Is Bretton Woods II in the offing?

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In 1995, a 25-year old mathematics graduate of Cambridge University devised a method of insuring against loan defaults – later named credit default swaps (CDS) — that, within a decade, became the financial derivative of choice for banking and financial institutions around the world, particularly in USA and Europe. Banks, investment houses, and insurance companies, reaped rich rewards from holding copious amounts of CDS which served as insurance cover for US mortgage-backed securities that were packaged and sold around the globe.

In addition to CDS, the world's financial markets saw the growth of exotic financial instruments such as collateralized debt obligations (CDOs), and collateralized loan obligations (CLOs), all being some form of derivatives of securitized home-mortgage loans. Warren Buffet, the world's most astute investor, described these esoteric financial instruments as nothing short of financial weapons of mass destruction (WMDs). The problem is that these instruments held sway over much of the developed world's financial sector, except Japan. The going was great as long as US homeowners continued to pay their mortgage.

Until they didn't. In 2007, the housing bubble burst, giving rise to the sub-prime crisis. The rest is history.

All said and done, we are facing the worst economic crisis since the Great Depression (GD). A valid question before us is: how did a sub-prime mortgage failure in the US housing market trigger a financial meltdown of global scale? Analysts blame CDS as the principal catalyst of the crisis. As of September 2008, the face value of total CDS outstanding was estimated by the International Swaps and Derivatives Association (ISDA) at nearly $55 trillion. That was more than world GDP of $53 trillion. Almost half of this was held by institutions in Europe.

CDS worth $13 trillion was held by the top 25 US banks, which included Bank of America, Citibank, JP Morgan Chase and Wachovia, as reported by the US Comptroller of Currency. Even a leading bank in the United Arab Emirates was left holding CDS in the amount of $2.0 billion. The problem is that the entire derivatives market was unregulated, and under-capitalized. One thing became clear. Financial globalization had taken deep roots, but regulation was weak to nil.

It takes an economic crisis of major proportions to shake things up and bring systemic change. The clear consensus now is that the global financial system cannot be left to its own devices any more. Governments now own or control big chunks of the financial system. If it was a failure of regulatory oversight, then they have all the levers of power to set things right.

That brings us to the forthcoming economic summit in Washington. The US President, George W. Bush, in the twilight of his tenure, has succeeded in convincing global leaders to come to a summit in Washington in November. This could be the first of a series of summits. The goal would be to thrash out the rubric of a more functional and lasting financial architecture by drawing lessons from the present crisis. Given the remarkably coordinated and coherent set of policy actions the world witnessed in the past few weeks from both sides of the Atlantic, it would not be far-fetched to surmise that perhaps something like a Bretton Woods II might be in the offing for the financial markets. Suffice it to say that Bretton Woods I, convened in 1944, long after the Great Depression, aimed to prevent a repeat of GD. It gave the world a new economic order that lasted for over 60 years, while generating enormous wealth and prosperity for a large part of the globe. Is it still relevant for the globalized economies of the 21st century?

If at all, this would be Bretton Woods II with a lot of difference.

First, attendance will not be from members of the exclusive club of G7. Notable in the proposed summit of G20 is the presence of BRIC countries, Brazil, Russia, China and India, and even Saudi Arabia. The realization has dawned on global leaders that resuscitation of the global economy requires a global approach that has to include countries that, over the past decade, generated huge current account surpluses (e.g. China, Saudi Arabia), and are flush with surplus savings that, ironically, contributed to the lax credit regime in the US and

elsewhere.

Second, although economists and analysts have been able to identify the catalysts of the present crisis – subprime mortgages and unregulated financial derivates – a consensus is yet to emerge on what shape the future global economic order should take.

Third, this summit does not come after a decade of ruminating over the events relating to the economic crisis. The summit is called at a time when the crisis, by all accounts, is still unfolding. Although the root causes have been identified, articulating the framework of a sustainable global financial system is months away.

Fourth, there is none of the stature of John Maynard Keynes this time around. The Great Depression began with the 1929 stock market crash, followed by a misguided policy of credit restraint when the opposite was needed. Economist John Maynard Keynes published his epochal treatise, The General Theory of Employment, Interest and Money, in 1936, where he not only diagnosed the root causes of the Depression but also gave new directions for economic policy, to combat such economic contraction in the future.

Thanks to the global reach of electronic and print media today, ideas will not be in short supply. For instance, Nobel Laureate Joseph Stiglitz, for one, has been on top of crisis analytics and seems to be favouring a return to some form of Keynesianism at the national level (he proposes a stimulus package a la Keynes), and sounding the need for a multilateral agency at the international level for global regulation and oversight mechanism of the world's financial system. More important, while blaming the crisis on unfettered markets, he warns, very rightly, that there was no room for unilateralism in meeting the challenge of the present crisis. Surely, there will be scope for numerous other ideas that are also floating around. If a new economic order is on the cards, will it be all-encompassing, like Bretton Woods I, or will the new order address only the woes of the current financial system?

The crisis originated in the financial sector. On the surface, the culprits were sub-prime mortgages in the US, linked to the explosive growth of complex but unregulated financial derivatives. The world should now be convinced that capital market liberalization does not go hand in hand with financial market stability. This was amply demonstrated during the Asian financial crisis of 1997.

Since the problem lay in the financial sector, will it not be sufficient to re-write the rules of the game in that sector alone instead of calling for a complete overhaul of the current economic order? If so, there is need to think hard and long. This is not the time to panic and go for quick-fixes. Call it Bretton Woods II or not, the November Washington summit will have to be followed by technical sessions before a final summit is convened.

If the recent coordinated global measures are any guide, one hopes that, unlike the Doha Round of trade talks, world leaders will rise to the occasion and reach consensus on critical issues promptly, if a Depression is to be prevented. To be realistic, a Depression will have catastrophic consequences for the world's poor as global efforts on poverty reduction will face cuts in resources.

Finally, in light of the turbulent events of the recent past, is the world ready to write an epitaph on the capitalist economic system? Not yet, I would think. This is not the first time the system has come under threat. The Great Depression of the 1930s was the last major threat. The system was bruised but survived to generate prosperity for many, though not for all. The existence of pervasive poverty clearly remains the darkest spot. The emergence of the present crisis is arguably the most serious threat to the system since the Great Depression; this time under the rubric of another concoction of modern times — globalization.

To be sure, the root causes of the crisis have been identified. The following strategies could yield lasting results. First, the US government has to devise ways to stem the tide of housing foreclosures that started it all. Second, none will disagree that the crisis has created the grounds for stronger regulation of financial institutions across borders. I wouldn't be surprised if a multilateral agency with global regulatory authority emerges out of the November summit or thereafter. Third, it is true that a multiplicity of financial instruments have been devised over time; some rather complex; and many of them unregulated, over-leveraged, and under-capitalized. To take all of them off the market would be akin to throwing the baby out with the bathwater. The wise approach would be to standardize these instruments, backed by adequate reserves, and made subject to proper monitoring by regulatory authorities.

The choice before the world is not between state and market. It is about striking the right

balance between regulation and laissez faire. The world’s poor would be better served if lessons learnt from the present crisis were used to manage its recurrence better.