Policy Brief No. 9 – December 2009

Collaborative Research on:

- International Macroeconomic Governance
- Globalisation and financial stability
- The Integration of Markets for Trade in Goods and Services
- **Migration and the Mobility of Labour**

After the crisis: Domestic politics and the challenge of rebalancing

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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. Some of the most important changes will be in the domestic politics of economic policy in the nations most affected by the crisis. These changes are likely to affect the willingness and the ability of the Great Economic Powers to collaborate in managing the international economy.

The Political Economy of Rebalancing Today

The global imbalances that were central to the sources of the crisis, and whose resolution will be central to the aftermath of the crisis, have powerful domestic political economy effects. The run-up to the crisis, as capital flowed from surplus to deficit countries, was associated with the prominence of particular groups and sectors in both sets of economies. The surplus countries were dominated by their export industries – that, of course, is where the surplus is coming from. But this, in turn, meant that resources were being reallocated away from consumers and the non-tradeable sectors.

For thirty years, the Chinese government has based its economic growth strategy on ever-increasing manufactured exports. Those whose livelihoods have depended on export markets – provincial authorities, coastal regions, state and local enterprises, foreign investors – have been central players in the country's political economy. So too have other East Asian export powerhouses, such as South Korea and Taiwan, bound their fortunes tightly to the fate of their manufactured exports. The pattern is not unique to developing countries. Germany and Japan, too, have powerful export interests which have been central both to these nations' economies, and to their political economies. All of these strategies were encouraged by America's enthusiastic consumption binge, which included an insatiable thirst for imports.

And indeed deficit countries were the mirror image of this, as the capital inflow primarily benefited consumers and the non-tradeable sectors. As capital flowed in and the price of non-tradeables rose, there was an expansion in finance, insurance, real estate, and services more generally. Meanwhile, tradeables producers were weakened, especially as the capital inflow led to a surge in imports. Borrowing fed spending sprees in the United States, the United Kingdom, Spain, and elsewhere, with much of the spending going to imports, and much of the rest going to financial services and real estate. The American real estate bubble was only the largest – but not the most extreme – example. In Spain, another deficit country, housing prices tripled over the decade to 2007, at the end of which one job in seven was in construction; at the peak of the boom, more houses were being built every year in Spain than in France, Italy, and Germany *combined*.

Eventually, as the inevitable rebalancing takes hold, borrowing nations must reduce their deficits and lending nations their surpluses. The deficit countries have to wean themselves from foreign borrowing, and to service their debts. During the borrowing spree, the deficit countries consumed more than they produced and invested more than they saved; now they have to produce more than they consume and save more than they invest; they also have to increase exports and reduce imports. The domestic political economy of this sort of adjustment cannot be popular, involving as it does reduced consumption and lower real wages. While some will applaud the decline in housing prices, and the shrinkage of oversized financial sectors and overpaid financiers, much of the previous economic growth of the deficit countries was dependent upon these industries. Without capital flooding in, without a ceaseless stream of new building, without a continual rise in home prices to make homeowners feel richer, many of the sources of the past decade's prosperity will dry up. Now economic growth will have to depend on a reorientation of the previous deficit economies toward making belt-tightened nations more efficient, and their products more competitive. The easy days of credit-financed growth are over.

Surplus countries face problems, too, which are the mirror image of these adjustments. They have to reduce their dependence on exports, which implies that they have to increase consumption and activity in the non-tradeables sector. Exporters will be less favored than they were in the upswing, as their economies turn away from relying on the export sector and toward the promotion of consumption and domestic services. This process might be driven by stronger national currencies – almost certainly the case in China, probably the case in Germany – or from a generalized decline in the demand for imports from foreign markets now struggling with austerity. From Shanghai to the Rhineland, industries will need to find expanded markets at home, or new markets abroad – in an environment in which most of the previous sources of export demand will have strictly reduced their ability to buy foreign goods.

Rebalancing is likely to create great political difficulties within nations. Deficit countries face obvious tensions, as they confront austerity and reduced consumption. Their attempts to implement the policies necessary to deal with their accumulated debt overhang will inevitably impose serious costs on many. Adjustments in the surplus countries will not be trivial, either. It will be no minor matter for the Chinese government to oversee a reorientation of the economy toward the production of goods and services for the local market. The manufactured export sector that has been at the center of the country's economic, social, and political order for decades is unlikely to welcome anything that might displace it from its privileged position. Nor will Japan and Germany easily trim the economic and political influence of their powerful export manufacturing sectors. In all instances, rebalancing implies a fundamental change in the center of gravity of the economic, and therefore political, life of the societies in question.

The economic changes brought on by crises of this sort often lead to fundamental political change, as winners became losers, losers became winners, and political conflict ensues. Whatever becomes of these conflicts, there is little question that the countries in question will be absorbed with the domestic problems they face as they deal with the national social, political, and economic implications of rebalancing.

Rebalancing and international economic conflict

As we look past the immediate future to the medium and long run, the world will adjust to a new reality, in which we cannot expect a return to the macroeconomic imbalances that have characterized the last 10 years. This raises important challenges to the political support for an open international economy.

As the major countries in the system undergo substantial economic, social, and political change, it will not be easy to sustain domestic support for global economic engagement. The new environment will threaten politically important interests in many societies. Interests under threat will resist the kinds of economic changes required for rebalancing and adjustment to take place, and for the major economic powers to maintain collaborative relations.

The threat is not so much that crassly nationalistic politicians will deliberately sabotage international cooperation. Instead, it is that well-meaning governments facing insistent demands from their constituents may be pulled toward policies that unintentionally harm their neighbors. This harm can then provoke hostile reactions, eventually dragging all parties concerned into bitter conflict.

Such conflict might begin on the monetary front. American policymakers are likely to face powerful temptations to address the country's problems, at least in part, with a bit of inflation and a bit of depreciation. Inflation will reduce the real burden of the country's enormous debt – both to itself and to others – while depreciation will help reduce the current account deficit. Both measures excite fear in foreigners, both by reducing the real value of their investments in American assets and by reducing their producers' ability to sell into the American market. Or conflict might emerge in trade policy. Countries desperate to increase exports and reduce imports might embark on aggressive unilateral moves to force open foreign markets, or attempts to close their own. Again, the response is likely to be hostile, and the results damaging.

Positive and constructive ways forward certainly exist, but finding them will not be easy. The structure of interests in the major societies will change as their economic orientation changes. These economic transformations, and the austerity measures associated with them, are difficult to manage and sustain without appropriate policies to smooth the path of adjustment. The more exposed citizens feel to the dangers these transformations entail, the more likely they are to attempt to shift the adjustment burden onto others, at home or abroad. One way to facilitate a more orderly rebalancing, then, would be to enhance the panoply of compensation mechanisms, social safety nets, and adjustment assistance available to those liable to be hardest hit by the process of rebalancing. Governments that provide adequate assistance to those who will be harmed, or who fear they will be harmed, by global economic trends, thereby reduce the risks associated with rapid economic change. This will not be easy, especially as deficit countries emerge from the crisis with even greater debt burdens than when they entered, but the alternative to compensating the dissatisfied socially is confronting them politically – never an enviable prospect.

By the same token, national governments can facilitate positive change by making political use of real and potential supporters of international economic integration. A shift from reliance on debt-financed consumption to a more productive export capability will expand the range of businesses, workers, and regions with a stake in the world economy. Just as opening developing countries to the world economy created or strengthened more internationally engaged groups, reorienting the previous deficit economies to search out opportunities abroad is likely to create or strengthen eventual supporters of an open international economic order. Governments can look to the beneficiaries of rebalancing, and can help mobilize them to support international economic involvement.

The institutions of international cooperation can also play a role in sustaining and strengthening the environment in which collaboration among the major powers takes place. There are always temptations to pursue national policies without regard for the externalities imposed on other countries; international institutions and international consultation can help ensure that these temptations do not lead countries down the road of international economic conflict. The International Monetary Fund (IMF) has largely focused on monitoring the behavior of developing debtor nations, on the principle that the actions of developing-country debtors can have systemic consequences. In the current setting, the more urgent task facing the world economy – and the IMF – is to monitor the behavior of rich countries, both deficit and surplus.

The Group of 20 has recognized the need for much more consistent surveillance of national macroeconomic policies, and the IMF is expected to enhance its efforts on this front. However, the attention paid to this has been limited, even desultory, as policy-makers and analysts focus on the purely economic components of rebalancing –which appears to be taking place as market forces operate to reduce deficits and surpluses alike. This misses the true challenge the world faces. It is not the purely economic features of rebalancing that will be difficult: markets will clear, one way or another. It is, instead, the political implications of the coming adjustments that will test the capacity of national governments, and international institutions. If national leaders grasp the political stakes, they may manage the unwinding of imbalances in a way that reinforces an open international economic order. If they fail to grasp those stakes, the recent financial crisis may be a harbinger of even greater dangers to come.

References:

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Jeffry A. Frieden is Professor of Government at Harvard University. He specializes in the politics of international monetary and financial relations. Frieden's most recent book is *Global Capitalism: Its Fall and Rise in the Twentieth Century* (2006). He is also the author of *Banking on the World: The Politics of American International Finance* (1987), of *Debt, Development, and Democracy: Modern Political Economy and Latin America, 1965 1985* (1991), and is the editor or co-editor of over a dozen other books on related topics. His articles on the politics of international economic issues have appeared in a wide variety of scholarly and general-interest publications.

PROJECT IDENTITY

Objectives of the Research

Increasing global integration processes involve a rapid intensification of cross-border and cross-sectoral economic linkages, affecting distributional patterns and the costs/benefits for the full range of economic agents and constituencies. Furthermore, these linkages have often dramatic effects on the preferences, interests and capacities of a wide range of actors in the global market, across institutional layers (national, regional and international). Such an evolution challenges the sustainability of existing political and social structures and systems of governance, posing important dilemmas in terms of legitimacy and sustainability.

The project is organised in four work packages:

WP1 International macroeconomic governance;
WP2 Globalization and financial stability;
WP3 The integration of markets for trade in goods and services;
WP4 Migration and the mobility of labour.

Each of the four research domains admits of at least three conceptual dimensions of research which require integration, hence a second reason for interdisciplinarity and integrated research teams. Underlying governance and policy problems are dynamic economic relationships, whose distributional consequences provide the initial key to understanding shifting patterns of preferences, old and emerging conflicts of interest, and institutional shortcomings.

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- CEPREMAP, France
- Centre for Economic Policy Research, CEPR, UK

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- European University Institute, EUI, Italy

Funding Scheme	Seventh Framework Programme, Theme 8, Socio-economic science and humanities (SHH), Collaborative Research Project, Contract Number 217559.
Duration	48 months: July 2008 – June 2012
Budget	EUR 3,305,999.00
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The PEGGED Collaborative Project is supported by the European Commission's Seventh Research Framework Programme, Contract no. 217559.
Project funded under the Socio-economic Sciences and Humanities theme.