Book reviews on global economy and geopolitical readings
The System Worked: How the World Stopped Another Great Depression


“The degree of interdependence among the key actors in the current era of globalization gave powerful interests a strong stake in maintaining a functioning, open global economy.”

“There is no denying that in the wake of the crisis, the global economy shrunk, protectionism rose, cross-border financial flows dried up, and governments squabbled over macroeconomic policies. Nevertheless, the system worked. In the presence of functioning global economic governance, the global economy suffered only a temporary downturn. In its absence, the world would have likely experienced an explosion of trade and investor protectionism, an evaporation of liquidity, and a second Great Depression.”

Summary

Despite the huge scale and repercussions of the 2008 financial crisis (one could argue that they are greater than those of the Great Depression of 1929), the global economy is recovering remarkably well. In The System Worked, Daniel W. Drezner tries to analyse and explain why he mistakenly believed, at the beginning of the crisis, that the system had failed. He also argues that analysts who continue to believe this are, in fact, wrong.

After examining the main stimulus measures taken by the G-20, the IMF and the WTO, among others, Drezner argues that the international response was sufficiently well co-ordinated to stop the world plunging into a full-blown depression. He considers that the tale of the failure of multilateral economic institutions is still going the rounds because the recession hit powerful countries hardest – not least because they had badly mismanaged their economies, and because the most influential political analysts writing books and articles about the crisis are from these countries.

Although Drezner admits that the global economy is still fragile, he stresses that the institutions of global governance survived the ‘stress test’ posed by the financial crisis. Indeed, he goes so far as to say that these institutions have become more valuable and robust precisely because of the crisis. Thus he dismisses conventional wisdom, whose ideas focus on the ‘G-Zero world’. In so doing, Drezner restores the image of these much-maligned institutions and dispels some of the most dangerous myths about the financial crisis.
The author

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Key ideas and opinion

A widely-held view over the last few years is that the economic crisis has spawned bad, inadequate policies. However, in The System Worked, Drezner challenges this notion, arguing that contrary to expectations: “In response to the 2008 financial crisis (...) global economic governance responded in an effective and nimble fashion. In short, the system worked.”

Unlike in preceding crashes, the world economy escaped lightly and growth recovered much more quickly than expected. This is largely due to the fact that global economic governance furnished the public goods needed to stop the worst scenarios coming true. Drezner stresses that international institutions mitigated the global economic crisis by keeping markets open for trading, ensuring sufficient liquidity, co-ordinating macro-economic policies, and rewriting the rules of the system where necessary. In this respect, both national governments of the major economic powers and global institutions rose to the challenge. In parallel, the rules and criteria for membership of many global institutions were altered to reflect the rapid rise of developing countries within the international system.

Nevertheless, the author also admits that there were fields in which governance is either shaky or failed. These fields include the battle against global warming, cybersecurity, and the co-ordination of macro-economic policies. Here, co-operation has either been wholly lacking or fleeting at best. Drezner argues that greater progress would have been made if the Doha Round of negotiations had been completed or if the G20 had always spoken with a single voice on macro-economic policy. However, to show that the system did in fact work, he first analyses how global economic governance functioned. Second, he explains why the widely-held, mistaken views arose. Third, he focuses on the key components of international relations: interest, power, and ideas. The author considers it vital to understand these arguments if we are to avoid the temptation of tinkering with mechanisms and policies that already work well.
Yes, the system worked

In analysing how the world bounced back from the 2008 crisis, the key question is: in relation to what? Drezner considers the best comparison is the last grave world financial crisis: the Great Depression of the 1930s.

By any measure, the world economy has bounced back much more strongly in the wake of the 2008 crisis than it did after the Great Depression. Four years after the Wall Street Crash of 1929, world industrial output stood at just two thirds of that before the crisis. The story of world economic growth was equally bleak — growth shrank by roughly 3% in 1930 and then by a further 4% per annum during the following two years. By comparison, according to the IMF’s World Economic Outlook, global economic growth contracted by just 0.59% in 2009, growing at 5.22% in 2010 and 3.95% in 2011.

The author considers that an even more fascinating difference is that in the latest crisis, growth continues to reduce poverty. Despite the 2008 economic crisis, extreme poverty continues to fall across the globe. The United Nations Development Fund (UNDP) notes that since 2001, greater strides have been made in human development than in the 1990s. Drezner considers that this is largely due to the fact that the poorest countries now have greater access to global markets than in the 1990s.

An important reason for the rapid return to economic growth is that international trade did not fall in the wake of the 2008 crisis. Unlike in the Great Depression, trade recovered strongly after 2008. In 1933, trade had fallen by 25% since the Wall Street Crash four years prior. By comparison, four years after the 2008 economic shock, trade had grown by 5% over its pre-crisis level. More important still, five years after the 2008 crisis, protectionist measures only affected 4% of world trade. This contrasts starkly with the 1929 crisis, in which rising barriers depressed world trade by a staggering 40%.

Global governance played a key role here. Drezner says that the G20 was a useful forum to dissuade its members from raising trade barriers — especially in the countries most affected by the crisis. Central banks and finance ministers also took coordinated action in the autumn of 2008 to ensure the continuity of transnational loans, thus averting a currency and solvency crisis. The IMF set up the Short-Term Liquidity Facility (SLF) for those countries with sound economic policies but that had liquidity problems. In 2009, the G20 agreed to triple the IMF’s reserves to $750 billion. In response to the worsening European sovereign debt crisis, the G20 nations also pledged over $430 billion extra in 2012.

Progress was also made in the co-ordination of financial and investment regulations. In September 2008, an IMF working group agreed on a set of principles and practices
covering sovereign funds with regard to institutional frameworks, governance and risk management. These guidelines — also known as the Santiago Principles — greatly enhanced the transparency of sovereign funds. International regulators also approved the Third Basel Accord in just two years (negotiations for the Second Basel Accord had dragged on for six years). Basel III enshrined more effective measures to prevent bank failures. The achievement was all the more merit-worthy given that the accord was approved in the teeth of opposition from the world banking industry. Drezner also praises the changes made to enhance the legitimacy and representativeness of the IMF, the World Bank and the G8. Drezner admits that further reforms are needed, but stresses that the G20 is a great improvement over the G8. Although the G20 does not include all nations, it at least covers those countries that make up 85% of the global economy.

Last but not least, global governance created a favourable climate for international security. Drezner notes how the UN Security Council approved two resolutions (1846 and 1851) to deal with piracy off the Somalian coast. An ad hoc coalition of more than 25 countries formed Combined Task Force 151 to patrol the Gulf of Aden. Other countries not contributing to the Task Force (among them, China and Iran) also sent patrol vessels. The author notes that in September 2013, the total number of pirate attacks had fallen to its lowest level for seven years. He also argues that the 2008 crisis did not spawn more political conflicts, a finding included in the Institute for Economics and Peace’s 2012 report, which concluded that world peace stood at much the same level as in 2007.

**Mistaken impressions**

Why then is there this mistaken impression of poor global economic governance in the wake of the 2008 crisis? First of all – as one can conclude from the facts set out by Drezner – many commentators extrapolated a number of serious failures in global economic governance to the workings of the system as a whole. As a result, they grossly over-simplified in suggesting that the system as a whole had become unworkable.

Second, Drezner suggests that nostalgia was partly to blame. The tendency to see any time in the past as better than today led many commentators to wrongly assume that the problem lay in global economic governance. However, the author stresses that the ‘Golden Age’ during which the Gold Standard held sway was one in which the working classes were poorly organised, allowing governments to slash spending and keep the system working. Likewise, the author recalls that although the era following World War II is now seen as the period when co-ordination in global economic governance was at its best, it was in this same period that the United States chose not to ratify the Havana Charter, which would have established a world trade body with much greater powers than those currently enjoyed by the WTO. Furthermore, through the Marshall Plan, the United States decided to act outside the institutional framework of the
Bretton Woods Agreement, weakening the latter as a result. In addition, although post-Bretton Woods global economic governance cut tariffs, the industrialised nations erected a host of non-tariff barriers to limit imports.

Third, Drezner notes that the pattern of economic growth since 2008 does not mirror the geographical locations of its commentators. Most of those writing about the crisis dwell in the countries most gravely affected. They naturally tend to extrapolate the situation in their own nations to the rest of the world, often confusing national governance with global governance. Drezner considers that it is pretty clear that Japan, the United States and the European Union have experienced dysfunctional politics and policies since 2008, and that these political weaknesses have contributed to grave errors in the macro-economic field, especially after 2010. Nevertheless, these mistakes do not evidence a failure of global economic governance but rather of national institutions and their beliefs. According to the author, the shift in the locus of economic power and the ideas on which it was based has made commentators even more pessimistic about the results of global economic governance. Even so, the system worked. The question is why?

Interests, power, and ideas

In the 21st century, manufacturing, trade and finance are so globalised that they create truly transnational interests. In most of the OECD countries, about a third of imported intermediate products are used to manufacture finished products for export. This fraction rises to 50% for exporting countries on the Pacific Rim. Drezner considers that the political impact of the global supply chain and capital markets spurs harmonisation of interests among the trading sectors of the world’s main economic powers. Thus while there is fierce competition among individual suppliers, the impact of global interaction is even greater. A good example of this, says Drezner, is the negotiation of the Third Basel Accord, which was fiercely opposed by most of the finance industry. The bankers feared that stiffer regulation and requirements covering solvency and short-term liquidity would cut their long-term profits. However, the fact that the Basel Committee’s interacted with a wider range of players (experts, chambers of commerce, national regulators) meant that the banking industry was forced to compromise.

The author stresses that Basel III not only imposed greater regulation on banks but also reduced their control over capital movements. Drezner recalls that for decades, the IMF had used its influence to get countries to de-regulate their capital markets. However, the crisis made the IMF’s economists ponder whether controls over capital movements should be re-imposed. In February 2010, an IMF paper reached the conclusion that control over capital movements could be both legitimate and useful under certain circumstances, a line the IMF officially adopted in 2012. This U-turn did not do away with de-regulation of capital flows – rather, it involved tweaking the system. Even so, it marked a sea change in attitudes towards the financial industry.
Drezner argues that the role of interests must be studied together with the role played by power. According to the author, although the United States has declined somewhat, it still holds sufficient power to keep world leadership. Furthermore, it is supported by its long-standing ally, the European Union, whose power has also waned, though it remains powerful enough to play a key role.

Equally important, in Drezner’s eyes, is the fact that China, the player most likely to play a spoiling role in the international liberal order, acted responsibly following the 2008 crisis. The author notes how the inter-war trade system collapsed when the countries that had supported it – such as the United States and Germany – later did much to undermine it. In the latest crisis, Drezner stresses that while China drags its feet in certain fields (for example, export subsidies, cyber-war and territorial disputes), in others it lent unstinting support.

Such is the case with anti-piracy measures. China sent a naval force to the Horn of Africa after the Security Council resolutions in December 2008. This was the first time in 500 years that China had a sustained naval presence in the region. China also supported macro-economic co-ordination policies: for instance, in 2008 China applied one of the biggest fiscal spending programmes (as a percentage of GDP) among the G20 nations. In 2010, its took steps to reduce its role in macro-economic imbalances.

With regard to trade, Drezner stresses that China was allowed to join the WTO in 2001 after it had agreed to limit protectionist barriers.

The hegemonic coalition between the United States, the European Union and China in key aspects of global governance meant the main rules of the global economic game were stuck to and the worst was stopped from happening. However, why is it exactly that the United States and China continue to comply with WTO rules? What explains the preferences of these two great powers? Drezner says that the answer lies in ideas.

Drezner argues that there were good reasons for believing that the 2008 crisis would delegitimise the economic principles on which the global economic order was based. China seemed to be the best candidate for challenging the Washington Consensus. However, China’s political elites never agreed on a viable alternative nor on what the Chinese economic model was. Indeed, an official report jointly written by the World Bank and China, titled China 2030: Building a Modern, Harmonious and Creative High-Income Society, stressed that whatever the merits of the Chinese model, they were becoming increasingly blurred. It explained that China’s spectacular growth after 1978 stemmed from special circumstances that are unlikely to be repeated. Furthermore, environmental damage, growing inequality, the demographic crisis and low consumption levels all spell trouble for China. The country must alter its development strategy and embark on a new stage in its economic development. This new phase requires measures in which the government loosens its stranglehold over the economy. The report also declares that China’s long-term interests lie in free world trade and a stable, efficient international monetary and financial system. The report
thus follows much the same lines as the political economy of advanced industrialised democracies.

The cleft between those arguing the need for stimulus measures and those advocating (more) austerity is clear-cut when it comes to global macro-economic policy. Drezner says this gap explains why policy is so volatile. As a corollary to this, Drezner boldly states that when people finally come to realise that the system worked following the 2008 crisis, they will have faith in it in the future.