' sentiment.

This is more or less what happened in February 1994 when the Fed reversed its monetary policy and raised interest rates to slow down economic activity and control inflationary pressures. With US Treasuries now providing a competitive return at moderate risk, international investors began to turn their backs on Mexico. The assassination of Colosio in March 1994 exacerbated the situation. The inflow of foreign capital came to a sudden halt, causing a sharp fall in reserves – they dropped from $26 billion to $18 billion almost overnight. Still, the Mexican government did not change its exchange rate policy. Instead, it raised domestic interest rates, used its reserves and issued more Tesobonos, i.e., dollar-denominated short-term government debt instruments. International investors were still attracted by the high rates offered by Mexico, but they were not prepared to take the exchange rate risk by holding instruments denominated in pesos – a problem that I'll discuss in Chapter 4. Put simply, they didn't trust the government's exchange rate policy and the dollar denomination of Tesobonos protected investors against devaluations in the peso. By December 1994, 87 per cent of Mexico's debt was in Tesobonos; a year earlier they had accounted for only 6 per cent. Mexico was therefore left even more vulnerable as most of its debt had now to be repaid in dollars.

In July 1994, the monetary authorities decided to increase domestic credit and reduce domestic interest rates. They did this to support the domestic economy and avoid a credit crunch, but investors began to flee. With a current account deficit of 8 per cent of GDP and a track record of devaluation every six years since 1976, it was difficult to continue to believe the government's promise to hold exchange rate parity. By December, Mexico's international reserves had dropped to approximately $11 billion.

When the government finally announced a change in the exchange rate policy – a de facto 15 per cent devaluation of the peso against the dollar – it was too late to be credible. Indeed, international investors did not believe that the peso parity was sustainable. The modification in the exchange rate came too late; the reserves had dropped too far, and the government lost control as it could no longer underpin the exchange rate. The devaluation resulted in a financial crisis that spilled over into many other countries, hitting those in Latin America particularly hard. A few days – and $5 billion worth of capital flight – later, the Mexican authorities found themselves with no choice but to take up a floating exchange rate regime – and Mexico was left on the verge of default.

To restore calm in the markets and stop the financial contagion, the US government under Bill Clinton proposed a package of $40 billion in loan guarantees. Mexico was the United States' third largest trading partner at the time, but still this proposal was rejected by Congress. Mexico was instead offered a $50 billion bailout – of which $20 billion came from the United States and $17.8 billion from the IMF. This rescue package is largely considered to be a success – confidence in the peso was restored, the exchange rate soon stabilised and before long Mexico's economy returned to growth.

There are three important lessons to be learned from the Mexican crisis.[14] The first is that countries that rely on foreign capital instead of domestic savings do so at their peril. However, as we will see with subsequent crises, relying on domestic savings is easier said than done. This is because financial globalisation has made it much easier for developing countries to achieve high rates of GDP growth by attracting foreign capital than it is for them to do so by developing their economies slowly and sustainably. The second point, related to the first, is that policy measures to deter speculative capital flows should be applied – even if that implies reducing such flows in the short term. The final point is that exchange rate policies need to be flexible. For if policymakers can't make adjustments without losing credibility, damaging capital flight is certain to ensue. A corollary is that when capital movements are unrestrained, a flexible exchange rate allows adjustments that a fixed exchange rate system doesn't. The debacle of the European Monetary System (EMS) shows the problems with rigidity and lack of international cooperation, as I discuss in the next section.

BRITAIN AND ITALY'S 'BLACK WEDNESDAY', 1992

In the currency crisis that shook Europe at the beginning of the 1990s, capital movements and difficulties in managing the relationship with capital markets were, again, at the core of the problem. To some extent, the Black Wednesday crisis – when both Britain and Italy had to ignominiously abandon the EMS in September 1992 – was the first episode of tension in the process of financial integration. Despite having become more integrated, European nation states found their goals to be in direct conflict with those of their fellow Europeans. In order to cooperate they needed to put domestic goals aside for the benefit of all, but they struggled to do this and ultimately found themselves trapped in a self-inflicted crisis.

The collapse of the Bretton Woods system and the subsequent crisis of the 1970s had left Europe in a state of restlessness. The free trade market – which would later become the Single European Market – was emerging, but many believed that it was under threat from the exchange rate volatility that occurred in the decade after 1971. Policy in Europe thus shifted its focus towards reconstructing a system of pegged but adjustable exchange rates. The EMS was established in 1979, with the European Exchange Rate Mechanism (ERM) at its core.[15] This set Europe on the path towards the EMU. The ERM called for EEC members to keep their national currencies within either a 2.25 per cent or a 6 per cent band of the European Currency Unit (ECU) – a unit of account determined by a basket of participating nation's currencies weighted by their strength. For this equilibrium to be achieved, the nations with the strongest currencies would have to sell theirs for those of the nations with the weakest.

Britain was the only EEC member not to join ERM in 1979 and, initially, Italy was the only country granted the wider 6 per cent band due to the intrinsic weakness of its currency. Eventually Britain did join the ERM in 1990, and sterling was put in the wide band along with the Spanish peseta and the Portuguese escudo. The same year, the Italian lira moved to the narrow band.

The crisis that led to Black Wednesday was triggered by Danish voters narrowly rejecting the Treaty of Maastricht in June 1992. The lira was already under pressure from Italy's large budget deficit and political turmoil. The nationwide anti-corruption investigation, Mani Pulite, had decimated the country's political elite in the previous months, causing the lira to quickly fall towards its lower limit. Sterling, together with the peseta and the escudo, considerably weakened. This took place against the context of the dollar depreciating against the deutsche mark (which dropped by 17 per cent between March and September), the Japanese yen weakening against the EMS currencies, and escalating exchange rate tensions throughout the Nordic countries.

Pressure continued to build throughout the summer with the approach of the French referendum on the Maastricht Treaty, which was held on 20 September.

At the end of August sterling fell to its ERM floor, forcing other ERM members to intervene to support their own currencies. The European finance ministers, however, did not deem it necessary to realign the ERM currencies. France was adamant it would maintain its link to the deutsche mark – the strongest currency at the time – and not play on realignment, for it was believed that any sign of franc weakness would reduce the chances of a yes vote in the upcoming referendum. Britain did not want to devalue alone, nor together with Italy, as this would be seen as an indication of sterling's weakness.[16] Investors were not appeased and continued to test the ERM member states' ability and willingness to defend their currencies. Thus, in order to underpin the krona, the Swedish Riksbank was forced to raise its overnight lending rates to 500 per cent. The krona, although not a member of the ERM, was pegged to European currencies that were under pressure.

The main target within the ERM was Italy's lira. The Bank of Italy allowed short-term rates to increase to over 30 per cent, and the German, Dutch and Belgian authorities – whose currencies had hit the ceiling of their permissible divergence against the Italian currency – had to heavily intervene. Despite this, the lira was devalued by 3.5 per cent and, on 13 September, the other ERM currencies were realigned by the same amount. This realignment – the first in five years – was not enough to steam off pressure from countries with weak currencies. Britain, Spain, Portugal and Italy continued to be under fire.[17]

Speculators worsened the situation even further. The day before Black Wednesday, professional investor George Soros bet against sterling, selling large amounts on the market. As a result, the price of sterling plummeted even further. In an attempt to cap the speculation, the United Kingdom further increased interest rates and authorised billions of spending on marginal intervention. But this didn't stop the selling and, at the end of trading on Wednesday 16 September, the United Kingdom was forced to suspend its membership with the ERM. The Bank of England reversed the two increases in the interest rate that it enacted earlier that day. Also in the face of speculative pressures, Italy announced to the EEC that its reserves were not adequate, forcing it to suspend intervention in the foreign exchange market and allowing the lira to float. Within three days sterling had depreciated 6.5 per cent against the deutsche mark and the lira by 3.8 per cent. This debacle won Soros the reputation as the man who 'broke' the Bank of England. It is estimated that he made over £1 billion profit from the Black Wednesday crisis.[18]

The French franc, Danish krone and Irish pound were the next to suffer from speculative pressure. French voters narrowly accepted the Maastricht Treaty, but this did little to defuse the situation. The Bank of France raised the interest rate; concerns over the stability of the franc spilled over into Belgian currency markets. In November 1992 Sweden abandoned its ECU peg, as the government lacked support for fiscal austerity measures. Denmark's central bank was then forced to raise interest rates to defend the krone as the pressure spread. Both the Spanish peseta and the Portugese escudo needed to be devalued by 6 per cent.[19]

By December, Norway was forced to abandon its unilateral ECU peg. In the meantime, the French franc was successfully defended, but the Irish pound was not. In compliance with the European Single Act, Ireland removed capital controls in January 1993. This forced the Irish monetary authorities to increase market rates to triple-digit levels. In May 1993, Spain and Portugal devalued their currencies by 8 per cent. In July, due to a double-digit unemployment rate, high interest rates and exhausted reserves, the French government was faced with the dilemma of either cutting interest rates to stimulate demand, with the risk of triggering massive sales of francs, or increasing them further to defend the 'franc fort', i.e., the value of the franc against the deutsche mark, with the risk of worsening the real economy outlook. To avoid a repeat of Black Wednesday, in the early hours of 2 August 1993 – at the end of a difficult session – the European Commission Monetary Committee decided to widen the ERM band to 15 per cent, de facto suspending the EMS. It was an implicit recognition of the difficulties that member states were experiencing in attempting to contain market pressures and endure further increases in unemployment. Although these difficulties were very much pressing, it was the inability of participants to cooperate with one another that, above all else, took the toll on the system.

Like the United States' decision to end the convertibility of the dollar into gold in 1971, the suspension of the EMS was a key moment in the development of the postwar economic order. The relationship between Germany and France, and Germany and the United Kingdom, was put under strain – with consequences that last to this day. The French felt that they were paying for the cost of German reunification, just like in the 1960s when they felt that the United States was using the dollar to fund their budget deficit.[20] The British shared this sentiment. As Prime Minister John Major wrote to German

Chancellor Helmut Kohl: 'German reunification is at heart of these problems [. . .] Britain strongly supported [this] but many in Britain believe that we are now having to pay a high price.'[21]

The British and Italians felt that the speculative attacks on sterling and the lira could have been mitigated, or even avoided, if Germany had been willing to actively drive the value of the deutsche mark down, allowing the other currencies to adjust. Recall that equilibrium in the ERM was achieved by participating nations selling the strongest currencies for the weakest ones – and the mark was the strongest currency at the time. There wasn't a technical obstacle preventing the Bundesbank from purchasing sufficient quantities of British pounds and Italian lira to avert the precipitous depreciation of sterling and the lira against the mark. But the Germans were persuaded that their economy was booming and monetary policy should be steered towards avoiding inflation regardless of the impact on other countries in Europe.

Although the Bundesbank did provide support, it was limited because of Germany's fear that a weaker mark would usher in price inflation. Indeed, Germany's preference was for the other currencies to be devalued against the mark. Helmut Schlesinger, the Bundesbank president, reportedly pushed for a general realignment of the EMS currencies, but in the end this proved impossible. The Bundesbank feared that unlimited support for the lira and sterling would result in massive liquidity inflows in the German market. Subsequently, during the weekend of 12 and 13 September, the Bundesbank informed its EMS partners that they should not expect further support when the markets reopened the following Monday.[22] Apparently the German central bank was not satisfied that the other EMS member states would take corrective measures to stem their inflation and balance-of-payments deficits, and so it felt that it needed to retreat from its obligation to intervene. The overvaluation of the deutsche mark lasted several years and depressed economic growth in Germany and Europe.

Unlike the Italians who were used to a weak currency, the departure of sterling from the ERM was humiliating for Britain, cementing long-lasting suspicions about fixing exchange rates with the European nations and deepening euroscepticism. When the fate of sterling was sealed at the end of 16 September 1992, the then Chancellor of the Exchequer Norman Lamont said: 'we will set monetary policy in this country to meet our objectives. It will be a British economic policy and a British monetary policy.'[23] In 2003 Gordon

Brown's so-called five economic tests put an end to the possibility of Britain joining the EMU – as we have seen Britain secured an opt-out during the negotiations for the Maastricht Treaty and so, unlike other EU member states, was not legally bound to join Europe's monetary union.[24] In June 2016 the British voted to leave the EU – and Norman Lamont was a prominent supporter of the Leave campaign.

THE 'ASIAN TIGERS' GO INTO DEFAULT MODE, 1997

Another example of the risks of embracing a fixed exchange rate system with unconstrained capital movements is the financial crisis that affected the fast-growing economies of south-east Asia. In the mid-1990s, the 'tiger economies' of Asia – such as Thailand, Indonesia, Malaysia and South Korea – were growing at an average annual rate of 7.5 per cent in real terms; the average for the world economy was 3.5 per cent.[25] They had relatively low inflation rates, while government budgets were broadly in balance. Further, their exchange rates were pegged to the dollar, which considerably capped the exchange rate risk. Not surprisingly, they were the favoured destination for many international investors. Foreign capital fuelled rapid credit growth which, in turn, encouraged more capital inflows and lending. But before long, the peg to the dollar proved itself to be a monetary straightjacket, which – together with the strong capital inflows – triggered the 1997 Asian crisis.[26]

Prior to the Asian crisis, the broad exchange rate stability and rapid credit growth muted investors' and banks' capacity to adequately assess risk. As such, currency mismatches on corporate balance sheets and the highly leveraged positions of the borrowers went under the radar. Banks were also increasingly exposed to maturity mismatches, so much that foreign borrowing was short-term and domestic lending long-term. Lax prudential regulatory and supervisoty practices also contributed to the problem. Indeed, many non-bank financial institutions had emerged in the region in the runup to 1997. This was because the licensing requirements were much lighter in places such as Thailand, and regulations in South Korea and the Philippines – including lower capital requirements – were much less stringent than those applied to commercial banks. As long as money was flowing in, however, the system was kept in equilibrium. In 1996, Thailand amassed inflows equal to 14 per cent of its GDP. As domestic borrowers were tapping into cheap foreign-currency loans, the situation was becoming clearly unsustainable.

The strengthening of the dollar was the spanner in the seemingly well-oiled wheel of Asian economic and financial growth. After hitting lows in April 1995, the dollar began to rally against the yen and the deutsche mark (which was soon to be replaced by the euro). This spelled trouble for the Asian Tigers, and their intrinsic vulnerabilities began to emerge. Questions began to arise about their ability to defend their pegs against a strong dollar and whether their foreign exchange reserves were deep enough to allow for market interventions to support the exchange rate.

The determination of the Asian monetary authorities was put to test in summer 1997 when the speculative pressure intensified. In July, the Thai monetary authorities were the first to capitulate. Faced with a strong speculative pressure and a rapid rundown of reserves, they decided to break their peg with the dollar. Subsequently, Thailand's currency, the baht, plummeted – and capital began to flow out of the country. At this point, domestic financial institutions were confronted with large liabilities denominated in dollars. Their assets, however, were denominated in bahts. Finance companies in Thailand, along with merchant banks in South Korea, were suddenly faced with liquidity shortfalls and many became insolvent and had to be shut. This mismatch triggered a financial crisis that soon spread to Indonesia, South Korea, Malaysia and the Philippines, and a deep recession ensued. In 1998, the real GDP of Thailand and Malaysia dropped by 7.6 and 7.4 per cent respectively, that of South Korea by 5.5 per cent, while the growth of the Indonesian economy contracted by 13.1 per cent. All countries in the region were to some degree affected, and ripples went as far as Europe and the United States.

Thailand, Indonesia and South Korea sought assistance from the IMF, which amounted to $35 billion underpinned by a programme of adjustments and structural reforms. In addition, roughly $85 billion were committed from other multilateral and bilateral sources. But the IMF programme was deemed too severe, with a strong focus on structural reforms – arguably beyond the immediate need for macroeconomic stabilisation – and not enough focus on providing measures to backstop the crisis, restore confidence, stem capital outflows and support the weakening currency. 'By the end of 1997, many of us came to the view that the IMF was mishandling the crisis, especially in Indonesia' recalls

Stephen Grenville, the then Deputy Governor of the Reserve Bank of Australia, 'its responses were exacerbating domestic errors. The available assistance package was too small; fiscal policy was tightened unnecessarily; [. . .] conditionality was aimed at unachievable structural reform.'[27]

The governments of the countries affected by the crises accepted the IMF intervention because they had no other choice. They were resentful of this fact and developed mistrust towards the IMF and, implicitly, the United States, that holds to these days. Thanks to a strong demand for their exports, the crisis-hit countries managed to rebuild their economies within a few years and made an early exit from the IMF programme. For this, they abandoned a tightly pegged exchange rate regime for a more flexible one. The adoption of an explicit inflation target also helped to keep inflation under control and provided the foundation for sustained growth. Further, they committed to fiscal reforms in order to strengthen their fiscal positions.

The Asian crisis, once again, put the problem of unfettered capital flows under the spotlight – especially for developing countries. There are four critical lessons to be learnt here. First of all, financial globalisation and the liberalisation of capital movements without an appropriate regulatory framework put the financial stability of many countries at risk. The second point, linked to the first, is that the speed and impact of financial contagion among economies interconnected through capital flows can generate a vicious cycle of debt, and hit the real economy. Third, rebuilding and expanding foreign exchange reserves in countries that were affected by the crisis is seen as a form of self-insurance against further crises. But the final and most important point is that the Asian financial crisis brought to light the need for greater financial cooperation within the region in face of a common crisis. Indeed, in May 2000, finance ministers from ASEAN+3, the Association of Southeast Asian Nations plus China, Japan and South Korea, met in Chiang Mai, Thailand and agreed on a series of bilateral swap arrangements. This sowed the seeds of the regional financial safety net, the Chiang Mai Initiative (CMI), as I'll discuss in Chapter 9.

CRISIS AFTER CRISIS, ARGENTINA, 2001

1992, 1994, 1997 – one crisis after another. One would think that lessons were learnt, but unfortunately that was not the case. Just one year after Asia, a crisis broke out in Russia that was almost a carbon copy of 1997. This led to a devaluation of the ruble, a default on public and private debt and the near collapse of the US hedge fund Long-Term Capital Management, which had to be bailed out by the Fed. Nor did it stop there, for a couple of years later, in 2001, Argentina was plunged into a deep crisis that closely imitated that of Mexico in 1994. Both tell the tale of boom and bust, irresponsible lending, greed and complicity and, eventually, immense suffering.[28]

In 1991, Argentina's new Economy Minister, Domingo Cavallo, introduced the Convertibility Plan in an attempt to stabilise the exchange rate, put an end to hyperinflation and improve economic performance. This consisted in a hard peg that fixed one Argentinian peso to one US dollar, forcing the central bank to curb money creation. Between 1991 and 1994, this did help to reduce Argentina's hyperinflation, but also equated to a monetary straightjacket. Unsurprisingly, the one-peso-to-one-dollar peg would prove to be a disastrous measure for a developing economy with structural imbalances and a dependency on commodities exports. But not yet. Deregulation in the manufacturing sector, the removal of trade barriers and the privatisation of state-owned companies followed Argentina's dollar peg. Thus the country managed to achieve enough stability to persuade many investors that it had turned a corner, entering a virtuous circle of low inflation and high economic growth. Indeed, between 1991 and 1997, the economy grew in real terms at an annual average of 7 per cent, with just a short recession at the time of Mexico's crisis. US investment banks and brokerage firms were spinning the story of Argentina's rediscovered success (it was the world's fifth largest economy at the beginning of the twentieth century) and Argentinian bonds began to pile up in their client's portfolios.

As foreign capital poured into Argentina, the country's exposure to debt increased to unsustainable levels. Nonetheless, those US financial institutions continued to push Argentinian bonds in the portfolios of their clients. During the boom years, they collected approximately $1 billion in fees for issuing and underwriting the Argentinian debt. Like the Mexican government a few years earlier, the Argentinian authorities were reluctant to weaken the exchange rate and so curb capital inflows. This approach was implicitly supported by the IMF which, throughout 2000 and 2001, kept extending fiscal rescue packages to Argentina. But, when the IMF announced that it would not distribute further funds to Argentina in December 2001, the country was plunged into a deep crisis. This resulted in a massive bank run, a default on the majority of its $141 billion public debt and the end of the peso convertibility programme.

In response to the bank run, the government declared capital controls and froze bank accounts for ninety days, leaving thousands of people locked out from accessing their life savings. By this point, discontent in Argentina had been brewing for a couple of years. Poverty was rife, and thousands had staged multiple protests against the government's severe austerity programme and massive spending cuts. Riots and looting broke out in the major cities, during which dozens of people died – including a number of children. This marked the worst social unrest that Argentina had seen in over a decade. The government declared a state of siege and the president, Fernando de la Rúa, was forced to resign. The severity of the political instability resulted in four different presidents taking office in the two weeks after de la Rúa's resignation.

The Argentinian crisis required the intervention of the IMF. The Fund was reluctant to push the government for significant changes and adopted a rather lenient approach towards Argentina – a country strategically and diplomatically close to the United States that, in the years before the crisis, had been praised as a model for other developing countries. The level of financial support granted to Argentina – a total of $22 billion – was indeed exceptional compared with the $35 billion made available to Thailand, Indonesia and South Korea together.

It is now easy to see why Argentina was a disaster for the IMF's reputation in crisis management, as well as highlighting the intrinsic problem of financial globalisation. Two issues clearly emerged. The first is the inability – or unwillingness – of policymakers, such as governments, central banks and regulators, to call off the game when there could still be money to be made. Recall that between 1987 and 2006, the critical years of financial globalisation, when Alan Greenspan was at the helm of the Fed, the belief in self-regulated markets deemed any intervention that could prick a bubble unnecessary – if not risky. 'It presumes that you know more than the market' is Greenspan's well-known line. This was the complete opposite of what, for years, many had thought to be the role of central bankers. In the words of William McChesney Martin Jr, who ran the Fed from 1951 to 1970, central bankers should take away the punch bowl just as the party gets going.[29] That is, they should curb market activity when it gets unsustainable.

The second issue was that financial globalisation had spread junk bonds and other toxic products all around the world. Let me stress that banks and other financial intermediaries have a critical function for economic development – to connect savers with investments. This way, people with an excess of savings – who are planning for retirement, perhaps – can benefit from the financial returns generated by profitable and sustainable investments. Interest rates paid on loans are a remuneration given to people who are prepared to defer consumption and take on some risks. Riskier individuals, firms and governments need to pay more to borrow than those with good credit ratings. But unsophisticated savers are often attracted by higher returns without considering the higher risks. And many unscrupulous advisers in the early 2000s heavily promoted Argentinian debt with their clients. Along with the American banks, Italian banks promoted and sold Argentinian debt to their clients, claiming that the yields would be twice the amount of those on Italian sovereign or US Treasury bonds.[30] The warning lights should have flashed, but instead Italians ended up holding a great deal of risky Argentinian bonds. When Argentina defaulted, private investors across the world were left with roughly $24 billion worth of claims against Argentina. I'll return to this in Chapter 8.

In hindsight, the Argentinian crisis was the prelude to what was going to happen on a larger scale in 2008. But like the crises before it, it was dismissed as a series of problems exacerbated by policy mistakes, localised in a developing country. Argentina's underdeveloped financial sector was pinned down as the main shortcoming and so it was concluded that there was surely nothing that the developed countries needed to worry about. Importantly, unfettered capital movements were allowed to continue and widened the debt–credit imbalances. In the early 2000s, the IMF was still encouraging fully open capital markets. Indeed, some IMF staff thought that it was a mistake that the Fund's articles were not amended to make an open capital market an entry requirement in September 1997.[31]

Similarly, there was no sign of the slowing down of financial deregulation. The premise continued to be that markets would deliver efficient allocation of financial resources and any regulation or intervention would harm this search for market equilibrium. Prudential measures should therefore be light-touch and too much depositor protection would create 'moral hazard' and distort risk-taking incentives. Put otherwise, despite a relatively high number of crises in a decade, the basic pre-crisis framework remained intact, for – it was thought – there were no lessons here for advanced economies. It came as a shock, then, when those financial sector vulnerabilities eventually did trip them up.

THE CRISIS THAT SHOOK THE WORLD, 2008

In early September 2008, as I made light conversation with a senior executive at the London office of US bank Lehman Brothers, he informed me that he was looking forward to two weeks on safari in west Africa. 'There isn't mobile phone coverage in any of the lodges where we're staying, so nobody from work will be able to reach me,' he said. 'I'll have a restful and uninterrupted holiday.' And, indeed, this proved to be a very long holiday, as Lehman Brothers folded on 16 September 2008. The images of Lehman employees spilling onto the streets, cradling their possessions in cardboard boxes, is part of the collective memory of the 2008 global financial crisis. To paraphrase the Queen during her November 2009 visit to the London School of Economics, why did no one see this coming? As the above anecdote indicates, many economists, analysts and bankers did not see it coming – and even if they did, inertia and herd instinct prevailed until it was too late.

There had been some signs. When the US subprime mortgage market collapsed in 2007, it brought the housing boom to an end and forced many families to hand their properties over to the banks. Defaults on mortgages spread to investment banks and commercial banks – not just in the United States, but across the world via the intricate network of derivatives. As discussed in the opening of this chapter, many believed that spreading the risk had strengthened the global financial system, but the uncertainty about the value of mortgage-backed securities in fact raised questions about the soundness of other loans that underpinned many transactions. In August 2007, in an attempt to protect their funds, the banks began to implement new and stringent restrictions on their lending to one another. The Fed and other central banks had to intervene, so they provided substantial amounts of liquidity to unfreeze the interbank market. The Fed cut their funds rate by 3 per cent, but this did little to help the situation.

It wasn't long before other problems began to emerge. In March 2008, the Fed had to arrange the bailout of the investment bank Bear Stearns. At the time, Bear Stearns was one of the world's largest financial institutions, holding around \$400 billion in consolidated assets.[32] The bank was also widely considered to have pioneered the subprime mortgage-backed securities market.[33] In the years leading up to the market's collapse, Bear Stearns turned a blind eye to the warning signs and instead increased their exposure to subprime mortgages in order to up their share in the market. When Bear Stearns told the Fed that they expected to default, the Fed provided funds to the investment bank J.P. Morgan Chase to acquire the troubled bank. They deemed this a necessary move, for fear that the bank's collapse would trigger a much worse crisis. J.P. Morgan Chase acquired Bear Stearns for $2 a share – a radical departure from just fourteen months earlier, when their shares closed at a record high of $171.51.[34]

A couple of months later came the bailout and nationalisation of two mortgage lenders, Fannie Mae and Freddie Mac – officially the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corp (FHLMC). At the time of the crisis, both were government-supported enterprises, essentially meaning that they could take huge risks to boost the value of their shares, safe in the knowledge that they would always be bailed out by the government. It isn't surprising that they were both hit hard when trust evaporated and the subprime mortgage market collapsed. In response, the Fed prepared a rescue package that included access to their funds. Despite this, both lenders continued to post losses. In September 2008, in order to provide market stability and support the national housing market, the US government seized control of Fannie and Freddie. This was intended to be a temporary measure, but they are both still under the conservatorship of the federal government.

There were of course even more problems that occurred that summer. At the end of June, Lehman Brothers announced a loss of $2.8 billion, forcing them to sell off $6 billion in assets. Similarly to Bear Stearns, Fannie and Freddie, Lehman's position in the subprime and other lower-rated mortgage-backed securities market had left them largely exposed to the 2007 crisis. As a result, in the first half of 2008, the market value of the Lehman Brothers dropped by 73 per cent. Senior executives, however, remained confident that they would be able to find a new partner willing to put some fresh capital into the ailing bank. At the end of August, it looked like a deal with the Korea Development Bank was imminent, but the negotiations collapsed and the share price took another deep plunge – this time by 45 per cent.

Many hoped that the Fed would bail out Lehman Brothers in order to avert a deeper crisis but, in an attempt to prevent moral hazard – and discourage the belief that all insolvent institutions would eventually be saved – the Fed left Lehman to its dire fate. Chaos then broke out. The fear that no banks were safe threatened the entire US banking system which risked being shut down as shock waves emerged throughout the entire international payments system.[35]

The liquidity crisis, caused by the subprime mortgage crisis, had turned into a global credit crunch and stock market crash. The day after the collapse of Lehman Brothers, the Fed bailed out and nationalised the insurance giant AIG. It feared that, had it allowed AIG to fail, the consequences for insurance contracts on securities[36] would be systemic.

The crisis spread, hitting Europe and the emerging market economies by October. The global interbank market then ground to a halt. The authorities in the United Kingdom responded to the crisis by pumping capital into British banks, guaranteeing all interbank deposits and providing huge amounts of liquidity. The EU countries responded in a similar fashion and the US Treasury followed suit. They injected $250 billion into the US banks, providing insurance to senior interbank debt and unlimited deposit insurance for non-interest-bearing deposits.

The crisis revealed just how easily powerful shocks could transmit through the highly integrated system. But, at the same time, it also showed the intrinsic contradiction and potential tension between global markets and nation states. For, where should the line be drawn, if at all, between underpinning global markets and protecting domestic economies? Where are the trade-offs in channelling national financial resources – or, as some would say, taxpayers' money – in supporting transnational banks in order to restore financial stability?

The global financial crisis thus marked a turning point. Even if the many crises that littered the global scene in the 1980s and 1990s could be dismissed as circumscribed to developing countries or monetary experiments like the EMS, the 2008 crisis that originated in Wall Street could not. It brought to light the problems with global markets, questioning the 'free market' doctrine and the governance – including the burden sharing – that ensures the functioning of global capitalism. It also raised the issue of setting up a new system – indeed a new Bretton Woods – to underpin the functioning of global markets and governance, with rules to avoid excessive risk-taking and moral hazard. Finally, the global financial crisis seriously undermined the credibility of the United States' suitability to lead (what is supposed to be) a liberal rules-based economic order. This order has been beneficial for the development of China and other large emerging market economies that have anchored their development to the dollar-based monetary system. But what are the costs intrinsic to the dollar game? I'll discuss this in the next chapter.

4
PLAYING THE DOLLAR GAME

In the opening of Chapter 2, I mentioned how President Sarkozy made a public call for a 'new Bretton Woods' in the aftermath of the collapse of Lehman Brothers in 2008, solidifying Bretton Woods's reputation as the symbol of concerted and decisive action capable of saving the international financial system. The severity of the 2008 crisis acted as a catalyst and the leaders of the Group of 20 (G20) gathered in Washington, DC on 15 November 2008. The G20, a composite group of the most advanced economies and the largest developing countries, together account for around 85 per cent of the world's economy.

The G20 reconvened again a few months later, in London in April 2009, in an attempt to remedy the economic and financial system as much as possible. The summit was met with thousands of protesters on the streets of London, expressing discontent for a variety of intertwined issues, including the international banking system, economic policy and climate change. Although the protest was mostly peaceful, it was met with a heavy-handed response from the London Metropolitan police which stirred public discontent even further.

The G20 London Summit provides the context against which, just a couple of weeks earlier, Zhou Xiaochuan – the soft-spoken technocrat at the helm of the People's Bank of China (PBoC), China's central bank[1] – made a public call for reconsidering the role of national currencies in the international monetary system. 'What kind of international reserve currency,' asked Governor Zhou, 'do we need to secure global financial stability and facilitate world economic growth, which was one of the purposes for establishing the IMF?' Governor Zhou then invited the international community to consider reforming the international monetary system by establishing 'an international reserve currency that is disconnected from individual nations and can remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies'.[2] Indeed, only national currencies – and not supranational ones – are hostages to domestic priorities.

Although Governor Zhou was careful not to mention the dollar, his speech reflected the themes from the monetary debate of the 1960s, especially the Triffin dilemma. Can the dollar be trusted to hold its value, even when the US administration is lowering interest rates – and embracing non-conventional monetary policies, as I will discuss later – while increasing public spending to grow the domestic economy and labour market? And can the dollar continue to provide liquidity to the world if its credibility is undermined by the widening current account deficit of the United States? Finally, is there a future for the dollar as the key international currency? In 2009, the students of Peking University implicitly answered this question during a visit from Tim Geithner, the US Secretary of the Treasury at the time. Geithner's statement that 'Chinese assets [i.e., China's dollar holdings] are very safe'[3] was met with a loud burst of laughter from the crowd.

When it comes to seizing the opportunity, Governor Zhou's speech was a masterpiece. The timing was perfect, his tone was measured and balanced and the call for reform sent a clear message. China had come to value multilateral action and international cooperation – and was willing to be part of the effort to reform the international monetary system. Unlike President Sarkozy, who put reform of the international monetary system at the centre of the G20 agenda when France hosted the summit in 2011, Governor Zhou avoided any bombastic rhetoric and didn't call for 'a new Bretton Woods'.[4] But just as had happened with Keynes's bancor some seventy years earlier, it was not long before Governor Zhou's proposal for a pivotal supranational currency was dropped.[5] However, this didn't stop China – or Governor Zhou – from launching a much broader debate on the future of the international monetary system and implicitly on the international economic order.

I recall this episode because it helps to frame where we are now, as well as to define the aspirations and frustrations of China and the other emerging market economies vis-à-vis the dollar-dominated system. The economic order underpinned by the United States has been beneficial for the development of China, as well as the other BRICS and developing countries. In addition to this, they have benefited from piggybacking on the dollar-led international monetary system. For some decades, the dollar has provided the monetary stability that the developing countries' own currencies lacked – but the limits of this system have become increasingly clear.

This point is of particular importance for China. As they were reforming an economy that had remained closed off from the rest of the world, the Chinese leadership had to peg their currency, the renminbi-yuan, to the dollar in order to stabilise the exchange rate. They knew that, without the stability that pegging provides, their reforms were unlikely to get off the ground. In April 1994, following a significant devaluation of the renminbi from its unrealistic levels prior to China's economic reform, the leadership decided to fix the value of the renminbi at 8.7 per dollar. It stayed steady at about this level for a decade until July 2005. The stable and predictable exchange rate was a boon to firms involved in foreign trade – and especially to exporters – as Chinese exports (in dollar-terms) were relatively cheap. Indeed, this was the value of the renminbi when China joined the WTO in 2001.

China's cheap exports coupled with strong external demand soon resulted in a surplus in the trade balance. Dollars were pouring in to China and accumulating in their official reserves. But as this accumulation steadily grew, the Chinese leadership became increasingly aware of their deepening financial and monetary links with the United States, and the potential vulnerabilities intrinsic in the holding of dollars. Recall that the main challenge for a country that chooses to peg its exchange rate is maintaining it around the chosen parity. This can be achieved through active interventions in the foreign exchange market, as I'll discuss later in this chapter. But when and what interventions are necessary doesn't entirely depend on the country that is seeking exchange rate stability – but rather the whims of international markets and the United States authorities' monetary policy stance. It became clear that China's accumulated dollars were vulnerable to the domestic policy (and political decisions) of the United States.

The problem here is that often the monetary policy and political decisions that will benefit the United States domestically are exactly those that will cause havoc for the countries that rely on the dollar system. This highlights the broad and deep contradiction in having an international monetary system that has retained the dollar standard of Bretton Woods bar gold.[6] In this chapter, I will explore some of the many tensions that have materialised for developing countries when trying to play along with the international dollar game. I'll set the foundation for what will come in the rest of the book, notably the need for the leading country and the issuer of the key international currency to provide the financial safety net and backstop the international monetary system when it goes into a tailspin. I'll start the chapter with a discussion on how countries should be playing the dollar game and why many find this difficult. I'll then look at what happens when the system no longer behaves, i.e., when liquidity constraints and spillovers adversely affect the dollar game, and finally, I will turn to China.

ORIGINAL SINNERS . . .

Let's recall for a moment the features of a well-functioning international monetary system, that is to underpin international trade and facilitate all international exchanges. For exporting countries like China, being plugged into the dollar system has helped to open up and grow their economies. But to make the most out of playing the 'dollar game', countries need to embrace the following policies. First, to ensure a nominal anchor, they need flexible inflation targeting to be achieved by monetary policy. Second, they need to use floating exchange rates to ensure adjustment in the face of shocks. Third, they need to embrace prudential fiscal policy that prevents the accumulation of excessive public debt, shielding inflation and the exchange rate. Finally, they need adequate banking and financial regulation without which inflation, the exchange rate and the fiscal position would also be at risk. Regulation, therefore, holds the key to balanced economies that don't suffer recurrent episodes of financial instability.

In an ideal world, these policies would help individual countries fit together as a system. The reality, however, is more complex, with significant differences among countries that affect how they play the dollar game. Let's take, for instance, exchange rate flexibility that allows a country the scope necessary to pursue domestic policy objectives without the risk of unmanageable external shocks. Advanced economies have the credibility – linked to the ability of managing inflation and the independence of the central bank – to let their exchange rate float. In addition, as issuers of international currencies they can – in principle, at least – rely on unlimited liquidity and act as lenders of last resort for their banks. This is what happened in the United States during the global financial crisis and again in Europe during the sovereign debt crisis in 2010–12.

Developing countries, on the other hand, need to anchor the value of their currencies to those of the advanced economies and align their domestic economic policies with those of the country that they are anchored to. Furthermore, unlike developed economies, they need to accumulate foreign exchange reserves to counter the almost inevitable bursts of financial instability. Indeed, their external debt obligations, due to the fact that they need to issue their debt in key international currencies, make developing countries particularly vulnerable to financial crises and debt defaults.

Accessing financial resources is essential for economic growth and development, but the challenge of doing this while maintaining financial stability is not quite the same for developed and developing countries. Many developing countries cannot generate capital at a pace that matches that of their expected economic growth. The answer to this problem is to look at international financial markets and borrow externally, but developing countries struggle to find loan conditions that are both fair and sustainable. As always in the business of loans, lenders need to be convinced that their borrowers have or can generate the capacity to repay their debts. As there isn't such a thing as free money, the less convinced the lender is, the more constraining the loan conditions will be. For example, lenders may opt to impose a steeper interest rate to reflect a higher risk of default. Although such a loan is riskier, then, the possibility of a higher return makes it attractive for the lender to participate.

Another common way for lenders to make risky loan transactions more appealing (and this is the important point for this discussion) is to dictate the currency that the loan is issued and therefore repaid in. Hard currencies – normally issued by developed countries – are those that are not expected to fluctuate greatly in value. So, by imposing a hard currency condition on the loan, lenders are able to avoid the risk of being repaid in a depreciated currency. Limited geographical circulation and limited liquidity have made many people wary of holding developing countries' currencies. The many currency crises of the 1980s and 1990s served as yet another reminder of the risks involved – nowadays, even many residents of developing countries are reluctant to hold their national currencies. Over the years, many governments and firms from developing countries have issued debt and floated equity in dollars or euros in New York and London.[7]

When a country borrows in a different currency, it creates a currency mismatch between revenues generated in the domestic currency and liabilities denominated in an international currency (unless revenues are in the same foreign currency, like in the case of oil exporting countries). Think of a domestic firm that produces revenues in the domestic currency, for example, but is financed internationally in dollars. This puts a further burden on the borrower in terms of costs for the loan if the domestic currency depreciates, increasing the risk of default. What this means is that developing countries cannot manage their risks in ways that have become the standard in countries with international tradable currencies.

Recall the experience of the Tequila Crisis, where sound domestic policy required the depreciation of the peso, but the government continuously delayed taking this step out of fear of reversing capital inflows. If the confidence of international lenders is undermined and capital outflows are triggered, then the currency will weaken and the situation will worsen. When this happens, the prosperity of the entire country is left hanging by a thread. The inability of developing countries to borrow in international markets by issuing debt in their domestic currency is known as the 'original sin' because it appears to be a problem that all of the developing world was 'born' with.[8]

When a country can no longer rely on the international capital market and runs out of liquidity – i.e., dollars – it needs to turn to the safety net provided by the IMF instead. But unfortunately most IMF loans are not guaranteed to come without conditions attached either. Getting access to these funds can mean agreeing on a programme that, to some extent, does remedy the situation, but effectively limits the country's independence to autonomously determine its own economic policy.

In his book *Playing Monopoly with the Devil*, Manuel Hinds, a former finance minister of El Salvador (one of the world's poorest countries), equates the situation that developing countries find themselves in while searching for liquidity to be just that. To show this, Hinds imagines a dialogue that takes place between Dema Gogo, the newly elected president of 'a poor country in an underdeveloped area of the world',[9] and the Devil. While enjoying a celebratory cognac and cigar, President Gogo offers the Devil the option on his soul in return for enough cash to fund the development of his country. He hopes that this will secure his reputation as an excellent leader and, in turn, his re-election. The Devil – also strapped for cash – politely declines, but offers another solution instead: 'you should issue your own currency, the gogo, with your face on each coin and bill'.[10] President Gogo obliges, happy not to have to hand over his soul, but the steps that he is forced to take to find liquidity in the dollar system while holding gogos ultimately (and literally) lands him into hell regardless.

... AND IMMATURE LENDERS

Another, albeit less common, problem for developing countries is financial maturity, or the ability to lend and issue international securities denominated in domestic currency. Financial maturity is possibly the most effective dividing line between developed and developing economies.[11] In the words of economists Ronald McKinnon and Gunther Schnabl, Germany, for instance, is a 'mature creditor' as it avoids the exchange rate risk by lending, and therefore being repaid in, its own currency.[12]

Mature creditors have access to better-remunerated investments in foreign markets without taking up the exchange rate risk as interest is paid in their currency. A US pension fund, for example, can invest in dollar denominated bonds issued by a large manufacturing company based in France and receive the interest in dollars. Countries with 'mature' currencies can also reduce their aggregate exchange rate risk by denominating more of their official claims on the rest of the world in their own currency.

Immature lenders, on the other hand, face the exchange rate risk on top of the lender's default risk without, usually, being able to charge a higher rate. So lending in dollars, for instance, means that a country could receive, in domestic currency, less than the amount lent if the dollar weakens in the meantime. Furthermore, immature lenders find it difficult to diversify away from domestic credit risk if they cannot take on foreign currency risk. China epitomises the constraints of immature lenders[13] – another is Singapore with a current account surplus in excess of 16 per cent of GDP. With a surplus in its current account, even if it has significantly narrowed over the years, China tends to offset this excess by investing abroad. In one sense, this is not dissimilar from Britain when it invested sterling all over the world in the nineteenth century, or Germany nowadays, which lends heavily to other countries in the euro area. But in another sense, it is radically dissimilar because China invests abroad in dollars – not in renminbi. Over the years, China has offset its trade surpluses by accumulating dollars and financial assets denominated in dollars and, increasingly, by expanding its financial diplomacy in Asia, Africa and Latin America. It is indeed the renminbi's reduced international circulation and liquidity, as I will discuss in Chapter 7, that has limited worth for international lending, dictating that China's external claims must be made in dollars. In doing so, however, China continues to take on the exchange rate risk.

Another route for immature creditors is to make illiquid foreign direct investment in overseas physical infrastructure, such as Chinese-built factories and plants, as well as a number of investments that are linked to the receiving country's government-sponsored aid programmes (and are largely under that government's control). Take China's Belt and Road Initiative (BRI), the large infrastructure development strategy launched in 2015. Ideally loans should be denominated in renminbi to remove the exchange rate risk, but this is hardly the case. I'll return to the BRI in detail in Chapter 7, where I also discuss the implications of China's currency immaturity for the global economic order.

It cannot be denied that the dollar system has provided China and other developing countries with the monetary stability that was necessary for them to deepen their integration within the world economy. But this has not been a free or an easy ride. For many developing countries, the attempt at achieving monetary stability and attracting foreign investors by 'riding on the dollar' has landed their economies in a straightjacket, just as happened to Mexico in 1994 and Argentina in 2001 (as discussed in Chapter 3). At best, the outcome is constrained domestic policies – but, at worst, it is crisis and overall misery.

'TAPER TANTRUM' HITS THE EMERGING MARKETS

Whether developing countries are constrained because of 'original sin' or 'financial immaturity', the outcome is the same and it is the inappropriate allocation of financial risk through excessive exposure to both currency risk and duration risk. Prevention through better financial regulation and better private sector behaviour should be the answer. Individual countries should learn about more sustainable policies, but the issue is systemic and needs a coordinated approach and an international regulatory framework. But who will be promoting such an approach? Surely not the United States, which has little incentive to engage with other countries given the dollar's unchallenged domain, and which tends to operate unilaterally. 'The dollar is our currency, but your problem' means that the burden of adjustment falls on other countries. 'Ensure that your house is in good order' is the IMF's advice to developing countries, i.e., ensure that your economy can withstand external shocks and financial turbulence.

When the Fed decided to carry on its non-conventional monetary policy after the financial crisis, it didn't consider the impacts on other countries and the resulting imbalances from capital flows, exchange rates adjustments and capital losses on dollar holdings. In response to the weakening economy, in late 2008 the Fed slashed interest rates to near zero, hitting the point where they could not be pushed down any further without creating a situation in which savers and investors pay to lend their money (i.e., a negative interest rate). Having exhausted the conventional monetary policy measures, the Fed then turned to unconventional policy action in early 2009 when it became an active market participant and began to purchase large quantities of financial assets.

Quantitative easing, or QE as this programme is known, focused on actively purchasing assets such as bonds and other securities – mainly low-risk financial instruments such as Treasuries and US government-backed mortgage-related securities – in order to reduce the cost of borrowing, stir market activity and increase the money supply. By pushing the prices of these instruments up, the Fed thought that the cost of borrowing would go down and confidence would be restored in the banking and financial sector, and this is indeed what happened. Prices are sensitive to the interaction between supply and demand of a given good, and the prices of financial instruments are no different. So the cost of Treasuries, for instance, will go up as the demand for them increases, and vice versa when demand is low. As the prices of financial securities increase, the interests paid in return go down. By channelling money into these assets, the Fed was able to grant investors some profit, thereby restoring some confidence in the market.

QE became a device for money creation – or dollar printing, as opponents called it – that the Fed pumped into the financial system to offset the crisis. As a result, the Fed's balance sheet expanded from less than $900 billion before the crisis to approximately $4.5 trillion in 2015.[14] Other central banks followed suit – the Bank of England in 2009, then the Bank of Japan and the ECB in 2013 and 2015 respectively.

By the time that 2013 came around, the US central bank was four years deep into QE. The Fed began to contemplate how they could phase this policy out and return to normality without creating significant volatility and disruption. The problem of monetary policy normalisation had haunted the QE programme from the outset – not only was it unconventional, but also largely untested with little previous experience to refer to. It was an instance of learning by doing, with policymakers assessing market reaction as they went.

The Federal Open Market Committee (FOMC) became concerned about the costs and risks that could arise as a result of further asset purchases. They felt that 'the Committee should be prepared to vary the pace of asset purchases, either in response to changes in the economic outlook or as its evaluation of the efficacy and costs of such purchases evolved'.[15] Reading through the transcript of the FOMC meeting held on 29–30 January 2013, it is evident that the Fed was ready to start reducing its purchases of treasury and agency bonds, with the aim of stopping them altogether by the end of the year. However, such a plan needed to be implemented gradually – and market participants needed to be well prepared. This is the background against which Fed Chairman Ben Bernanke, in May 2013, declared to the US Congress that 'tapering' the pace of the asset-purchasing programme was a possible means of shifting the course of monetary policy.[16]

Unfortunately, Bernanke's statement misfired and all hell broke loose. Market participants misinterpreted the Fed's intentions, taking Bernanke's words to indicate an imminent turn in monetary policy and an earlier-than-intended tightening of interest rates. What followed was a panic-driven sell-off. In effect, this response undid the effects of the QE programme, erasing years' worth of stimulus-led gains in currencies and stocks, spurring defaults globally. The FOMC had anticipated a negative reaction to Bernanke's message. As Jerome H. Powell, the current Fed Chairman and member of the FOMC in 2013, told his colleagues at the January meeting, there is 'no risk-free path [. . .]. We've got to jump.'[17]

In the months following Bernanke's announcement, asset prices and currencies tumbled globally. Developing countries were hit particularly hard as doubts were raised about their growth prospects and capital flows became increasingly volatile. Even more so than the others, Brazil, India, Indonesia, Turkey and South Africa came under huge pressure. In just a little over three months from Bernanke's statement, on average, their bond yields had increased by 2.5 percentage points, their stock markets had fallen by almost 14 per cent, exchange rates had depreciated by 13.5 per cent and reserves declined by about 4 per cent.[18] These were countries with large current account deficits, weak fiscal balances, high inflation and low GDP growth.

There are three points related to the taper tantrum that are critical for our discussion of how to play the dollar game and the role of developing countries in the global economic system – all of which are related to regulations. The first point consists of the misallocation of risk intrinsic in the rapid credit expansion and favourable credit conditions that often accompany strong capital inflows.[19]

This was what happened in Mexico, Asia and Argentina (as discussed in the previous chapter) and continues to be the case. Rapid credit growth underpins the overheating of domestic economies and the buildup of vulnerabilities, and it results in growth that is not sustainable and often leads to bubbles and subsequent bursts. Between 2010 and 2013, issuance of below-investment-grade debt in developing countries, especially India and Turkey, rose from 15 to 35 per cent of total debt issuance.[20] When inflows turn – and they always turn when economic growth eventually slows, financial conditions become tighter and exchange rates depreciate – then a financial and banking crisis may be just around the corner. For developing countries with weak economic fundamentals and unsustainable exposure to capital inflows, this has always been the case.

The second point is that countries with robust and large domestic banking and financial sectors, and effective regulations, are better at dealing with capital movements. The size of these sectors allows for the movement of large amounts of capital outside the country or towards other domestic markets without significant changes in prices. Mexico, for example, experienced little volatility during the 'taper tantrum' in 2013 compared with other developing countries because its domestic financial and banking sector was able to adjust to changes in capital flows as well as portfolio rebalancing.

The third point is that countries with robust capital flow management measures – that also influence the composition of flows – will experience a less severe market reaction. China, for example, maintains a selective approach to capital movements, with significant restrictions. This has insulated their domestic financial and banking sector from external shocks.

The story of the 'taper tantrum' highlights the financial fragility of many developing countries and their dependence on the dollar-system. In other words, the Fed's monetary policy – and even just its announcements – can correlate with movements in asset prices and capital flows in developing countries. The remedy devised by the Fed did kickstart the US economy and therefore the world economy after the global financial crisis, but simultaneously landed the developing countries in a difficult position. At the time QE was presented as an almost inevitable measure, but it was not the case. Given the downturn in demand was large enough to require exceptionally loose monetary policy, fiscal policy should have been used to sustain demand, but it was politically unfeasible. (Equally politically unfeasible was to lower interest rates below zero – an approach that was embraced in 2013 by the Bank of Japan and in

2015 by the ECB). Without such fiscal expansion, QE became the only game in town. It was a policy with an implicit 'beggar-thy-neighbour' bias that partly ensured currency depreciation, so that demand could be 'stolen' from other countries. By calling it a 'currency war' Brazil's Finance Minister Guido Mantega was not completely off the mark.

QE AND 'CURRENCY WARS'

In September 2010, Brazil's then Finance Minister Guido Mantega aired a key concern that other finance ministers and central bankers had kept behind closed doors. 'We are in the midst of an international currency war', Mantega warned, 'this threatens us because it takes away our competitiveness'.[21] He was lamenting the impact that capital inflows on the back of the Fed's QE were having on the Brazilian currency, the real. After the 2008 banking and financial crisis, the Fed's ultra-accommodative monetary policy shifted short-term capital flows into countries, like Brazil, with relatively higher interest rates. As a result, the real continued to strengthen against the dollar; from January 2009 it appreciated by approximately 24 per cent, and in 2010 the US investment bank Goldman Sachs declared the real to be the most overvalued major currency in the world.[22] When a nation is the recipient of capital flows, the value of its currency tends to increase as a consequence of stronger demand; imports become cheaper, exports become less competitive, and the trade balance is left to topple.

As I have previously touched upon, Brazil – as a member of the BRICS – is one of the largest emerging markets economies, and one with a long history of struggling with its currency. Despite changing its currency twice throughout the 1980s and 1990s, the country failed to rid itself of high rates of inflation and devaluation. With the creation of the real in 1994, Brazil was finally able to bring inflation under control, and economic growth became the government's main objective by the early 2000s. This objective was successfully achieved; between 2002 and 2008, Brazil's GDP more than tripled from $509 billion to $1.7 trillion. During this period, exports of goods and services accounted for an average of 14.6 per cent of the country's GDP.[23]

At first glance, the lower cost of borrowing that resulted from unprecedented accommodating monetary policy seems like something that would be beneficial for all. Think of entrepreneurs who require capital to fund a new venture, for example, people wishing to get a foot on the property ladder, or even those who just want to improve the value of their home or business. But there are people who are worse off as a result. A lower cost of borrowing can be detrimental for pensioners, for example, as they draw their incomes from the interest paid on capital. Unsurprisingly, QE triggered a global search for yield, with significant capital flows being channelled towards the developing countries. Latin America and Asia were offering particularly high returns and good prospects for economic growth – much unlike the economies of the United States and Europe, which were still struggling under the pressure of their debt that had built up in the pre-crisis years.

Between 2009 and 2012, developing countries experienced large inflows of foreign money, receiving close to half of the global total.[24] Most inflows were concentrated in the largest countries, with China, Brazil, Mexico, Turkey, Indonesia, India, Peru and Poland receiving 90 per cent of net capital flows. Relative to their size, several small developing countries also attracted large volumes of capital. During the pre-crisis period, inflows into many developing countries generally came in the form of foreign direct investment that acts as a major catalyst for development as they are tied to physical investment and therefore not easily reversible. These inflows, however, were not the foreign direct investment of the pre-crisis period, but instead mostly consisted of portfolio investments that are more likely to turn volatile. During this period, one in every four dollars flowing into developing countries came in the form of portfolio investment. This inevitably resulted in excessive exposure to both currency risk and duration risk.

The portfolio flows mainly fed into local currency sovereign and corporate bond markets. In 2013, corporate bond issuance in developing countries reached $630 billion – in 2000, they had amounted to just $13 billion. During the same period, the share of debt issued in local currency expanded from close to zero to over 50 per cent.[25] We have seen in the previous chapter, with examples such as Mexico and Argentina, that mixing heavy capital inflows with sovereign debt in a developing country tends to create a breeding ground for crises. Indeed, all crises since the 1980s have been triggered by excessive indebtedness and excessive reliance on portfolio inflows, and banking crises are frequently born out of debt crises. In addition, a surge in capital inflows is conducive to stimulating strong credit growth. In some countries, as I will discuss in the next section, some of these inflows were channelled in the shadow banking sector.

The monetary policy of the United States, that was designed to support the American economy and implicitly the rest of the world, was causing serious problems for countries that were struggling to manage their capital inflows and the subsequent impact on their currencies. Not only were developing countries like Brazil on the frontline, but also advanced economies like Japan. Some central banks and treasuries were left with no choice but to unilaterally intervene in foreign exchange markets. This is usually a suboptimal way to deal with foreign exchange imbalances. Japan, for instance, opted to intervene to the tune of $25 billion in September 2010.[26] This intervention, however, did not curb the increase in the value of the yen against the dollar – it achieved the exact opposite of the declared goal of reducing volatility.

There are instances when the monetary policy stances of the United States – and its focus on domestic priorities – risks undermining the economic and financial stability of many developing (and some developed) countries and hinder the multilateral dialogue on global economic and financial issues, the very core of the G20 process. Following Mantega's 'currency war' cry, Naoto Kan, the then Japanese prime minister, pointed out that attempts to depress currencies were contrary to G20 cooperation. He publicaly urged South Korea and China to 'act responsibly' with their foreign exchange policies.[27] Mantega and Kan were right to underline the spillovers and the shift in the burden of adjustment to other countries, but to what result? Would it not have been better to lean against the wind while waiting for the US economy to get back on track?

SITTING ON A PILE OF DOLLARS

In 2009 China was stuck with too many dollars – more so than any other country. As the Fed's monetary policy was affecting the value of the dollar – while the Chinese currency was appreciating due to the strong domestic economic recovery – China was sitting on a pile that was losing value against the renminbi as well as other international currencies such as the euro. Calculations made by the Bank of International Settlements in December 2010 estimated that, should the renminbi appreciate against the dollar by 10 per cent, China's potential losses on their official reserves (which totalled almost $2.7 trillion at the time) would be approximately 1.8 trillion renminbi (equivalent to roughly $270 billion at the time).[28] So, for China, a stronger renminbi equated to a drastic reduction in the value of its dollar reserves – a lessening of the 'wealth of the nation'. But, to some extent, China could only blame itself and its exchange rate policy. As the renminbi was appreciating against the dollar, the central bank was intervening in the foreign exchange market to curb the strength of the Chinese currency and as a result continued to expand its dollar holding. China's official reserves would go on to peak at just over $4 trillion in June 2014.[29]

This story illustrates the risks of sitting on a large pile of dollars. Dollar accumulation means taking on a large exchange rate risk and also being exposed to the domestic politics of the United States as well as vulnerable to swings in US foreign policy. In Chapters 1 and 2, I explained that the current international monetary system is based on fiat money – i.e., it is unrelated to the value of a physical good such as gold or silver. Thus, it is critical that the issuers of key international currencies retain confidence and trust in their policies, that they will not pursue policies that can undermine the value and liquidity of those currencies. But if this happens, then the holders of these currencies are exposed to capital losses. China – like other countries with large dollar holdings – faces the risk of substantial capital losses any time the dollar dwindles.

The composition of China's reserves are not officially disclosed, but reasonable estimates suggest that the dollar share accounts for around two thirds of the total. Japan, Switzerland, Saudi Arabia and Russia are also at the top of the list, with reserves that range from approximately $1.2 trillion for Japan to $468 billion for Russia. Switzerland and Saudi Arabia hold reserves worth approximately $787 billion and $509 billion respectively.[30] With the exception of Switzerland, which expanded its reserves on the back of market interventions to manage the exchange rate after the global financial crisis, the other countries are strong exporters of manufactured goods (Japan) or commodities (Saudi Arabia and Russia).[31]

There is nothing inherently wrong with holding foreign exchange reserves. Developing countries tend to accumulate foreign exchange reserves for precautionary reasons, such as paying for imports during a sudden dearth of dollars or shielding against currency crises. Furthermore, foreign reserves can be deployed in order to stabilise the exchange rate, although this is a risky strategy – recall the story of Black Wednesday in 1992. This is what the PBoC did in August 2015 and then again in January 2016 as the exchange rate weakened and capital began to leave the country. Having relaxed many controls over the years, the PBoC had to go into reverse and use more than $1 trillion to intervene in the foreign exchange market in support of the currency – official reserves shrank from their 2014 peak and currently total approximately $3.2 trillion.[32] But holding reserves has a cost for countries that are still developing their economies, where a significant share of the population is poor and where the income per head is relatively low. Indeed reserves are capital that is accumulated instead of being used for domestic development.

When a country does hold large foreign exchange reserves for precautionary purposes, they must ask themselves: how much is enough? The widely used benchmark is for central banks to hold reserves proportionate to their countries' total stock of outstanding short-term debt. As of September 2019, China's outstanding external debt was listed at $2 trillion,[33] equal to roughly 67 per cent of their reserves (there are, however, serious doubts as to whether China's figure for their total external debt is accurate, with some suggesting that it could in fact be much higher). It is important to note that China's external debt as a share of its reserves has increased significantly over the past few years – from 26 per cent in March 2016 – but its foreign exchange reserves have remained at about the same level.[34] External debt has historically been a smaller portion of China's reserves; between 2006 and 2016, China's short-term debt as a percentage of reserves averaged at 20 per cent.[35] An alternative measure suggests that a country should hold official foreign exchange reserves equivalent to three or four months of imports, as this is the amount that is deemed adequate to provide protection in case of a sudden drop in liquidity. For China, this totals approximately $700 billion – again, indicating that the level of their reserves is far too high. So, even if it cannot be denied that, as a developing country operating within the dollar system, China has been disadvantaged from the outset, it is also, to some extent, the maker of its own woes.

There is an additional constraint of being too dependent on the dollar and this is the possibility that the United States will weaponise the dollar for its own foreign policy objectives. This equates to a sort of measure of last resort, but, as I will discuss later, it is becoming increasingly frequent. As the dollar dominates trade and finance for China, Russia and many other developing countries, the weaponisation of the dollar is at the same time a reason of concern and for reflection on the intrinsic fragility of these economies. Not surprisingly then, large developing countries, spearheaded by China, have been pushing for some time the idea of a multi-currency international monetary system – a topic that I'll return to later in Chapter 9.

BLAME YOURSELF

Over the years China has benefited from being able to use the dollar for international transactions, but has also pursued active measures to keep the exchange rate in line with the government's objectives for economic growth. But what exactly does China do to sway its exchange rate against the dollar? Even if recent reforms have introduced some flexibility and limited its scope, the Chinese monetary authorities intervene in currency markets by buying and selling dollars in quantities large enough to shift the price of the renminbi in relation to the dollar. By doing this they aim to maintain financial stability and contain exchange rate volatility – admittedly with mixed results. At the same time, by keeping a cap on the value of its currency, China has tried to avoid excessive appreciation of the exchange rate that could undermine the country's domestic development, job creation, competitiveness and exports, hence slowing down economic growth.

Such interventions are possible because China's central bank, the PBoC, holds onto the dollars that are earned through trade, stashes them in its foreign exchange reserves and gives exporters renminbi in return. In other words, the PBoC buys dollars in exchange for renminbi, which changes the dynamic between supply and demand of the two currencies and prevents the renminbi from appreciating against the dollar. In practice, this equates to injecting a lot of renminbi liquidity into the banking system that, in turn, feeds domestic demand and pushes up both consumer and asset prices. Coupled with capital markets' limited diversification, this has the potential to result in the creation of asset bubbles in markets such as real estate, as I discuss in Chapter 7.

To avoid any undesired effects on consumer prices, the Chinese authorities need to control monetary expansion in the domestic market. They have an array of policy tools at their disposal to mop up the excess liquidity – or sterilise it. One option is to increase the reserve requirement ratio for large domestic banks, which has been raised by up to 20 per cent of banks' capital. Another option is for the central bank to sell financial securities such as bonds. Between 1999 and 2005, the PBoC bought nearly all of the foreign currencies that came into the country, invested them and then sterilised them by issuing local currency bills to take the funds – mainly dollars – out of circulation. Around 90 per cent of China's reserves have accumulated from the joint process of foreign exchange intervention and sterilisation.[36]

Foreign capital inflows have forced the PBoC to absorb US dollars for years, with the official reserves growing much faster than the rate of growth of China's economy, exacerbating the exposure to the dollar. The result has been a series of distortions in the Chinese economy as a whole. Commercial banks, for instance, need to reduce the quantity of funds that are available for their customers if they are required to increase the reserve ratio and buy sterilisation bills. In addition, the central bank needs to issue securities whose yield is higher than that on US Treasuries, with a loss for the PBoC.

A combination of financial repression and the search for 'a safe haven' have maintained the dollar as an attractive asset for Chinese investors. Currently, the PBoC sets a daily exchange rate for the renminbi against the dollar which is based on recent prices of the currencies. This allows currency trading to impact on the exchange rate within a 2 per cent band, but the strong demand for dollars frequently pushes the value of the renminbi below the lower limit of the fluctuation band. This forces the PBoC to intervene to prop up its value, as well as leaving it with little choice but to clamp down on capital movements. The solution here would be to reduce policy interventions down to the absolute minimum. This is surely on the cards for the future, but unfortunately not quite yet. The PBoC explained its long-term plan of reducing market interventions and improve exchange rate flexibility, adding that 'this adjustment process, of course, takes some time'.[37]

To say the least, China's relationship with the dollar has been long and complicated. It is true that China's development over the last three decades has been facilitated by the dollar. But 'free-riding' on the dollar – an endless source of annoyance for the United States, as I'll discuss later – has not come without its own set of burdens. Although it may have suited the Chinese leadership's goals in the heyday of reforms and opening up, there is no doubt that it has become a constraint. Having the dollar at the core of China's financial and monetary system is a constant reminder of the limitations of such a system. For, despite the size of its economy, financially China remains a developing country. Further to this, there are costs implied in using the dollar such as mismatched assets and liabilities on firms' balance sheets, and exchange rate and liquidity crunch risks. Another facet of China's dependency on the dollar is that the renminbi is an 'immature' international currency with limited convertibility outside of designated markets, restricted payment facilities and so constrained international circulation. As for the United States, China's (and other countries') large dollar holdings highlight that the dollar can be a powerful weapon in the event of geopolitical tensions. I'll come back to this point in Chapter 6.

DOLLARS ON TAP

There is no doubt that the decision made by many developing countries to open up their capital markets has forced them into a precarious balancing act. I have already discussed how the differences in interest rates between domestic and international markets drives cheap but short-term foreign currency lending to developing countries to finance long-term investment in their domestic currency. This leaves their banking and corporate sectors exposed to huge risks when advanced economies – notably the United States – increase their interest rates and reverse capital flows. As we have seen, time after time, havoc ensues.

What measures, then, can be taken in order to stabilise the financial system? I have already discussed the role of foreign exchange reserves as the first line of defence. But since reserve accumulation can take years and carries significant costs, there needs to be a plan B. Currency swap agreements – i.e., bilateral agreements between the country in need and the issuers of key international currencies – are effective safety nets in such circumstances. The story of the Fed providing assistance in the form of dollar liquidity in the aftermath of the global financial crisis via bilateral swap agreements is very telling. This assistance ended up being the most important stabilising factor at the time of the crisis – even more so than the multilateral financial safety net provided by the IMF and the G20. Dollar liquidity on demand proved to be the ultimate backstop.

When the crisis hit the US banking and financial system in the autumn of 2008, the dollar shortage that ensued slashed the supply of global liquidity. Access to dollar liquidity is critical for many countries – advanced as well as developing economies – that are therefore dependent on the US monetary and financial conditions. When dollars are scarce, maintaining financial stability becomes extremely challenging. Being offered the possibility to rely on a dollar liquidity line from the Fed is a highly effective way to stabilise a country's banking and financial system. The Fed indeed agrees to accept some countries' currencies in return for a loan in dollars, acting as de facto lender of last resort.

The Fed signed the first swap agreement in December 2007 with the ECB, agreeing to extend support to European banks in the case of a dollar shortage.

By December 2008, just a year later, the Fed had signed swap agreements with a number of central banks around the world amounting to almost $600 billion – notably Brazil, Mexico, Japan, Australia, South Korea, Singapore and New Zealand.[38] Once a country had passed the predetermined criteria for access, this liquidity was provided on demand without conditionality apart from penalties interest rates. The swaps enabled the central banks of signatory countries to act as lender of last resort to their domestic banks, offering liabilities in dollars without running down their foreign exchange reserves. This, of course, left the Fed exposed and so typically the swaps were short term, with many expiring in 2010.

Note that most of the US swap agreements were made with the central banks of advanced economies. In this sense, they were consistent with the Fed's mandate of promoting financial stability in the US domestic market through the supply of dollar liquidity to market participants. But the key difference is that swaps extend the liquidity provision to overseas banks and financial institutions in international financial centres (most of which are of course in advanced economies).

The case of South Korea highlights just how positive the impact of the swaps was. In October 2008, when South Korea was going through a repeat of the 1997 crisis, the Fed announced that they had agreed a swap line worth $30 billion.[39] At approximately $240 billion, South Korea's foreign exchange reserves were large – they were the sixth largest in the world at the time – but the country's monetary authorities were concerned that these might not be adequate to fend off financial instability and speculative attacks. Similarly, the bilateral arrangements that South Korea had with China and Japan ($30 billion each) were deemed insufficient in case of severe financial instability as they could easily be depleted overnight. The Fed's announcement was effective in restoring calm, as many investors felt reassured. They implicitly assumed that the $30 billion Fed liquidity could be extended without limit – the Fed can print dollars at will, after all – while the foreign exchange reserves (in dollars), however large they might be, are finite.

Which central banks it extends dollar liquidity to is entirely up to the discretion of the Fed – and, indeed, it is very selective in its choice of counterparts. Again, this is in line with its mandate to maintain financial stability in the United States without exposing itself to credit risk. Thus only large emerging markets economies with financial links to US banks and financial institutions have been offered dollar swaps. But the Fed's selectivity has harboured resentment in the countries that have been excluded and left to fend against financial instability by themselves. They have not forgotten that this instability was generated in the US market and exacerbated by the Fed's monetary policy.

At the peak of the global financial crisis in 2008–9, a number of emerging market central banks applied for swap lines, only to be turned down. At the time of the 'taper tantrum' in 2013, the Fed was even more selective. The 'fragile five' – that is, Brazil, India, Indonesia, Turkey and South Africa – were not supported.[40] The notable exclusion of India was what prompted the then Governor of the Reserve Bank of India, Raghuram Rajan (the unassuming IMF economist that we met in the introduction to Chapter 3), to call for greater international cooperation between central banks in terms of monetary policy.[41]

In October 2013, the Bank of Canada, the Bank of England, the Bank of Japan, the ECB, the Fed and the Swiss National Bank announced that their existing temporary bilateral liquidity swap arrangements were being converted into standing arrangements. With the exception of Switzerland, these central banks comprise those of the Group of Seven (G7) countries – the grouping of the seventh largest advanced economies in the world and the issuers of the main international currencies (although the Canadian dollar is not exactly in the same league as the others). These standing arrangements constitute a network of bilateral swap lines among the six participating central banks, allowing each access to the provision of liquidity in any of the others' currency.

Once again, the developing countries were excluded from the club. They were left with little choice but to accumulate foreign exchange reserves and attempt to self-defend should financial stability waver. As always, the IMF safety net was available as a last resort. It is of great significance that China – which has the world's second largest domestic financial market and a currency that is part of the IMF's group of key international currencies – was excluded. The upshot of the exclusion of the developing countries is that those in Asia, where distrust for the IMF has remained strong, have started to turn to regional multilateral financial safety nets instead. The CMI (as discussed in Chapter 9) marks the first significant step in this new direction. (In response to the Covid-19 pandemic, on 19 March 2020 the Fed extended dollar liquidity to the central banks of Australia, Brazil, Denmark, South Korea, Mexico, New Zealand, Norway, Singapore and Sweden.)[42]

GASPING UNDER TOO MUCH DEBT

The dynamics of financial integration constrain domestic policy choices, especially for developing countries when they are trying to play the dollar game. In order to get a 'good housekeeping seal of approval'[43] and persuade foreigners to bring in capital and invest in their markets, they link their currencies to the dollar and constrain their monetary autonomy. As exemplified by Mexico, Argentina and Thailand – to name a few – this frequently does not end well. However, the constraining impact of unfettered capital is far from being limited to developing countries. I have already discussed how, in the past three decades, the lack of effective regulation and unsustainable debt exposure have led to financial crises. The sequence is always the same: excessive inflows, overly loose credit conditions, unsustainable credit growth, complacency in the face of early warnings, corporate and personal bankruptcies, bank collapses, exchange rate devaluation, credit crunch, contraction in economic activity, recession and rise in unemployment. Indications about the building up of financial imbalances are clear, and yet we – as countries, businesses and individuals – are still grappling with too much debt.

Ever since the global financial crisis, the pace of indebtedness has significantly accelerated worldwide. The United States, Japan and China are the biggest borrowers, and together account for more than half of the total global debt. According to recent data, at the end of 2017, the United States' total gross debt weighed in at 256 per cent of GDP, Japan's at 395 per cent and China's at 254 per cent.[44] (The same year, these countries' GDPs totalled \$19.5 trillion, \$4.9 trillion and \$12 trillion respectively.) Combined, total gross debt exceeds the three countries' aggregate global output. When it comes to assessing the sustainability of this debt, China stands out as an upper-middle income country whereas the United States and Japan are both high-income. Unlike in Japan, where well over half of the debt is public, in China it is mainly private. The rate at which China's debt has grown is a cause for concern and this is what prompted the monetary authorities to keep a tight grasp on capital movements. As I will discuss in Chapter 7, capital controls have ensured that individuals' and families' savings remain in the country and are channelled back into the banking and shadow banking sectors. This means that China's highly indebted companies and the banks that lend to them are never without financial resources. As long as China keeps control on capital movements, then, its current account surplus and large holding of foreign exchange reserves should keep its debt sustainable and ward off financial instability.

Much more worrying than China's overall debt is the size of global debt and its distribution. At the end of 2017, global debt reached a nominal all-time high of $184 trillion (the equivalent of 225 per cent of global GDP). Roughly two-thirds of this was non-financial private debt and the rest was public debt. The world's debt amounts to more than $86,000 per capita – an amount more than two and a half times higher than the average income.[45] Aggregate public debt is now at 45 per cent of GDP with a number of low-income countries such as Bangladesh and Ethiopia grappling with their debt burdens. According to IMF figures, the percentage of low-income countries in debt distress or at high risk of debt distress has increased by almost a half since 2012 and now sits at 43 per cent.[46]

China is far from being the only large emerging market economy that is grappling with a debt burden. In 2019, the combined debts of thirty large emerging market economies hit an all-time high at 216 per cent of GDP. The average general government gross-debt-to-GDP ratio for the emerging market and developing countries is currently 53 per cent; however, countries such as India (69 per cent of GDP) and Brazil (over 90 per cent of GDP) have rates that are much higher.[47] It is no coincidence that both these countries fell victim to the 'taper tantrum' in 2013. Indeed, these are the countries that received destabilising levels of foreign capital inflows in the years after the financial crisis when the dollar was weak and interest rates in the United States were near zero. Over the course of 2017 and 2018, the Fed increased interest rates seven times – taking them from 0.50–0.75 per cent to 2.25–2.50 per cent – before chairman Jerome Powell announced a pause in February 2019, followed by three cuts in 2019. (As a result of the Covid-19 pandemic, the Fed cut interest rates twice in March 2020, bringing them down to a range of 0–0.25 per cent.) The ramifications of the Fed's tightening again spanned far wider than the United States and resulted in currency depreciations against the dollar and increases in government borrowing costs in the large emerging markets. Argentina, for instance, with its high exposure to foreign-currency-denominated debt has experienced a spike in government debt and found itself, once again, in the doldrums. I'll go back to Argentina in Chapter 9.

Corporate debt has also grown significantly since the global financial crisis and this can be traced back to two measures enacted in its wake. The first one was the deleveraging in the banking sector. This process, essentially an exercise to reduce debt and remedy balance sheets, meant that the banks became more risk-averse in their lending and introduced more stringent requirements on the level of capital that they need to hold against losses. The upshot of this is that commercial bank lending dwindled. The second measure consists in the steps taken by the central banks to stir economic activity by lowering interest rates to zero, or even below. The impact of this was that investors – especially institutional ones such as pension funds – became desperate for returns higher than those offered by government bonds.

Bonds now account for around 20 per cent of total global corporate debt – almost twice the percentage that they had done in the year before the crisis. In the first decade after the crisis, the annual issuance of non-financial corporate bonds increased 2.5 times from roughly $800 billion to $2 trillion. During the same period, the global value of outstanding corporate bonds increased 2.7 times, hitting $11.7 trillion.[48] But as corporate bonds became more available, the quality went down.[49] This is a key issue with regard to debt sustainability. There are currently more highly indebted companies than there were prior to the crisis as restrictions on borrowing have been considerably relaxed alongside protections for investors. The share of 'covenant-lite' loans, for example, has reached record highs while investment funds, insurance companies and pension funds are much more exposed either directly or in the form of collateralised loan obligations.[50]

The *Global Monitoring Report on Non-Bank Financial Intermediation 2018* published by the Financial Stability Board (the financial stability arm of the G20) signals an increase in the number of companies that rely on the market-channel to access short-term funding. This is problematic, as investment vehicles susceptible to runs account for approximately 71 per cent (or $37 trillion) of the most liquid risk-based financial intermediations. These assets grew by almost 10 per cent in 2017.[51] Vulnerabilities have clearly increased in the non-banking part of the global financial system. Since 2008, the banks' share of total global financial assets has decreased (from 45 to 39 per cent), as other financial intermediaries have gained a larger share (from 26 to 31 per cent). This trend is most evident in China and the euro area. It is important to note that the total global assets under management have almost doubled since 2009, from $100 trillion to $184 trillion.

Whether or not a debt is sustainable is directly linked to the difference between the interest rate and the growth in the income that is expected to repay the debt. The long-term real interest rates are important here, and these have come down in the last forty years on the back of long-term changes in the supply of savings and the demand for investment. In the shorter term, however, and over the economic cycle, temporary factors can influence the interest rates. The IMF has warned that high corporate debt levels will amplify stresses and put financial stability at risk[52] – and there are many potential sources of stress in the global financial system. Trade tensions could worsen the outlook and cause investor sentiment to sour, resulting in stress from an increase in risk premiums, for example. A shock of this type would result in increased interest rates, corrections in stretched asset valuations (such as properties), exchange rate volatility and sudden international capital flow reversals. Such developments would bring leveraged companies, households and sovereigns under strain, deteriorate banks' balance sheets and cause damage to public finances, especially those of emerging market economies. (Mindful of this context, during the Covid-19 crisis the Fed and other central banks extended a wide financial safety net to firms and companies to avoid that the exceptional economic hardship ends up threatening financial stability.)

5
EUROPE STRUGGLES WITH INTEGRATION

As economists like to tell you, life is full of trade-offs, from the simple day-to-day ones – shall I cycle to work today or take public transport? – to more complex ones – accept a good job offer now or finish my degree? Similarly, trade-offs confront countries, for example, when they decide to lock themselves into economic and monetary frameworks. As I discussed in the previous chapter, developing countries have been playing the dollar game, enjoying the resulting monetary stability, but also facing the risk of financial turbulence every time the United States touches its interest rates. In this chapter I look at another trade-off that underpins the international order. It is the one that European countries – i.e., the EU member states – are facing between the benefits of being part of a large regional bloc and the ability to shape their own policies. How to reconcile domestic priorities with broad international objectives and ultimately peace and security was the key question that the Bretton Wood conference tried to answer, and it remains fundamental to this day.

Europe came out of the dollar game at the end of Bretton Woods, and faced the challenge of establishing common monetary standards to help EU countries trade with one another while removing the option of competitive devaluations. From the second half of the 1970s the EEC and then the EU member states have embraced a series of arrangements – the monetary 'snake' first, and then EMS as I have discussed in Chapter 3. Europe's monetary integration eventually came with the EMU that crowned the establishment of the single market in 1992; currently nineteen member states have further deepened their integration by sharing the same currency, the euro, and the same monetary policy.

At the core of the European project there is a level-playing, rules-based, non-competitive and cooperative economic and monetary system, and the most advanced form of intergovernmental cooperation with twenty-seven member states,[1] a customs union and a single market of more than 450 million people – the largest free-trade area in the world, where individuals, goods and capital are free to move around without restriction. Policy coordination is key to this system. At the same time, however, there are also deep-rooted problems, especially in the design and implementation of the single currency where issues around cooperation and policy coordination have threatened the stability and even the integrity of the whole EU. For countries that are locked into a monetary union with fixed exchange rates it is crucial to have a framework that allows them to adjust when confronted with an economic and monetary shock, as I have already discussed. Members of a monetary union such as the EMU cannot have inflation targeting separately and cannot have floating exchange rates among themselves. Said otherwise, EMU member states cannot adjust the exchange rate in response to a deficit in the balance of payments, and so buying time while adjusting on the trade side.

In the first decade of the EMU these problems were not recognised, partly because they were not adequately present and economic growth was on average strong across the region. Thus the euro's first decade looked like a resounding success, especially if one chose to focus on only some indicators, as policymakers in member states and the European Commission did. Indeed, inflation had come down in those years – in some cases, like Spain and Greece, from two-digit figures – and so had interest rates, but there had been an excessive growth of credit and many banks had built up excessive exposure to real estate on the back of what ultimately proved to be a large bubble. At a conference EMU @ 10 in May 2008 convened in Brussels by the European Commission the mood was celebratory, not to say buoyant, even if the discussion revolved around the euro's success as well as challenges.[2] Six months later all hell had broken loose, bringing down a number of European banks. By May 2010 the euro was on the brink. What has followed has been a decade of crisis that has left the European project in tatters.

In this chapter, I will explore how European countries struggle to conform to the requirements imposed by further economic and financial integration, capital movements and, for those in the euro area, a common monetary policy and a fixed exchange rate. I'll replay the events around Europe's debt crisis and look at how monetary policy has expanded its remit in the decade after 2008, giving non-elected central bankers considerable power. I will ask whether non-elected bureaucrats should tell democratically elected governments how to conduct their policies, or should the latter fulfil the mandate they receive from their voters even if this is in contrast to international commitments? Badly thought out austerity programmes to rein in the public debt have opened the door to economic nationalism – epitomised by the anti-EU stance – and populism. As a result, politics has become more fractious with less scope for international policy cooperation and more scope for permanently destabilising both the international economic and monetary system and the international political and legal order. I'll discuss the consequences of this in Chapter 6.

WHO SHOULD BEAR THE BURDEN OF ADJUSTMENT?

It is in good years that resilience should be built and structural weaknesses addressed, but often we are oblivious to problems until disasters strike. The financial crisis in the late 2000s made it clear what countries in Europe's monetary union needed to do 'to live within the euro area' and 'live with the euro'.[3] They needed, and still do need, structural policies to boost productivity growth, active fiscal policies to manage demand, and in those countries where domestic demand is too exuberant, financial regulation to constrain private sector booms and so avoid the buildup of bubbles. These measures would help keep the EU together as a system without creating internal tensions and shocks. Otherwise, as I have discussed in Chapter 2, monetary straightjackets are just about bearable, socially and politically, when the economy is growing 'like the tide that lifts all boats', but they become unbearable when the economy is not doing well.

Like in the 1930s, in late 2000s backstopping the financial crisis proved very difficult politically. Unlike in the 1930s, and to some extent in 1971, a system such as a monetary union, with common policies and common institutions and which is deeply integrated through capital flows, cannot be unravelled without seriously undermining the banks and real economies of member states. As I will discuss in this chapter, the possibility of Grexit – Greece's exit from the monetary union – was contemplated only when the financial contagion to other euro area countries was reined in. As in 1992 at the time of the Black Wednesday, the crisis showed that even within a monetary union with a common monetary policy, countries found it difficult to cooperate. Austerity programmes and constraints on fiscal policy pushed the burden of the post-crisis adjustments on deficit countries – like Greece – while no adjustment was required from surplus countries – like Germany – which were allowed to accumulate surplus and push onto others the impact of their deflationary policies.

Recall Keynes's advocacy for balance of payments adjustments and resolution of debt to be imposed on creditor countries as well as on debtor ones. 'The social strain of an adjustment downwards is much greater than that of an adjustment upwards', Keynes wrote in 1941, in his notes on the postwar world, echoing *The Economic Consequences of the Peace*.[4] For, if the burden of adjustment falls only on the debtor country, then for them the whole adjustment process would become painful and politically difficult. Germany instead takes the debtor-adjustment approach by the letter: creditors need to be repaid and debtors need to fasten their belts to come up with the money. During the euro sovereign debt crisis, Angela Merkel's preoccupation with moral hazard – never let the debtors off the hook! – and Germany's obsession with debt and inflation resulted in so much misery in southern Europe that it seriously weakened the whole European project. Germany's surplus peaked at 8.9 per cent of GDP in 2015 in the middle of the crisis; it is currently at around 7 per cent – far higher than that of Japan, China and the other large exporting countries. Unsurprisingly it is also much higher than the euro area as a whole, which overall runs a surplus of approximately 2.8 per cent of GDP. Unlike China, where the adjustment has been driven by a turning point in the country's development, Germany has made no pretence of rebalancing its growth model and its intransigency was dictated by domestic politics. Such an intransigency has put the relationship between Germany and the crisis countries of southern Europe under strain with significant political reverberations.

In addition, since the implementation of the Fiscal Compact in 2012 the EMU fiscal rules have become stricter on the basis that stronger preventive action and monitoring will deter the buildup of imbalances. Member states are required to include in their legislation the commitment to keep the general government budget balanced or in surplus. Surveillance rules have become stricter and include provisions to improve fiscal procedures and create independent national monitoring agencies and economic forecasts.[5] Member states need to submit their budget plans to the Commission and European finance ministers during the early stages of planning. Rules on the excessive deficit procedure have also been tightened, making it more difficult to overrule any decision by the European Commission on sanctions for a country that is running an excessive deficit.[6]

Ultimately, however, the current state of play and the measures taken to manage the euro crisis have eroded the integrity of political systems. Anti-establishment parties across Europe have been challenging the Fiscal Compact and the constraints that its more stringent rules put on domestic policymaking. People have been questioning whether the trade-off of locking some domestic policies within the EU framework – notably trade policy and monetary policy – is still worthwhile and whether unelected bodies, with legal powers established by treaty, should have a say in member states' domestic affairs. Because the EU stands as a unique experiment in regional integration, it is where the difficulty of reconciling international markets and the free movement of capital with the aspirations and needs of domestic voters is most evident. In Italy, for instance, Matteo Salvini, Lega's leader and Italy's Interior Minister until August 2019, has advocated discarding the spending limits agreed with the European Commission in order to break free from Brussels, leave the euro and ultimately regain monetary sovereignty.

NOT QUITE FIT FOR THE EURO

In a European poll conducted in 2019, around half of the respondents in Italy were found to be positive about being a member of the EU. This compares favourably with the broader European picture – overall, approximately 45 per cent of those surveyed by Eurobarometer indicated a positive view[7] – but represents a significant fall from the 80 per cent of Italians who reported a positive image of the EU in the 1990s. The support for the EU was such that in 1996 Italians responded enthusiastically to the government's call and paid a one-off 'tax for Europe' in order to bring the budget deficit below 3 per cent of GDP and be among the euro's founding members. At that time, governments of countries in the lineup to establish Europe's monetary union were drafting their budgets for 1997, and it was far from certain that Italy would make the cut. The Maastricht Treaty dictates that members must have an annual deficit no greater than 3 per cent of GDP and a debt no greater than 60 per cent of GDP. With the projected budget deficit at 5.4 per cent[8] and with government debt at around 115 per cent, the chances for Italy were slim. But could one of the signatories of the Treaty of Rome and Germany's direct competitor in the manufacturing sector be left out? Italy's centre-left government, led by Romano Prodi, who would then become the president of the European Commission between 1999 and 2004, came up with a cunning solution: the one-off 'tax for Europe'. Italians responded positively and the European partners didn't object to what looked like a window-dressing measure. Italy qualified and the one-off tax was subsequently refunded.

I am telling this story for two reasons. First, Italy's initial enthusiasm petered out as the effort 'for Europe' was not followed by a policy framework designed to fit the Italian economy within the monetary union. Putting on the monetary straightjacket without a long-term strategy to address structural issues, such as a rigid labour market and demographic imbalances with an ageing population, resulted in sluggish economic growth – even in the booming years pre-2008 – and a deep recession and stagnation later on. Second, but directly related to the first point, the 'tax for Europe' was possible because of Italians' strong support for the European project.

Nowadays Italy represents a critical point of weakness in Europe. GDP growth has been slow for a quarter of a century and the Italian economy has been lagging behind the other large European ones. In the quarter-century between 1994 and 2019, annual real GDP growth averaged at 0.7 per cent, whereas the average for the advanced economies was 2.2 per cent.[9] Slow growth has hampered real wages, job creation and income growth. At the same time the lack of policy measures to support and improve productivity growth has hindered Italy's adjustment within the monetary union and its resilience to shocks.[10]

The rate of unemployment is high, especially among the younger generation where it is around 30 per cent.[11] The financial crisis and the subsequent recession has decimated the living standards of many families – in 2018, almost 27 per cent of the Italian population was at risk of poverty or social exclusion, the sixth largest share in the EU.[12] After having dropped dramatically in 2009–12, real disposable income per head has remained below the pre-crisis level which, in turn, was below the level seen in the years prior to Italy's adoption of the euro. Many Italians have left the country – approximately 244,000 in the five years up to 2017, 64 per cent of which are educated to university level.[13] Many more foreign immigrants are coming into the country; approximately 5 million people, or just over 8 per cent of total residents, are foreign-born – but this figure is likely to be higher once the illegal immigrants are factored in. Generally these migrants are less educated than the Italians who emigrated, leaving the country with a skills deficit.

There is an objective need for Italy to increase its public spending to support domestic demand and prevent its population from experiencing deteriorating living standards, but how to square this with the requirements for the EU Fiscal Compact? Can other member states risk that more spending would aggravate Italy's already fragile fiscal position and limit the scope for adjustment in the case of future shocks, especially in the context of political fragility? In order to stabilise its public debt – which currently weighs in at approximately 134 per cent of GDP and equals roughly €2.4 trillion – and prevent it from becoming even more difficult to manage, for instance, if (or when) monetary policy in the euro area is tightened, Italy would need to increase its primary surplus – i.e., the difference between tax revenues and expenditures when interest payments are disregarded. According to the Bank of Italy, a primary surplus equivalent to 3.5–4 per cent of GDP is necessary to shift the public debt on to a path of steady reduction over 20–25 years, which is politically unsustainable. In addition, Italy's primary surplus currently sits at 1.6 per cent of GDP and is expected to deteriorate further over the coming years.[14]

Italy is stuck between a rock and a hard place. Persistent low growth has made it difficult if not impossible to reduce public debt. It has been growing since the 1970s, but the pace really accelerated in the 1980s when public spending got out of control due to a combination of policies supporting domestic demand, a bloated public sector making ever greater calls on debt financing and the deliberate use of public funds to remunerate political favours. Up until the early 1990s, the household savings rate was high, and this, together with high inflation rates, helped Italy to roll over its debt and keep its finances relatively stable. Indeed, with two-digit nominal interest rates on offer Italians were happy to loan their money to the state. However, Italian savers failed to consider the impact of inflation to the point that many found the lower interest rates – and much lower inflation – that resulted from joining Europe's monetary union in 1999 unappealing. This sentiment was what pushed many savers towards the unscrupulous bankers selling Argentinian bonds in the early 2000s, and they were badly hit when the Argentinian crisis struck (as I explained in Chapter 3).

The last thirty years have been plagued with economic and political instability and, although Italy has just about managed to pull through, its economy is hanging by a thread. Italy desperately needs reform to modernise its economy and improve its overall situation, but since the early 1990s mostly ineffective governments have rolled over, unable to establish cohesive policy agendas. There is no indication that the political deadlock will be broken any time soon. In 2018, the anti-establishment Five Stars movement and the eurosceptic Lega formed a coalition government on an agreed programme of increased benefits, tax cuts, and the repeal of the most recent reform to the pensions system. The idea of increasing public spending to tackle poverty and help low-income families responds to an objective urgency, but the modalities of its implementation put Italy's government at odds with the programme of debt reduction previously agreed with the European Commission. In October 2018, in response to the coalition government's plan to expand public spending, the then president of the European Commission Jean-Claude Juncker warned Italy that it would not receive 'special treatment' should it fall into a Greek-style crisis.[15] This statement riled Matteo Salvini, who retorted that 'no one in Italy is taken in by Juncker's threats', adding that Brussels criticism 'will not stop us'.[16]

The combination of Italy's debt with stagnant economic growth and ineffective politics could be lethal for Europe as a whole. With the third largest economy in Europe's monetary union, the size of its debt is so big that there is no financial safety net big enough that could support it – more in Chapter 8. If Italy went through the same convulsions as Greece in 2010–12 it would trigger the collapse of the euro and possibly the collapse of the entire European project. It is now appropriate to turn to Greece to see how the need to rein in the public debt in a situation of low or no growth constrains economic activity and generates political disruption.

EURO TROUBLES START IN GREECE

Greece provides the most drastic example of just how bad things can get when a country struggles to fit into a monetary straightjacket like the EMU, and the knock-on effect for other countries within the same currency union. The events around Greece and its collapsing sovereign debt pushed the entire European monetary union to the brink.

At around 177 per cent of GDP, Greece's public debt ratio is the highest of all of the euro area countries and the second highest in the world. It has been large for a long time – it was at 107 per cent of GDP in 2001 when Greece joined the EMU, a rate far higher than the 60 per cent maximum entry requirement laid out in the Maastricht Treaty. But with a GDP of just €150 billion, Greece's economy only accounted for 2 per cent of the euro area total at the time and its debt amounted to approximately €160 billion – almost nothing compared to the tens of trillions currently owed by the United States and Japan.[17]

Greece's economy has always been small. It is mainly driven by tourism and shipping, and has a significant black market. Greece has long suffered from afflictions such as high unemployment, high inflation and high interest rates. Furthermore, it has a highly inefficient tax system and public spending has routinely been utilised to distribute political favours. When Greece expressed interest in joining the euro area, many countries questioned whether this was appropriate. Germany, in particular, was concerned about the possibility of it derailing the monetary policy of the entire euro area. It was ultimately concluded that such a tiny economy could only have a limited impact on inflation and monetary policy, and so Greece was allowed to join regardless of its debt ratio. After joining the euro, the economic outlook looked much more promising. In the early 2000s, the economy grew at an average pace of approximately 4 per cent a year in real terms,[18] which was partly driven by the effort to build the infrastructure for the 2004 Olympic Games held in Athens and 'structural funds' flowing in from the EU. High growth means high revenues and a reduction in the budget deficit, provided that no new expenses are incurred. Greece's deficit was on a downward trend, as was its debt to GDP level. It appeared to have entered a virtuous circle of high growth, low interest rates and fiscal sustainability.

In the pre-crisis years, yields on the Greek sovereign debt were slightly higher than those on the German one because the risk was deemed a bit higher.[19] After all, all debt issued in the euro area was denominated in euros, so the exchange rate risk was removed. There was also a mutual belief among all participants that being in the currency union considerably reduced the risk of default – despite the no-bailout clause in the Maastricht Treaty. Hence, investing in the Greek sovereign bonds in the pre-crisis years was a no-brainer and money began to pour into Greece. Unfortunately, these inflows soon led to unsustainable credit growth, as yields were historically low and credit conditions were extremely favourable.

Europe's monetary union has been built around the idea that the integrity of the union needs to be protected from the fiscal profligacy of its member states. This idea is solidified in the Maastricht Treaty fiscal rules, which – in addition to the sovereign debt and the annual budget deficit thresholds – state that no member country should have an inflation rate higher than 1.5 per cent, and that the union will not assume or be liable for the commitments of member states' central governments. The bottom line of this is that the union will not bail out its members if they have not respected the rules. In 2001, the year that Greece joined the EMU, its balance sheet satisfied the deficit criteria, but in

2004 the government revealed that its entry figures had been fudged and the numbers had been doctored since. For example, Greece declared its deficit for 2003 to be 1.7 per cent of GDP, but the European Commission found it to be 4.6 per cent (and later estimates put it much closer to 9 per cent[20]). In 2005, the right-wing New Democratic government committed to a harsh austerity programme in an attempt to get the Greek finances back in line.

Once again, things started to look up for Greece – its economy grew by more than 5.6 per cent in 2006 and 3.3 per cent in 2007 – but the outbreak of the global financial crisis would drastically reverse this trend. Europe went into recession in the first quarter of 2009 and Greece's tourism and shipping industries were hit hard. It felt the blow more so than many other countries in the euro area because its fiscal position was already weak. Tax revenues slumped and Greece was pushed to the verge. Voters were ready for a change and the social-democratic PASOK party led by George Papandreou was voted into office in October 2009. In April, the government had announced that Greece's 2009 deficit would sit at 3.7 per cent of GDP, but shortly after coming into office Papandreou revealed that – again – Greece's deficit was much larger than declared. The figure was amended to a whopping 12.5 per cent of GDP, which pushed Greece's debt ratio from 99 per cent of GDP to 115 per cent – an amount that the country simply could not manage.[21] Greece's credit ratings deteriorated and investors and banks everywhere dumped their Greek holdings. This pushed up the cost of borrowing and further exacerbated Greece's debt as revenues dwindled.

This episode marked the beginning of the European sovereign debt crisis that dragged on until 2015 (although the worst of it was over by 2012). It served as a brutal wake-up call for the many European governments that, up until then, had considered the global financial crisis to be an Anglo-American problem born out of investment banks' complex financial instruments with limited use in Europe's rather unsophisticated and so less interrelated financial system. With the revelation of Greece's fiscal troubles it became clear that not all debt issued by euro member states was equal vis-à-vis financial risk, and some sovereign debt was much more risky than others.

During the first couple of months of 2010, roughly €14 billion were withdrawn from Greek banks and transferred to other places in the euro area that were deemed safer.[22] It wasn't long before the Greek debt was downgraded to junk status. Greece found itself completely shut out from the bond market and a default in the near future seemed inevitable. Finally, in May, the Troika agreed to support Greece with €110 billion, the equivalent of 44 per cent of the country's GDP (or 30 per cent of its public debt). Greece received a second €130 billion bailout in 2012 and a final €86 billion in 2015. This support was conditional on Greece implementing a harsh programme of spending cuts and economic reforms that would leave the country ravaged. Salaries and pensions were slashed, health conditions deteriorated and unemployment rates skyrocketed to levels higher than those seen in the United States during the Great Depression.

LENDERS OF LAST RESORT

I have already mentioned that the Maastricht Treaty dictates that the EU would not bail out its members even if they are on the verge of financial collapse. So how exactly did Greece end up with a bailout package – and why was the IMF involved? The answer is that a financial safety net was eventually provided to Greece when it became clear that a Greek default would have a detrimental impact on the rest of the euro area and potentially the rest of the world.

After the revelation about the state of Greece's public finances in 2009, it was estimated that the country's debt would remain unstable unless the government cut public spending by 14 per cent of GDP and increased its tax revenues by the same amount.[23] Politically, this was an impossible task. It was clear that at some point the Greek debt would have to be restructured and would likely need to involve the IMF. Recall the discussion in Chapter 3 about the shame experienced by the Asian countries that in 1997 had to turn, cap in hands, to the IMF. Calling on the IMF is never good for a country's confidence, but it is particularly humiliating for a European one. Before the Greek crisis, the IMF had not had much involvement in Europe for the previous thirty-odd years. Furthermore, if the Greek debt was to be restructured, Greece would surely be cut off from short-term borrowing and inevitably default on its debt soon after. At the time, Greece's debt amounted to roughly €293 billion; around two-thirds of this was foreign owned, with European banks holding around €90 billion worth and pension and insurance funds holding the same amount.[24] A Greek default would resonate throughout the entirety of these holdings and would threaten the integrity of the euro itself. So, debt restructuring seemed the solution, but if Greece's debt could be restructured, what did this say about the quality of the rest of the euro area debt? The question, therefore, was how to go about restructuring the

Greek debt, with some significant write-downs and losses inflicted to creditors, but without triggering a panic across the whole euro area.

Germany was outraged when it learned of Greece's fiscal cover-up and promptly made it clear that it would not allow its taxpayers' money to be used to bail out a country that had so blatantly broken the rules. Without mincing her words, Angela Merkel told the German parliament that Greece was a risk for the euro and should consider leaving the monetary union. As at the time of the Lehman Brothers collapse, 'moral hazard' was invoked against Greece. Merkel was adamant that the EMU's principles of no bailout and no monetary financing of public debt could not be violated. Although German banks were exposed to the Greek debt, Merkel was happy for the debt to be written down and for Greece and its creditors to be left to fend for themselves. Germany's stance sent investors running for the exit.[25]

The sentiment in France was quite different. President Sarkozy let it be known that he did not want a crisis and opposed the restructuring of the Greek debt. If the Greek debt was to be written down, this would have directly impacted on France as it was the French banks that were most exposed. Indeed, BNP Paribas was the largest foreign holder of Greek debt. Although the nominal value of the Greek debt was relatively small, France was still reeling from the financial crisis. Its banks' balance sheets were a long way from recovery and Sarkozy knew that the public could not swallow another bank bailout. France was also strongly opposed to any IMF involvement. Unconcerned with the Maastricht Treaty fiscal rules, France favoured the mobilisation of funds to bail out Greece, as this would support the network of debt in which it had a large share.

The ECB led by Jean-Claude Trichet sided with France to the extent that it didn't want the Greek debt to be restructured, but it didn't want to provide Greece with emergency liquidity either. Its mandate dictated that it could only lend against good collateral – which clearly the Greek debt was not – and Germany wouldn't have allowed it regardless. The actions of the Fed and the Bank of England in 2008 have taught us that, in such circumstances, central banks need to provide liquidity or make active purchases in order to stabilise the markets, but the ECB flat-out refused to purchase Greek bonds.[26] This news reached the market and chaos broke out. The European interbank market ceased functioning, just as had happened on a global scale in 2008, and the euro fell to a four-year low against the dollar.

Fabrizio Saccomanni, then Bank of Italy's Director General and subsequently Italy's Finance Minister, tellingly recalls the question that Chinese policymakers repeatedly asked him during a visit to China in April 2010: 'Is the euro a true currency or is it just a basket of currencies, from which individual countries are free to come and go?'[27] To Saccomanni, a fine observer of European affairs, the Chinese question was a clear sign that the euro was on the brink. Indeed, the Chinese were looking at the risk implicit in each of the currencies that compose the euro – a basket of all member states' currencies – rather than at the euro as a whole. It was crystal clear that the breakup of the monetary union was a real possibility and the stability of the euro was under threat.

While France and Germany were arguing over the course of action, the heat was turned up for Greece.[28] It had debt repayments looming and it was not at all clear where it would get the funds from. In an act of desperation, Greece turned to the United States. The US administration knew well that Wall Street was exposed by hundreds of billions of dollars in French banks that in turn held a large chunk of Greece's sovereign debt – and it was hardly in a position where it could take another blow. There was no more time for bickering. The United States dictated that the EU would bail out Greece and that the IMF would be involved – and hence Greece's first bailout was secured. As we already know, this initial loan to Greece was not sufficient as it required two additional bailout packages further down the line. Although it allowed Greece to pay its creditors, it was not enough to feed back into the Greek economy, address the structural problems and generate stability. But as long as the instability was prevented from spilling into its markets, the United States was content.

As it wasn't just Greece that was in trouble, but the euro too. It was agreed that the EU would set up a European Financial Stability Facility (EFSF) that could be extended to the other vulnerable European countries. It would consist of €60 billion from the EU Commission, €440 billion from the EU governments and a further €250 billion from the IMF. The EFSF was a temporary emergency measure and was subsequently replaced by the European Stability Mechanism (ESM) towards the end of 2012. To receive an ESM loan the member state must be threatening the financial stability of the entire euro area and it must implement a reform programme in return. This fund had enough to support countries such as Greece, Ireland (which requested assistance in November 2010) and Portugal (which requested assistance in April 2011) that have relatively small economies, but not the larger ones such as Italy.

Calm was finally restored in 2012 when Mario Draghi, who had recently taken over as the ECB president, announced that the bank was ready 'to do whatever it takes to preserve the euro', cunningly adding 'and believe me, it will be enough'.[29] This marked the switch of the ECB towards fully embracing the role of 'lender of last resort', extending it to cover financial stability as well as bank stability. Playing the role of lender of last resort means that central banks provide liquidity to the commercial banking system in times of stress by lending against good collateral and charging interest rates. This function is now critical to our modern economy. Without the assurance that a central bank is both willing and able to provide liquidity, problems specific to one single bank will likely cause savers to withdraw their funds from other banks too. What this means is that a solvency crisis that begins in a specific part of the system can quickly evolve into a systemic liquidity crisis that has the potential to bring down the entire system. Unconstrained capital flows mean that a lender of last resort cannot limit its action to commercial banks. As it became evident throughout the unfolding of the Greek crisis, the lender of last resort should be prepared to provide liquidity to the bond market by actively intervening if a lack of liquidity and rising interest rates threaten to trigger a sovereign debt default.

In September 2012, resisting the opposition of Bundesbank President Jens Weidmann, Draghi launched the Outright Monetary Transactions (OMT). According to this programme, the ECB could buy bonds in potentially unlimited quantities and intervene in the financial markets of countries that were going through programmes of macroeconomic adjustment. Even if ECB intervention was conditional and based on the ECB assessment of the monetary situation, it was enough to calm international investors. The message was clear: the financial difficulties of member states are not going to jeopardise Europe's single currency. The risk of financial contagion subsided.

WHO SETS THE RULES?

Ultimately, the ECB rescued the euro and set up a safety net around Europe's monetary union. Mario Draghi firmly put the issue of the stability of the euro into the hands of the central bank where decisions are based on technical assessment and formalised by majority voting, rather than relying on the political judgement of member states as had been the case until then.[30] The measures that the ECB took were effective – Greece did not bring down the euro and when Italy went through a banking crisis in 2015, it had a limited impact on the rest of Europe. But they also left many deeply unsatisfied, especially in Germany, where the government had outright opposed such intervention. The OMT and the use of unconventional monetary policy pushed the ECB to trespass in policy areas that weren't strictly in its remit.[31] Was this a step too far in extending the power of a non-elected body?

It didn't seem so at the time. The depth of the financial crisis caused a state of emergency that dictated prompt and effective action – 'whatever it takes'. Increasing the functions and powers of the central banks seemed like the right thing to do. But such interventions are not neutral and have implications for collective welfare – i.e., how financial support is distributed and managed – and for the legitimacy of the existing institutional order. For how much power can be delegated to unelected technocratic bodies without undermining their legitimacy?

The issue of how to shape a balanced relationship between democratically elected bodies and delegated bodies lies at the core of organisations like the WTO, the IMF, the multilateral development banks, and the OECD. By providing the infrastructure (including data and analysis) critical for the implementation and monitoring of the rules that inform the international economic order, these institutions increasingly play a decisive role in shaping and influencing the economic policies of sovereign states that are part of such order.

It is widely assumed that the transnational and international institutions are legitimate because they emanate from legitimate sovereign states and function on the principle of delegation that in turn informs their governance. However, transparency and accountability are often lost in bureaucracy-led processes and non-disclosure practices. In addition, communications are often so full of jargon that they become incomprehensible for the general public. As a result, how these institutions operate, their goals and their achievements are often ignored by the electorate. In recent years the World Bank, the WTO and the IMF have promoted broader and far-reaching engagement with the general public, but these initiatives remain relatively limited.[32]

The IMF has a long history of strained relations with its member states, but the state of emergency presented by the euro crisis trampled over democratic principles on an unprecedented scale.[33] Indeed, during the crisis resolution, the preservation of the international economic order and the stability of the world economy were given priority vis-à-vis the decisions and preferences of democratically elected national governments. From here it was easy to conclude, as many voters did, that the governance of the international system, with its unelected bureaucrats, can dictate terms and conditions to elected national politicians. In January 2015, for instance, the Greek electorate voted in the anti-establishment Syriza party led by Alex Tsipras on the grounds that they would negotiate a more tolerable burden for Greece, but their aspirations were crushed by Germany. German Finance Minister Wolfgang Schäuble told his Greek counterpart, Yanis Varoufakis, that 'elections cannot be allowed to change economic policy'.[34] It did not matter what the Greek voters wanted.

It is similarly uncomfortable recalling how France, Germany and the United States persuaded – or coerced – Italy's Prime Minister Silvio Berlusconi to step down amid strong market turbulence. The risk was that Italy would eventually be unable to manage its public debt that was – and still is – too large to be rescued. At the 2011 G20 summit in Cannes, a handful of leaders from these key countries cornered Berlusconi and put him under huge pressure to resign. A participant later described the ordeal to me, saying Berlusconi 'was like dead meat'. By that point, Berlusconi had been hugely discredited and his government was certainly ineffective. Everybody – myself included – was happy to see the back of him and there was a sense of relief when a group of technocrats led by academic and former EU Commissioner Mario Monti were appointed in his place. But Berlusconi, for all of his faults, had been legitimately elected, whereas Monti was not. In this instance, the objective of rescuing Europe and possibly the world from another financial crisis could arguably justify the means of stamping over the government of a sovereign country, but it is not always obvious where the line should be drawn.

DEBT AND POLITICS

In February 2015, during an impromptu visit to London, Yanis Varoufakis, the flamboyant academic turned Greek Finance Minister, tried to win the sympathy of the financial community over a private dinner. He attempted to make the case that Germany's inflexible approach to the Greek crisis and too much austerity risked radicalising voters and turning them against Europe. A few weeks earlier, the Greek electorate had voiced their discontent and voted in Syriza on the pledge to negotiate a debt write-off and end austerity. At the time of the election Greece's economy was 25 per cent smaller than it had been in 2010 and in recession for six consecutive years. Public debt had shot up to 175 per cent of GDP, which in absolute terms was just over €320 billion. This signified the collapse of the traditional two-party system which had been in play for more than forty years. It opened the door to a movement of amateur politicians that sought a new political narrative with their European partners.

The other invitees at the dinner viewed Varoufakis's argument with some sympathy, although his manners and approach to debate did not go down well around the table. A former finance minister of Luxembourg quietly told me: 'Good luck to him, but he needs to learn how to negotiate if he wants to achieve anything with the Eurogroup.' Varoufakis put forward a couple of ingenious proposals to get Greece off the hook and allow the new government to fulfil its electoral promises, but fellow diners immediately raised the spectre of moral hazard. After all, international markets rely on the notion that international commitments will be honoured, otherwise there would be no basis on which lenders would be prepared to underwrite government debt, especially in the long term.

But Varoufakis was adamant that 'the notion that previous Greek governments signed on the dotted line on programmes that haven't worked, and that we should be obliged to just follow that line unswervingly, is a challenge to democracy'.[35] Armed with this notion he stormed Europe's austere ministerial meetings. Many leaders across the board became convinced that Greece had had a pretty rough deal and should not be left to collapse under an excessively draconian austerity plan. For a short period of time in 2015, Greece's Syriza government had the potential to put the debate over the future of Europe on a new track, but lack of government experience ended up limiting the scope for negotiation and compromise. The new ideas and energy that were coming out of Greece failed to be channelled into a positive reformist agenda that could be extended to progressive forces in other countries, including Germany.

Ultimately, Greece's troubles faded back to irrelevance as the risk of financial contagion subsided, but this did not bring an end to the story. All over Europe, and to some extent in the United States, the crisis of traditional politics is linked to the impossible compromise highlighted by Varoufakis, that between long-term commitments that were signed by legitimate, but former governments, and voters' current preferences and the agenda of the latest government to be voted in. Is following the latest preferences more democratic than honouring previous commitments?

Looking at Italy and Greece, the moral of the tale is clear: dealing with debt can disrupt domestic politics, especially when the adjustment required as part of the debt-management strategy disproportionally hits the most vulnerable in society. For debt-afflicted countries, either they play by the rules – and those in the single currency fit in the monetary straightjacket – or they risk losing market confidence and so undermining or even stopping capital flows that are necessary to refinance the existing debt. This, as we have seen in Greece, can bring havoc or simply push up the cost of servicing the debt as in the case of Italy.

Many of the political parties that were in power during the crisis have been pushed out. Despite having worked towards mitigating the impact of the crisis, in the UK the Labour Party led by Prime Minister Gordon Brown lost the parliamentary majority in the May 2010 general election. The same happened in Spain, Portugal and Greece. In Greece, the July 2019 election saw the return of the centre-right New Democracy party led by Kyriakos Mitsotakis on an anti-immigration and domestic security agenda that attracted voters that had previously turned to the far right.

Experienced (or market-oriented) politicians understand the market game and are prepared to play it. To borrow the words of Jean-Claude Juncker who, having served as prime minister of Luxembourg between 1995 and 2013, and president of the European Commission between 2014 and 2019, is easily one of Europe's most seasoned politicians: 'Politicians are vote maximisers [. . .] for the politician, the Euro can render vote-maximising more difficult, as a smooth and frictionless participation in the monetary union sometimes entails that difficult decisions have to be undertaken or that unpopular reforms have to be initiated.'[36] Juncker clearly refers to Europe's monetary union, the most constraining framework that countries can sign up to. But this is true for all countries that are exposed to capital markets, for debt is in principle at odds with democracy if debt management imposes policy choices that are difficult to reconcile with voters' preferences.

Most politicians are fully aware of the restraints and the inability, in democracy, to square long-term market commitments with short-term advantages that derive from having plenty of capital and debt-funding to grow their economies. Apart from the United States with its dollar privilege, all countries need to choose between domestic political equilibrium and external market commitments if they want to operate within open capital markets.[37] In the next chapter, I will explore how attempts to square international markets with domestic political preferences is creating cracks in the international order, especially when large developing countries like China are facing neither capital movements nor voters' preferences. I will reconnect the discussion on crises to the international economic order. Indeed, the issue of how to reconcile the policy framework that is consistent with financial stability and capital mobility, and the mandate of democratically elected governments has international implications.

6
SHOWING THE CRACKS

> *The liberal idea of freedom thus degenerates into a mere advocacy of free enterprise [. . .] the fullness of freedom for those whose income, leisure, and security need no enhancing, and a mere pittance of liberty for the people, who may in vain attempt to make use of their democratic rights to gain shelter.*
>
> Karl Polanyi, *The Great Transformation*, 1944

The international order is currently under stress and unfettered capital flows are the cause. As money moves around the world, it distorts the distribution of resources, generates crippling inequalities, spurs price bubbles and spreads instability. Put otherwise, capital flows increase the scope for financial imbalances. In countries all over the world, unfettered capital has resulted in financial instability and domestic policies have consequently been guided – and limited – by the need to win back the confidence of international investors. Because of the interconnectedness of the global financial system, time and time again, financial instability has threatened to have such dire consequences that the need to maintain market confidence has ridden roughshod over the wants and needs of the electorate. What we have ended up with is a situation where the steps that are considered necessary for maintaining the international order are going against liberal democracy – the very thing that it is intended to protect.

In this chapter, I will examine the cracks that are threatening the stability of the international order. There are four broad lines along which cracks have developed. First of all, the recent string of financial and economic crises – bank collapses, the dry-out of bank credits, corporate bankruptcies, stagnant economic activities, deflationary pressures and rise in unemployment – have increased the demand for enhanced sovereignty. This has left our political systems strained and the dialogue corroded. The assumption that the system could be reset after the crises without questioning whether financial integration and unconstrained capital movements are incompatible with democracy was a huge mistake. It has resulted in nationalistic reactions in all the countries at the core of the Bretton Woods system. The case of Britain and Brexit is of particular importance because of the United Kingdom's history, but the story behind it is in no way unique. Many voters have turned to parties and movements that were not involved in the financial crisis and predicate the defence of national sovereignty against global markets. In the face of economic constraints, the traditional parties in the traditional political systems in Europe and in the United States have been eroded.

Second, the 2008 crisis and the following disruption that emanated from Wall Street have challenged the idea that market-based, rules-light capitalism – the American economy being the archetype of this – delivers better outcomes than state-directed economic models. Many developing countries bought into the Washington Consensus and accepted the model of development that is predicated on open markets, free trade and unconstrained capital movements.

China, however, begs to be different and has pursued 'socialism with Chinese characteristics'.[1] Throughout the 1990s and early 2000s, China free-rode on the liberalisation of international trade, but did so with controls on capital flows and hence on the domestic banking and financial sector also. In other words, China adjusted the rules of the game to fit with its long-term plans. By ignoring the Washington Consensus of open markets and liberalised capital flows, China has maintained its policy autonomy. I will discuss China in the next chapter.

Third, the disenchantment with market-based, rules-light capitalism has removed the incentive to play by the rules, and so be a part of the international order. Such an incentive has helped to restrain destabilising impulses in some countries, especially large emerging market economies. For years, even non-liberal and authoritarian countries have opted to engage with the international economic order instead of being excluded and confronted. But now that the benefits of such an order are under question, we are seeing more contested geopolitics and the resurgence of state-based threats.

Finally, democratic politics in each country looks inwards rather than outwards with countries prioritising domestic issues over international ones.[2] The once perceived benefits of openness have been cast by the wayside and the threat to the global order can no longer be ignored. If international cooperation was possible immediately after the collapse of Lehman Brothers, it has now become much more difficult. As Hank Paulson, the US Treasury Secretary at the time of the Lehman collapse, asked in the runup to the 2016 presidential primaries: 'what would have happened if a divisive character such as Trump were president during the 2008 financial crisis?'[3] Clearly this question is rhetorical, but it works well to frame a clear and comprehensive understanding of recent events. Indeed, close international cooperation is critical for keeping the economic order in equilibrium and containing instability when crisis hits. International cooperation is difficult to maintain, because it often conflicts with national interests. It is impossible, however, when countries start from an uncompromising nationalistic position where domestic interests are too strong or the domestic political costs are too high. It always helps to have a country prepared to lead (which will also provide a safety net in the form of financial assistance when necessary) and cajole the others into cooperating. This has been the United States' role since the end of the Second World War , but now Trump's 'America first' approach is poisoning the well of multilateralism and undermining the rules-based multilateral order.

So, should we find that the US-led international order, and the dollar-led international monetary system, cannot withstand the pressure that it is currently under, are there any contenders that are both willing and able to take on the role of leader? China seems to be the obvious contender; its economic weight has grown exponentially over the past decades. However, China does not have the political or financial and monetary strength to take on this role. I will turn to China's limits in the next chapter. I now consider a number of examples that epitomise the cracks within and the issues currently facing the international order.

WORKING POOR AND THRIVING ELITES

The financial crisis was the final straw for many people. The general public ended up paying the price for rescuing the banking and financial system. The bailout packages may have been necessary to prevent a banking collapse, but they drained the public resources in many countries and brought about draconian and hugely unpopular austerity measures that impacted on many people. In Britain, in 2010 the newly elected Conservative and Liberal Democrat coalition government ushered in an emergency budget to correct the public debt trend that had reached a 'record' high. When George Osborne, the Conservative Chancellor of the Exchequer at the time, announced that the United Kingdom 'had to pay the bills of past irresponsibility', it was clear he was opening the door to an age of austerity.[4] The idea was that the confidence of foreign investors would be restored if Britain was able to repay its expanded debt. In order to bring down the deficit and reduce public debt to 67 per cent of GDP within five years (i.e., by 2015–16), it was necessary 'to accelerate the pace of fiscal consolidation'. Drawing on an academic paper by economists Carmen Reinhart and Kenneth Rogoff indicating that debts above a 90 per cent threshold have an adverse impact on economic growth,[5] a tough programme of spending cuts was implemented. This paper was intended for discussion and comment rather than for setting specific policy targets.[6] However, the austerity-prone UK government handled it as evidence for the necessity of their cuts anyway.

It is important to remember that the United Kingdom is not an 'original sinner': it has an advanced economy and an international currency that it can borrow in, so there is more in this story than just the need to rein in public debt. In 2013, David Cameron conceded that the ultimate goal of the British government's austerity programme spanned further than the reduction of debt and touched upon 'something more profound'. Indeed, Cameron was determined to shrink the state, to make it 'leaner [. . .] not just now, but permanently'.[7]

Extremely accommodative monetary policy and constrained fiscal policy did result in money flowing into Britain from all over the world, supporting a runup in prices of all assets. As a result, house prices skyrocketed, especially in the most dynamic areas of the country and notably in London. This shut many young people and low-middle income families out from the property market. The austerity programme ended up undermining the post-crisis recovery and disproportionally affecting low-income families and local communities. As the UN Special Rapporteur[8] on extreme poverty and human rights put it: 'the bottom line is that much of the glue that has held British society together since the Second World War has been deliberately removed and replaced with a harsh and uncaring ethos. A booming economy, high employment and a budget surplus have not reversed austerity, a policy pursued more as an ideological than an economic agenda.'[9]

Remember the postwar golden age that I explored in Chapter 1? This standard of living is increasingly out of reach for those who haven't been born into a solid middle-class background, which typically comes with a good education, professional skills, contacts and inheritable assets (usually in the form of residential properties). Housing costs are so high that home ownership is no longer possible for many young people unless they receive financial help from their families. Education is increasingly expensive. In the United States, student debt has become the main cause of personal bankruptcy. And health conditions have become a clear dividing line between those who can afford a healthy lifestyle with plenty of fresh food and opportunities for exercise and those who cannot. There is a 9.5 year gap in the life expectancy for men living in Kensington and Chelsea, the area with the highest household income in the United Kingdom, and those in Blackpool, one of the poorest.[10]

In Britain, the United States, and increasingly in many other advanced economies as well, more and more people are finding themselves trapped in poverty – and unemployment is no longer the main cause. What is causing this dire fate is rather the combination of low pay, high living costs and debt. The conditions for unskilled workers have considerably worsened in recent years. Innovations in technology have resulted in the automation of many manual tasks, many blue-collar jobs have been lost in industries that have been relocated to low-income countries and, as a result, many blue-collar workers have been demoted to low-skilled jobs. In many of these jobs, especially at the lower end of the services sector – for example, personal carers and cleaners – locals compete with immigrants. This has generated significant tension and a toxic anti-foreigner political narrative.

The UN report highlights that approximately 14 million people, or almost a fifth of the population, are currently living in relative poverty in the United Kingdom.[11] In 2017, 4 million of these people were living with an income more than 50 per cent below the poverty line, and 1.5 million were destitute, unable to afford basic essentials.[12] Around 60 per cent of people in poverty in the United Kingdom belong to a family in which someone works, while 50 per cent of them are working – the in-work poverty rate is on the rise.[13] In 2018, the in-work poverty rate grew more than the rate of employment, and is currently the highest it has been in twenty years. The Trussell Trust, the largest national food bank charity, reported that a sixth of people referred to them are working.[14]

Homelessness in the United Kingdom is also on the rise; it increased by 60 per cent between 2011 and 2017, and rough sleeping surged by 165 per cent during approximately the same period.[15] Housing in regions with plenty of jobs is unaffordable and the stock of publicly owned houses has been depleted. This is due to the lack of public investments in housing, but also Thatcher's 'right to buy' policy which has since resulted in the sale of around

2.6 million council houses.[16] There are currently 1.2 million people on the social housing waiting list, but only a fraction of that number of homes are built every year. Cuts in spending mean limited resources for assistance and welfare, and pressures are building as the UK population gained more than 8 million people between 2000 and 2017.[17]

The financial crisis was severe for Britain's banking and financial sector, but the austerity programme implemented in its wake has opened up a deep fracture in British society between the establishment and those who are perceived as part of it, and those who are not. The divide runs along the lines of political and economic power, influence, opportunity, education and health conditions – also insecurity and stress. But divided communities are time bombs that will eventually bring down institutions and political systems.

Thus, the membership of the EU became the lightning rod for a large and mixed bag of discontent. The United Kingdom's relationship with the EU has been difficult for a long time and was not helped by Black Wednesday in 1992, when sterling was forced to abandon the EMS (as I discussed in Chapter 3). When David Cameron called the EU referendum, he myopically assumed that a clear victory for the pro-European vote would put to rest the eurosceptic faction within the Conservative Party led by Boris Johnson and Michael Gove. As a member of the urban, educated, wealthy and connected elite, Cameron underestimated the extent of social discontent that came as a result of the austerity programme implemented under his leadership, and the fact that this discontent could find a channel in the vote on the EU referendum. Indeed, in the runup to the referendum, the polling group ComRes found social class to impact on people's voting intention, with 60 per cent of those in the upper-middle or middle class supporting EU membership but only 43 per cent of unemployed and unskilled workers doing the same.[18] In addition, the refugee crisis in Europe, coupled with the extensive media coverage that, just before the referendum, seemed designed to scare people, contributed to push people to vote for Brexit. As a result Cameron's ploy to use the referendum to eventually placate the eurosceptics within the Conservative Party backfired, ushering in more than three years of infighting and a crisis of the two-party political system. By winning an eighty-seat majority in the general election of December 2019, the Conservative Party led by Boris Johnson got a mandate to take the country out of the EU on 31 January 2020 – almost three years since serving notice to the EU as per article 50 of the Treaty of Lisbon.[19]

THE ROAD TO BREXIT

The defining characteristic of the international order is openness. The United Kingdom is undoubtedly the pioneer of this trait and hence it is the nation whose prosperity has depended on it for the longest. In Chapter 1, I showed how Britain was at the centre of the international order in the nineteenth century when the industrial revolution ushered in the first wave of globalisation. Many of the intellectual underpinnings of globalisation have come out of Britain. It is British economist Adam Smith, for example, who is considered to have 'fathered' modern trade theory in the eighteenth century, and British economists John Stuart Mill and Norman Angell who championed the idea that trade is economically and politically advantageous over war. (But it was Prime Minister Sir Robert Peel who in the late 1840s, on the back of the Irish famine, abolished the Corn Laws, setting Britain on the path to an open market for grains and commodities.) As I discussed in Chapter 2, the Bretton Woods system was created against a backdrop of vast debate and it was British economist John Maynard Keynes who provided the intellectual leadership at the Bretton Woods conference. It may be the case that the United States financed the establishment of the international order and still plays the role of leader; but openness – its trademark feature – has ultimately been championed by Britain.

This is the background against which British voters cast their vote in favour of leaving the EU – the most liberal experiment of our times – on 23 June 2016. By 2015 half of Britain's exports were going to the EU; half of Britain's $1.2 trillion stock of foreign direct investment came from the EU and 1.2 million UK citizens permanently lived in the EU.[20] However, the EU is not just a project that underpins free trade and free movement of people – it is also a project that promotes peace among the nations that fought against one another for centuries on the battlefields of Europe, protects human rights and cares for the environment. So how can it be that Britain came to turn its back on the EU?

There are many complexities in maintaining an open economy and Brexit epitomises the tension between openness and national sovereignty in areas such as trade policy and migration – i.e., the EU's two fundamental principles of free movement of goods and free movement of people. Indeed, in the Brexit narrative, it was the mantra of 'returning' power to the UK parliament – or 'taking back control' against the free movement of people and stopping the EU from interfering with domestic policies – that persuaded 52 per cent of the voters that leaving the EU was the best option for the United Kingdom. Critically, the Vote Leave campaign grossly misrepresented the number of the EU nationals living in the country, claiming that they were draining the NHS, and made the unsupported promise that £350 million saved from weekly contribution to the EU could be spent on the NHS.[21] In May 2016, just a month before the Brexit referendum, the Office for National Statistics announced that net migration had reached 333,000 – the second highest figure on record.[22] This came in light of the fact that David Cameron had long pledged to cut net migration to the tens of thousands.

However, as discussed in the previous section, the root of the problem in fact lies in free-flowing capital and the instability that this has caused, with the most important event being the 2008 global financial crisis. The severity of the financial crisis demanded a political response, but voters were left short-changed when 'business as usual' was reinstated. The lack of a tangible response to the crisis and the austerity programme imposed in its wake fractured British society and pushed the domestic reaction to evolve into a nationalist one, where a supranational structure like the EU – with its power by delegation and unelected bureaucrats within the European Commission – is perceived as interfering in the domestic affairs of sovereign states.

With Brexit, the United Kingdom faces the costs of being a middle power – no longer a super-power – that for years has been punching above its weight. It experiences the challenge of managing its own sovereignty – assuming that this is a viable concept in a world of unconstrained capital flows – against a background of resurgent state-based threats. As the then Security Minister Ben Wallace summarised the problem, there is 'obviously the question of the behaviour of a number of states. We're British – we believe in fair play [. . .] how do we maintain a level playing field and fair play that allows foreign investment, foreign access to our markets, and vice versa, but people don't exploit that goodwill to steal and cheat?'[23] This statement came in the middle of Donald Trump's controversial state visit to Britain in June 2019 when geopolitical tensions between the United States and China vis-à-vis Huawei and the 5G network were particularly fraught. I'll return to the topic of state-based threats later on in this chapter and in the meantime I turn, again, to Italy, the other country that was caught up in the Black Wednesday of 1992. The global financial crisis completely crippled Italy's already fragile economy; decades of sluggish growth and dysfunctional politics are undermining social cohesion.

ANTI-EU SENTIMENT IS RIFE IN ITALY

In August 2019, after just over a year at the helm of the coalition government, Italy's Prime Minister Giuseppe Conte resigned, only to be reappointed a few days later in charge of another coalition government. The constant bickering and fundamental divergences among the coalition partners had made agreeing on policies within the government almost impossible. This government had been formed in June 2018, when the right-wing chauvinist Lega[24] and the anti-establishment Five Star Movement unified over a political narrative that blames Italy's stagnation on the German-inspired fiscal austerity programme that resulted from the sovereign-debt crisis, and conveniently associates the country's economic malaise with the euro.

Rather than focusing on a coherent programme to improve productivity growth – Italy is one of the worst performing countries in the EU[25] – and support economic growth, the coalition government prioritised extending benefits such as a watered-down version of the basic universal income (Five Star) and tax cuts (Lega). This inevitably put the government at odds with the European Commission. The latter was concerned that Italy's proposed rise in public spending would expand its deficit beyond the 1.6 per cent of GDP target agreed for the 2019 budget. The government put pressure on Brussels to agree to more fiscal leeway, but without giving any indication of how Italy's sovereign debt could be held steady, if not reduced. Using public spending to patch up structural economic problems and buy consensus is a long-standing practice in Italian politics, but this has become wildly unsustainable given that the country has deep structural economic problems and chronically low growth, as I discussed in chapter 5.

Both the Five Star movement and the Lega regularly go head-to-head with the European Commission to affirm Italy's sovereignty over Brussels. But, in a world where capital moves in and out of markets freely, sovereignty – and especially fiscal sovereignty – is a fluid concept. International investors have not been shy to voice their concerns regarding Italy and, as we have seen repeatedly throughout this book, governments that struggle to maintain credibility in the eyes of international investors find it difficult – if not impossible – to refinance their debt when the money eventually leaves the country. Italy has all the ingredients for this to happen: stagnant growth, delays in the improvement of its debt position, a weak banking sector, falling saving rates – and no perceived urgency, let alone a clear plan to address structural reforms. With the eurosceptic members of Italy's government openly advocating leaving Europe's single currency, the spread between the interest rates applied to ten-year Italian and German sovereign bonds more than doubled between March 2017 and October 2018, hitting over 300 basis points.[26] As German bonds are considered to be extremely safe, investors were saying that they would only hold the risky Italian bonds if they were adequately compensated for doing so. (The spread narrowed in 2019 in response to expectations of a reversal of monetary policy tightening in the United States, and then again during the summer 2019 when the Lega dropped out and a new coalition government between the Five Stars and the centre-left Democratic Party was formed.)

Even more so than the issue of keeping public spending within the agreed targets, it is the migration crisis that has put a strain on Italy's relationship with the EU. In 2015, nearly 154,000 refugees arrived into Italian ports via the Mediterranean from the Middle East and Africa, with a further 181,000 arriving the year after. European cooperation crumbled in the face of domestic opposition to immigration; only a fraction of the refugees were relocated to other EU member states and a number of countries have been active in preventing the newly arrived migrants from entering their territories. France, for example, created a deadlock with Italy by suspending the application of the Schengen treaty.[27] 'We should send them all to Marseille, but we count for nothing in Brussels', I overheard an Italian man lamenting on a train between Rome and Milan, with 'them' referring to the refugees who had escaped the hell of Libyan immigration centres only to be refused permission to dock in the harbour of Lampedusa at the order of then Interior Minister, Matteo Salvini.[28]

Indeed, the migration crisis has cemented an Italian-style euroscepticism where economic motivations are laced with concerns about control of borders and national security. Like the Brexiteers, the Italian eurosceptics list the control of immigration coupled with an independent monetary policy – read, the ability to depreciate the currency in order to gain trade advantages – and an unconstrained fiscal policy as the key advantages of breaking up with Brussels (they are less clear about the many problems that this will create). Against this background, and confronted with the erosion of intra-EU solidarity, Italy has opted to foster better relations with Russia, as a way to diversify its risks given its exposure to problems in the Mediterranean and the Middle East, a region where the Russian government has been actively engaged.[29]

So, will Italy bring down the euro as an act of defiance against Brussels? Or will Italy's economic problems, coupled with a lack of robust economic policies, push the country and the euro to the point of no return? This is a question that has crossed many people's minds, as a fresh wave of chaos emanating from the Italian debt issue still remains a real and troubling possibility even if the ejection of the Lega from the government in August 2019 has reduced such a risk – alongside the renewed support from the ECB. With the deficit at around 2.3 per cent and GDP growth at 0.4 per cent it will be a herculean task to reduce Italy's public debt – at €2.4 trillion it is more than three times the size of the ESM.[30] Unlike in the case of Greece, the EU simply does not have the resources to backstop an Italy-driven financial crisis and member countries might conclude that pushing out Italy would be a better option.

MORE CONTESTED GEOPOLITICS

The idea that traditional political systems should be ditched in favour of direct democracy is attracting more and more people. In Italy, for instance, the Five Star movement has long theorised that online platforms where all voters have the opportunity to express their views directly are preferable to the current system of mediation via elected representatives in parliament. The widespread access to social media has fuelled the belief that opinions should be expressed anywhere and everywhere – so why sit around and passively receive the views of experts and politicians? This sentiment was evident during the 2019 UK local elections as some 'voters' uploaded pictures of their spoiled ballot papers to their social media accounts in a show of defiance; 'traitor', read one scribble, and 'none of these', read another.[31]

A poll conducted across ten countries just before the May 2019 European Parliamentary elections found that, on average, 45 per cent of Europeans believe that the rules of the EU are rigged to advantage the rich and powerful, and 52 per cent believe that the leaders of the EU don't care about people like them.[32] These figures reflect the widespread belief that Europe is a project run by the elites and for the elites. Civil servants working for the European institutions are seen to embody all the features of the international elite; they are mobile, well educated, well paid and enjoy all the alleged privileges that come with the job – like moving 'from dining room to dining room'.[33] Nigel Farage, former member of the European Parliament and leader of the UK Brexit Party (and formerly the UK Independence Party, where independence means independence from the EU), frequently refers to the bureaucrats working for EU institutions as 'the unelected gang in Brussels'. He has further branded the European Commission as undemocratic and anti-democratic.

Europe is going through some rough times and its progress – in terms of the development of the single market project and the freedoms of people, goods, capital and business – has been questioned. Is the European project actually sustainable in the long run without deeper political integration and concrete steps towards a more federal framework – as opposed to the current intergovernmental one? The English-speaking, British press repeatedly criticises the EU for being fundamentally flawed in its institutional design and implementation, but the reality is that the EU has been successful in creating a region where democracy, rule of law, economic prosperity and monetary stability have been combined with peaceful coexistence.

A few days before the 2019 European Parliamentary election, former UK Prime Minister Gordon Brown wrote a letter to the Electoral Commission, the independent body that oversees elections and regulates political funding in the United Kingdom. In his letter, Brown urged the commission to investigate the funding of the recently established Brexit Party and its leader, Farage. The controversy is around a mass of small untraceable donations under £500, as well as £450,000 donated by businessman Arron Banks. In both cases, the concern is that money ultimately came from foreign countries with a strong interest in derailing the EU, notably Russia.[34]

Concerns regarding Russia's meddling in elections are not confined to the United Kingdom. In March 2019, the Mueller report concluded a two-year investigation into Russian interference in the 2016 US presidential campaign. Interfering in other countries' elections is hardly a new occurrence, but never before have we seen allegations of a major emerging market interfering in countries belonging to the G7. Even more concerning is how technology and personal data are being used to target the political messages that people receive via social media and ultimately to manipulate their vote.

The Mueller report damningly concluded that Russia's Internet Research Agency conducted 'a social media campaign that favored presidential candidate Donald J. Trump and disparaged presidential candidate Hillary Clinton'.[35] It highlights how the Internet Research Agency sought to 'provoke and amplify political and social discord in the United States'[36] by purchasing thousands of Facebook and Instagram adverts, which reached around 150 million people, disinforming them on provocative issues such as gun control, police shootings and gay rights.[37] The ads were targeted at users interested in topics such as 'conservatism', 'deportation' and 'illegal immigration'. Another ad published after the election tried to heighten tensions again by encouraging Trump supporters to match a protest conducted by his opponents outside Trump Tower, the Trump Organization headquarters in New York.

In addition to the social media disinformation campaign, the Mueller report highlights connections between the Russians and Trump aides, citing a meeting on 9 June 2016 at Trump Tower to be of particular importance. Here, the president's son Donald Trump Jr, son-in-law Jared Kushner and campaign manager Paul Manafort met with a group of people with ties to the Russian oligarchy and the Kremlin, including the publicist Rob Goldstone and lawyer Natalia Veselnitskaya. Goldstone had approached Trump Jr via email with the offer of 'very high level and sensitive information' on Hillary Clinton. He described this as 'part of Russia and its government's support to Mr. Trump', to which Trump Jr responded: 'if it's what you say I love it'.[38] The Mueller report concluded that there was insufficient evidence to establish whether the Trump campaign had conspired with the Russians, but it left open the question of whether the president tried to obstruct justice. Ultimately the report failed to change any minds; a poll conducted by Ipsos for Reuters to examine the initial reaction to the report found 69 per cent of Democrats to believe that Trump should be impeached, but only 9 per cent of Republicans felt the same way.[39]

Fresh concerns regarding Russian meddling emerged in mid-2019 after Buzzfeed and the Italian media company l'Espresso obtained an audio recording in which high-ranking members of the Lega and Russian counterparts discussed a deal that would have seen tens of millions of euros illegally funnelled to the party through sham oil deals.[40] Although it is unclear whether the deal was actually executed, it is certainly not implausible. This sort of high-level collaboration between exponents of the Russian regime and prominent far-right forces in the EU is nothing new. Nationalist politicians ranging from France's Marine le Pen to the Dutch eurosceptic party FVD led by Thierry Baudet and Austria's Heinz-Christian Strache have been found to have accepted financial support from sources close to the Kremlin.[41] It is impossible to know the conditions on which the support was offered, but all these political forces are, needless to say, pro-Moscow – and advocate policies such as the recognition of Russia's annexation of Crimea and the removal of EU sanctions. Through its support for these parties, the Russian government hopes to change the political dynamic inside the EU and bring friendlier interlocutors for Moscow to the forefront of European power. However, this strategy has not yet produced great results for the Kremlin. Even when friendly parties such as Salvini's Lega have reached government, they have done little to push a pro-Russia line both within the national or European context. Sanctions remain in place, Crimea remains legally recognised as part of Ukraine and the EU as a whole maintains a distinctly confrontational attitude to its large eastern neighbour. However, these nationalist, eurosceptic and Russian-friendly parties have challenged the European project, underpinning Russia's domestic narrative of a shaky EU.

TROUBLES WITH RUSSIA

The United Kingdom's 2018 National Security Capability Review identifies the resurgence of state-based threats as one of the biggest challenges facing Britain. 'The risks from state-based threats have both grown and diversified,' the review states, 'intensifying wider state competition and the erosion of the rules-based international order, making it harder to build consensus and tackle global threats.'[42] As far as the British government is concerned, Russia, North Korea and Iran are the states that pose a threat to global security and stability. China has notably been omitted from this list – and is in fact mentioned as a strategic partner for the United Kingdom – while the United States is praised for continuing to be Britain's 'single most important international partner'.[43]

The review was published just a few weeks after the attempted assassination of former Russian military officer and UK double agent, Sergei Skripal, and his daughter Yulia in Salisbury. The British government was quick to point the finger of blame, claiming that 'the indiscriminate and reckless use of a military-grade nerve agent on British soil was an unlawful use of force by the Russian State'.[44] The attack came as a deep shock to Britain and added to the already heightened sense of vulnerability that had resulted from the Westminster Bridge, Manchester, London Bridge, Finsbury Park and Parsons Green terrorist attacks in 2017.

The Skripal poisoning marks a low point in the relations between Britain and Russia, but they have been difficult for some time. In January 2006, the

Russian government accused the British secret service of spying and covertly funding anti-government organisations. This episode is known as the spy rock allegation, named after the fake rock containing recording equipment that the United Kingdom planted in Moscow. The British ambassador in Moscow denied that the government was involved at the time, but it was later confirmed in 2012 by a former UK government official. Tensions escalated even further in November 2006 when former Russian secret service officer, Alexander Litvinenko, died in London after ingesting a radioactive substance. At the time of his death, Litvinenko was a British citizen on MI6's payroll. An inquiry published in 2016 formally attributed his death to the Russian state.

From assassinations to election meddling, Russia has very openly challenged the rules-based international order. With its large emerging market economy, BRICS member status and rich supply of natural resources, the impact of Russia's challenges have routinely shaken the international community. However, it was the annexation of Crimea in 2014 that served as the final straw for countries at the core of the rules-based international order and resulted in the United States, the EU and a number of North Atlantic Treaty Organisation (NATO) member states imposing sanctions on Russia that year. Ukrainians have long been divided along the lines of those who see their country as historically and culturally tied to Russia, and those who see it as a part of Europe. Towards the end of 2013, Ukraine's President Viktor Yanukovych sparked mass protests in Kyiv when he rejected a deal that would have further integrated Ukraine with the EU. The protestors persevered and Yanukovych's government toppled in February 2014, but only after over a hundred deaths at the hands of Ukraine's riot police. Russia acted fast to salvage its influence in Ukraine; Russian troops – minus their ID markings – seized Crimea on 27 February, with a separatist pro-Russia uprising appearing in eastern Ukraine imminently afterwards. In July that year, the separatist group shot down Malaysia Airlines Flight 17 with a missile belonging to a Russian military brigade, killing all 298 passengers and crew members on board. It is estimated that more than 10,000 civilians have died in the Ukrainian conflict so far.[45] The two countries agreed to a ceasefire at the end of 2019 after over five years of fighting, but it is not currently clear how exactly this will play out.

Addressing the UK parliament days after the Malaysia Airlines crash, David Cameron stated that 'the context for this tragedy is Russia's attempt to destabilise a sovereign state, violate its territorial integrity and arm and train thuggish militias', adding, 'a conflict that could have been curtailed by Moscow, has instead been fomented by Moscow'.[46] Britain had come to the forefront of the opposition against Russia after the annexation of Crimea, when it heavily advocated boycotting the Group of Eight (G8) summit that was due to be held in Russia in June that year. The western countries and Japan decided that they would meet in Brussels instead – their first meeting without Russia in sixteen years. The G8 became the G7 once again, and the door was slammed shut on the post-Soviet era of East–West cooperation. Russia did not seem too bothered. As Russia's Foreign Minister Sergei Lavrov put it: 'we don't believe it will be a big problem if [the G8] doesn't convene', unhelpfully adding, 'the G8 is an informal club, there is no formal membership in that club, so nobody can be expelled from that club by definition'.[47]

Russia joined the G8 in 1997, but even during its membership it disregarded the rules of the 'club'. In February 2007, at the Munich Conference on Security Policy, Russian president Vladimir Putin threw the first theoretical challenge to the international order: 'a unipolar world [. . . with] one centre of authority, one centre of force, one centre of decision-making'.[48] He stated that the United States had 'overstepped its national borders in every way',[49] and further claimed that 'interfering in the internal affairs of other countries, and [. . . determining] how these states should live and develop' should no longer be acceptable. Putin's Munich speech was a watershed in the transformation of the global order, even if it didn't appear so fundamental at the time. The main line, that the world needs to become multipolar in order to accommodate large emerging market economies like Russia and China, was hardly original, but it was a legitimate claim.

There was a time when being part of the multilateral order and economic system delivered clear benefits in terms of economic growth. As the international demand for oil, gas and commodities was strong and expanding – and natural resources account for 65 per cent of Russia's GDP – playing by the rules of the international order was indeed worthwhile. However, this is evidently no longer the case. The global financial crisis reduced the incentive for Russia to cooperate with other countries. The crisis has not only shown the cracks in US-led market capitalism, but it also resulted in a collapse in prices for natural resources. The price of Brent Crude oil, for instance, dropped from the peak of \$140 per barrel in June 2008 to \$44 per barrel in January 2009. It has been trading below \$75 per barrel since July 2015 – and in March 2020 it dropped below $30.[50] In the meantime, western sanctions implemented after the annexation of Crimea (and reinforced after the downing of MH17 Malaysia Airlines aircraft in July 2014) have forced Russia to refocus its economy on imports substitution and on becoming more self-sufficient. This has had mixed results. The Russian economy has not yet recovered the losses from the 2.5 per cent drop in real GDP in 2015, nor has it reverted falling real incomes.

In May 2019, President Putin again pushed Russia's isolationist agenda by signing a bill to create a 'sovereign internet' that will operate independently from the rest of the web.[51] Putin claimed that this was needed should the west try to cut Russia off, but censorship is clearly a driving force here as the law allows the government to directly block content without telling the public what has been blocked or why. Just a month after this, in an exclusive interview with the London-based, Japanese-owned *Financial Times*, Putin declared that the liberal order had 'outlived its purpose' and become 'obsolete' as the political balance of power is shifting from 'traditional western liberalism to national populism'. The reason? 'Public resentment about immigration, multiculturalism and secular values at the expense of religion.'[52] The interview – Putin's first with a major international newspaper in sixteen years – leaves many questions unanswered. Why now? Was this a way to tell the world that Russia is back at the top table with history on its side, as the *Financial Times* argues? And the idea that liberalism has run its course and has 'come into conflict with the interests of the overwhelming majority of the population', is it what 'our Western partners' believe or what they are led to believe?

Check the following statement: 'As for the liberal idea, its proponents aren't doing anything [. . .]. They are sitting in cosy offices while those who are facing the problem every day in Texas or Florida are not happy [. . .]. The migrants can kill, plunder, and rape with impunity because their rights as migrants must be protected.' These ideas seem to have come out of the propaganda books of the Lega in Italy, the National Front in France, Fidesz in Hungary and, of course, Trump in the United States, all of whom have been pushing domestically salient and politically profitable issues such as immigration or law and order. The significant financial and ideological ties between Moscow and the far right parties may not have translated into obvious successes for the Kremlin, such as the removal of sanctions, as one would logically expect. However, perhaps the expected outcome is one to be delivered over the long term – the undermining of 'the liberal idea' while ushering in the time of illiberals.[53]

RESPONDING TO THREATS?

When the United States, the EU and a number of NATO member states imposed sanctions on Russia in response to the latter's military action and annexation of Crimea in 2014, they told the world that national borders must be respected. The idea behind sanctions is that problematic governments will have the benefits of being part of the rules-based international order taken away. Indeed, sanctions are economic leverage resorted to only when all the diplomatic routes have been explored and exhausted, but before military action is deemed necessary. There is no set definition as to what counts as a problematic government, but it usually encompasses authoritarian regimes that are in breach of human rights and the rule of law, and most of all represent a threat to international security. The last condition is critical while the first two are not; if that were the case, the G7 countries would have already sanctioned some of the G20 member states. Sanctions need to be handled with care, because they can seriously undermine international dialogue and economic collaboration. For instance, Britain's decision to leave the EU means that it needs to deepen its economic integration with the rest of the world, and so economic levers should only be used in extreme cases. But for the Trump administration, economic levers have become the modus operandi to twist the arms of the countries that the United States has issues with.

President Trump has been described as an 'aggressive practitioner of economic sanctions'.[54] In the first year of his presidency alone, the Trump administration added over 700 people, companies and government agencies to sanctions lists. The United States runs a blacklist with several Russian banks and energy companies (or entities, as they are sometimes referred), but individuals are also targeted through travel bans and asset freezes. In April 2018, Trump unveiled a fresh wave of sanctions targeting Russian oligarchs. One of these, aluminium and power tycoon, Oleg Deripaska, came under scrutiny for his business dealings with Trump campaign advisor Paul Manafort. The day that the news of the sanctions on Deripaska broke, share prices of his London-listed holding company EN+ dropped by 22 per cent.[55]

The US sanctions pushed many British politicians to question why EN+ had been allowed to float on the London stock exchange in the first place and why there were no regulations in place preventing oligarchs from using London's banking and financial sector as a safe haven for their activities.[56] EN+ raised

$1.5 billion when it floated in London in 2017 – funds that were subsequently used to pay back loans from Russian Bank VTB, which had been unable to raise capital in the United States and EU due to sanctions. As this was happening, the United States was drafting another sanctions bill that threatened to cut Russian banks off from the dollar system.[57] Although this never came into effect, the United States did block many dollar bank accounts controlled by sanctioned individuals and companies.

Iran has also been a target of the Trump administration's sanctions. The United States reimposed sanctions on Iran in August 2018 after unilaterally withdrawing from the Joint Comprehensive Plan of Action (the Iran Nuclear Deal) that the two countries had signed in 2015, alongside the United Kingdom, France, Germany, Russia and China. The deal had put an end to decades of confrontation over Iran's nuclear programme, and most sanctions against Iran were lifted as a result of the International Atomic Energy Agency's satisfactory investigation of the country's compliance with an exclusively peaceful nuclear programme. The reimposed sanctions specifically targeted the Iranian economy by way of its oil and banking sectors, which resulted in a severe economic downturn. Feeling the pressure, the Iranian authorities threatened to break the terms of the deal outright unless the other signatories took action to ease the strain on the Iranian economy. In July 2019, Iran announced that it had broken the terms of the deal.[58]

The events surrounding the Iran Nuclear Deal are alarming and have the potential to send the entire global economy into a frenzy. In April 2019, the United States officially branded Iran's Revolutionary Guard as a terrorist organisation: the first time such a claim has been made against a faction of another country's government. To this, Iran retaliated by branding the US military as the same. Throughout mid-2019, Iran attacked several foreign oil tankers in the Strait of Hormuz – a waterway critical for the transit of 20–30 per cent of the world's oil supply. The importance of the Strait is such that any disruption here would push up the price of oil globally. The United States acted to limit the impact of the attacks by leading a naval coalition in the region to ensure safe passage. It has deployed several thousand more troops to the region, as well as various other defence capabilities, such as an aircraft carrier and bomber planes. The then US National Security Advisor John Bolton stated that the purpose of this was 'to send a clear and unmistakable message to the Iranian regime that any attack on United States interests or on those of our allies will be met with unrelenting force'.[59] At the August 2019 G7 summit held in Biarritz, France, Iran's Foreign Minister made an unexpected appearance at the behest of President Macron. France had been working alongside Germany and the United Kingdom to de-escalate tensions between Iran and the United States, but without tangible progress. To the dismay of the other G7 leaders, Trump said he needed Putin at the table before he would sit down with Iran. Tensions between Iran and the United States escalated even further at the beginning of 2020 when Qassem Soleimani, the head of the Revolutionary Guard's Quds Force, was targeted and killed in a US drone strike in Baghdad. Trump claimed that this was necessary for US self-defence, but it is not at all obvious that this move was legal. Soon after this, a Ukraine International Airlines passenger jet was mistakenly shot down by Iran's air defence system, killing all 176 passengers and crew.[60] At first, senior Iranian officials denied that the plane could have been hit by an Iranian missile and further claimed that the US allegation was a form of psychological warfare. When Iranians found out that they had been misled over the tragedy, public trust in the regime was seriously undermined.

Sanctions can be very effective insofar as they weaken the economy of the target country by blocking access to the international trade and financial system, making access to capital and international payments (in dollars) difficult. In theory, this should result in weakened domestic support for the government responsible for the international misbehaviour, but in practice the use of sanctions is frequently manipulated to criticise the nation that imposes them. Indeed, sanctions can become a powerful tool in the hands of authoritarian governments that appeal to their people's patriotism and ask them to tighten their belts for the sake of their country which is being threatened by foreign powers.

The problem with sanctions is that their impact tends to be imbalanced and frequently damages the population more than the administration in charge. In early 2019, for example, North Korea warned the UN that it was facing a 1.4 million-ton food shortfall and that sanctions were to blame. In 2018, the UN ramped up the enforcement of its sanctions on North Korea, and humanitarian aid entering the country came close to halting altogether. Around 41 per cent of North Koreans are already undernourished and the shortfall has halved the ration allowance to a measly 300 grams per person per day. UN spokesperson Stéphane Dujarric conceded that 'while Security Council sanctions clearly exempt humanitarian activities, there have been unintended consequences on humanitarian operations'.[61]

Sanctions also frequently result in tighter fiscal policy, which further undermines living standards. Russia has seen economic recovery but the continued threat of further US sanctions (such as being cut off from the SWIFT international financial messaging network, as Iran was between 2012 and 2016, and again from 2018 onwards) means that the Kremlin is keeping a tight control on its spending while continuing to raise taxes. This has put pressure on the Russian population, 13 per cent of which currently live in poverty,[62] while one-third can't afford to buy a second pair of shoes.[63] The sanctions imposed on individual people also have a much wider impact. For example, the sanctioned oligarch Deripaska has the controlling stake in GAZ, Russia's largest commercial vehicle manufacturer, which now faces bankruptcy as a result of the punitive measures; 40,000 jobs are also at risk.[64] The US Congressional Service claims that the Russian sanctions hit powerful individuals and companies close to the government, but they do also impact the economy as a whole.[65] Indeed, the IMF has reported that sanctions have reduced Russia's output by 1.0–1.5 per cent.

In addition, Russian companies that have become isolated from international financial centres on the back of American and European sanctions have been forced to eliminate the dollar and the euro from their commercial and financial transactions. Russian companies have turned to China to raise capital and, since 2015, some oil exports to China have been settled in renminbi[66] – although this is only a tiny percentage because payments to Russian oil exporters continue to be settled in dollars and euros.[67] Russia is now China's most important oil supplier, having overtaken Saudi Arabia. There have been other tiny but politically significant steps in the economic and financial cooperation between China and Russia. In 2014 their central banks signed a three-year currency swap agreement for 150 billion renminbi.[68] Three years later, in 2017, the financial regulatory authorities of both countries agreed to a series of major initiatives, which included launching renminbi clearing services in Moscow. Besides promoting financial cooperation between the two countries, the Russian clearing centre could develop into a large financial hub for countries in the Eurasian Economic Union, lessening their dependence on the dollar. In March 2017, the Russian central bank opened an office in Beijing – its first office overseas. This was set up with the intention of aiding cooperation in bond issuance, anti-money laundering and anti-terrorism measures between the two countries.[69] Even if the numbers are still far from being substantial, pressures from the United States have created the conditions for cooperation between China and Russia. Not only that, but by increasingly providing liquidity to countries that are denied or temporarily cut off by the United States, China has started down the path of potentially undermining the United States' ability to leverage access to financial markets and the dollar-payment system, and so its ability to weaponise the dollar. Even so, the renminbi's ability to rival the dollar has limited practical impact, as I will discuss in the next chapter.

7
BEING CHINA

'Acronym' is a somewhat awkward word – it doesn't exactly roll off the tongue – but a good acronym can summarise a complex concept, keeping it vivid in people's minds. Think of NATO – North Atlantic Treaty Organization – for example, or NASA – National Aeronautics and Space Administration. But sometimes the acronym becomes a concept in its own right, separate from the words that lie behind it. The furniture retailer IKEA, for instance, is a global household name, yet I doubt many people know that this stands for Ingvar Kamprad Elmtaryd Agunnaryd, a conjunction of the name of IKEA's founder and the place where he grew up. A good acronym, then, can make a product or idea very popular, regardless of whether the words behind it contribute to it being so. BRICS, the bundle of large developing countries that we encountered in Chapter 1, has transformed the landscape of international relations and international business, in a comparable way to IKEA having transformed the world of furniture retail. The question, then, is whether the idea behind the acronym – the grouping of Brazil, Russia, India, China and South Africa – does in fact hold, or is it just a catchy soundbite that has over-popularised an otherwise weak concept?

BRICS is based on the intuition that the large developing countries will contribute to the transformation of the global economic order. It depends on the condition that the world will remain open and peaceful, and barriers to international trade will continue to be dismantled, or at the very least they will stay the same. When the acronym was first coined by the US investment bank Goldman Sachs in the early 2000s, this scenario seemed very likely to play out over the following fifty years (which was the time frame set out in the second BRICS paper).[1] With the threat of global terrorism on the rise – the first BRICS paper was conceived in the aftermath of the attack on the Twin Towers on 11 September 2001[2] – the United States was still underpinning the international order. Nowadays, these assumptions and conclusions appear far less robust.

Fifty years is far too long a period for making plausible economic predictions. In the words of Keynes in his 1923 *A Tract on Monetary Reform*, 'in the long run, we are all dead' – meaning that the long run is a misleading guide for current affairs.[3] There are, however, certain trends that do span across several decades. Indeed, demographics can allow us to make good predictions about the size and age distribution of a population. Despite gaps that have arisen from varying levels of development, the average lifespan has significantly increased everywhere in the world. The children that were born when the first BRICS papers were published will be around to witness the state of affairs that has materialised by 2050.

A large population means two things for economic development: a large labour pool and the potential for a large domestic consumer market. These two factors, of course, do not always play out simultaneously. A closed economy that limits interaction with the rest of the world is more likely to find a large population burdensome. An open economy, on the other hand, can utilise its large labour pool to produce competitively priced exports, driving economic growth and deepening integration. Improvements in domestic living standards will subsequently serve to develop the domestic market. As the global middle class is expected to expand by three billion people over the next twenty years, the potential for global aggregate demand is large.[4]

The assumption behind the BRICS acronym is that population size does matter, and can – under the right circumstances – determine the size of a country's economy. Consider the late twentieth- and early twenty-first-century globalisation process. Here the conditions of economic integration meant that large countries with natural resources, those with large or young populations (or ideally both) could exploit those conditions and grow substantially. Eventually the size of their economies would converge with those of the most advanced countries. But the performance of the BRICS – with the exception of China – has not quite lived up to expectations, which has prompted many critics to question the soundness of the concept as a whole, as well as the inclusion of each country, all with their individual set of problems. This scepticism has plagued the BRICS concept from the outset. When Jim O'Neill, the Goldman Sachs economist responsible for the acronym, gave his first talk to a large audience in Brazil after the publication of the first BRICS paper, his host welcomed him to the stage, only to confide with a sly whisper, 'we all know that the only reason Brazil is there is because without it there is no acronym'.[5]

Even if the acronym was just fad marketing conceived to spin Goldman Sachs's products, the reality is that BRICS has come to epitomise the shift of the global economy from the west to the east and the 'weighted convergence' of developed and developing countries, where convergence is measured in relative terms with countries weighted by their GDP – and sometimes by their population. It has also become a sort of platform, an aggregate meeting point that has given the aspirations of developing countries visibility and a voice. As its title suggests, the second Goldman Sachs paper, 'Dreaming with BRICs',[6] focuses on potential as well as the current state of affairs, offering a world that is more inclusive than the one that emerged from the Second World War with the United States and Europe in the driver's seat.

We cannot ignore the fact that 'weighted convergence' is only part of the story. The BRICS and the other developing countries have a long way to go in narrowing the relative per head income gap with the most advanced economies. The average income per head in emerging markets and developing countries is roughly $5,650 a year at current prices, whereas in the advanced economies it is almost $50,000.[7] But what we must accept is that the developing countries – especially the BRICS and the other large ones – are entitled to be included in the governance of the world economy, and to have a seat around the table. Albeit still minor, they hold a significant share of the world economy and have substantially contributed to global growth, especially in the years immediately after the global financial crisis.

No other country in the BRICS group even comes close to standing out as much as China. Having developed its economy at a pace that even the most optimistic of forecasters could not have predicted at the time the acronym was coined, China's GDP, at $13.5 trillion, is more than double the size of that of India, Brazil and Russia together.[8] To some extent, the rise of China provides the template and the trajectory for the other developing countries: the opening up and the integration in the global supply chains, starting with low-value, low-skilled manufactured goods. At the beginning of China's development, global demand for cheap goods drove the country's economic growth while strong investment growth underpinned domestic economic development. Now China has the ambition – and the motivation – to become a global hub for innovation in areas such as artificial intelligence and green technologies. The Chinese leadership's goal as expressed in 'Made in China 2025' is to make China dominant in global high-tech manufacturing. In this chapter, then, I will explore the rise of China in detail.

THE LONG MARCH OF CHINA'S ECONOMY

The rise of China has indeed been the defining story of the past three decades and the one that has fuelled the narrative of the power shift from west to east. The global financial and economic crisis highlighted the faults of the developed countries' model of growth, in particular that adopted by the United States. This has served to reinforce the narrative of the shift to the east and cemented the idea that the dynamics of the world economic order are inevitably changing. But it has also exposed the vulnerability that financial integration and unconstrained capital movements can create. Even more than trade, it is financial integration that sets the recent transformation of the world economy apart from similar previous developments.

In the early twentieth century China was a large economy, accounting for roughly 9 per cent of global GDP.[9] But by 1949, the year that the People's Republic of China was founded, the outlook for the country was considerably different. Like the rest of the world during this period, China had suffered from the impact of two world wars, but was completely ravaged after an additional war with Japan as well as a lengthy civil war. By the late 1970s, China's share of global GDP was modest, relative to the size of the country, at roughly 2.5 per cent, its trade accounted for just 0.6 per cent of the global total and the sum of its imports and exports was less than $15 billion.[10] The Chinese economy was heavily dependent on agriculture, which accounted for approximately 30 per cent of its GDP.[11]

By 2010, however – in just a little over thirty years – China had transformed itself into the world's second largest economy. Its share of global GDP was approximately 9 per cent,[12] the sum of its imports and exports had hit over $237 billion and the contribution of agriculture towards GDP was roughly 9.5 per cent.[13] A year earlier, China had become the world's largest merchandise exporter, and the second largest merchandise importer. As of 2019, China's share of global GDP is up to 16 per cent,[14] a figure not far from its share of the global population (roughly 19 per cent). The percentage of the country's workforce employed in agriculture is down to 26.5 per cent – in 1991 it was approximately 60 per cent.[15] China is now widely considered to be an industrial powerhouse. Over the last decade, no country has contributed more towards global economic growth and global poverty reduction than China. No other country has lifted more people out of poverty. The country's average income per capita in current prices has reached around $10,000, a significant increase from the mid-1980s when it had been roughly $300.[16]

China is completely unchallenged when it comes to undergoing such great economic changes in such a relatively short space of time. So the question arises: how has it managed to pull it off? As soon as the People's Republic was founded, the Chinese authorities initiated economic reforms, but overall the country made little headway. Over the next couple of decades, the Chinese economy yo-yoed back and forth, as the reforms were repeatedly successful and then unsuccessful. During this period, the country was operating under a strict regime of self-sufficiency and was largely isolated from the rest of the world, as its tiny share of global trade indicates. Furthermore, China was almost completely cut off from international capital markets. It did not receive foreign direct investment, nor did it invest abroad, and it neither borrowed nor received aid from any of the postwar international financial institutions. The changing point came after the Cultural Revolution, which lasted from 1966 to 1976, when Deng Xiaoping took power. Deng embarked on a series of reforms in 1978, which aimed at transforming China from its state of isolation to one of openness.[17]

Trade, of course, played a massive role in this. Tariffs were reduced, trade licences were eliminated and the country became a part of the WTO in 2001. Since the early 1980s, the authorities have granted certain areas the status of a 'Special Economic Zone' (SEZ), allowing them to operate under policies that are compatible with the market-system. China's timing here – just like Governor Zhou's speech discussed in the opening to Chapter 4 – was perfect. As the world economy was becoming ever more integrated, China was able to easily cash in by exporting the cheap goods produced by its state-owned enterprises.

It is important to note the role that capital flows played in China's development. As the economy opened itself up and exports flourished, large quantities of capital began to pour into the country. China welcomed foreign direct investment with open arms, but not because it was short of funds. The Chinese leadership realised that the country's state of isolation had left it in a poor position to compete in international markets and so it desperately needed to innovate, knowing that better technology would result in better productivity. They knew that with capital come skills and knowledge, hence they opened up their markets. In 1979 the Chinese government ratified the law of Chinese-Foreign Joint Ventures, which allowed partially foreign owned companies to operate in the country. The aim of this was to expand 'international economic cooperation and technical exchange'.[18] In 1990, the Shanghai Stock Exchange – China's oldest financial hub, which had been closed since 1950, just after the People's Republic was founded – was reopened. The reopening solidified the growth and development of the country's capital markets. A second stock exchange was established in Shenzhen the same year. Since the 1980s China has attracted a steady flow of direct foreign investment. In 2018, only the United States received more foreign direct investment than China and it has consistently ranked among the top five over the past decade.[19]

The other side to this story is Chinese investment abroad. The State Council has encouraged this by branding the state-owned enterprises leading the way in internationalisation as 'national champions', offering both financial and political support. China's outward direct investment really took off in the mid-2000s; by 2018 China's direct investment outward stock had reached almost $2 trillion, making it a net exporter of capital for the first time, and the second largest outbound investor in the world.[20]

By investing abroad, China has managed to connect itself to a variety of resources that have been invaluable for its development, including commodities such as oil, iron ore and copper. Also, the development of various cities over the past forty or so years would not have been possible without the access to foreign engineering and construction sectors obtained through foreign direct investment. These cities are now larger than many in the west. Dongguan, for instance, was only granted the status of a city in 1985; it is now a global manufacturing base, with a population size not too far behind that of London or New York.

It is also worth mentioning that, even though the economic reforms prior to Deng's leadership operated under the principle of self-sufficiency, there is evidence that China had been considering opening up for some time. The National Committee on United States–China Relations, for example, was founded in 1966 by a broad mix of business leaders, scholars, religious leaders and other notable members of society with the goal of fostering understanding between the two countries. The first American congressional staff delegation was hosted by the Chinese People's Institute of Foreign Affairs in the summer of 1976.

SAVING FOR THE COUNTRY

China is a middle-income country and a nation of savers. Of their disposable income, Chinese households saved an average of roughly 38 per cent over the last decade.[21] It is always a good idea to set aside some money, for savings can provide protection or insurance against unexpected events and funds for future consumption. In China, the motivations to save are strong. The public provision of social safety nets that provide for healthcare and retirement are limited, and this leaves Chinese families with little choice but to rack up savings as a necessary form of self-insurance. In addition, consumer credit is not widely available. Without savings, then, few Chinese people would be able to finance the purchase of larger consumer durables such as cars, furniture and white goods. As a result, accumulating savings over the years has become a necessary component of household life. At roughly 23 per cent of GDP, China's entire cumulative stock of household savings is well over 7 trillion renminbi (or \$2 trillion), and 15 percentage points higher than the global average.[22] In 1978, when reforms began, the rate had been much lower at roughly 21 billion renminbi or 6 per cent of GDP.

Chinese people have limited choice on how to employ their savings outside of domestic banks – including taking their money out of the country. There is not much competition between banks in China, as the rates are set centrally to ensure favourable lending conditions.[23] In response to the 2008 global financial crisis, China, along with all of the other large economies, lowered its interest rates even further. Between 1998 and 2007, the lending rate in China averaged at almost 6 per cent, but between 2010 and 2018 the average was lower at 5.2 per cent, although it has been flat at 4.3–4.4 per cent since 2015.[24]

Thus, the large pool of savings that have been accruing in China's domestic banks for several decades have been instrumental for the country's rapid economic growth. Indeed, the Chinese authorities have channelled these savings towards the country's industrial transformation. By tightly controlling the maximum deposit rate (capping savers' returns), the minimum lending rate (and so keeping the cost of borrowing low) and credit quotas, the monetary authorities have adequately managed the allocation of these savings from the banking system into state-owned enterprises.

Low interest rates are China's main instrument of financial repression.[25] The deposit rate is low enough to allow banks to make profits by 'squeezing' depositors, so they can then continue to offer cheap loans to state-owned companies. As financial resources are shifted away from depositors and towards borrowers, savers essentially end up subsidising state-owned enterprises. This is in line with the economic development strategy set out by the Chinese state.

For years, this system of financial repression has been an intrinsic component of China's model of growth, with plenty of cheap capital available to fund projects that are strategic to China's economic development.

Such a system has created some serious distortions and vulnerabilities. Banks are saddled with too much low-quality lending and non-performing loans, and they are vulnerable to insolvency that can in turn trigger a liquidity crisis. Savers, on the other hand, feel the pressure as they do not get much for their money, and so they turn to non-bank financial institutions instead in the hope of getting better returns. Within the so-called 'shadow' banking sector savers can invest in unregulated short-term instruments, such as, for example, commercial papers that pay high interest over three months, but are riskier than the bank deposits – with the offer of increased returns, of course, comes an increased rate of risk. Low interest rates can create problems for borrowers too. Chinese firms often borrow more than they need, and give little consideration to efficiency or profitability. After all, if they were to incur any financial losses, this would simply be covered by state subsidies. As such, many Chinese firms find themselves in an unsustainable financial position with high leverage, as I discussed in Chapter 4.

The ultimate consequence of China's system of financial repression is that it builds on and reinforces the relationship between state-owned companies and the big banks, helping the latter to gain access to bank credit. The link between these organisations is a pillar of the Chinese system of state ownership and is a key feature of the country's blend of plan and market – and the state-owned enterprises themselves are very much a legacy of China's planned economy of the past.[26] Often China's big banks find themselves in the position of lending money to support a project dear to senior government officials or local party leaders. Many of these projects are poor quality and the cheap money – intended to keep failing businesses afloat – leaves banks burdened with non-performing loans. This has led to a decline in the asset quality of state-owned banks. Additionally, privately-owned firms have been crowded out and increasingly turned to the capital market. Here too banks are pervasive, hindering the pace of development of both the bond market and the equity market that have lagged behind the fast growth of China's real economy. In the bond market, for example, Chinese banks (together with the PBoC and the Ministry of Finance) are the main players, issuing and buying the most.

There has been some progress in recent years in softening the link between state-owned enterprises and the big banks. These have become more used to assessing a firm's profitability before deciding whether to grant a loan and on which conditions. Private firms now have better access to credit and less onerous conditions than in the past. This doesn't mean, however, that credit is allocated in a transparent and unbiased way. State-owned companies continue to enjoy fast-tracked and preferential access to credit compared to private companies. So, regardless of recent progress, the banks remain an overwhelmingly dominant force in China and an instrument for the implementation of the government's objectives. The five large-scale commercial banks – Bank of China, Industrial and Commercial Bank of China, Agricultural Bank of China, China Construction Bank and Bank of Communications – account for almost 50 per cent of assets in the domestic banking system. Thus, China is a paradoxical nation of both savers and debtors. The consequences for Chinese individuals and families are indeed a huge burden.

FINANCE FOR DEVELOPMENT

The so-called 'policy banks' – the Agricultural Development Bank of China (ADBC), China Development Bank (CDB) and Export–Import Bank of China (Exim Bank) – are the other pillars of China's banking system. They were all established in 1994 to finance trade, development and state-led projects. Not holding any deposit, they get their capital by issuing bonds on the domestic capital market where they are dominant. Indeed, approximately three-quarters of the total bonds on the Chinese market are issued by the policy banks.

These banks have been utilised to fund a variety of state-led infrastructure projects such as China's infamous Three Gorges Dam. As the largest hydropower project that the world has ever seen, it is considered to be one of China's most ambitious and important projects – but also one of its most controversial. It provides an interesting example, because it highlights the need for a system of checks and balances within China's governance and banking system.

Whether or not the dam should be built was a contentious issue for many years. Construction on the project started in 1994, shortly after it had been formally approved, but the idea had been floating since the 1920s and was heavily endorsed by Chairman Mao in the interim. Those in favour of the dam argued that it would bring an end to devastating floods, spur development in central China by providing electricity and facilitating inland trade (by lowering cost and increasing capacity), reduce China's dependence on fossil fuels and contribute towards better environmental standards overall by cutting emissions. However, many officials and environmentalists opposed the project, stating that the cost would be exorbitant and the purported environmental benefits were incorrect. In an almost unprecedented act of defiance, a third of Chinese delegates either abstained or voted against the building of the dam.[27]

When the National People's Congress (the Chinese parliament) approved the project, it was estimated that it would cost about 50 billion yuan, with an additional 40 billion yuan needed for the resettlement of the 1.3 million people who would be displaced as a result. At the 1993 price level, this amounted to roughly $12.8 billion. The CDB lent 30 billion yuan and additional funding was received from a variety of different sources such as corporate bonds, proceeds from other hydropower projects, and national and foreign commercial banks.[28] Both the US Export–Import Bank and the World Bank refused to support the dam, citing disastrous social and environmental consequences.[29] The dam has ultimately resulted in the exacerbation of droughts, water pollution, and a worsening of climate change. In 2011, the Chinese authorities announced that the project had cost more than 254 billion yuan.[30] It was conceded that the project was spawning environmental issues, yet was still hailed as a triumph of man over nature and a symbol of the Communist Party's success.

Projects such as the Three Gorges Dam have tainted the Chinese state's reputation as a good steward of environmental and social standards; instead political objectives have often been put ahead of long-term sustainability. Not surprisingly, then, China's 'going out' strategy has raised many concerns at the international level since the leadership launched it at the turn of the millennium. With the support of the policy banks, Chinese commercial firms are encouraged to join forces with foreign companies and bid for contracts, most of which have been for large overseas infrastructure projects.[31] This brings together diplomatic and commercial goals and is consistent with the motivations that typically drive firms to invest abroad – i.e., expanding into new markets, accessing commodities or energy, acquiring new assets and reducing costs.[32] There is, however, a further motivation for China to 'go out'. After undergoing a sustained period of isolation, China now needs friends around the world. Allies provide access to investment opportunities and natural resources in return for financial aid and loans with favourable conditions – often meaning no sovereign rating, governance criteria or human rights 'strings' attached at all. By obtaining friends, then, China can gain a commercial advantage and ultimately push its goals closer to full fruition.

The 'going out' strategy has been so successful that China has become one of the largest providers of development finance – along with having become the world's second largest exporter of capital. The unfortunate fact of the matter is that this support all too often equates to support for undemocratic and repressive regimes. There are several examples of controversial Chinese financial interventions in countries with poor standards. The appalling track record of dictatorship and human rights abuses in Zimbabwe, for example, has done little to discourage China from being the country's largest source of foreign capital, as well as being its fourth largest trading partner.[33] China is also heavily involved in Venezuela, a country that currently lacks any independent government institution. At the end of 2017, China held approximately \$23 billion worth of Venezuela's foreign debt, making it the country's largest creditor.[34] While many nations have welcomed Chinese investment as a catalyst for their own development – and an alternative to the multilateral international financial institutions – others have expressed concerns about establishing ties with China because they know that the relationship will not be equal. China is simply too big – in terms of economic weight, financial resources and geopolitical standing – for many countries to set a partnership on equal terms.

In addition, it is difficult to separate the interests and goals of state-owned companies from those of the Chinese government – and, by extension, the Chinese Communist Party – so that often a commercial partnership with a state-owned company transcends purely commercial objectives.[35] These concerns have increased in recent years, and the 'America first' rhetoric promulgated by the Trump administration has added fuel to the fire. The fact that Chinese companies have acquired (or show intent to acquire) stakes in overseas companies that are deemed strategic has caused worry, but this had been contained by applying a rather loose concept of 'strategic'. The same cannot be said of the exploitative attitude often displayed by Chinese firms (and banks), where disregard for intellectual property rights and the influence of the Chinese state has caused widespread concern for some time.

In very recent years, China's financial diplomacy and commercial 'going out' have become much more conspicuous, not only in terms of financial resources, but more importantly in terms of overall vision and modalities. The AIIB and the New Development Bank (NDB), established in 2016 and 2014 respectively, have created a great deal of angst in Washington. Both banks are China-led and China-headquartered. I will put these aside until Chapter 9, and now turn to China's BRI instead. This is the country's large infrastructure programme, which is underpinned by bilateral agreements with various countries along and beyond the ancient Silk Road. It has served to further escalate the already fraught tensions between China and the United States, and made public the question already occupying many minds in the west: will China use its vast financial resources to strengthen and grow its geopolitical influence in Asia and Europe, offsetting that of the United States?

BELT AND ROAD

In China, major policy initiatives that have a significant long-term impact tend to start off in a relatively low-key fashion. This is what happened in 1979 when Deng Xiaoping announced the opening of four SEZs in the southern region of Guangdong. It was not at all obvious that this was the onset of China's major economic transformation. Again, in 2009, when the authorities introduced a pilot scheme to use the renminbi to settle international trade, few grasped that this was the first step towards developing the renminbi into an international currency. The Chinese approach to reforms – the method of gradual and experimental implementation – is epitomised by the proverb 'crossing the river by feeling the stones'. As you would expect, it takes some time for information about these initiatives to trickle down from the authorities – and especially outside China.

It is not exactly surprising, then, that when the 'One Belt, One Road' initiative was announced in 2013, not many people outside the government departments understood its implications. The name of the initiative did not help at all. I remember endless discussions regarding what on earth the 'belt' was supposed to be – and the indication that there was only one of them was certainly misleading. It in fact stands for the Silk Road Economic Belt (a network of land routes) and the 'road' stands for the twenty-first-century Maritime Silk Road (a network of sea routes). President Xi Jinping presented the 'One Belt, One Road' initiative as such during a visit to Central Asia shortly after the initial announcement and subsequently shortened the name to the BRI.[36] But unfortunately this did not provide much clarity. Journalists tend to refer to the Belt and Road as a modern version of the ancient Silk Road that connects China to Europe through countries across Asia and west Asia, but the Silk Road Economic Belt also connects China to south-east Asia, south Asia and the Indian Ocean. The initiative intends to link China to Europe through the South China Sea and the Indian Ocean, using the South China Sea to access the South Pacific (the twenty-first-century Maritime Silk Road) as well.

The outcome of the BRI should be the creation of an economic and trade corridor going through central Asia and into Europe, and the development of ports and hubs across the Indo-Pacific route.[37] The ultimate goal of constructing and improving the railway connections between China and Europe is to connect the Eurasian region, transforming it into an integrated and cohesive economic area. Similarly, the construction of port facilities and related infrastructure in Malaysia, Indonesia, Bangladesh, Sri Lanka, Pakistan, Kenya, Oman – to name just a few – are intended to provide China with maritime access across the Indian Ocean, complementing the direct access to Europe that China acquired in 2016 when COSCO (the Chinese shipping group) purchased the major Greek port of Piraeus. In addition, the China-Pakistan Economic Corridor will connect China's western provinces with the Indian Ocean through the Pakistani port of Gwadar, while the Bangladesh-China-India-Myanmar Corridor links Yunnan province with the Bay of Bengal.

In March 2015, the Chinese authorities issued an 'Action Plan' that defined the motive behind the BRI as 'an ambitious economic vision of the opening-up of and cooperation among the countries along the Belt and Road', adding that 'countries should work in concert and move towards the objectives of mutual benefit and common security'.[38] In reality, rather than a project of international cooperation, the BRI is China's economic and foreign policy strategy to engage with countries in the region through infrastructure projects and investment. Closer partnership between China and the countries on the Silk Road to build infrastructure networks should support economic development, deepen investment and trade relations, improve financial cooperation, and even underpin closer social and cultural exchanges.

The infrastructure investment plan around the BRI undoubtedly provides a myriad of commercial opportunities for Chinese and international construction companies with the capacity to undertake large building projects. As such, the initiative has been welcomed with open arms by the private sector. For China, there is also the additional benefit of finally being able to allocate some of its excess capacity, particularly its labour force. But the impact on the countries where the infrastructure is built is at the very least ambiguous, as the benefits are mainly derived from second-round effects. If investment in infrastructure does not have an immediate impact on the labour market, better facilities and more connectivity should plug the receiving country more firmly into the regional economy.

The BRI has been described as a modern Asian equivalent of the Marshall Plan. However, the Chinese leadership is keen to deny this comparison, with Wang Yi, China's Foreign Minister, claiming that '[the BRI] is neither a Marshall plan nor a geostrategic concept'.[39] The comparison with the Marshall Plan is far from appropriate but it is clear that the BRI fits China's international strategy; it emanates from China's 'go out' that, under a variety of different banners, has informed Chinese enterprises' financial engagement with the rest of the world since the late 1990s. As I have already mentioned, China's deployment of financial resources abroad – whether through development aid, loans, foreign direct investment, portfolio investment or partnerships and joint ventures – does not exclusively respond to commercial objectives. There are other factors that work to influence the allocation of China's financing, as it is fundamentally an instrument to promote the goals and the interests of the Chinese state.

The BRI is consistent with all of these purposes and its institutional structure reflects its multi-faceted objectives; it is coordinated by the National Development and Reform Commission, but the ministries of Foreign Affairs and Commerce also provide input. China engages with countries on the Belt and Road on a bilateral basis, leading this engagement and formally sealing it with a memorandum of understanding. Besides the rhetoric of 'common development' and 'win-win cooperation' with countries in the region, the BRI ultimately serves China.

The Chinese policy banks have been at the front line in providing financial resources to the BRI. In December 2014, the Exim Bank and CDB, together with China Investment Corp. and the backing of China's foreign exchange reserves, launched the Silk Road Fund.[40] Some funding also comes from partnerships with the multilateral development banks, especially the AIIB. Through the BRI, as well as various other related 'going out' policies, China seems determined to considerably expand its footprint in international development finance. An additional advantage would be the use of the Chinese currency in

Belt and Road projects and so the promotion of the renminbi as an international currency.[41] But considering that it still has an immature financial system at home, a currency with limited international use and circulation and many domestic areas that are still not fully developed, is BRI really the best move for China to make? It is the limitations of China's currency that I turn to now.

THE RENMINBI: WORK IN PROGRESS

December 2015 marked a milestone for China. After consultations that lasted for over a year, the IMF finally concluded that China's currency, the renminbi, was to be included in its Special Drawing Rights (SDRs).[42] SDRs are a supplementary reserve asset used internally by the IMF. The value of the SDR is determined by a weighted basket of the world's most important international currencies, the composition of which is reviewed every five years. The other currencies in the basket are the dollar, the euro, the yen and sterling. Being part of the basket means that SDRs can be exchanged in renminbi, signifying that it has ticked most of the boxes as a 'usable' currency and granting the PBoC's policy strategy to internationalise the renminbi the validation that it had been seeking since its outset in 2009.

Unfortunately for the renminbi, SDR inclusion is not the be-all and end-all when it comes to international currencies. The dollar's share of the SDR basket is roughly four times that of the renminbi's, and the euro's share is three times, reflecting the reality that the renminbi is not yet a fully fledged international currency.[43] Unlike the dollar, the renminbi remains limited as a means of exchange, a unit of account and store of value. This is because it is constrained by its limited international circulation, liquidity and payment facilities, and so it is an unattractive currency for use in international trade and finance. The Chinese currency therefore has a very low appeal for individuals, businesses and governments around the world.

The renminbi's shortcomings are linked to its limited convertibility and the capital controls that the Chinese monetary authorities apply to its circulation. In an open economy, capital flows are dictated by investment – either foreigners investing (or disinvesting) in that country or residents doing so abroad – and trade transactions. China opened its current account in the early 2000s so that it could gain WTO membership, but restrictions on its capital account are still in place. By keeping controls on capital movements, the Chinese monetary authorities are able to maintain domestic financial stability. Due to China's combination of high savings and financial repression, unrestricted capital movements would pose a threat. If the authorities were to loosen controls, Chinese people could choose to invest their savings abroad for better returns. China's domestic banks would then be left with two options – compete or collapse. A similar threat could also arise from a change in external conditions such as a change in the US monetary policy that could trigger domestic financial instability in China. Managing capital movements to avoid sudden shifts in the demand for renminbi and renminbi-denominated assets ultimately feeds back into the Chinese monetary authorities' control of the exchange rate. For example, in the years after the global financial crisis when the Chinese economy was growing strongly, interest rates in the United States were zero and the dollar was weak, controls on capital movements served to restrain the inflows, helping maintain financial stability and keep the exchange rate at the level consistent with China's economic objectives.

The conventional path taken to expand the use of a currency overseas and push it towards international recognition is for it to become fully convertible. This normally happens after the underpinning economy undergoes a significant level of development and opens its capital account. But China's monetary authorities have chosen not to open the capital account and so they have to pursue alternative paths to develop the renminbi's international use. First of all, they need to channel renminbi into the hands of non-residents and create some traction. Second, assuming that demand for renminbi does pick up, they'll then need to respond to and expand the foreign demand for renminbi funds and renminbi-denominated assets, but do so in a balanced manner that doesn't jeopardise domestic financial stability. All of this will need, in turn, to be achieved without curbing the demand for renminbi. The challenge lies in the fact that there is no guarantee that the market participants will follow.

In 2009, the Chinese monetary authorities launched a policy strategy that aimed to overcome the limits posed by the renminbi's lack of convertibility, develop its international use and encourage market demand. I call this China's 'renminbi strategy'.[44] This strategy started as a pilot scheme focusing on the use of the renminbi in international trade, but it has since developed into a full-scale operational programme covering a broad and sequenced set of policies. The Chinese approach to the internationalisation of the renminbi is unprecedented;

never before have monetary authorities attempted to engineer the development of a currency in this way. Pivotal to this is a cross-border trade settlement scheme and the establishment of an offshore market. The former is to increase the use of the currency in international trade while the latter works to establish it as a currency that foreigners are happy to hold as a store of their wealth. In particular, the Chinese authorities have focused on Hong Kong to establish a framework for the circulation of the renminbi within Asia.[45] Here the authorities have built offshore market infrastructure – with clearing, payments and other banking facilities to facilitate the use of the renminbi in investments and trade – which functions as an official channel for the renminbi to flow freely within the region.

As a result of this strategy, the renminbi was used to settle about 26 per cent of China's trade by 2016 – in 2009, it was used for less than 1 per cent.[46] This has driven the use of the renminbi in international payments; the Chinese currency now accounts for the fifth largest share, although it is still a long way behind the dollar and the euro that account for 42 and 33 per cent respectively.[47] A reasonably liquid and diversified market for renminbi assets now exists in Hong Kong, London, Singapore and most other international financial centres around the world. The United States is the notable exception to this rule.

Despite this progress, the renminbi is clearly still a currency in progress rather than a fully fledged international currency. It is far from being a 'great currency' like the dollar, whose usage extends far further than international transactions with US firms and individuals. So, if it is true that 'great nations have great currencies',[48] then not having a great currency is preventing China from achieving its ambition of being a great nation. But what does the obstruction actually consist in? I have already discussed the limitations that face countries lacking an international currency when they have to issue debt (the original sinners) or lend (the immature creditors) on international markets, using currencies that are not their own. With an excess of savings, China is a lender rather than a borrower and so suffers from the latter of these issues with all of its related costs and risks.

There are, however, other problems for China that stem from the limits of the renminbi. First of all, the dollar remains the cornerstone of China's trade and financial relations. So Chinese exporters that invoice in dollars, while their costs – wages, rent, running costs etc. – are mainly in renminbi, face the exchange rate risk or the additional cost of hedging. Second, Chinese firms experience a mismatch between liabilities, such as foreign direct investments that are held by foreigners and denominated in renminbi, and claims against foreigners, such as cash reserves, that are denominated in major reserve currencies, particularly the dollar.

And finally, a dearth of dollars could negatively impact on international trade and cause problems for an exporting economy like China. For example, China's trade in the months following the Lehman Brothers collapse in September 2008 was roughly 14 per cent less than the same period the year before.[49] The United States and Europe consume a significant amount of Chinese exports, so the reduction in China's trade shows that the crisis decreased demand in these markets. It also shows that the bottlenecks in the US banking system had impacted on the availability of dollars to settle trade transactions. Indeed, limited liquidity makes it difficult for exporters to swap their letters of credit or bank guarantees for dollars. This is exactly the point that Governor Zhou raised in March 2009, when he advocated that the international monetary system should no longer revolve around the dollar.[50]

China is not without financial resources, but the structural limits of the renminbi constrain its ability to use these resources to advance its economic and political agenda, and underpin international relations – both at the bilateral and multilateral level. This has not stopped the United States from perceiving China as a threat. China's plan to upgrade its manufacturing sector from producing Christmas trees – i.e., low-value, low-skilled goods that are suitable for a developing economy with an excessive supply of labour – to developing capacity in high-skilled, high-value areas such as artificial intelligence, has raised huge opposition from the United States, as we shall see in the next sections.

THE LIMITS OF CHINA'S MODEL OF DEVELOPMENT

During a recent trip to Shanghai I found myself with a free afternoon, which I decided to spend browsing in one of the city's upmarket department stores. While wandering around the accessories department (shoes and bags to be precise) I came across three managers who had been sent from the store's headquarters to assess the quality of the products. As it happened, they were Italians and were speaking in their native tongue – and so I was presented with a unique opportunity for some eavesdropping. What interested me was not the technical details of bag manufacturing that they were discussing, but the comparisons that they were drawing with goods produced elsewhere: 'the design, material and presentation of these bags [made in China] have improved remarkably compared with where we were when we started, but we are not yet close to the quality of similar products made in Italy – and customers are fully aware of this'.

This comment well summarises the dilemma that China is facing in its manufacturing sector. Like many countries in a relatively recent phase of their industrialisation, China still relies on the 'pile them high, sell them cheap' model. Imitation instead of innovation, abundant labour instead of strong productivity growth, state support instead of market competition – these all epitomise China's industry. Over the years, China's manufacturing sector has become notorious for producing cheap goods – mostly for foreign multinational firms – and fuelling mass consumption. Cheap consumer goods such as clothing, shoes and electronics have massively expanded China's exports, boosted economic growth and underpinned the country's development. This is a trajectory that China shares with other developing countries such as Mexico, Brazil, South Africa, Turkey – and earlier on, South Korea, Singapore, Taiwan. Indeed, China now finds itself in direct competition with low-income countries in low-value and low-wage industries.

In May 2015, in the usual understated fashion, the Chinese State Council unveiled 'Made in China 2025'. The idea was to upgrade China's industry and increase its technology footprint, improve labour productivity, reduce energy consumption and achieve overall international competitiveness, taking the country from 'a manufacturing giant into a world manufacturing power'.[51] This strategy is consistent with President Xi Jinping's objective of shifting China's economic growth model from exports to domestic demand, which he unveiled on coming to power in early 2013. This approach is telling of the Chinese authorities' awareness that China's development has been too dependent on the external sector – exports and high-value imports – and has left the country's industries vulnerable to an array of external shocks such as downturns in demand and geopolitical tensions. It has also been too reliant on low domestic costs and an artificially low exchange rate which has in turn depressed living standards while it has been oblivious to environmental costs and sustainability. Although this growth model has lifted China out of poverty, it risks locking it into the middle-income trap. 'Made in China 2025', as put by Minister of Industry and Information Technology Miao Wei, develops a strategy for China to achieve a level of industrialisation 'nearly equal to the manufacturing abilities of Germany and Japan at their early stages of industrialisation'[52] by 2025. China has made it clear that it intends to compete with the most advanced economies at their level.

Minister Miao's comment is critical to understanding China's objectives vis-à-vis 'Made in China', as well as its long-term industrial strategy and general policy approach. First of all, it highlights the fact that the Chinese authorities and policymakers see China as a developing country that needs to continue down the path of economic development. Although China's income per capita has significantly increased since the 1980s, it is still far behind that of the advanced economies that boast an average close to five times higher than that of China.[53] Among others, then, China's long-term prosperity depends on its industrial strategy and improvements in 'innovation capacity, efficiency of resource utilization, quality of industrial infrastructure and degree of digitalization'. The 'Made in China 2025' plan notes that the 'task of upgrading and accelerating technological development is urgent'.[54]

Secondly, it shows the Chinese authorities' concern about the country's trade composition. Compared with that of the other large exporters such as the United States, Germany and Japan, it is skewed with low-value, labour-intensive exports and technology-intensive imports. McKinsey Global Institute has estimated that, in 2017, China imported machinery and equipment, computers and electronics, chemicals and cars from developed countries, for a total value of almost $700 billion.[55] Third, Minister Miao's comment suggests that China recognises that it is still in the early stage of its industrialisation. 'Made in China' should help to push the country to the second stage of such industrialisation and achieve 70 per cent 'self-sufficiency' in high-tech industries by 2025. The aim is not only to reach a point similar to that of advanced economies in the earlier stage of their industrialisation, but also to respond to the competition from other developing countries. Without an ad hoc industrial strategy, the authorities felt that the advantage in terms of competitiveness acquired over the first stage of industrialisation would be dissipated, and China would be squeezed in between advanced economies and developing countries with a lower cost base.

Developing China into a 'world manufacturing power' will take a long time. This is the final point to be drawn from Minister Miao's comments. The authorities expect China 'to lead innovation and possess competitive advantages in major manufacturing areas', and 'develop advanced technology and industrial systems' by 2049 – the hundredth anniversary of the founding of the People's Republic of China. 'Made in China' is the first step in China's broad and long-term strategy to transform itself into a leading manufacturing power. Having substantially improved competitiveness in major industries, an 'intermediate level' should be reached by 2035.[56]

The plan centres on the development of ten high-tech industries, notably electric cars and other new energy vehicles, next-generation information technology and telecommunications – big data, cloud computing and their integration into the global manufacturing supply chain.[57] Advanced robotics and artificial intelligence are also at the forefront of China's industrial strategy.[58] The ten-year plan will be evaluated against indicators such as spending on research and development, broadband internet penetration and carbon dioxide emissions.

As they have done so with many other policy initiatives, the Chinese leadership did not boast about the new industrial strategy, possibly because of more pressing matters – such as the protracted turbulence in the stock market, the weakening of the renminbi and initiatives like the BRI. Regardless, Chinese policymakers have been known to test new policies as they are implemented, leaving the door open to changes and even U-turns, indeed, 'crossing the river by feeling the stones'. The authorities, then, were expecting to be able to grapple with the reforms and measures necessary to underpin the new strategy, as always, away from the spotlight. They could never have imagined that 'Made in China 2025' would soon become the prime bone of contention with the Trump administration.

THE PROBLEM WITH TRADE AND FINANCIAL IMBALANCES

Tensions between China and the United States go back a long way. A significant turning point was 2001, when China joined the WTO. Having churned out manufactured goods for consumers in advanced economies – particularly those in the United States – for some years, the growth of China's exports was already strong, but this propelled them even further. By 2006, the United States was importing a total of $288 billion worth of Chinese goods – almost triple the $100 billion worth that they imported in 2000. Over the same period, the US trade deficit with China grew from $83 billion to $234 billion. Similarly, imports of goods from China into the EU – China's main trade partner – more than doubled between 2000 and 2006, from almost €75 billion to €195 billion. EU exports of goods to China also grew strongly, although not as much as the imports, with the result that the trade deficit expanded from almost €49 billion in 2000 to €131 billion in 2006.[59]

The trade imbalance with China widened the US current account deficit from 3.9 per cent of its GDP in 2000 to 5.8 per cent in 2006. (Due to the strength of its export of services to China, the EU deficit remained rather small, below 1 per cent.)[60] This highlights a problem that the United States has been facing since the end of the Second World War; they consume more than they produce and so they have to borrow in order to pay for this consumption. Indeed, as I discussed in Chapter 2, the United States' inability to curb the widening payments imbalance was one of the main causes of the collapse of the Bretton Woods system in 1971.

The mirror image of the US deficit is China's surplus – along with the US deficit it has considerably narrowed since the late 2000s. It peaked at 9.9 per cent in 2007 and is currently 0.4 per cent. But the trade dynamic between the two countries has remained the same and continues to define the economic and diplomatic relations between them. China's surplus means that Chinese households and firms save more than they consume, and this in turn reflects a real exchange rate kept in line with the goal of maintaining its exports competitive. Since the mid-1990s, China has managed its exchange rate using either the dollar or a basket of currencies in which the dollar has the largest share. To some extent, China has been free-riding the dollar, as I discussed in Chapter 4.

Cheap exports are a necessary but not sufficient condition for driving demand in export markets. A number of other conditions need to occur for people to feel confident enough to spend or borrow in order to support their consumption. For instance, economic growth has to be robust and generate employment, political uncertainty needs to be minimal, and credit conditions have to be favourable for individuals and firms to borrow. This was indeed the outlook for the United States in the early 2000s, especially after 2003, once tensions over the 9/11 terrorist attack and the subsequent military intervention in Iraq had subsided. In response to this and the dotcom crash – when investors threw caution to the wind, certain that the growing use of the Internet would ensure returns from Internet startups – the Fed implemented low real interest rates. This, known as the 'Greenspan put', fuelled economic growth, ensured full employment and inflated house prices. Between 2001 and 2006 the American economy grew in real terms at an average annual rate of 3.2 per cent. Feeling wealthier and confident in their future, Americans spent, spent and spent – and a lot of this spending was on goods made in China.

We can see, then, that the Chinese (and other east Asian countries) policy of managing the real exchange rates and the United States' very accommodating monetary policy are the two sides of the same coin. Demand in the United States drove global demand, which remained high, and the global economy continued to expand. Real GDP growth for the world economy peaked at 5.6 per cent in 2007. As for China, the growth rate of its economy skyrocketed in those years – the average annual real GDP growth was 12.3 per cent between 2001 and 2006, peaking at 14.2 per cent in 2007.[61] This happened, however, by compressing domestic living standards and creating income inequality.

It was an unusual situation for the United States. The world's largest economy and one of the richest countries in terms of per capita income was in an economic and financial symbiosis with a developing country. 'China is still a poor country' was the mantra that the Chinese authorities often repeated in those years. However, it was a situation that suited the policy goals of both countries. For the Bush administration, it showed that tax reduction and shrinking the public sector expanded the economy, while the Chinese authorities could rely on strong economic growth to underpin domestic consensus for economic reforms.

Policymakers at that time, including the IMF, did not seem to see these imbalances as a problem. Indeed, as long as there were enough savers happy to defer consumption and invest their money in the US debt – and many of these savers were Chinese – then the system could remain in equilibrium for a long time. Ultimately, the banking and financial system of the United States was not brought down by the large exposure to China. However, the issue of trade imbalances was a political time bomb and it has seriously undermined the relations between the United States and China, and the whole global economic order.

'CHINA IS STEALING OUR FUTURE'

China may continue to regard itself as a developing country – and in many respects this is what it is. But for the Trump administration, which has made competition with China a key point of its mandate, China's long-term industrial strategy is difficult to accept. For the White House it is a way for China 'to ensure its global dominance' and threaten 'not only the U.S. economy but also the global innovation system as a whole'.[62]

President Trump has openly engaged in direct and harsh confrontations with China, calling out the country's regular infringements of the rules. As Peter Navarro, Director of US Trade and Manufacturing Policy, put it: 'China is basically trying to steal the future of Japan, the U.S. and Europe by going after our technology'. For Navarro, an academic turned presidential advisor, 'Made in China 2025' is a 'label for a Chinese strategy to achieve dominance in the industries of the future';[63] he maintains that the US brand of capitalism cannot survive the competition from China's state-led capitalism. In his book, *Death by China,* Navarro lists a catalogue of threats posed by China – consumer protection (or lack thereof), environment standards, export subsidies, counterfeiting of US intellectual property, human and workers' rights, losses of manufacturing jobs, pollution, subsidies to green industries and currency manipulation all make the cut. Navarro binds all of these issues together with security concerns, concluding that 'China's "one-way free trade" is simply America's unilateral surrender in an age of Chinese state capitalism.'[64]

The Trump administration has undoubtedly shouted the loudest, but the issue of China's 'threat', however, pre-dates the election of Donald Trump; the renminbi, especially, has been the lighting rod and a major thorn in relations between China and the United States for some time. The reason? 'Currency manipulation', that comes well before the Trumpian 'trade war' in the catalogue of US–Sino quarrels. The bone of contention stems from China's active policy of foreign exchange intervention that I discussed in Chapter 4. For years, the United States has claimed that China manages its currency to keep it artificially low in order to gain an unfair advantage in international trade, and Congress had repeatedly confronted China on the issue of 'currency manipulation'.[65] For – the argument goes – if China had a floating exchange rate like the United States and its other trade competitors, then the US–China trade imbalance would be significantly smaller because of a stronger exchange rate and hence more expensive exports. In 2018, the US deficit in goods traded with China reached over $419 billion.[66]

This argument is dubious on many grounds, but mainly because the exchange rate is not the sole determinant of exports' competitiveness – a point we have come across in Chapter 2. It is, however, politically powerful. Indeed it reinforces the view of international trade as a zero-sum game – where one country gains at the expense of another – as opposed to a process of adding value at each stage of the supply chain. There are, of course, winners and losers in international trade. But it is both over-simplistic and fundamentally wrong to infer a direct causality between China's exchange rate policy and the US trade deficit – and even more so, to link the trade deficit with the de-industrialisation of the American 'Rust Belt'.

On a number of occasions – in 2005, again in 2008 (just a few weeks before the outbreak of the global financial crisis) and more recently in April 2014 – China narrowly avoided being labelled a currency manipulator by the US Treasury Department in its semi-annual reports to Congress. After some initial skirmishing, in the end pragmatism always prevailed, either because China tweaked its exchange rate arrangements or because difficult financial conditions, like in summer 2008, appeased the tension. In August 2019, however, all these considerations were put aside and the US Treasury officially labelled China a 'currency manipulator' after the renminbi dropped below the psychological threshold of 7 renminbi per dollar, the lowest rate seen since 2008; in January 2020 the US Treasury backtracked just before the United States and China signed the US–China Phase One deal. Donald Trump had emphasised the issue since his inauguration. In February 2017, he declared China to be the 'grand champions' of currency manipulation, to which the Chinese government retorted: 'if you must pin the label of "grand champion" [. . .] on China, then we are the grand champion of economic development'.[67] Chinese academics were not shy to chime in either: 'he has such a big mouth. What can we do about it? Let him talk.'[68] This shambles set the tone for the following trade confrontation, as well as an assortment of derived issues.

As for challenging Beijing on international trade, this has not been solely Trump's prerogative. Barack Obama excluded China from his 'pivot to Asia', the US foreign policy programme that aimed to strengthen ties with the region. Notably, he did not invite China to join the Trans-Pacific Partnership (TPP), the trade agreement that was signed in 2016 by twelve countries to create an economic area in the Asia-Pacific region. Obama pushed this further by insisting that China should not be allowed to have a seat at the table or have a say on the rules for international trade in the twenty-first century. This could be seen as a tactical move, a strategy to cajole China into reforming its system so that it could be welcomed in the liberal order. But this was not the case.

When arguing the need for the TPP, Obama cited the establishment of a China-led regional trade deal,[69] claiming that 'China is negotiating a trade deal that would carve up some of the fastest-growing markets in the world at our expense, putting American jobs, businesses and goods at risk', and adding that the TPP would allow the United States to 'call the shots' on trade in the region.[70] On signing the TPP, Obama stated that not inviting China to be a member 'allows America – and not countries like China – to write the rules of the road in the 21st century'.[71] This turned out to be a mistake that deepened the divide between the US administration and the Chinese leadership.

THE UNITED STATES CONFRONTS CHINA

In 2018, the United States imposed three rounds of tariffs on China, affecting a total of more than $250 billion worth of goods. The duties imposed covered a wide range of industries, from textiles and leather goods to electricals, aluminium and solar panels. This quickly descended into a full-blown tit-for-tat trade war, with China promising to match the United States equally with counter-tariffs. China targeted a similarly wide array of US industries, including coal and medical equipment, although tariffs on US soybeans play an important part in this story. China imports more soybeans than any other country and the United States was its second largest supplier in 2017, providing $12 billion worth of trade.[72] By November 2018, however, Chinese imports of US soybeans had completely ground to a halt. By the end of 2018, the two countries agreed to a hiatus and embarked on a series of trade talks. For a while, it looked like these had the potential to be quite promising, but in May 2019 Trump confirmed that the United States would impose further tariffs on an additional $200 billion worth of Chinese goods. China retaliated to this with tariffs on a further $60 billion worth of US goods. By this stage, it was impossible for China to even come close to matching the US tariffs, because the trade between the two countries is heavily imbalanced and China simply does not import that much from the United States.

Increased tariffs – a major 'weapon' for the United States to use against China – should, according to the administration's objectives, protect the US domestic market and restore manufacturing, improve the trade balance and boost job creation. The bilateral trade imbalance, then, is the first of three US objectives in the trade war.

American access to the Chinese market is the second objective. Besides the US administration's rhetoric, China is far from blameless. It has long implemented controls that restrict foreign companies from accessing their domestic market. This is particularly true in the banking and finance industry, partly because of controls on capital movements, as I discussed in the previous section. Take the case of payment card companies, for example. In 2012, the WTO ruled that China's policies in this area were discriminatory against foreign companies, but it wasn't until 2017 that China pledged to give 'full and prompt market access' to US payment operators.[73] China has done little to act on this pledge. At the end of 2018 American Express received preparatory approval from the PBoC to become the first foreign payments company allowed to operate within China, but PayPal became the first to actually obtain a licence in September 2019 after buying a majority stake in a Chinese payments group.[74]

The third objective of the trade war is the protection of intellectual property rights that the Chinese authorities have often failed to safeguard – somehow reflecting US concerns about China's potential to grow its technological edge. The creation of the WTO established near-universal intellectual property laws, which extended to China on their joining in 2001. The United States has long complained that China does not comply with these rules. I'm sure we have all come across the off-looking or misspelt branded goods that litter the pavements of cities across the world, almost all tagged as 'made in China'. In 2011, the US International Trade Commission reported that trademark infringement was China's most frequent offence, while copyright infringement caused the most damage.[75] The report estimated that Chinese infringements cost American intellectual property-intensive firms (i.e., those whose prosperity is heavily dependent on research and development) over $48 billion in 2009.[76] However, China's violations do not stop with branding: the country is also notorious for exploiting information and trade secrets from companies desperate to gain access to their market. This is particularly true of technology. In 2015 the Federal Reserve Bank of Minneapolis found that foreign companies accounted for over half of the technology in the hands of Chinese firms.[77]

Around the same time that the United States broke the tariff hiatus, it also announced that it had added Chinese tech giant Huawei and seventy of its associates to the trade blacklist. China called this move out for going against WTO rules, but this did not budge the Trump administration. Huawei has long been a critical point of contention between the two countries, as the United

States has repetitively voiced concerns over the fact that Huawei's founder was previously a technician for the Chinese armed forces and that it has received tens of billions of dollars in funding from the Chinese authorities.

In 2018, Huawei announced that it would increase its annual research and development budget to over $15 billion – and US intelligence officials have cautioned that there could be national security complications if Chinese technology were to overtake that of the United States. In particular, they are worried that Huawei will infiltrate the United States with 'backdoor' products that can be used to spy and steal data, or that they will weaponise their technology in some way. The fact that Huawei is a stakeholder in 5G technology has massively intensified the United States' concerns. The relations between the United States and China vis-à-vis Huawei deteriorated to an all-time low when Meng Wanzhou – Huawei's chief financial officer and daughter of its founder – was arrested and detained in Canada in 2018 at the request of the US justice department. In response, China detained two Canadian businessmen, sparking an international diplomatic crisis.

The Chinese government has come up with some concessions in order to appease the United States and strike a deal, at least in the medium term. They have tabled concessions for three of the US objectives such as, for example, to purchase an extra $200 billion in American products in 2020 and 2021, and floated proposals that would allow American companies to gain access to previously restricted sectors, including finance, cars and energy.[78] The only thing not open to negotiation is China's industrial strategy and state subsidies. Planning for the long term and subsidies covering local production and 'indigenous' innovation has long been official Chinese policy. Indeed, both are pillars of China's state-led system. Even though 'Made in China 2025' does assert as a basic principle that the government will 'comprehensively deepen reform' and give markets the 'decisive role in allocating resources',[79] it is difficult to see the long-term strategy being delinked from state intervention. A state-directed industrial policy will inevitably be focused on reducing China's dependence on foreign technology and also helping Chinese firms become dominant global players in numerous advanced industries. It is the role of the state in managing the economy – the so-called 'socialism with Chinese characteristics'[80] – that sets China apart from the United States and the other advanced economies that have been leading the international economic system since Bretton Woods.

This situation and the Trump administration's policy of aggressively confronting rather than engaging with China, and its use of economic and financial tools to disrupt China's trade raise several questions. Will the international economic system eventually break into two competitive systems? Or will China take over? And, in any case, who will provide and underpin the global goods of an open trade system, international development finance and an international safety net to backstop financial instability should this arise and threaten the stability of the world economy as in 2008?

8
BUILDING A RESILIENT FRAMEWORK

We have come to recognize that the wisest and most effective way to protect our national interests is through international cooperation – that is to say, through united effort for the attainment of common goals.

US Treasury Secretary Henry Morgenthau Jr, closing address at the Bretton Woods Conference, 22 July 1944

Forty years ago China was a poor country with limited contact with the rest of the world. Today, many Chinese who remember the old days – not such a long time ago, after all! – marvel at their country's role in the world even if it is something that feels alien to their day-to-day life. As a Chinese colleague of mine once put it: 'Is China qualified enough to participate in the shaping of the new economic order?' It is indeed the perception of many people: how can a middle-income country with some intrinsic economic weaknesses like the ones I have described in the previous chapter be such a thorn for the United States?

It is the relative competitive position of different countries in international trade as a result of the rise of China – and other developing countries – that bothers the United States. Through its process of 'opening up' China has challenged the multilateral trade system to accommodate for the increase in cheap exports that have resulted from its exports-led growth model. The world is still grappling with the impact of this on labour market arrangements, consumption patterns and environmental sustainability.[1] In addition, China's large accumulation of savings, a consequence of its export-led growth model, has exacerbated the imbalances between creditor countries (i.e., China itself) and debtor countries (such as the United States). And controls on capital movements in and out of China constrain the adjustment through the exchange rate.

All this has critical ramifications besides the US bilateral trade position with China and, along with creating sustained tensions and open rivalry, is challenging the workings of the international monetary system that is centred on the dollar and the international movement of capital. As I have discussed in Chapters 4 and 7, China is not *another* developing country that happily conforms with the Washington Consensus of open capital markets, liberalised capital movements and adjustments through the exchange rate. Controls on capital movements and management of the exchange rate have underpinned China's development of the last forty years and continue to do so – regardless of the increasing costs and problems – to protect domestic markets and the banking sector.

To some extent the rise of China with its 'socialism with Chinese characteristics' has been undermining the post-Bretton Woods non-system. Being plugged into the dollar system because of the intrinsic limitations of its own currency, China has created a new version of the same old problem that sabotaged the Bretton Woods system, that is the development of trading relations which threaten the workings of monetary institutions. Recall the issue with Germany and Japan in the late 1960s when their governments were not prepared to inflate the value of their currencies in order to reduce the competitiveness of their exports and narrow the trade surplus with the United States? When Donald Trump accuses China of 'currency manipulation' he is rewinding the same old story – one that has afflicted the US administration since the early 2000s. He is also implicitly saying that that the US trade deficit is a macroeconomic problem that comes from the lack of adjustment through the exchange rate – the corollary of this is that the solution should be macroeconomic and not based on tariffs.

Against this background, and because the outcomes of this deep underlying adjustment process are uncertain, free movement of international capital makes the current system intrinsically unstable. Emerging markets and developing countries continue to be exposed to net external borrowing – in particular because of the Fed's ultra-accommodating monetary policy – while investors desperate for higher returns have increased their exposure to corporate borrowing. Thus, the challenges facing both domestic and international financial regulations remain significant. Drawing on the experience from the global financial crisis, resilience needs to be created through measures of crisis prevention and crisis resolution. These, in turn, need to be underpinned by international institutions through the provision of global public goods – an open trade system, international development finance and an international financial safety net.

In this chapter I discuss how this framework of resilience can be strengthened by focusing on a number of areas. I will start with measures of crisis prevention and crisis resolution such as financial safety nets, debt restructuring and a framework for multilateral lending to reduce the scope for bilateral loans and financial help with no strings attached. Institutions are pivotal to extend a safety net to a system that remains structurally dysfunctional, in order to reset it every time it short-circuits. This is more or less what the major central banks – the Fed, the ECB, the Bank of Japan, or the issuers of the key international currencies – have done since the global financial crisis by providing plenty of liquidity. The ECB and the Bank of Japan have avoided prolonged deflationary pressures that would have further depressed economic activity. As for the Fed, tellingly in 2019 it reversed its monetary policy stance when it became clear that further tightening had the potential to trigger significant instability and perhaps another crisis. These, however, are all bilateral institutions and, instead, here I make the case for multilateralism and for strengthening the existing international institutions, those that came out of Bretton Woods.

I will then turn to international trade as a lightning rod for tensions that come from macroeconomic imbalances. I will finally explore the governance reform of the Bretton Woods institutions and the overlapping issues of quotas and votes. The rise of China has made such reform a pressing issue. These institutions need to be more inclusive and their funding needs to be enough to pursue their objectives – lending for development and providing financial support at the times of crisis. Strengthening the governance and improving the capital base of the international financial institutions matter in a world that values international policy cooperation and multilateral action. But, first, I take a look at why a 'new Bretton Woods' did not happen after the global financial crisis, while open confrontation and repeated nationalist reactions are on the rise throughout the countries that were at the core of the Bretton Woods system.

A 'NEW BRETTON WOODS'?

I have already mentioned the call for a 'new Bretton Woods' in the aftermath of the global financial crisis and the first gathering of the leaders of the G20 in November 2008. What the French president Nicolas Sarkozy, as well as the

British prime minister Gordon Brown, had in mind for this meeting was a new multilateral agreement that would stabilise international finance in the twenty-first century.[2] It was felt that the international financial institutions needed to be reformed. They needed to be updated and brought into line with the complexities of modern finance, as well as making them more responsive to risk-taking and better at crisis prevention. The IMF, in theory, could monitor risk in the global financial system as well as provide a safety net in the wake of crises, but needed more resources before it could effectively do both.[3] Additional resources could be provided by expanding the quotas of the member states whose economies had grown – large developing countries and China, in particular, held a much larger share of the world economy than they did in 1944.

The coming together of the G20 was an important initiative that stressed the necessity of multilateral cooperation at times of crisis as a way to contain the risk of 'beggar-thy-neighbour' policy actions – and reactions.[4] Their coordinated measures helped to restore confidence in the system, without tying the hands of the largest economies – notably the United States. A later summit, held in London in April 2009, further gave the sense of multilateral cooperation and that 'somebody was at the steering wheel'.[5]

Unfortunately, however, this wasn't the beginning of a broad, deep, and independent discussion on how to reform the global economic order with the objective of rethinking the rules-based international monetary system and the forms of international cooperation that are required to sustain such an order. The post-2008 initiatives like the G20 have been more of an attempt to fix the existing approach than an effort to create a new system. Lax financial regulation and a lack of harmonisation within global markets – and the consequent scope for regulatory arbitrage – were identified as the main problems that needed to be fixed, and the focus was mainly on banks – where the crisis had incubated. It was more a case of tweaking the problems and introducing some rules rather than coming to terms with the shortcomings of financial globalisation – including its unequal distributive impact.

Thus, despite the catchy soundbite, the call for the 'new Bretton Woods' was not answered. There are a number of reasons for this. Firstly – as I have already stressed – Bretton Woods did not come out of the blue and was the result of years of intellectual debate and policy discussions. Second – again a point already mentioned – the post-2008 initiatives were driven by the urgent need to reset the system, so there was simply not enough time – and possibly not enough inclination – to consider any alternative. The third reason was the fact that the global financial crisis, despite its devastating effects and long-term impact, did not compare to the knock-on effect of two world wars. The state of affairs was undeniably severe, just not severe enough to trigger the rebuilding of the international economic order – as had happened in 1944.

Finally, at Bretton Woods, the United States was willing to take up the leadership of the western world – in terms of economics and security.[6] But this was not the case in 2008, when the emphasis was rather on burden sharing. In addition, the United States was no longer the young and dynamic new power that it was in 1944. By 2008 it was an established power whose leadership had been strained for years. The fact that the crisis was generated in the United States did not help confidence in other countries, especially the developing ones. When the crisis spread from the transatlantic region to the rest of the world, policymakers in developing countries were quick to repeat the criticism that they had received in the wake of the crises of the 1980s and 1990s.

Even though it failed to result in a new Bretton Woods, the multilateral response to the 2008 crisis has broadened the global economic order. Key emerging markets have been brought to the table, as the G20 has replaced the G7 as the key forum for global economic and financial affairs. Bilateral and regional initiatives are now more prominent, and can be seen in balance of payments support, development lending, and foreign exchange swap arrangements. These initiatives have been actively pursued (particularly by countries such as China and Brazil) in tandem with the support for the international reform efforts that the G20 have led.[7] In addition a new landscape of multilateral institutions has emerged at the regional, national and global levels. From the AIIB and CMI, to the NDB and the BRICS Leaders' Summit, these initiatives attempt to harmonise an open multilateral world economy with the objective of greater policy autonomy at all levels. I will consider these initiatives in detail in the next chapter.

The world survived the 2008 global crisis, and still retained some level of cooperation. This is because none of the main countries involved went through a major political upheaval as a result of it. Indeed, the most remarkable feature of the post-crisis years was the lack of politics, despite the massive taxpayer bailouts of private financial firms and severe impact on domestic economies. This was to come later, however, with significantly disruptive effects as I have discussed in Chapter 6.

As rivalry among countries is on the rise while the economic and monetary order is intrinsically unstable, multilateral institutions – those that came out of Bretton Woods – must stay relevant and continue to provide international public goods. The multilateral trade agenda and the global financial safety nets are critical to the relevance, effectiveness and even survival of the current global economic order. International trade and international finance need a multilateral institutional framework to avoid a race to the bottom where the dominant countries – in terms of markets, resources, political and security clout – impose terms and conditions on smaller countries. International institutions are there also to act as arbiters among member states, smooth different views, pool information, monitor compliance and, as last resort, sanction those who break the commitments. Above all, international institutions help countries compromise over competing domestic objectives and even special interests, and reconcile the desire for autonomy in domestic economic policies with the goal to keep an open world economy without restraining economic integration. They act like a commitment mechanism that improves the quality of democracy by constraining special interest organisations.[8] International commitments are indeed the foundation of a stable international order,[9] especially when financial instability strikes, as I discuss next.

A BROAD SAFETY NET

The international economic order is like a big tent that houses almost everyone. The tent is still the one made available by the United States that was cut and sewn at the Bretton Woods conference and its two main supports – development finance and the global financial safety net – are also still in place. It has become more crowded over the years and some of the furniture has been pushed out to make space for the newcomers, but it still shields from the wind by underpinning the international monetary system and international trade. In practice, coming into the tent means entering into a network of official arrangements and committing to abide by the rules and governance that underpin the system, but there are many benefits that you get in exchange to being part of global risk-sharing arrangements. Importantly, a country obtains access to official financing in the event that it cannot meet external payments by raising capital through markets (such as in the case of a solvency crisis as it happened in Greece), or when a country suffers from balance of payment difficulties, or needs some funds for development. Some of the rules and arrangements have changed over time to allow for financial globalisation. Ever since the 1980s, the controls on capital movements have gradually been removed, leading to 'free money'. This has resulted in several episodes of financial instability, as I have discussed in Chapter 3. The first of these were shrugged off as run-of-the-mill balance of payments crises, hitting the developing countries because, it was believed, they were unable to modernise their economies. But now we know that financial contagion spreads much more quickly when capital markets have become much more interconnected, meaning shocks tend to transmit faster.

Because of this, the global financial safety net is now supporting more of the weight of the international order then it has ever done before. As a result, the integrity of the net has never been more important than it is now. The safety net should be able to help countries that face an economic or financial crisis and reduce the global systemic risk by preventing crises from spreading but its participants need to cooperate. A coordinated approach to crisis resolution and crisis prevention is necessary to ensure that moral hazard risks are managed and the risk of future crises is reduced. Historically, the international financial safety net has been organised around the IMF and this is where resources have predominantly been mobilised. The World Bank and the Bank for International Settlements have both also put resources into the international safety net at different times in the past.[10]

Often – and this was increasingly the case during the global financial crisis – countries under the shelter of the international order have grappled with liquidity crises. Even those without persistent financial imbalances can experience a liquidity shortage on the back of episodes of strong capital outflows. This is the direct consequence of unfettered capital movements and financial globalisation, as I have discussed in Chapters 3 and 4. The complexity of financial instability since 2008 – its size and potential for financial contagion through the highly integrated international system – has highlighted the importance of ensuring plenty of liquidity at times of dwindling market confidence. Think of the 2013 'taper tantrum', when capital flowed out of the large emerging market economies on the back of the Fed's indication that it would be changing its monetary policy stance, for instance. Hence it is necessary that the financial safety net has an intervention tool that can provide liquidity rapidly and effectively.

The G20 addressed this concern at the April 2009 London Summit and added a new component to the global safety net in the form of a non-conditional liquidity line. This consists of the Precautionary and Liquidity Line which is tailored for countries with a sound economic track record, and the Flexible Credit Line which is tailored for countries with structurally sound economies. Countries with a temporary shortage of liquidity can now access these lines and restore market confidence without going through the procedure of a fully fledged IMF rescue. This lending is now a more prominent component of the IMF's action and requires the commitment of large contingent lines of credit, which ties up a significant amount of the IMF's resources. The fact that this lending is non-conditional has not served to rid it of the stigma attached to requesting support from the IMF. Only three countries to date – Mexico, Poland and Colombia – have used the Flexible Credit Line and only two – Macedonia and Morocco – have used the Precautionary and Liquidity Line. Alongside these credit lines, regional components such as the ESM in Europe and the CMI in Asia – later to become the Chiang Mai Initiative Multilateralization (CMIM)[11] – have emerged, with bilateral components such as currency swap lines.

The regional and bilateral components of the international financial safety net are appropriate instruments for addressing the recent crises and they reduce, in principle at least, the scope for IMF interventions. As I have discussed in Chapters 3 and 5, the 'classic' IMF assistance is conditional on the country's government making the necessary adjustments to ensure that the underlying causes of financial imbalances are addressed, so that the financial help can eventually be repaid. This approach responds to the need to manage moral hazard risks that are inevitably associated with the provision of financial resources to countries that struggle to get access to credit. For instance, a way to reduce moral hazard is dictating that private sector lenders share some of the losses, thereby removing possible incentives to take up excessive and unsustainable lending knowing that official financing will eventually bail out the private sector, as happened with banks in Europe. The need to mitigate moral hazard for lenders makes the IMF interventions and the process from insolvency to financial sustainability painful and politically difficult. People resent external interventions and see them as a diminution of national sovereignty, especially when such interventions require fiscal sacrifices such as considerable cuts in public expenditure or tax increases.

Like in all insurance contracts, there are costs and risks that are linked to providing the global financial safety net – as well as for those who contribute to it. A commitment to lend is a contingent liability, and so the IMF quotas require paid-in capital or assets. This will accrue interest, but the rate is typically lower than those from low-risk commercial assets. Reserve holdings also come with both direct financial and opportunity costs, while currency swaps bring credit, sovereign, and foreign exchange risks that are difficult to alleviate. Furthermore, there is an opportunity cost when taxpayer money is put towards the safety net, as these funds can no longer be used for other purposes, such as domestic priorities.

Although the IMF acts as a lender of last resort, it is not a central bank and it cannot print money.[12] Its total financial resources amount to $1.4 trillion in quota subscriptions, commitments to the new arrangements to borrow, and fixed-term bilateral borrowing agreements. Only 80 per cent, however, is available for lending – approximately $865 billion. This is because some members are not financially strong enough to lend to other members and also to ensure that there is enough liquidity.[13] These resources are due to decline over the next three years. About $443 billion in bilateral borrowing from members expired at the end of 2019 and $39.2 billion will no longer be available after 2022 if the United States does not renew its commitment. At the same time, demand for the IMF's resources is not going to diminish and can only increase. For instance, supporting large emerging markets such as Brazil, Indonesia and South Africa would require $51.3 billion. Pakistan and Turkey might need and qualify for expanded access programmes on the scale of Argentina's programme today (12.8 times its IMF quota) for a total of $118.6 billion. And if three countries of particular political interest to the United States, such as Venezuela, Iran and North Korea, each were to have an IMF programme on the scale of Argentina's, the commitment of IMF resources would be a total of $145.2 billion.[14] (In response to the Covid-19 emergency in April 2020 the IMF exceptionally offered $1 trillion in lending capacity to its members and established a short-term liquidity line to help member countries manage short-term liquidity pressures.)

A FRAMEWORK FOR MULTILATERAL LENDING

In July 2018, while commenting on the possibility of a second IMF bailout to Pakistan to help avert a currency crisis, US Secretary of State Mike Pompeo made it clear that the United States was not prepared to approve multilateral financial institutions' loans that indirectly may benefit China. 'Make no mistake,' he said without hesitation, 'we will be watching what the IMF does. There's no rationale for IMF tax dollars, and associated with that American dollars that are part of the IMF funding, for those to go to bail out Chinese bondholders or China itself.'[15] In an abrupt and confrontational way driven by the rivalry between the United States and China, Pompeo put his finger on the issues surrounding the large loans book that China has accumulated over the years with countries that are increasingly unable to repay. Indeed 44 per cent of the loans to the thirty-two developing countries with unsustainable levels of public debt in 2017 were provided by China – up from 30 per cent in the years between 2013 and 2017.[16] There is also a strong possibility that these figures are in fact higher still, as China is reluctant to disclose the exact details of its lending activities.[17]

Despite the renminbi's intrinsic immaturity (Chapter 7), China has become more active in investing and lending overseas 'with no strings attached' on the back of geopolitical considerations. This financial diplomacy has nurtured Beijing's relations with many developing countries and solidified China as an alternative to the US-led economic diplomacy and the Washington Consensus. The South Pacific region, for example, is clearly an area that is becoming increasingly strategic. While Australia is redeveloping a Papua New Guinea naval base in the region, New Zealand has announced that it will spend an extra $500 million on overseas aid (over four years), with most of this directed at South Pacific nations. For China, this area provides it with access to the Pacific without sailing through Japan, Taiwan and the Philippines – all US allies. Thus, since 2011, China's presence in the region has increased, and it has committed approximately $6.9 billion in aid and low-interest loans, about $1.6 billion of which have already been deployed.[18] Repaying Chinese loans is daunting for the poor Pacific island nations. Tonga, for example – a developing country vulnerable to natural disasters, with an economy that depends on foreign aid and foreign remittances – has received about $163 million from China which it is struggling to pay back. In 2018, China agreed to delay due payments by five years.[19] Shortly after this, Tonga announced coincidentally that it would be joining China's BRI. And the case of Tonga is not unique. During its economic crisis of 2012, Sudan secured a five-year delay on its debt to China, and, in 2018, Ethiopia became the first among China's top African debtors to secure a rescheduling deal, a further twenty-year extension on some of its debt to China.[20] Not to mention Zimbabwe and Venezuela, which have de facto defaulted on their debt to China.

The question of how to deal with large-scale intergovernmental lending is clearly a pressing one. There are four reasons to explain why we need a framework for multilateral lending as opposed to uncoordinated bilateral action. First of all, borrowing from multilateral institutions is a way to smooth rivalries. As the United States and Europe increasingly see their relationship with China as competitive, the Bretton Woods institutions need to mediate between competing claims that arise specifically from China's bilateral lending in sensitive countries such as, for example, Pakistan or Venezuela.

Second, uncoordinated bilateral lending can have an adverse impact on financial stability and trigger measures of crisis resolution. For if countries are lured into excessive bilateral borrowing by favourable conditions that, in turn, arise from political and diplomatic considerations – i.e., not in line with prudential borrowing – then extending the multilateral financial safety net to such a country smells of moral hazard. The same case occurs for the lender that is prepared to take the risk knowing that eventually the borrower could be bailed out on the back of the IMF or the regional financial arrangements. This is indeed the concern expressed by Secretary of State Pompeo, that China could push its bilateral lending knowing that ultimately there is the IMF as lender of last resort – even with the limitations discussed in the previous section.

Third, Pompeo's comment, with its anti-China rhetoric, reiterates the importance of multilateral lending as a tool to overcome political and diplomatic considerations. As it is delinked from member states' specific goals, interests and geopolitical preferences, it ensures that money is deployed where it is needed and the risk of favouring allies and friends should be minimised if not removed. In addition, multilateral lending is framed within a set of rules and standards agreed by the member states. These rules and standards ensure that lending is directed towards projects that are respectful of human rights, workers' welfare and environmental sustainability. Conditional lending that is dependent on the implementation of policies imposed by the lenders are often used to introduce sustainability in government policies in borrowing countries, making it easier for sovereign governments to accept conditionality than if this would come from another sovereign government or a private entity.[21]

And it is also a way to ensure that governments are not tempted to introduce rules against international creditors after money has been lent.

Finally, multilateral international institutions have built a large analytical capacity and have amassed a large amount of data over the years. Hence they can provide technical support to assist the decision-making process on lending and monitor government policies in recipient countries. They regularly carry out intensive consultations with the governments of member states to assess the state of their economies. In doing this, these institutions provide information to private investors, helping them to assess the quality of their investments in any of the member states.[22]

Pompeo's comments are also interesting as they hint – and not too subtly – at the pressures that the main shareholders, notably the United States, regularly put on the Bretton Woods institutions. He was speaking on behalf of the main shareholder of the international financial institutions. These are often constrained by political considerations and are involved in controversies in developing countries where they are seen as the enforcers of the Washington Consensus. Over the years the action of the multilateral financial institutions has been flawed by political biases that are, however, a consequence of the dominance of the United States within the governance structure – a point that I will revisit later.

DEBT RESTRUCTURING: 'A GAPING HOLE'

Where there is lending there is borrowing, and where there are cross-border capital flows, there are debt obligations towards foreign individuals, firms and banks. This being so, what is the international framework for debt restructuring? Despite the frequent and recurrent sovereign debt defaults and insolvency crises, the world is currently without an international mechanism to assist governments with restructuring debt. The debate about the desirability as well as the technicalities of such a mechanism has been going on, in an intermittent fashion, for several years. The most notable proposal remains the one that Anne Krueger, the then IMF Deputy Managing Director, presented in November 2001, during the crisis in Argentina; it revolves around making restructuring less onerous for the debtor country, providing it with fresh capital to meet its financial needs and offering creditors guarantees that the debtor country will act responsibly during the course of any standstill.[23]

International action has been patchy at best and the costs of debt restructuring have been far higher than they needed to be. Widespread financial instability, poorly functioning sovereign-debt markets, high interest rates, stringent borrowing conditions and general misery for the populations of debtor countries are all part and parcel of inordinate debt restructuring. In 2015, concerned about the state of global poverty and inequality, Pope Francis, who as Archbishop of Buenos Aires lived through the miseries caused by the financial crisis in the early 2000s, spoke out against the international financial institutions for not having a debt-restructuring mechanism: 'If a company can declare bankruptcy,' he questioned, 'why can't a country?' The current 'road of loans and debts' he concluded, 'in the end, it never ends'.[24]

In the absence of fair and transparent international rules, disputes around debt defaults are generally resolved by bargaining among unequals – or bullying and blackmail, as others prefer to phrase it – with those who can afford complex and costly lawsuits imposing their will on those who can't. Private creditors such as commercial banks and bondholders tend to get bailed out by the international community in order to keep access to private capital markets open. There are some well-oiled mechanisms for restructuring bilateral debts, such as the Paris Club – an informal group mostly comprised of OECD creditor governments with China as an observer – but conventional sovereign debt restructuring techniques are far less effective when the restructuring requires extensive coordination among diverse creditor classes.[25] This is particularly true when bondholders – a large and anonymous group of creditors without a shared goal as to what they want the restructuring to achieve – have a dominant presence. Individual investors or institutions such as pension funds generally lean towards a rapid and orderly restructuring and the preservation of the value of their claims. 'Vulture funds', on the other hand, buy discounted debt on the secondary market in the hope of profiting through litigation and so favour a disorderly process that allows them to buy even cheaper distressed debt.

The need for the international community to agree on a debt mechanism is now urgent as debt in developing countries hit an all-time high in 2019,[26] both in dollar terms and as a percentage of GDP, as discussed in Chapter 4. The combination of unfettered capital movements, the huge increase in private financial flows and the rise in sovereign bilateral lending by China has left many developing countries dependent on the mercy of these flows as well as on the demand for oil and commodities that are often used as collateral for debt.

Thus the lack of a coherent multilateral approach to public debt restructuring is a 'gaping hole'[27] in the international economic and financial order, due to be especially problematic as geopolitical and geo-economic rivalry increases.

The fate of Argentina epitomises the problems that arise from the absence of an international debt-restructuring mechanism. Recall Argentina's sovereign debt crisis (discussed in Chapter 3), where an $80 billion default on the country's international bonds in 2001 led to a lengthy recession and political turmoil. As a result, the negotiations to determine how the debt would be restructured were postponed until 2005. By the time the Argentinian government settled on a restructuring offer, numerous lawsuits had been filed against it in several jurisdictions. Some of those lawsuits would drag on for over a decade, hindering the country's access to international capital markets for fifteen years.[28] In 2016, for the first time since the 2001 default, Argentina was able to access capital markets and issued $16.5 billion of debt. In 2017, it issued a further $2.75 billion debt in a widely acclaimed issuance of bonds with a hundred-year maturity.[29] This was only a short respite as Argentina was back on the doorstep of the IMF securing the fund's largest rescue to date in 2018, as we will see in the next chapter.

The absence of an international debt restructuring mechanism has had direct and dire consequences for the population of Greece. I have discussed in Chapter 5 the miseries that this brought to many individuals and families who fell into deprivation and poverty as their living standards collapsed. A quick and orderly debt restructuring would have spared an immense amount of suffering and presented Greece with an opportunity for a fresh start, for no country can rebuild its economy while grappling with an excessive debt burden. Importantly, it would have prevented the deep split in opinion between Europe's public – as well as its leadership – that the European sovereign debt crisis caused. Eventually there was a debt restructuring, though it came too late and was heavily resisted by countries whose banks were exposed, i.e., Germany and France.[30]

It is Venezuela, however, that provides the most recent and dramatic example of a country grappling with its debt burden in the absence of an international restructuring mechanism. Venezuela defaulted on its debt in November 2017, and the Venezuelan government and state-owned oil company PDVSA have since accumulated approximately $8 billion in late interest payments.[31] Plagued with bad governance and corruption, Venezuela has fallen into a deep economic crisis with hyperinflation, soaring crime rates, and shortages of food and medicines. The country has plunged into a humanitarian crisis and over 3.3 million Venezuelan refugees – roughly 10 per cent of its population – have fled into neighbouring countries since 2015.[32] Venezuela is home to the world's largest oil reserves, with oil sales accounting for roughly 98 per cent of the country's export earnings and up to 50 per cent of GDP.[33] Most of the Venezuelan oil sold for cash is shipped to the United States and the majority of Venezuela's external debt instruments are bonds governed by New York law, so disputes over these bonds need to be adjudicated in New York courts. Any attempt at debt restructuring without an internationally coordinated mechanism could only result in a small number of holdout creditors finding an effective legal remedy against Venezuelan oil assets and receivables in the United States, but this would create an unmanageable situation. As a result of sanctions that the US government imposed on Venezuela in August 2017, the US Treasury had to grant a licence for the participation of US entities in debt restructuring.

The situation in Venezuela is even more complicated because the country is at a political impasse. In January 2019, Venezuela's long-standing President Nicolás Maduro was sworn in for a second term, despite international criticism that the election was rigged. Shortly after, the leader of the opposition Juan Guaidó took to the international stage to assume the role of the legitimate head of state. He received instant support from the United States and Canada with Britain, France, Germany and other US allies also getting behind him. The majority of power and assets, however, are still in the hands of Maduro. A debt restructuring cannot even get off the ground until there is a change in the regime. For how can the United States even begin to start the process of restructuring with Venezuela, when the Venezuelan government that they recognise as legitimate does not even have power over the very thing that they are supposed to be negotiating? The only way for things to develop in Venezuela is like in the case of Iraq, where the country's $140 billion debt was restructured under the cover of a UN Security Council resolution[34] after Saddam Hussein was removed. The US government is open to whatever action needed to drive a change in the regime in Venezuela, including military action. Indeed, President Trump has made it clear that 'all options are on the table'.[35]

The power struggle in Venezuela has not just halted the United States in its actions, but has put the entire international community on hold. It has created a deep division among the members of the World Bank and the IMF as some –

including China and Russia – have gone against the United States and its allies in recognising Maduro as Venezuela's legitimate leader. The World Bank and the IMF cannot help Venezuela ease the humanitarian crisis until the issue of the leadership is resolved. Unless the current debt crisis is addressed and guarantees for creditors are negotiated, including a radical change in the approach to economic policy, no fresh money is due to come into the country. This again brings up the problem of bilateral lending being utilised as a strategic tool to extend the lending government's political or military ambitions. Over the last decade or so, China has pumped more than $50 billion into Venezuela, making it the country's biggest foreign creditor.[36] Much of this financial support came in the form of oil-for-loan agreements, according to which Venezuela would send more oil than the amount needed to service the loan and China would reimburse Venezuela the excess. This worked well until the drop in oil prices and the consequent cut in Venezuela's crude output – Venezuela is a member of OPEC.[37] The people of Venezuela are desperate, but even China has responded to the Venezuelan crisis with deafening silence.

IMBALANCES THREATEN INTERNATIONAL TRADE

The notion of a rules-based multilateral framework remains critical to international trade. As in the 1930s, and at any point of crisis in the international order, trade is the lightning rod for geopolitical tensions and rivalries even if the lightning comes from monetary imbalances. The constrained monetary system of the 1930s led to a rise in protectionism which in turn resulted in political catastrophe, global conflict and the collapse of international cooperation.

Trade is currently at the core of the tensions between the United States and China. Mistrust of and open attacks against the rules-based trade system are on the rise, and so protectionism. During his inaugural address in January 2017 President Trump declared that 'protection will lead to great prosperity and strength',[38] but this fails to recognise that the trade imbalance with China is a macroeconomic problem that comes from China embracing a macroeconomic framework with 'managed' capital flows.[39]

When the G20 met in monsoon-struck Osaka at the end of June 2019, all eyes were on the bilateral meeting between Donald Trump and Xi Jinping. Trump's outlandish behaviour from the previous year's G7 summit in Canada was still fresh in everyone's mind; not only did he arrive late and leave early – skipping all the meetings on climate change – but he pulled the United States out of an already agreed communiqué at the last minute while launching a personal attack on Canadian Prime Minister Justin Trudeau. A couple of hours prior to the meeting, the EU and the South American trade bloc Mercosur brought decades of negotiations to a close as they finally settled on a free trade agreement. Then president of the European Commission Jean-Claude Juncker praised the deal, stating that 'in the midst of international trade tensions, we are sending today a strong signal with our Mercosur partners that we stand for rules-based trade'.[40]

The 2019 G20 communiqué made a point to 'reemphasize that international trade and investment are important engines of growth, productivity, innovation, job creation and development',[41] implicitly hammering the point that a rules-based international trade system is at the core of a peaceful and prosperous world. The widespread removal of tariffs and non-tariff barriers has driven the economic and financial integration of the last three decades. Between 1980 and 2015, the average tariff rate in advanced economies fell from 10 per cent to 4 per cent, while those in the developing economies fell from 31 per cent to 9 per cent.[42] Ever since the global financial crisis, however, the pace of trade integration has slowed. Indeed, the global financial crisis and the subsequent recession have had an adverse effect on international trade – international finance and trade are two sides of the same coin. The number of new trade restrictions implemented has increased since 2008, with the level of G20 imports affected by new measures hitting 6.5 per cent in 2016.[43] Trade-restrictive measures do not just include tariffs, but also domestic policy barriers such as the health and safety regulations that imported goods are required to meet. These regulations apply more in the advanced economies than in the developing world, but quantity and price controls – factors that are more likely to directly distort trade – are more prevalent among low-income countries.

As a result, the ratio of trade to output, an indicator of the importance of international trade, has declined dramatically. Prior to the crisis, the annual rate had been 6.3 per cent,[44] but between 2011 and 2015 it dropped to 3.3 per cent. The strong drop in aggregate demand and investments after the crisis explains much of this drop.[45] On the back of the 2008 crisis world trade declined by 10 per cent – a rate higher than the drop in world output. It would be some years before this figure moved back into positive territory in 2011. However, structural factors were also important, for example, the collapse of the global supply chain that was developed during the 1980s by the advanced countries of North America, Europe and Japan on the one hand, and China and other fast-growing Asian economies on the other.[46]

The WTO's Doha Round – a series of trade talks launched in 2001 to establish a multilateral trade agreement between all WTO members, with a particular focus on bringing up the developing countries – was eventually put to rest in 2015 as it had failed to achieve any tangible results. This led many policymakers to question the existence of the WTO itself. At the same time, the success of bilateral and regional trade agreements stipulated outside of the WTO framework, especially those led by the EU, put a further nail in the coffin of trade multilateralism and created a tangled web of cross-country and regional groupings not dissimilar to a spaghetti bowl. Between 1990 and 2015, the number of trade agreements declared to the WTO increased from about 50 to 280, while their scope has also significantly expanded.[47] More than half of the existing preferential trade agreements include provisions in policy areas both within and beyond the current mandate of the WTO such as customs regulations, export taxes and technical barriers to trade.

There have been some recent attempts to give a fresh lease of life to the WTO, such as the implementation of the Trade Facilitation Agreement in 2017, a landmark achievement seeking to promote efficiency and transparency, and the first multilateral agreement since the WTO was established in 1995. While the Trade Facilitation Agreement is significant and should serve to counter some of the costs of bilateral agreements, the future of the WTO is still on very shaky grounds. In spring 2019, when the representatives of the United States, the EU and Japan met in Paris to smooth trade tensions, they expressed their concerns 'with non-market oriented policies and practices', industrial subsidies and state-owned enterprises, and reiterated their commitment to reform the WTO.[48] As the then EU Trade Commissioner Cecilia Malmström put it: 'There is no point in enforcing rules that are not fit for the purpose.'[49]

History is littered with instances of trade tensions descending into more serious matters, but the dispute resolution procedures maintained by the WTO (and the GATT before it) have directly worked to change this trend. Indeed, trade experts have hailed the WTO's dispute system for supporting the organisation as a whole and providing the keystone of the international effort to prevent protectionism.[50] The WTO's highest trade court, the Appellate

Body, has come under direct fire from the Trump administration. Ever since his inauguration, President Trump has blocked every appointment to the appellate, claiming to have done so because it is unfairly biased against the United States. The reality of the matter is quite different, as the United States has won more than its fair share of appeals. The body usually consists of seven judges, although it needs a minimum of three to continue functioning, and has always contained an American – a privilege that no other country has enjoyed. The appellate was reduced to just three judges in 2018 when Trump blocked the replacement of existing judges whose terms had come to expire. No new appointments have been made even though two more judges' terms expired at the end of December 2019, rendering the body unable to decide cases.[51] The appellate has the power to override US law – and this most likely explains Trump's hostile stance.

Tariffs, subsidies and restrictions continue to weigh on trade and this in turn has had an impact on global economic growth. The slower pace of reform since the early 2000s and the post-crisis uptick in new trade distortions leaves a large agenda for reforming the global trading system as one of the pillars of the economic order. Despite the successes of bilateral agreement and the prevalent aversion to the complexities of multilateral trade, it still holds as a general principle that the benefits of trade are greatest if undertaken multilaterally without discrimination. Such reforms therefore need to focus on strengthening the multilateral institutional framework that guarantees that the system remains fair, open and transparent for all.

OLD INSTITUTIONS, NEW WORLD

The 2019 G20 summit took place just a couple of days prior to the seventy-fifth anniversary of the Bretton Woods conference. A lot has changed in those seventy-five years, but Bretton Woods is still upheld as the pinnacle of international policy cooperation. The world today faces serious issues, such as the climate crisis, that, in 1944, were less pressing. The nature of these issues demands collective action coordinated by multilateral organisations and leaves no scope for bilateral or unilateral action. At the same time, the changing dynamics of the world economy require new and more inclusive governance. This means that the countries that now have a more significant weight in the global economy need to have better institutional representation, and policies need to be designed and implemented in order to improve inclusivity and sustainability.

The communiqué from the 2019 G20 meeting of finance ministers and central bank governors states that the G20 reaffirms its 'commitment to a strong, quota-based, and adequately resourced IMF, to preserve its role at the centre of the global financial safety net [. . . to conclude] the 15th General Review of Quotas no later than the 2019 Annual Meetings, and call on the IMF to expedite its work on IMF resources and governance reform as a matter of the highest priority'.[52] To some extent, however, the very story of the G20 itself is telling of the fact that although the advanced economies recognise that change is needed, they are not quite willing to take the plunge. After the 1997 Asian financial crisis, the developing countries called out for the global financial architecture to change. The G7 responded to this call by establishing the G20 in 1999 as 'a new mechanism for informal dialogue in the framework of the Bretton Woods institutional system'.[53] Initially this equated to a coming together of finance ministers, but the severity of the global financial crisis in 2008 necessitated the G20 to be elevated to a meeting of the heads of state. After its upgrade, the G20 was able to put the reform of the Bretton Woods institutions firmly on the agenda and some substantial changes were agreed in 2010. However, it took over half a decade for these changes to come into effect and the problems ran so deep that they still fell short. In principle, then, the developing countries' call for change was answered – but in practice it has been ignored. Excluding China, developing Asia still only has a footprint of less than 8 per cent in both the IMF and the World Bank.

Such ambivalence begs the question of whether advanced economies are ready and willing to make more space around the main table under the communal tent. At the 2007 G8 summit held in Heiligendamm, Germany, the leaders unveiled an initiative to formalise a high-level dialogue between the G8 and the five most important emerging market economies – i.e., China, Brazil, India, South Africa and Mexico – all of which are members of the G20.[54] Russia was a member of the advanced economies club at the time, having been invited in by Italy in 1998. Although this was not the first time that the G8 had engaged with the key emerging markets, it was the first time that it had done so under a formal structure. Yet the significance of this move was diminished from the outset as the communiqué that announced the programme was published without any input from the emerging markets and before they had attended any

G8 meetings.[55] I remember an embarrassed Italian sherpa explaining the principle of 'variable geometry' to a puzzled British audience a few months before the G8 summit in L'Aquila in 2009 – Italy was chairing the G8 that year. According to such principle the leaders of those five emerging markets would only be invited to participate in selected events of the G8 summit. The audience immediately visualised the president of China together with the other invited leaders being kept on hold in an antechamber until the G8 leaders were ready to see them. Were they just there to join for dessert and coffee? This was not a productive way to encourage international dialogue. By this point, however, the G20 had overtaken the G8 as the 'premier forum for international policy cooperation', and the Heiligendamm countries were full G20 members – so what was even the need for the G8 and their Heiligendamm process? China's then President Hu Jintao cut his visit to Italy short, allegedly because of riots in north-western region of Xinjiang, and did not attend the 2009 G8 summit.

This episode indicates how difficult it is for the advanced economies to accept that the world is changing and everything therefore needs to adapt. The G20 upgrade and recent reforms of the Bretton Woods institutions have been critical but lacking. The global financial crisis should have been the turning point that gave the main emerging market economies and developing countries an adequate voice, but they are still kept on the periphery of international governance. The advanced economies have recognised that the world economy has become broader and more integrated and that international governance needs to evolve in order to reflect this, but they have hesitated in acting to address the imbalance.

We can see that the Bretton Woods institutions are adapting to changes in the world economy and global challenges, but changes are not coming forward fast enough. Both the IMF and the World Bank remain dominated by the United States which holds veto rights. As for the BRICS and the other developing countries, their contribution and therefore their voting rights do not lend them enough influence in either organisation. However, to respond to the intertwined challenges that the world currently faces, we need international institutions that can effectively coordinate international policy action. For this, they need to be representative and accountable, offering democratic space at the regional and global level.[56] If not, the gap between international policy action and domestic policy preferences will continue to widen, impairing international policy cooperation at the time when it is most urgent.

STAGNANT GOVERNANCE

Multilateral institutions should function to depoliticise relations between countries, especially when political conditions are attached to the supply of loans and financial support. Shareholders of the development banks and the IMF accept that there are external constraints on how capital can be used, and that these constraints are in place to open up opportunities for financing operations that may not be available through bilateral channels. The independence of multilateral institutions from the direct control of their shareholders should strengthen their credibility, but practice differs from principles.[57] This mainly results from the fact that the United States is the largest shareholder in the IMF (with a 16.7 per cent hold) and the World Bank (with an average holding of 15.5 per cent across all of its subsidiaries) and therefore has veto rights in both institutions. This means that the United States has the power to direct funding in accordance with its own priorities, not only in terms of underpinning the growth prospects of the US economy, but also for promoting national security interests – as in South Korea in 1997–98 and Ukraine in 2014, as I will discuss in the next chapter.[58] By the same token, Asian countries considered the IMF's lending during the European debt crisis to be far too large and easy to arrange in comparison with the support extended during the Asian crisis – a sentiment that was not shared by the Europeans.

The governance of the Bretton Woods institutions is dated. Indeed, the 'gentlemen's agreement' regarding the leadership of the institutions – whereby an American leads the World Bank and a European leads the IMF – is telling. The mould was somewhat broken when Korean-American Jim Yong Kim took the helm of the World Bank in 2012, but after his abrupt resignation in 2019 the bank quickly snapped back to its default. Although any executive director or governor is entitled to nominate an appointee on the condition that they are a national of a World Bank member country, no country other than the United States actually put a name forward, likely because they 'did not want to pick yet another fight with a unilaterally-inclined and sovereignty-obsessed administration'.[59] The Trump administration eventually settled on David Malpass – although the president did float the name of his eldest daughter, claiming that Ivanka 'would have been incredible'[60] in that role. Trump's choice of Malpass was controversial as he has not been shy in vocalising his scepticism regarding multilateralism and his lack of concern for global issues such as climate change.

There are three broad lines along which the governance of the Bretton Woods institutions needs to be reformed: the developing countries need to be better represented, they need to be given an adequate voice in decision-making processes and the leadership needs to be appointed on the basis of merit and through a transparent process. The rise of China has made the need to reform the governance of the Bretton Woods institutions a critical issue, but now that its rivalry with the United States has escalated into open confrontation, it has become an increasingly politicised and tricky matter. The full impact of this rivalry on the renewal of funding streams, the distribution of voting shares and the appointment of leading roles within the IMF and the World Bank is yet to be seen.

As for the IMF, its reform is critical for the institution to continue acting as the multilateral safety net. Most of its financial resources come from the quotas paid in by its members, although it does also receive funds from the borrowing agreements it has in place with a number of industrial and emerging market countries. For the IMF to continue in its role, then, its members need to be persuaded to pay in more resources, and the way to do this is to reform the structure of voting rights. Members' quotas – i.e., their financial contribution – are the principal determinant of their relative voting share, as well as the metric used to scale their capacity for borrowing. Quotas are calculated by a formula intended to assess a country's position in the world economy. It considers GDP in several measures, openness, economic variability and the size of a county's international reserves. Increasing the voting power of the emerging markets and developing countries means decreasing the quotas and hence the voting rights of the United States and Europe, but the US veto power and Europe's dominant representation on the IMF executive board also need to be curtailed. For example, to reflect its share of the world economy (nominal GDP) China should hold approximately 11–12 per cent of the total IMF capital;[61] but its quota is currently just 6.41 per cent. Diverging national interests have hampered agreements over how quotas should be increased to replace expiring borrowings, and hence there is a level of uncertainty about the size of the IMF lending pool available in the medium term.

The IMF's Articles of Agreement require the fund to review its quotas once every five years to bring the distribution in line with changes in its member country's economic weight as well as to ensure that the overall pool of resources is adequate. The 14th General Review of Quotas demonstrates the United

States' contentious approach to financial multilateralism. Agreed in 2010, the review concluded that the fund's lending capacity, which stood at $250 billion prior to the crisis, be tripled and that its quotas be doubled to approximately $659 billion.[62] The quota increase also secured a significant realignment of quota shares from advanced European economies and the Gulf to developing countries. China became the third largest member country in the IMF and Brazil, India and Russia are now also among the ten largest shareholders. Overall the review shifted approximately 6.2 per cent of quota shares to the developing countries. (Prior to this, the Clinton administration advocated a small adjustment in quota and voting shares as part of the eleventh general review of quotas in 1998. The Bush administration also agreed to reform the IMF quota formula in 2008 to make it simpler and more transparent, and then used the revised formula to enact a sizeable realignment in IMF quota and voting shares in favour of the developing countries.[63])

Unfortunately, the 14th review fell short. As per the Articles of Agreement, the 15th review should have taken place in 2015, but the 14th review didn't even come into effect until 2016.[64] I mentioned at the opening of this chapter how the G20 pushed for the 15th review to be completed by the 2019 IMF and World Bank annual meetings, meaning that the quota reviews are effectively operating on a ten-year basis instead of a five-year one. The delay was due to the fact that the United States was not on board with the changes and Congress failed to approve them until the end of 2015. Although the shift in voting power was significant, it was still far from levelling the unequal weighting between the advanced and developing worlds. In the Bretton Woods institutions, the status quo still prevails over good governance as the United States, Japan and the advanced economies of Europe continue to hold the majority of the power. And although the review secured the Fund significantly more capital, the reality is that the IMF still needs more to provide an effective safety net in a world of volatile capital flows.

For the Bretton Woods institutions to continue being credible, their governance needs to be inclusive and their funding needs to be enough to pursue their objectives – lending for development and providing financial support at times of crisis. The effectiveness of the institutions depends on the willingness of the United States to support high levels of commitments to the IMF, but also its willingness to offer China the opportunity to increase its quota and hence its voting rights in line with its weight in the world economy.[65]

REFORM IN DEADLOCK

Unless they are reformed, the Bretton Woods institutions will fade into irrelevance and the international order as we know it will cease to exist. They cannot be reformed, however, without the active participation of the United States. Ever since the election of Donald Trump, the United States has shown nothing but increasing disdain for the current international order. Since Trump's inauguration, the United States has withdrawn from TTP and run the negotiations with the EU for the Transatlantic Trade and Investment Partnership (TTIP) into the ground. It has withdrawn from the Paris climate change agreement – an issue so contentious that the G20 and G7 communiqués have come to ignore its existence altogether. President Trump has created a stir with NATO partners by frequently criticising the organisation, going as far as branding it 'obsolete',[66] while President Macron defined it as 'brain dead'.[67] And as for the IMF, the Trump administration has accused it of being too lenient in monitoring trade and exchange rate policies.[68] The IMF is of particular importance for the future of the international order because it is the only institution that can provide a global financial safety net on a multilateral basis. The ideal situation would be for the United States to put more dollars into the IMF in order to allow others to do the same – proportionally – and so increase the IMF's overall resources. At the same time, a relative reduction of the US quota would accommodate China and the other emerging markets economies.

The issue of the adequacy of IMF resources is an existential one and marks the difference between the Fund being a fully engaged force that leads and shapes the international order, or one that finds itself no longer relevant. If the latter, the risk is to leave the world exposed without a mechanism for preventing or resolving the next financial crisis. It is already arguable that the IMF lacks the necessary political clout for global crisis prevention, but it certainly has the analytical capacity to identify the buildup of imbalances. Indeed, recall that it was IMF chief economist Raghuram Rajan who warned his audience of economists and finance ministers at Jackson Hole of the systemic risks looming in the global economy in the years leading up to the global financial crisis (as discussed in Chapter 3).

The IMF decision-making procedure requires that reforms need to be approved by at least three-fifths of members – a condition that is not too difficult to achieve – and those members must hold at least 85 per cent of the voting power. The United States, therefore, has the power to veto any decision – with, recall, approximately 16.7 per cent of the votes. However, the division of power within the US government means that no administration can support or reject a decision regarding the IMF reform without the approval of Congress. It is therefore the US Congress that ultimately holds the key to reforming the IMF. This is a completely unique situation, as no other parliament plays such a role in an international institution.

Congress has not shown much commitment towards the Bretton Woods institutions. Remember how the 14th review of IMF quotas took over five years to come into effect, solely because Congress did not cooperate and failed to approve it. Congress is allegedly concerned about the risk involved in the financial commitments to the IMF and the possibility of exposing the United States to credit risk. But this fails to recognise that in reality such a risk is limited. When the IMF draws on the US quota or other financial commitments to lend to other IMF member countries, the resulting claims fall on the IMF as a whole, not on any individual borrower. In any case, the IMF has established precautionary balances (reserves) totalling around \$15 billion in addition to gold reserves of an estimated value of approximately \$120 billion.

The current political climate has further exacerbated positions. As Congress has become increasingly polarised under the Trump administration, it more frequently finds itself in a state of deadlock. Indeed, the administration has made it clear that it is not willing to engage on this matter – or any other matter relating to international cooperation. On a number of occasions, Treasury Secretary Steven Mnuchin has argued that there are many 'sources of liquidity and financial support' for countries facing financial instability.[69] This point was reiterated by Treasury Undersecretary David Malpass, now president of the World Bank: 'the IMF has ample resources [. . .] countries have considerable alternative resources to draw upon in the event of a crisis'.[70] Neither Congress nor the Trump administration are prepared to support more funds coming from the United States or more funds from the emerging world, especially from China. The United States is now the major barrier to the governance reform.

Despite the evidence of a potential shortage of IMF resources – and even against the United States' own interest in continuing to use the IMF as a tool of financial diplomacy – open and robust support for governance reform does not seem to be on the cards. So, what does the future hold for the IMF and its sibling international institutions – and implicitly for the international economic and monetary order? One scenario is that the United States stops contributing towards the non-conditional credit line while the other IMF members renew their commitments. In this case, the United States would drop to second place in the IMF shareholder rankings and would lose its current level of influence. As such, this is clearly not an option that the administration is prepared to consider. The more likely scenario is for the EU members that currently provide around 50 per cent of the IMF's bilateral borrowing potential to reduce their contributions to the non-conditional credit line after 2020. This would leave the IMF with enough financial resources to address a moderately serious crisis in one or a few member countries, but interventions would be more focused on short-term provision of liquidity rather than on structural programmes. On the back of this move, more and more countries would cut their bilateral IMF lending commitments in favour of liquidity lines. Under this scenario, the IMF will struggle to maintain its relevance as it won't have enough resources to achieve its goals. Ultimately, countries that find themselves in financial trouble would first turn to non-IMF emergency bilateral financing or regional arrangements, which could be expanded in size and membership.[71]

Against this background, regional arrangements, especially if shaped on the model of the Bretton Woods institutions, could become critical to the transformation of the international economic order and stir it to become truly multipolar with strong regional multilateral institutions. If not, new rules or no rules will prevail, where bilateral 'deals' will replace multilateral agreements, weakening standards and politicising lending. The Bretton Woods system, with its institutions reduced to irrelevance, will eventually topple with nothing to replace it.