The crisis and beyond: Prospects for international economic cooperation

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The ongoing international economic crisis and its aftermath will have a profound impact on the politics of international economic relations. The crisis will change the ways in which major nations interact with the world economy, and with each other. The principal economic powers will find their interests, and their bargaining positions, altered by the changed environment. Among the many implications of these changes, I focus on how they will affect the willingness and the ability of the Great Economic Powers to collaborate in managing the international economy.

After the initial stabilization phase of crisis management ends, the world faces a difficult adjustment process to reduce or reverse the macroeconomic imbalances that were the root cause of the crisis.[1] This adjustment requires a reduction in the surpluses of the major surplus countries, in East Asia and Europe; and a reduction in the deficits of the major deficit countries, in North America and Europe. Both processes require substantial domestic economic changes, which will occupy governments and peoples for years to come. There will be a natural tendency for economies and people to turn inward, and for governments to reduce the priority they give to their external ties. As they do so, there is a real risk that they will gradually slip toward a breakdown in international cooperation, and toward open conflict. This makes it crucial to anticipate the challenges ahead, to analyze the politics and economics of these challenges, and to think about the sorts of measures that could help sustain and strengthen political support for an open world economy.

Understanding the crisis

Without an appropriate diagnosis of the problems that led to the crisis, neither a correct prescription nor an accurate prognosis are possible. The American core of the crisis was a classic debt crisis, the result of a similarly classic capital flow cycle. From 2001 to 2007, the country borrowed between half a trillion and a trillion dollars a year from the rest of the world, about five trillion dollars in total.[2]

As these five trillion dollars – roughly five percent of GDP a year – flooded into the economy, they had the typical effects of a large-scale capital inflow. Consumption exceeded output; investment exceeded savings; government spending exceeded revenue, and all on the basis of borrowing from abroad. The result was a massive expansion of consumption, especially because almost the entirety of the inflow went to the household sector or the government. The relative price effects of the capital inflow were also the typical ones: the prices of nontradables rose substantially relative to tradables in a classic real appreciation. Between 2000 and 2007, while durables prices declined 13 percent, services prices rose 25 percent. This was especially evident in the most important nontradable sector, housing.

As is often the case with a capital flow cycle of this type, the inflow created an economic expansion, then a boom, then a bubble. The bubble has now burst, and we are living with the effects of the downswing of the capital flow cycle.

Fortunately for the United States and the world, the debt crisis did not result in a "sudden stop" of lending to the United States, as it often does in developing countries. Instead, the central position of the United States and of the U.S. dollar has meant that the government has continued to be able to borrow from abroad. And this is a very good thing, as it has allowed fiscal and monetary policy to cushion the blow of a financial collapse of massive proportions.

Eventually the current, stabilization, phase of crisis management will fade, and the longer-term implications of the crisis will become clear. Governments face the challenge of overseeing the adjustments required to restore some semblance of balance to the global macroeconomic imbalances that were the ultimate source of the current crisis. What can we expect from those adjustments, and what might they imply about the future of an integrated international economy?

Lessons from theory and history

There are important historical precedents that can help us understand the strengths and weaknesses of globalization. For decades before 1914, the world economy was very tightly tied together – on some measures, such as immigration and a monetary standard, the world was more tightly tied together than the contemporary international economy. And the pre-1914 world economy worked very well, providing rapid growth, the convergence of many poorer and middle-income societies with the industrialized world, and general macroeconomic stability. Yet it could not be restored after the interruption of World War One, despite many efforts to rebuild it.

An important global macroeconomic imbalance was in fact central to the dynamic of the interwar period, and turned out to be a major obstacle to attempts to sustain international economic openness. Over the course of the 1920s, one of the world's leading industrial powers came to rely for its economic growth on borrowing, in particular on borrowing from a young and dynamic rising power. Yet there was ambivalence on both sides of the relationship, both about the relationship itself and more broadly about the nature of their ties to the world economy. When a crisis hit, things fell apart quickly. The surplus rising power was unwilling to play a major role in working toward a cooperative resolution of the crisis, preferring to focus its attentions on its domestic concerns.

The deficit debtor nation, faced with the imposition of major austerity measures, exploded into social and political unrest and ended up in the hands of rabid nationalists and protectionists.

There was nothing technical, or purely economic, about the collapse that ensued. Rather, the principal problem – in particular in the two nations at the core of the crisis – was a lack of domestic political support for international economic engagement. Neither a United States dominated by isolationists, nor a Germany torn asunder by revanchist sentiment and labor-capital conflict, could muster any domestic enthusiasm for making further sacrifices to sustain an international economic order that was deeply unpopular at home.

The lessons from this experience accord with theoretically grounded analyses of international economic affairs. An integrated world economy requires purposeful cooperation among major economic powers. This is true in normal times, as cross-border economic relations need some political infrastructure to provide the kinds of stable expectations that governments supply and economic agents expect domestically. It is especially true in times of stress, for there is no global government capable of confronting a crisis – no lender of last resort, no counter-cyclical demand manager, no supplier of market-preserving public goods. Without determined cooperation among the principal powers, globalization is unlikely to survive the inevitable shocks to which it is subjected.

International economic cooperation requires, in turn, domestic political support for global economic engagement. If domestic publics, mass and special-interest, are unwilling to compromise their national goals for international achievements, cooperative policies will not emerge. Governments will not be willing, or able, to serve as constructive collaborators if their constituents do not evaluate the tradeoff between national and international concerns positively.

The point is not that nations in crisis collapse into evil predation and malicious provincialism. It is that governments faced with very difficult economic, social, and political conditions have as their first priority addressing the needs of their people. And meeting the immediate demands of an anxious electorate can dictate policies that aim to ameliorate national conditions, even if this comes at the expense of neighbors and partners. This is the true threat the crisis poses for globalization – now as in the interwar period. It is not of a sudden plunge into trade wars, but of a gradual erosion of support for measures that require compromise with commercial and financial partners, a gradual decline in patterns of cooperation and collaboration.

The aftermath of the crisis and the willingness to cooperate

We are now in the early stages of reaction to the crisis – what would be considered, in the typical debt crisis, the stabilization phase, in which policy aims at limiting the immediate damage and avoiding too deep a decline. What comes next are the adjustment and reform stages, in which governments must address the policies that caused the crisis, and then the economic and political structures that led to those policies. What will these stages require from the major economic actors, and what does that imply for international economic cooperation?

The ultimate cause of the crisis was the global macroeconomic imbalances discussed above. Of particular importance were the unsustainable deficits of some countries, which created the conditions for the bubbles which have now burst. Of course, these deficits could not have persisted without financing out of substantial current account surpluses, many of which are hard to explain on normal macroeconomic grounds. In any event, it is almost certain that neither the unsustainable deficits nor the excessive surpluses of the size we have seen in the past decade are likely to recur in the near future. These imbalances will of necessity have to be reduced.[3]

The major deficit countries will no longer be able to rely on running massive current account deficits. This will especially be the case given the very large additional debt burdens their governments are taking on as they enact counter-cyclical fiscal policies. The United States is likely to come out of the Bush

Boom and Bust with a net external debt in excess of ten trillion dollars. Even if the private sector might be able to maintain access to external sources of capital, the public sector will spend most of the coming decade attempting to control and reduce the fiscal deficit. Governments in the former deficit economies – the United States, United Kingdom, Spain, many of the transition economies and emerging markets – will focus single-mindedly on the inevitable austerity measures they will have to implement. They had financed substantial portions of their consumption, investment, and government spending abroad; they will now have to reduce all three and/or increase output, spending, and government revenues.

The major surplus countries will also face significant adjustments. Even if they wanted to continue to run such substantial surpluses, and to sustain currency and other policies aimed at maintaining these surpluses, their previous markets will be reducing their demand for imports. And there will be pressures from the surplus countries to start realizing the earnings on their accumulated foreign assets. These pressures will come from private citizens and firms with assets abroad; they will also come from consumers whose purchasing power has been limited by reserve policies that keep exchange rates extremely weak.

In both instances, governments and societies are likely to turn inward to deal with the adjustments they face. The United States and other former deficit nations will have to wrestle with stagnant or declining real wages and consumption in an atmosphere of generalized austerity. This comes on the heels of decades of deterioration of their income distribution. This trend has led to substantial public dissatisfaction and resentment, but for the past decade and more the socio-political impact of deteriorating income distribution has been cushioned by the consumption boom. Now that the financial bases of this expansion in consumption are gone, there is the risk that latent antagonisms will come to the fore.

There is little doubt that the United States (and other countries in similar position) faces a very difficult next ten years. It will not be easy simultaneously to restore macroeconomic balance, create the conditions for future growth, and maintain a reasonable social consensus. Most of the government's, and the society's, efforts are likely to be expended in this effort. And where international economic commitments seem to come in conflict with these crucial domestic objectives, the domestic aims are almost certain to predominate. This trend will be heightened by the fact that the country has to radically trim its trade deficit, which will almost certainly lead to aggressive measures against imports and to stimulate exports.[4] All in all, American policy and American politics are likely to be very self-absorbed; and when aimed at the foreign sector, heavily oriented toward improving the country's competitive position.

China, Germany, and other surplus countries will also of necessity turn inward.[5] They will find it more difficult to rely so heavily on exports as an engine of economic growth. They will need to search for domestic sources of demand. In the case of China (and many other East Asian countries), attempts to keep the currency weak will face domestic and international political and economic obstacles. Domestically, there will be political and economic pressure for consumption to rise, which implies either a nominal appreciation or a real appreciation or both. Internationally, there will be foreign hostility to weak-currency policies, and perhaps even implicit or explicit attempts to counter them with corresponding weak-currency policies. This risks 1930s-style competitive depreciations. It also risks spilling over into trade disputes driven or exacerbated by currency misalignments.[6]

As the former surplus countries transfer much of their energy home, some of their enthusiasm for international commitments may wane. Less reliance on foreign markets, and on foreign currency reserves, presumably means less concern about the letter and spirit of international institutional commitments and other international economic obligations.

The American component of this trend is likely to be particularly important. The American need to reduce its current account deficit may translate into many sorts of pressures. One might be to weaken the dollar. Another might be to undertake vigorous efforts to open foreign markets, including by the sorts of unilateral trade measures that have been a source of such friction in the past (such as super 301 cases). There may be heightened demands for import protection. By the same token, the country will emerge from the crisis with strong incentives to reduce the real burden of its very substantial external debt by way of modest inflation and currency depreciation. All of these are almost certain to exacerbate conflicts over commercial, financial, and currency policy with the country's major partners.

The possibility of more conflictual policies toward commercial and financial partners is heightened to the extent that the principal domestic supporters of globalization emerge weakened from the crisis. This was much of the dynamic of the 1930s: as international trade and finance dried up, the economic agents most closely tied to the world economy (such as coffee in Brazil or banking in the UK) lost much of their domestic political clout. Today the major financial institutions, which had been among the most powerful supporters of international economic integration, are weakened or in disrepute almost everywhere. Potential counter-weights to more nationalistic and inward-looking interests have become much lighter.[7]

All this runs in the direction of reducing the interests of major governments in international economic cooperation. It is not that the global economy will become irrelevant, for the depth and breadth of commercial and financial ties is extraordinary. It is, however, that the goals of major governments are likely to be more inward-looking than they have been. Their constituents will be more concerned about domestic matters, and less concerned about international ones, than they have in the recent past. This is likely to translate into a reduced *willingness* to make the difficult sacrifices and accept the daunting tradeoffs necessary to sustain international economic cooperation.

The new environment and the ability to cooperate

Even if major governments are able to rally domestic support for global engagement, the strategic environment within which they operate will have changed. One aspect of this is the potential de-linking of many national security and international economic goals. Another aspect is the toughened bargaining atmosphere, in which more governments may be tempted to adopt more uncompromising positions as they interact with others.

For most of the past sixty years, there has been a felicitous correspondence between the diplomatic and economic relations among the principal Western powers. In the aftermath of World War II, and as the Cold War progressed, there was a common interest in building stronger political and economic ties between North America, Western Europe, and Japan. This was particularly important in the domestic American context. It is not widely enough recognized how unpopular trade liberalization, and global economic engagement more generally, were in the United States in the 1940s and 1950s. It is almost certainly the case that American leadership in the world economy in this period depended in large part on the validity of the argument that the country could not expect to lead a Western diplomatic alliance if it excluded alliance members from access to American markets and American capital. The negative example of the interwar period helped point Americans away from a return to isolationism, but there was great popular ambivalence about economic openness. To the extent that policymakers could point to the nexus between national security concerns and foreign economic policy, a consensus in favor of both the Western alliance and international economic integration could be created and sustained.

The security-economic connection is much more tenuous today. After the Cold War, there is far less perceived need for Western solidarity; China and Russia have joined the world's capitalist economy. One set of American national security concerns focuses on Islamic extremism. The nation's economic interests seem either unrelated or inimical to these concerns; some might argue that dependence on Middle Eastern oil may be particularly ill-advised in the new security environment.[8] Another set of American national security concerns focuses on China. Again, American economic interests seem to many Americans to be at odds with its security goals. Reliance on Chinese imports, and Chinese capital, does not appear to be a sound basis upon which to prepare for potential conflicts with a rising Chinese power.

Whether these concerns about the contradiction between American security and economic goals are justified, it is certainly the case that it will be far more difficult to muster domestic political support inside the United States for globalization as part of a broad Western alliance-building strategy. America's core foreign policy goals have seemed for many decades to be in line with its international economic goals; today and in the future that may not be so obvious. And similar things could be said about many of the other major powers.

In addition to the erosion of strong ties between security and economic relations, there is also likely to be an evolution in the potential bargaining power of the principal economies that could complicate international agreements. For the continuation and deepening of international cooperation – especially in difficult times – depends not only on the *willingness* of governments to entertain collaborative results, but on their *ability* to negotiate their way to such results.

Economic interdependence is often said to facilitate inter-governmental cooperation. This is not only because it creates interests in favor of cooperation, but also because it raises the costs of failing to cooperate, hence encouraging more accommodating negotiating positions. To the extent that countries place more stress on their domestic problems, and less on the foreign sector, they tend to harden their bargaining positions with their interlocutors.

Inasmuch as the aftermath of the crisis leads policymakers to be more absorbed with domestic conditions, there will be an impact on the bargaining problems they will face with one another. A basic principle of bargaining is that the more attractive is the alternative to achieving an agreement, the harder it will be to make the agreement (this is the role of the "outside option" in bargaining power). And as national constituencies become more insistent on the urgent need to address domestic problems, policymakers in many nations are likely to find themselves drawn toward unilateralism as an attractive alternative to the complexities, uncertainties, and potential sacrifices involved in working toward greater international cooperation.

As governments of major countries turn inward to design and implement post-crisis adjustments and reforms, they are likely to be less conciliatory, less willing to forgo immediate national advantage for long-term global improvements. And this will make it more difficult to find the common ground and feasible compromises necessary to permit more international agreements. Not only, then, will major governments be less *willing* to make compromises with their commercial and financial interlocutors, but they will be less *able* to find a bargaining space that would make such compromises relatively easier to achieve.

Where there is hope

This is not to imply that the coming decade will of necessity be one of dire austerity, social unrest, and global conflicts. It is, instead, to attempt to identify the principal sources of tensions that could undermine or block the reconstruction of a well-functioning integrated international economy.

The first such source of tension will be the domestic constituents who will chafe at the economic changes forced upon them. Former deficit countries will be driven to impose austerity so as to restore macroeconomic balance, and this austerity will be socially onerous and politically dangerous. Former surplus countries will have to refocus their economic efforts on domestic demand, and the transition away from so heavy a reliance on export growth will impose adjustment costs on many segments of the economy. Policymakers need to address these pressures effectively and judiciously, providing enough of a safety net to help soften the opposition of affected and entrenched interests, but also allowing necessary adjustments to take place.

At the international level, the preoccupation with domestic concerns risks diverting national governments from their global obligations. The aftermath of the crisis will pull governments away from commitments to international economic cooperation. It will also push them toward harder, more intransigent, bargaining positions. All this risks starting the world's major governments toward a vicious circle, in which conflicts proliferate and deepen as concern for national recovery mounts.

There is, however, nothing inevitable about greater conflict. If policymakers can accurately identify the sources and dimensions of pressures that push in the direction of conflict, they can act to mitigate or counteract them. If they do so, they can help create a self-reinforcing virtuous circle in which cooperative initiatives end up *reinforcing* rather than undermining national attempts to achieve national goals.

Notes

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[1] My emphasis on the macroeconomic-policy origins of the crisis is not meant to ignore or downplay the role of regulatory failures, or broader failures in financial markets. These certainly played a role, but in my view the macroeconomic imbalances were the crucial enabling or catalyzing force.

[2] There are almost as many estimates of the net (and gross) capital inflows as there are ways to measure it; this is meant simply to be illustrative. There is little doubt, no matter how the flows are estimated or the stocks are valued, that the United States incurred a substantial additional debt to the rest of the world between 2001 and 2007.

[3] I do not mean to be too judgmental about the surpluses or the deficits. A more objective observation might simply be that capital flows of the size and nature we have seen are difficult to justify in the context of normal rate-of-return considerations. It seems to me unquestionable that the imbalances were in very large part driven instead by macroeconomic policies, such as loose monetary and

fiscal policy in the United States and attempts to avoid currency appreciation in China.

[4] The crisis has already dramatically reduced the country's trade deficit, but it is almost certain this is a temporary result of the compression of consumption; what I have in mind here is the longer-term tendency of trade deficits to be reduced.

[5] There is a possibility, I suppose, that China and other surplus countries will *not* in fact reorient their economies toward more reliance on their domestic markets. I regard this as unlikely. In any case, continued reliance on trade surpluses might, in the final analysis, be even more likely to cause political conflict with trading partners. It is also the case that an inward economic turn does not *necessarily* mean a turn toward economic nationalism, but it certainly raises the danger of such a turn (by reducing its opportunity cost, for example).

[6] For one discussion see Jeffry Frieden, "Global Governance of Global Monetary Relations: Rationale and Feasibility." *Economics* Vol. 3, No. 6 (March 2009).

[7] One such potential counter-weight, of relatively recent emergence, may be international corporations with global production networks, who have come to rely upon the free movement of goods and capital in their global sourcing.

[8] A potential national-security fear of the dangers of dependence on foreign oil may, however, mesh with environmental concerns.