The G20 must look beyond Bretton Woods II

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Published: November 7 2010 18:10 | Last updated: November 7 2010 18:10

With talk of currency wars and disagreements over the US Federal Reserve's policy of quantitative easing, the summit of the Group of 20 leading economies in Seoul this week is shaping up as the latest test of international co-operation. So we should ask: co-operation to what end?

When the G7 experimented with economic co-ordination in the 1980s, the Plaza and Louvre Accords focused attention on exchange rates. Yet the policy underpinnings ran deeper. The Reagan administration, guided by James Baker, the then Treasury secretary, wanted to resist a protectionist upsurge from Congress, like the one we see today. It therefore combined currency co-ordination with the launch of the Uruguay Round that created the World Trade Organisation and a push for free trade that led to agreements with Canada and Mexico. International leadership worked with domestic policies to boost competitiveness.

As part of this "package approach", G7 countries were supposed to address the fundamentals of growth – today's structural reform agenda. For example, the 1986 Tax Reform Act broadened the revenue base while slashing marginal income tax rates. Mr Baker worked with his G7 colleagues and central bankers to orchestrate international co-operation to build private-sector confidence.

History moved on after the huge changes of 1989 and the experience of the 1980s is still being debated, but this package approach was significant for its combination of pro-growth reforms, open trade and exchange rate co-ordination.

What might such an approach look like today? First, to focus on fundamentals, a key group of G20 countries should agree on parallel agendas of structural reforms, not just to rebalance demand but to spur growth. For example, China's next five-year plan is supposed to transfer attention from export industries to new domestic businesses, and the service sector, provide more social services and shift financing from oligopolistic state-owned enterprises to ventures that will boost productivity and domestic demand.

With a new Congress, the US will need to address structural spending and ballooning debt that will tax future growth. President Barack Obama has also spoken of plans to boost competitiveness and revive free-trade agreements.

The US and China could agree on specific, mutually reinforcing steps to boost growth. Based on this, the two might also agree on a course for renminbi appreciation, or a move to wide bands for exchange rates. The US, in turn, could commit to resist tit-for-tat trade actions; or better, to advance agreements to open markets.

Second, other major economies, starting with the G7, should agree to forego currency intervention, except in rare circumstances agreed to by others. Other G7 countries may wish to boost confidence by committing to structural growth plans as well.

Third, these steps would assist emerging economies to adjust to asymmetries in recoveries by relying on flexible exchange rates and independent monetary policies. Some may need tools to cope with short-term hot money flows. The G20 could develop norms to guide these measures.

Fourth, the G20 should support growth by focusing on supply-side bottlenecks in developing countries. These economies are already contributing to half of global growth, and their import demand is rising twice as fast as that of advanced economies. The G20 should give special support to infrastructure, agriculture and developing healthy, skilled labour forces. The World Bank Group and the regional development banks could be the instruments of building multiple poles of future growth based on private sector development.

Fifth, the G20 should complement this growth recovery programme with a plan to build a co-operative monetary system that reflects emerging economic conditions. This new system is likely to need to involve the dollar, the euro, the yen, the pound and a renminbi that moves towards internationalisation and then an open capital account.

The system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values. Although textbooks may view gold as the old money, markets are using gold as an alternative monetary asset today.

The development of a monetary system to succeed “Bretton Woods II”, launched in 1971, will take time. But we need to begin. The scope of the changes since 1971 certainly matches those between 1945 and 1971 that prompted the shift from Bretton Woods I to II. Serious work should include possible changes in International Monetary Fund rules to review capital as well as current account policies, and connect IMF monetary assessments with WTO obligations not to use currency policies to remove trade concessions.

This package approach to economic co-operation reaches beyond the recent G20 dialogue, but the ideas are practical and feasible, not radical. And it has clear advantages. It supplies a growth and monetary agenda that parallels the G20 financial sector reforms. It could be built upon prompt incremental actions, combined with credible steps to be pursued over time, allowing for political dialogue at home. And it could help rebuild public and market confidence, which will remain under stress in 2011. Perhaps most importantly, this package could get governments ahead of problems instead of reacting to economic, political and social storms.

Drive or drift? How the G20 decides could determine whether multilateral co-operation can achieve a strong economic recovery.

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