WILL GLOBAL CAPITALISM FALL AGAIN?

by

Jeffry Frieden

BRUEGEL ESSAY AND LECTURE SERIES

WILL GLOBAL CAPITALISM FALL AGAIN?

by

Jeffry Frieden

BRUEGEL ESSAY AND LECTURE SERIES

FOREWORD

Fifteen years ago, in December 1991, the dissolution of the Soviet Union epitomised the end of the division of the world into separate blocs and the emergence of a truly global economy. Though the term had been coined somewhat earlier, it was at about the same time that globalisation entered the public debate. At that time, it was looked upon as a promise.

Fifteen years on, however, dissatisfaction is widespread. When asked in Spring 2006 whether globalisation was a threat or an opportunity, 47% of EU citizens chose the first answer and only 37% the second. They blame international economic integration for job losses, increased economic insecurity and rising inequality. The proportion of those who regard globalisation as a threat is as high as 70% in France and Greece. In the US, fears are not identical to European ones, but while the concern about jobs is somewhat less pronounced, alarm over security is more prominent.

At the same time, the vision of a truly multilateral world in which global rules and institutions would ensure a level playing field for workers and producers from all countries, big and small, has receded. True enough, multinational companies are less and less national and some strive to sever privileged links with their home country to become really global. In other sectors, however, especially primary energy and raw materials, the opposite trend is at work as national companies dominate the market and consuming countries rely on bilateral agreements to secure access to resources.

Politicians have taken note of these trends and in at least some countries they are increasingly embracing economic nationalism. Throughout the world, and across Europe, more governments are moving away from reliance on multilateral rules to emphasise the promotion and protection of national interests. Even within the EU, doubts over the benefits of integration and competition are noticeable, including among the founding members.

This is why Bruegel chose "Economic Integration Under Threat?" as the topic of its June 2006 Annual Meeting in which guests, participants from Bruegel members and its Board, and scholars discussed the changing world landscape, its significance and its implications for Europe. On this occasion, it fell to Jeffry Frieden to highlight and discuss the lessons from

history in a lecture which Bruegel is happy to publish.

Economists and historians have frequently emphasised the similarities between the first wave of globalisation – the one which ended with World War I – and the current one. Then as now, consumers and investors had access to products and assets from the whole world as trade and capital flows flourished. Then, as increasingly nowadays, people were also on the move in search for better economic opportunities. But what Stefan Zweig would later call "The world of yesterday" abruptly ended in 1914.

The question Jeffry Frieden focuses on is why this world could not be rebuilt in spite of several attempts. Drawing on his recent book, *Global Capitalism: Its Fall and Rise in the Twentieth Century*, he investigates why a system that everybody seemingly wanted to reinstate could not, in fact, be restored and why it was ultimately replaced by a system based on a very different set of rules, those of Bretton Woods.

Frieden's main conclusion is that against the background of major adjustments, the economic rules of the XIXth century's global economy had become incompatible with the politics of post-WWI societies. As encapsulated in US Treasury Secretary Andrew Mellon's advice to president Herbert Hoover, which he quotes, those rules would have required societies to "liquidate labour, liquidate stocks, liquidate farmers," and this was simply not possible any more. In the battle between harsh economics and politics, politics won.

Frieden, however, goes beyond offering a topical reminder of the tensions inherent in a world of global economics and national politics. From his analysis, he also draws lessons for today. The main one is that whatever the benefits of free trade, persuasion alone won't suffice. This especially applies to the US where rising inequalities, macroeconomic strains and security worries could soon interact and lead public opinion to question the country's international economic policy.

To make worldwide economic integration politically sustainable, Frieden suggests working simultaneously at the global and national levels: he calls both for a legitimate political governance of globalisation and for domestic policies to smooth transitions and compensate those who lose in the process. Recommendations of this kind are not unfamiliar to economists. Yet to move from intellectual acknowledgement to actual implementation will require that instead of trying to increase their political capital by criticising globalisation,

politicians invest this capital in making it politically and socially sustainable. The message is especially important for Europeans, as they often assume that they can free-ride on the back of the US, as guardian of the world economic order. What Frieden implicitly tells them is that they cannot afford to rely on this assumption anymore, and that they will need to act locally and globally to ensure that globalisation remains sustainable, and to continue enjoying its benefits.

Jean Pisani-Ferry
Director, Bruegel

WILL GLOBAL CAPITALISM FALL AGAIN?

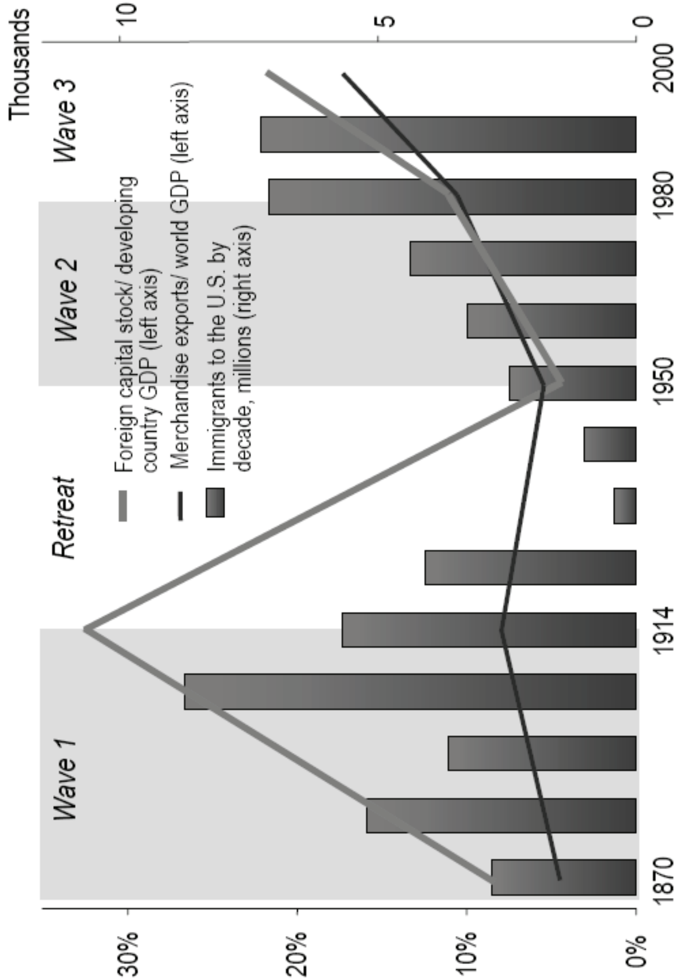
Over the past thirty years, the world economy has become increasingly integrated. Despite continued conflict over globalisation, most people – especially in the industrialised nations – appear to accept that an international system in which goods and capital can move quite freely among countries has become the normal state of affairs, and is likely to continue for the foreseeable future.

Nonetheless, there is widespread unease about the current state of international economic relations. Activists worry that footloose corporations may undermine attempts to protect the environment, labour, and human rights. Beleaguered businesses are troubled by foreign competitors. Nationalists and religious traditionalists fear that globalisation will undermine cultural and other norms.

Whether an integrated global economy will be maintained is one of the great questions of our age. The relevance of the question is underscored by the knowledge that an integrated world economy has collapsed before. Indeed, current patterns of international economic integration are similar in many ways to the condition of the world economy in the generations before 1914. As indicated in Figure 1, in general we have only recently returned to a pattern of globalisation that was the norm for decades before World War I. Indeed, on some dimensions – especially labour flows – we remain well below pre-1914 levels. The world has substantial experience with a globally integrated economy, and we may have something to learn from this previous epoch of globalisation.

FIGURE 1

Globalisation, Then and Now: International Economic Integration, 1870-2000



Source: Paul Collier and David Dollar, editors, Globalization, Growth, and Poverty: Building an Inclusive World Economy (Washington: World Bank, 2002).

GLOBAL CAPITALISM, 1850-1914

The classical international economy of the late nineteenth and early twentieth century was in fact extraordinarily integrated. On virtually every dimension -- the movement of capital, goods, and people, the availability of information across borders, the ease of long-distance transportation – the level of international integration came close to or exceeded the level that we have experienced over the last 25 or 30 years. Although there may be debate over the precise numbers, there is little doubt that the world economy was tightly integrated for at least 50 years before 1914. In addition, there was an international gold standard, a monetary order that linked virtually every country in the world together with a common monetary standard. By the early 1900s, in fact, only two countries of any significance – China and Persia – were not on the gold standard. So in addition to this great integration of goods, capital, people, technology, and other factors, there was a monetary order that tied the world together. Capitalism was truly global; and virtually the entire globe was drawn into markets and capitalism.[1]

Despite the impressive gains of the era, there were problems and tensions. The rise of new economic and military powers caused much consternation. European, American, and Japanese colonial expansion threatened the sovereignty and sense of national identity of many in the developing world. Ethnic conflict wracked the Balkans and the Middle East. What we might now call anti-globalisation sentiment was growing, with movements against free trade in Britain, against the gold standard in the United States, and against immigrants almost everywhere. And perhaps most worrying to residents of the industrialised world, cheap products were flooding into the rich countries from rapidly growing nations elsewhere, threatening the livelihood of millions of people.

The low-priced imports that caused such suffering a hundred years ago were the agricultural products coming into Europe from North America, Latin America, Australia, and other developing regions; the people whose livelihoods were threatened were European farmers. The foreign competition was in any event bitterly resented. During the decades before 1914, Europe was in an almost continual farm crisis, and there were times when starvation and near-

starvation conditions prevailed in many areas of Europe. There was, in short, no shortage of socio-economic and political problems.

Nonetheless, any retrospective on the classical global economy before 1914 would have to conclude that the system worked extraordinarily well. For generations, economic integration was deepened and sustained. More important – for economic integration is not an end in itself, but a means to the end of economic growth – the world experienced the most rapid growth it had ever known. This growth led to an impressive convergence. Countries like Australia and Canada, and the nations of the Southern Cone of Latin America, had been poor in the 1860s and 1870s; by the early 1900s they had surpassed much of Western Europe. Countries that had been even poorer, such as many in West Africa and Asia, moved into the ranks of what we would now call middle-income nations. Very substantial economic convergence took place.

The world economy was, despite many problems and periodic crises, characterised by generalised growth and macroeconomic stability. Overall, especially in the developed countries, there was a sense that the world economy was doing well, that people were becoming more and more prosperous. And the people of the industrialised world could be forgiven for thinking that an integrated world economy had become the normal and natural course of events and would continue for the foreseeable future.

And yet it all collapsed in a matter of weeks in 1914. At first, the world's economic and political leaders believed that the problem was only a wartime distortion, sure to fade once World War I ended and the post-war settlement was worked out. But as it turned out, they spent the next 20 years attempting to restore the pre-1914 international economy, and failing. The classical international economy could not be put back together. The 20th century turned out to be a series of political, economic, intellectual and military conflicts, over what had gone wrong and whether and how to fix it.

Given our current circumstances, I think it is worth asking about the implications for us of that first era of globalisation and its end. What was the problem? Does it hold lessons for the present day?

THE END OF THE FIRST ERA OF GLOBALISATION

Why could the first era of global capitalism not be restored? It was not for lack of trying. For twenty years after World War I ended, statesmen and diplomats engaged in round after round of conferences and consultations. The nations of the world signed treaties, created international organisations, and committed themselves to new obligations, in unprecedented measure. Yet nothing seemed to work.

The problem was not lack of technological progress. The 1920s and 1930s were one of the most exciting periods in the history of technical change. A whole host of new products and services (some invented a little earlier) became widely available – the automobile, the phonograph, air travel, such consumer durables as washing machines and refrigerators, the radio, long-distance telephony, movies. The modern corporation, embryonic before 1914, came into its own in the inter-war years, as did the modern multinational corporation. These decades, in fact, saw the definitive rise of mass production and mass consumption in the advanced industrial world.

Nor was the problem necessarily slow growth. While the crisis that erupted in 1929 certainly made matters much more difficult, during the 1920s growth had been extremely rapid. Many contemporaries experienced this decade as a prosperous one – the Roaring Twenties in the United States, the Dance of the Millions in Latin America, the Baldwin Age in England, the Weimar Era in Germany. Yet even in these good times, global capitalism seemed unstable and unpredictable.

The underlying sources of weakness in the international economic order after 1918 were political. One problem, which has received a great deal of attention, was international political conflict. Certainly this was important. The United States was by 1918 the world's largest and most important economy: the world's largest trading nation, largest lender, most important financial centre and international investor. Yet the United States government, dominated by isolationists who wanted little to do with the rest of the world, withdrew from international politics after 1920. This was unquestionably debilitating. By the same token, the continuation

in the diplomatic realm of the Franco-German rivalry that had been fought out on the battlefield was also a serious problem. After all, France and Germany had been two of the three principal pillars of the pre-1914 classical world economy, and cooperation between them had helped sustain the world trading system and the gold standard. The continuation of war by economic means in the 1920s and 1930s made international cooperation very difficult.

International political problems introduced great instability into the inter-war political economy, but I would focus attention on an even more important source of conflict: domestic politics. For in addition to international political conditions conducive to a functioning, integrated international economy, there are also domestic political requisites. And in my view, the principal problems that affected and infected the international economy in the inter-war period were domestic and political.

The previously existing domestic political underpinnings of the international economic order were no longer present. What were they, why were they important, and how did they disappear?

THE DOMESTIC POLITICAL ECONOMY OF THE CLASSICAL AGE

The classical international economy of the gold standard era rested upon a consensus among elites about the priority of international economic commitments. In virtually every country, for virtually all of this period, economic and political leaders agreed that governments needed to ensure that their economies would adjust quickly to changing international economic conditions, rather than the other way around. They agreed on requiring the domestic economy to pay the price necessary to realise the benefits of integration into the world economy. And what was that price? What did it mean for the national economy to, as they said, "take the strain?" Typically it meant allowing, or forcing, prices, profits, and wages to drop in response to adverse terms of trade or other shocks.

During the gold standard era, wages and prices were extremely flexible. It

was not unusual for countries to experience a decline of 30 or 40 percent in prices and wages over a three to five-year period. In the United States in the middle 1860s, for example, prices dropped by nearly 35 percent in less than two years as the country emerged from the Civil War and tried to return to gold.[2] Other countries experienced similar shocks, and similarly rapid downward movements in wages and prices.

This adjustment mechanism, based on enormous wage and price flexibility, was feasible and sustainable for both economic and political reasons. Economically, even the industrial societies of the age were dominated by small firms, small farms, and atomistic, disorganised labour. Goods and labour markets were quite competitive, so that the economies were flexible. When demand dropped and unemployment rose, prices and wages fell.

Politically, most of these societies were governed by policymakers who did not have to pay much attention to whatever the costs of adjustment might be. Most political systems before 1914 were either not completely democratic or completely undemocratic. Even the most representative of political orders typically had limited the franchise to a third or less of the nation's adults; labour unions were discouraged, repressed, or illegal. Political leaders could ignore many of the concerns of labour, small businessmen, and farmers. The short, sharp shocks of the classical gold standard era were economically effective at restoring macroeconomic balance, and they were politically relatively unproblematic.

By the 1920s neither the economics nor the politics of the classical adjustment mechanism were what they had been. Economic and political conditions now worked to impede, rather than speed, the adjustment of national economies to fit international economic conditions. On the economic front, by the 1920s most of the industrial societies were dominated by large firms and organised labour. Large-scale modern corporations, epitomised by the big automobile manufacturers, were now the rule rather than the exception. Labour was well organised in the workplace, and typically it had won the right to collective bargaining. While before 1914 business and labour alike had largely been price-takers, after 1920 more and more were price-makers in oligopolistic industries or organised labour markets. This meant that it was now possible in many instances for both firms and workers to counteract the operation of market forces – after all,

that was the express purpose of labour unions, and the real effect of oligopoly. There was nothing wrong with workers and capitalists attempting to protect themselves from the vagaries of rapid price changes. However, these protective efforts impeded the macroeconomic adjustments that had come to be expected on the basis of gold-standard experience.

Analogous changes had taken place in the political arena. The expansion of the franchise and other forms of representative democracy fundamentally altered the political balance of modern industrial societies. There were few truly undemocrati c societies left in the industrial world, and democracies had grown up even in parts of the developing world. European labour was now represented by large socialist and communist parties – and many of Europe's socialist parties were important members of coalition governments in the 1920s. Small farmers were crucial constituencies for many pivotal parties, or were organised into agrarian parties that were themselves pivotal. In these new and now expanded democracies, it was much more difficult for policy-makers to sit back and wait for economies to adjust; now they faced insistent demands from labour, farmers, and the middle classes that they could no longer ignore.

These economic and political changes meant that wages and prices were much more rigid than they had been. Where there had previously been little to stand in the way of an adjustment process that required a great flexibility of wages and prices, by the 1920s there was tremendous economic and political resistance by firms and by labour. The political economies of the advanced industrial countries, previously characterised by small businesses, small farms, and unorganised labour, were now dominated by big business and big labour.

To summarise and generalise, the first age of globalisation worked because it was economically and politically feasible for governments to do what was necessary to sustain their international economic commitments. It was not restored after World War I because these enabling conditions were no longer present. Keynes drew his conclusions early on: it was, he said exceedingly dangerous "to apply the principles of an economics, which was worked out on the hypothesis of laissez-faire and free competition, to a society which is rapidly abandoning these hypotheses."[3]

Of course, many political and economic leaders continued to hew to the beliefs of an earlier day. After all, the gold-standard policies had worked

before. Policymakers had learned that economies would adjust themselves, and that what governments needed to do was resist the temptation to step in. The appropriate stance was to follow the dictum: "Don't just do something, stand there." If the interwar economies ran into difficulties, the solution was to force an adjustment to market realities. As Treasury Secretary Andrew Mellon told Herbert Hoover: "Liquidate labour, liquidate stocks, liquidate the farmers, liquidate real estate... purge the rottenness out of the system."[4]

Whatever the intellectual justification for the classical stance, conditions had changed in ways that made it no longer economically or politically practicable. And yet, alternatives were very slow to develop, and even slower to be adopted. Keynes expressed his frustration to a member of the Bank of England's board, accusing the Bank of "attacking the problems of the changed post-war world with... unmodified pre-war views and ideas. To close the mind to the idea of revolutionary improvements in the control of money and credit is to sow the seeds of the downfall of individualistic capitalism. Do not be the Louis XVI of the monetary revolution."[5]

FROM COLLAPSE TO COMPROMISE

Despite the warnings from Keynes and others, when difficulties arose in the 1920s, and especially in the 1930s, there was initially little or no politically viable response. The result of this failure was, as we know, a terrible backlash, and one that in some sense was predictable. For those whose needs were not met by the existing order now had the ability to fight back. Recall, for example, the flood of farm products from the New World and elsewhere that devastated the European farm economy in the late nineteenth and early twentieth century. Before 1914, the choices farmers had were to migrate to the cities, emigrate, or suffer. Governments provided few alternatives – a few supportive trade policies (especially for well-placed large farmers) and some very minor subsidies, but little else. Typically governments simply sat back while their farm sectors shrank.

But in the 1920 and 1930s, when farmers were again faced with some very difficult choices, the outcome was quite different. It is not, I think,

coincidental that small farmers and small businessmen were among the principal sources of mass political support for the fascist movements of the era. It was no longer possible for politicians simply to shrug their shoulders, for there was a powerful political response to adverse economic trends.

The ensuing backlash had some predictable properties. Supporters of the classical order had argued that giving priority to international economic ties required downplaying such concerns as social reform, nation building, and national assertion. In the new environment, some of those newly empowered responded that if the choice was between social reform and international economic integration, they would choose social reform – thus leading to the Communists' option of radical autarky. If the choice was between national assertion and global economic integration, another set of mass movements chose nation-building – thus leading to fascist autarky in Europe and economic nationalism in the developing world.

In fact these views – economic nationalism as applied by fascists, developmentalists, or communists – appeared to be in the ascendant all through the interwar period. A look around the world in the late 1930s would have seen a virtually solid phalanx of nations that had turned away from the world economy in one way or another. Only a Western European fringe, North America, Australia, and New Zealand seemed not to have opted for the new economic nationalism.

It took quite a while for any sort of serious alternative to develop. Eventually what arose was what we think of today as the social democratic welfare state. This involved a commitment to both the market and a well-formed system of social insurance at one and the same time. Despite the somewhat suspect nature of social democratic principles in today's environment, their rise in the 1930s and 1940s did seem to capture something inherent in modern capitalist economies. Societies dominated by big business and big labour seemed also to require big government. The result was a compromise, which started to form in the mid 1930s and gradually increased in strength and speed. One of America's financial leaders summarised the trend in monetary relations as "a union of what was best in the old gold standard, corrected on the basis of experience to date, and of what seems practicable in some of the doctrines of 'managed currencies'."[6]

This compromise, whether in its Scandinavian socialist, American New

Deal, or several other incarnations, became the central component part of the industrialised world's social organisation after World War II. And the Bretton Woods system that arose at the same time was an extension and expansion of this compromise to the organisation of the world economy.

The Bretton Woods system reflected this compromise in many ways. First and foremost, it acknowledged the legitimacy – even the centrality – of governments' commitments to social insurance and redistributive social policies along with their commitment to greater international economic integration. The Bretton Woods order was in fact full of compromises on every relevant economic dimension. Most aspects of the dedication to economic integration were partial or tempered. Trade was liberalised, but only gradually, in some products (not agriculture and services), and with many escape clauses. International investment was to be encouraged, but restrictions on capital movements were the norm. The character of the Bretton Woods monetary regime was typical of this compromise: there was gold backing for the currency, but in practice only for the dollar; exchange rates were fixed in general, but could be varied if necessary (except for the dollar); financial integration was encouraged, but capital controls were virtually universal.

This Bretton Woods system of compromise worked spectacularly well. Global economic integration advanced continually if gradually; government spending on a wide variety of social programmes advanced as well; and the world experienced the most rapid and most stable period of sustained economic growth in history.[8]

The extraordinary success of the Bretton Woods order actually helped undermine the very operation of the system itself. The gradual pace and compromise nature of the path to economic integration allowed an ever greater opening of markets; but the more open markets became, the more difficult it was to sustain gradualism and compromise. The international monetary system, the centrepiece of the Bretton Woods order, was symptomatic. The stability of the dollar standard encouraged international investors to expand cross-border financial activities, eventually increasing the integration of national financial markets. This financial integration in turn began to undercut the comprehensive capital controls necessary for the dollar-based adjustable-peg system to operate smoothly. International financial integration came to interfere with the ability of national governments

to run autonomous macroeconomic policies that responded to national political and economic realities. Eventually the contradictions between increasingly integrated international financial markets, on the one hand, and the continued desire of national governments to run independent monetary policies, on the other, brought down the Bretton Woods monetary regime.

FROM BRETTON WOODS TO GLOBALISATION

The breakdown of the Bretton Woods system was accompanied by some difficult times in the world economy – stagflation, as the unaccustomed combination of recession and inflation was called. And for at least a decade after the collapse of Bretton Woods there were real questions about the future of the international economy. We often forget how troubled the 1970s and early 1980s were, both for economic policy and on the broader international political stage. Certainly there were many times and countries in which proposals for a redoubling of economic nationalism, or a deepening of social democracy, seemed in the ascendant. This was, after all, the era of commodity cartels and Third World demands for a New International Economic Order, of Eurocommunism in Southern Europe and the Rehn-Meidner plan for socialising capital in Scandinavia.

But after more than a decade of conflict, these political disputes started to resolve themselves. First came the turn toward restrictive monetary policies in the developed countries – the “Volcker shock,” which was accompanied by a deregulatory trend in the United States. These were followed and deepened by the Reagan-Thatcher drive to restrain or roll back redistributive social policies. By the mid-1980s, most industrial countries were on this path, which implied both a greater reliance upon market forces domestically and a redoubled commitment to international openness. In Europe, the crucial turning point probably came between 1983 and 1985, as France and Italy joined the European Monetary System and the continent began the arduous journey toward Economic and Monetary Union.

On the heels of this turn in the developed world came even more momentous changes in the developing nations. The Third Worldist demands of

the 1970s had gotten nowhere, while the expansive years of freewheeling foreign borrowing by the newly industrialising countries (NICs) had collapsed into a debt crisis. By 1985, people in the developing countries were starting to turn away from the decades-long dedication to import substitution in favor of export promotion, which seemed to have worked well in East Asia. A wave of trade liberalisation and privatisation swept the developing world, so that by the early 1990s it too was clearly committed to global economic integration.

Then came the most striking development: the collapse of the centrally planned economies and their startling change in direct-ion toward domestic and world markets. The process had started in China and Vietnam, but when the Soviet Union disintegrated and the countries of Eastern and Central Europe made aggressive plans to join the European Union, the resurgence of global capitalism seemed complete. The Communist world, symbol of the most complete rejection of both global economic integration and of capitalism itself, had rejoined the world economy.

By the mid-1990s, it appeared that we were irresistibly launched on the second age of globalisation. And in fact the world economy has continued along these lines since then, with all of the indicators of integration trending upward – some of them, such as international financial flows, at a very rapid pace. Yet over the past ten years concern has grown about globalisation in many quarters, and the generalised enthusiasm of 1995 is now less general, and less enthusiastic. This raises the question I posed at the outset: What might the previous experiences of global capitalism teach us about contemporary affairs?

THE POLITICAL ECONOMY OF GLOBALISATION

The first era of globalisation collapsed because there was no effective political and policy response to changing economic and social conditions. It did not fail, in my view, for technical or objective economic reasons, but rather for political-economy reasons. The major nations' reigning social orders faced new, and newly powerful, demands, and did not satisfy them.

During the global capitalism of the late nineteenth and early twentieth century, national political systems were perfectly capable of reflecting,

representing, and responding to the beneficiaries of international economic integration. They were, however, wholly inadequate to – indeed, largely indifferent to – the task of reflecting, representing, and responding to the concerns of those who were harmed, or thought they were harmed, by the international economy. This pattern was sustainable when these last groups were not well organised politically, and when their access to politics was limited. But it was disastrous in the modern societies of the 1920s and 1930s. The simmering discontent of those hostile to foreign competition and international economic exposure turned out to be able – quickly and stunningly – to overcome the support of the beneficiaries of global capitalism.

As was the case a hundred years ago, access to international markets today provides enormous benefits. Globalisation's contribution to economic growth and development are palpable, and are widely enjoyed. The biggest human story of the past 25 years is the integration of China and India into the world economy, and the remarkable increase in living standards of hundreds of millions of people that has resulted. Nevertheless, exposure to the international economy can impose serious costs on people, industries, regions, even whole countries. Not even the most fervent supporters of globalisation would deny that international economic trends can hurt some of the people, some of the time. These costs and this harm , which vary from place to place and time to time, underlie the widespread sense of unease that has developed about globalisation. This unease varies across countries, among people, and over time, but it is not trivial and is – both in its own right and in historical perspective – important to recognise.

In Europe, in Latin America, in the United States, and elsewhere, there are clear indications that support for international economic integration is slipping, and even that it has become unpopular. These sentiments take different forms in different places – economic reform fatigue in some developing countries, anti-immigration sentiment in many developed countries, and hostility toward the European Union among its current and potential members. What they have in common is the belief that, while global capitalism may have extensive benefits and important beneficiaries, it also creates substantial groups of losers, casualties of the world economy.[9]

The prevailing approach to dealing with firms, workers, farmers, and others who are sceptical about globalisation appears to be to rely on

persuasion. The idea seems to be that it is sufficient to convince people that their current difficulties are outweighed by the long-term benefits of international economic integration; or that there is no alternative to current trends; or that there are overpowering, long-established, intellectual reasons for the welfare superiority of free trade. These are powerful arguments, and they are correct – in the abstract. But they are irrelevant to the problem at hand, and they will not work. For the problem is not that there is a miasma of false consciousness in the air, but that the aggregate benefits of economic integration come bundled with substantial distributional costs.

There are real, concrete, accurately perceived interests at stake. We have powerful theoretical reasons to believe that the free movement of goods and factors will have a negative impact on some people – for example, that unskilled workers in rich countries will lose if trade is opened to countries rich in unskilled labour.[10] And there is plenty of empirical evidence to support these theoretical expectations, both in the academic literature and in the social reality of today's world. So the challenge is to address the legitimate concerns of those who are either losing or not gaining in the contemporary economic environment. Certainly many of the fears expressed in the political arena are exaggerated, and opportunistic politicians exploit them mercilessly; but that should not obscure the reality of the underlying socio-economic trends that motivate these fears.

AMERICAN POLITICS AND THE WORLD ECONOMY

I can be a bit more concrete about the political economy of these concerns in the current American context, about the challenges the American political economy faces that might endanger its commitment to an open international economic order. These challenges all have to with how current trends in the United States, and in the relationship between the U.S. and the world economy, might affect the making of the nation's international economic policy.

The backdrop to this discussion is the general unease in the United States about globalisation. The very phrase has, to some extent, become a

lightning rod for discontent. It is rarely used in a positive sense – indeed, American popular political discussions rarely invoke the world economy in any context in a positive sense. There is something relatively new about this sense of unease.

Americans are quite used to specific pressures from affected industries and groups facing foreign threats in trade, finance, investment, and other arenas. This has led to plenty of traditional protectionist pressures. Typically, attempts to open the economy faced particularistic challenges from more insular segments of the business community. Certainly this was true before World War II, when most of American industry was highly protectionist. Since then, it has been true of certain industries facing competitive threats, such as the steel or auto sectors. In all this, mass politics was basically irrelevant to the making of international economic policy; there was no mass politics of international economic policy. Some businessmen had strong views about foreign economic policy – some in favour of openness, some protectionist – but almost nobody else cared. This traditional pattern has changed. Today, the most significant portions of the American business community are quite solidly in favour of international economic integration. There is very little remaining of the traditional business protectionism of previous eras. To be sure, there are protectionist pressures from farm communities and industries, but these pressures are much less important politically than they have been in the past. Some of the traditionally protectionist industries have simply faded away, while others have become internationally integrated; in any case, these industrial lobbies are weaker than they have been.

In their place has come a drumbeat of broad discontent with international economic integration. This is something that is relatively new – at least in more modern America. It is reminiscent of the mass public concern of 75 or 100 years ago in the United States, when economic isolationism was the norm in American public opinion. But in recent years there has rarely been so much, and such generalised, uneasiness about America's place in the world economy.

The state of the nation's public opinion should be kept in mind as we look at three important trends in American society: deteriorating income distribution, macroeconomic imbalances, and concern about national security. All of them have serious implications for the political economy of America's role in the world.

First is the secular deterioration in income distribution in the US. The

general story is well-known: after decades of declining inequality, American incomes have become more unequal almost continually from 1973 to the present. This general trend can be disaggregated into two important components. For about 15 years after 1973, the wages of unskilled and semi-skilled workers in the United States went down in both relative and absolute terms. This sparked a debate on whether the source of the decline was greater exposure to world trade, or technological change that was biased against unskilled workers, or some combination.[11] Whatever the mix of causes, it is generally agreed that imports of products intensive in unskilled labour, and immigration by unskilled workers, played a part in this trend.

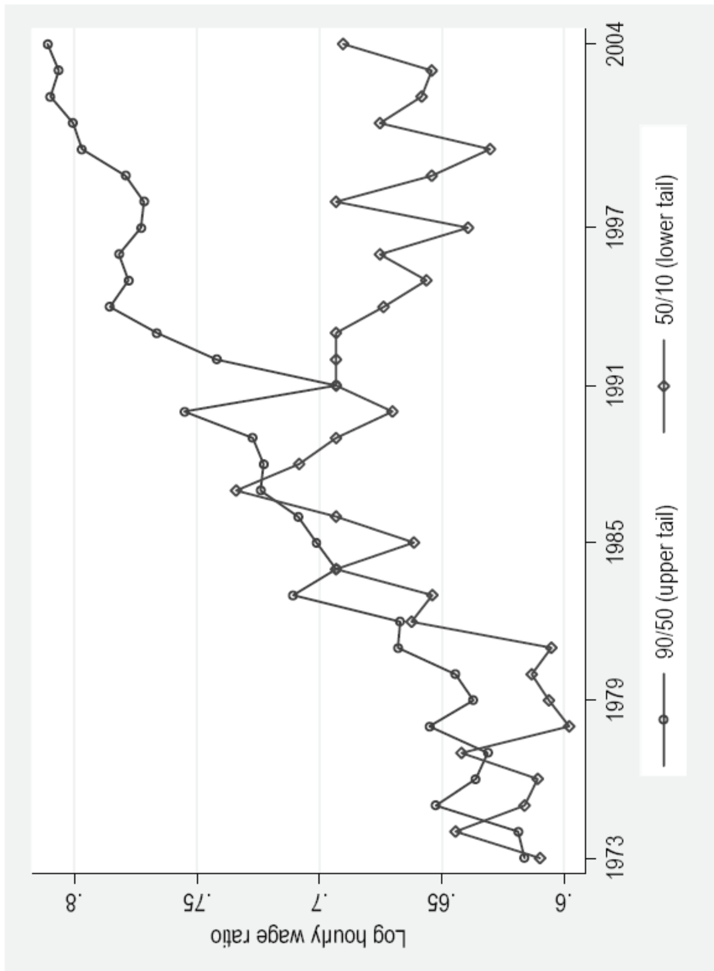
In the past fifteen years, the relative position of unskilled workers has tended to stabilise – albeit at a much lower level than before. However, the income of the middle registers of the American income distribution has continued to decline relative to that of the country's top earners – the wealthiest ten percent, or one percent, or less. The headline stories here are about executive compensation, for the extraordinary increase in top salaries makes sensational reading, especially in the context of corporate scandals of the Enron variety. Leaving sensationalism aside, it seems clear that middle-income Americans have not been doing nearly as well as wealthy Americans.

David Autor and Lawrence Katz have done particularly interesting work on the process, and Figure 2 summarises some of their findings.[12] The two lines show the evolution of the ratio between the hourly wages of the wealthy and the middle class, on the one hand, and between the middle class and the poor, on the other (the 90-50 ratio and the 50-10 ratio, respectively – that is, the ratio between the 90th percentile and the 50th percentile, and between the 50th and the 10th percentiles). It can be seen that the relative position of the middle class and the poor declined between 1973 and the late 1980s, after which the position of the poor stabilised, while that of the middle sectors continued to decline. There are, of course, many technical issues associated with understanding trends in income distribution, but the general picture seems clear. Downward pressure on the position of poor Americans has reduced their relative income; downward pressure on the position of middle-class Americans continues to reduce theirs.

Trends in income distribution are central to some of the political passions

FIGURE 2

Trends in Inequality between Rich, Middle-income, and Poor Americans, 1973-2004 (Ratio between wages of 90th-percentile and 50th-percentile workers, and 50th-percentile and 10th-percentile workers)



Source: Autor, David, Lawrence Katz and Melissa Kearney, The Polarization of the U.S. Labor Market. American Economic Review 96, No. 2 (May 2006).

inflamed by economic integration. Hostility to both immigration and imports from poor countries is motivated, at least in part, by concern about the conditions of unskilled American workers. This is now joined with apprehension on the part of middle-class Americans. Some of the middle-class malaise has taken the form of a furore over "outsourcing," especially as the jobs affected now include many in the service sector previously seen as immune to global economic trends. There is some indication that middle-income workers may resent the influx of highly skilled immigrants, especially in technology-intensive sectors. Perhaps more importantly, the pressure on the middle class feeds into long-standing resistance to tax increases, especially when coupled with the perception that the wealthy are not paying their "fair share."

These trends have prompted much social and political dissatisfaction, but this disgruntlement has been softened by general economic growth. For years now the United States has experienced a nearly continual increase in consumption. The counterparts of this have been much remarked upon, usually in a negative sense, for the consumption boom has been associated with a low national savings rate and with a large inflow of capital from the rest of the world. Certainly there is cause for concern inasmuch as United States consumers are enjoying a prosperity that is, at least in part, being purchased from foreigners, at the expense of future generations (I return to this issue below). Whatever the longer-term implications, it seems that the good economic times of the past 15 years have dampened immediate fears about trends in real wages. Nonetheless, in the United States there is an insistent, if muffled, drumbeat of apprehension about what globalisation means for unskilled workers, and now increasingly for semi-skilled and skilled workers in the middle class. Global economic integration has clearly provided tremendous benefits to the top quarter or so of the income distribution, but there are many in the United States who are not convinced that the remainder of society has benefited.

The second important feature of the contemporary American political economy is what the rest of the world thinks of as global macroeconomic imbalances. Here my focus is not on the very important implications for the world economy in general, but rather on the narrow and parochial implications of these global imbalances for the United States.[13]

For the global imbalances have been, and will continue to be, a very

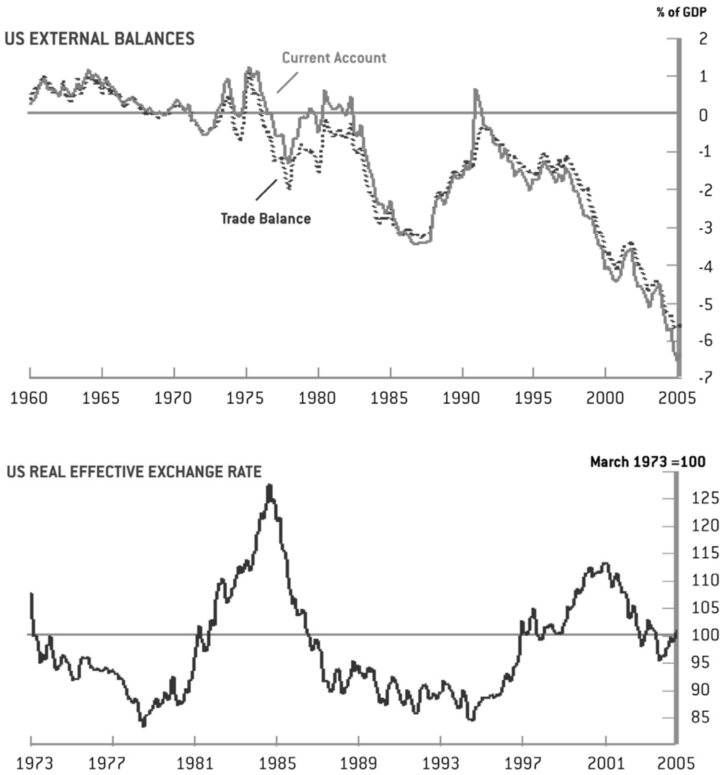
important part of how the United States interacts with the world economy. Two component parts of these imbalances – America's fiscal stance and the capital inflow from abroad – have been central to the American economic expansion. This capital inflow has, among other things, tended to keep the U. S. dollar stronger than it otherwise would be. Figure 3 shows both trends clearly.

The relatively strong dollar has, over the past ten years, been associated with increased non-tradables prices, especially housing prices. The housing-market expansion in turn has contributed to the generalised feeling of prosperity that has mitigated some of the latent dissatisfaction with trends in income distribution. For the booming housing market has had a significant wealth effect, allowing many middle-class Americans to borrow against the rising value of their real estate. These interrelationships could be developed on many dimensions, such as with how the availability of foreign funds made substantial tax cuts possible. The general point is that the current state of the American economy and of its political economy is related to the massive capital inflows.

The current imbalances are unsustainable. I do not pretend to know when they will come to an end, or how; but eventually the United States will have to reduce its fiscal deficit, and eventually the capital inflow will have to be reduced and even reversed as external liabilities are serviced. And this in turn implies a reduction in consumption, an increase in savings, and a decline in the real exchange rate of the dollar – an unwinding of what has happened in the past ten years. Any number of scenarios might follow from this; almost all the realistic ones involve a decline in the relative price of housing (as the real exchange rate declines). The resulting pressure on the mortgage market is likely to cause financial distress, which will exacerbate the general macroeconomic pressures on the middle classes.

Whatever the preferred scenario one chooses for an end to the current imbalances, the process will create strains in the American macroeconomy – and in American politics. For the mass public support for – or at least lack of open opposition to – America's current integration into the world economy is largely due to the current boom. When the expansion comes to an end, and when many of the factors that have sustained it, turn around – when the United States goes from living beyond its means to living within its means and

FIGURE 3
U.S. External Balances and Real Effective Exchange Rate



Source: Alan Ahearne and Jürgen von Hagen. 2005. Global Current Account Imbalances: How to Manage the Risk for Europe. Bruegel policy brief 2005/2 (December).

then some – latent tensions over globalisation will almost certainly come to the fore. The eventual resolution of the current global imbalances is most important, in my opinion, because of how it may affect social and political developments in the United States.

This brings me to the third dimension of relevance to assessing the likely future of America's international economic role, and that is how national security concerns interact with the politics of foreign economic policy. Here it is helpful to recall the historical record of how Americans have in the past approached the intersection of national security and the international economy.

It is not widely appreciated today how unpopular international economic engagement was even at the point at which the United States was leading the world toward the construction of the Bretton Woods system. In the aftermath of World War II, public opinion appeared overwhelmingly opposed to trade liberalisation, which after all had been anathema to most Americans for nearly a century. Congress was, after the 1946 midterm elections, controlled by a Republican Party that was itself largely controlled by such isolationists as Robert Taft, who had defeated the League of Nations and other attempts to involve the United States in international political and economic affairs in the 1920s and 1930s. There seemed little prospect that the Truman Administration would be able to convince a Republican Congress, and a reluctant mass public, of the need for renewed global engagement.

In the event, the Truman Administration was able to secure Congressional and popular support for its international economic policies by linking them to the struggle against the Soviet Union. One can think about the domestic politics of America's post-war foreign policy either in coalitional terms or in terms of public persuasion, or both. At one level, business and foreign-policy elites who strongly supported trade liberalisation and Bretton Woods – the Wilsonians who had lost in the 1920s – were able to make a bargain with some of their erstwhile opponents. Many conservative Republicans in the Congress were unenthusiastic about international economic engagement – as they had always been – but believed in the need for military and political involvement in stopping the spread of Soviet-backed Communism in Europe and elsewhere. The Northeastern economic internationalists were less enthusiastic about the anti-Soviet crusade, while the Midwestern anti-Soviet

militants were less enthusiastic about economic internationalism; but together they could agree on doing both. Pivotal Republicans in the House and Senate signed on to Bretton Woods, and to international economic integration, because they saw them as essential to the anti-Soviet alliance.

On another level, the American leaders who supported economic integration were able to make the argument to the public that building closer economic ties with Western Europe and Japan was an essential part of cementing an alliance with our supporters in the battle against the Soviet Union. The argument was not complicated: for the United States to gain the support of the Western Europeans and the Japanese in our battle against the Soviet Union, we needed to give them access to our capital and to our markets.[14] In both senses, there was a clear connection between the security component and the international economic component of American foreign policy.

The connection between national security and international economic engagement no longer seems so obvious. If, as many would argue, the principal concern of American national security policy is the struggle against extremist Islamic terrorism, the international economic implications are less than straightforward. Certainly, cementing ties with Saudi Arabia and other Persian Gulf states – many of which seem closely linked to Islamic extremism – does not seem to sit well with many Americans. The Dubai Ports World fiasco, in which a groundswell of public opposition effectively blocked investment in American port facilities by a United Arab Emirates-based firm, is indicative of the murkiness with which many Americans see the intersection of the two concerns.[15] In the words of a one-sentence letter sent to President Bush by a prominent Republican member of Congress, "In regards to selling American ports to the United Arab Emirates, not just NO — but HELL NO!"[16] Whatever the connection may be between the war on terror and American international economic policy, very few people seem to be able to find any link between this national security concern and support for globalisation.

Others would insist that the principal security concern of the United States over the coming decades will be the rise of China. Here, too, it is hard to know how America's current international economic policies relate to that national security challenge. Some in the security community argue that the United States needs to prepare to deal with the potentially destabilising role of China

in international politics. What then are we to make of the fact that current policies appear to be making the United States dependent upon China as a supplier of both goods and capital? Here, too, there is a disjuncture between the national security stance of the United States and its foreign economic policy. American policymakers can no longer invoke national security considerations to justify otherwise unpopular foreign economic policies; and that may amount to an important restriction on their freedom of movement. American foreign economic policy may well be hotly contested in years to come, and that has powerful implications for the future of the international economic order.

WHITHER GLOBAL CAPITALISM?

The lessons of history are rarely simple. But there are some things we can learn from the experiences of the past century, especially from how the first era of global capitalism fell and how it rose again. In the aftermath of the age of globalisation that ended in 1914, attempts to restore and sustain the system led to a resounding failure and a terrible backlash. While that backlash may not have been justifiable, it was at least understandable.The economic and political leaders who ignored or attempted to gloss over the costs of globalisation were swept aside by the people, groups and countries that experienced first-hand these costs. The ancien regime failed to adapt to the new economic and political realities, and collapsed.

The new regimes that arose on the wreckage of the classical order erred in a different direction, as they ignored the potential benefits of globalisation. Fascist autarky achieved some early successes but eventually collapsed into militaristic adventure and war. Economic nationalism in the developing world, and central planning in the U.S.S.R., also showed initial promise, but they too played themselves out over time. Attempts to close national economies off to the rest of the world led to terrible policies that failed just as miserably as those they replaced. The purported alternatives to international economic integration were tried, and found wanting.

As the twentieth century wore on, its central problem turned out to be

whether and how to restore international economic integration. Early experiences taught two sets of lessons. On the one hand, those that ignored the costs, the tensions, and the losers of globalisation led their societies to disaster, and contributed to the collapse of the interwar political economy. On the other hand, those that ignored the benefits of the world economy went down equally disastrous paths, steering their countries toward ill-advised adventures in self-sufficiency. In the aftermath of World War II, governments committed themselves to pay due attention to these costs and tensions, and were able to engineer a gradual reconstruction of the global economy.

Compromises between globalism and nationalism, and between social reform and markets, permitted the Western economies to grow rapidly and stably after World War II. But those compromises eroded as the world economy became ever more tightly integrated, especially after the developing countries and centrally planned economies rejoined the international economic order.

Today capitalism is at least as global as it was in the decades before 1914, which raises the spectre of a return to the failures that ended that earlier episode of global capitalism. And so the central challenge of our portion of the twenty-first century will be to avoid a repetition of past tragedies, of both sorts. We need to eschew an exaggerated reliance on market forces to solve all problems, and on the support of the beneficiaries of the global economy to address all discontent. But we also need to avoid an unwarranted turn toward economic insularity, and a simple surrender to the proponents of protection.

This will require a delicate balancing act, of the sort whose failure caused such calamities in the past. The first part of it is to build and sustain a functioning, integrated, international political and economic order. There will be continuing threats to this order, both from traditional opponents in the economic realm and from a great variety of non-economic forces – geopolitical, ideological, religious – that oppose a global economy as a matter of principle or expedience. Supporters of an open international economy need to work together to build an effective and stable governance structure for international economic interactions.

The second part of the balancing act is to create and sustain domestic political and economic conditions that allow enduring support for inter-

national commitments. This might include consultation among affected social groups, compensation for those asked to sacrifice, targeted interventions to smooth transitions, and whatever else helps maintain the social and political stability necessary for national political economies to reap the fruits of international economic integration.

There is no magical formula that makes it easy for governments to combine a commitment to international economic openness with attention to the legitimate concerns of national constituents harmed by the international economy. We cannot identify in advance what policy package is ideal for any group or country; that is the job of national political systems. However, on the basis of the past century's experience, we can have some confidence that the stakes are very high, and include the prospects for prosperity of much of the world.

REFERENCES

Ahearne, Alan and Jürgen von Hagen. 2005. Global Current Account Imbalances: How to Manage the Risk for Europe. Bruegel Policy Brief 2005/2 (December).

Autor, David, Lawrence Katz and Melissa Kearney. 2006. The Polarisation of the U.S. Labour Market. *American Economic Review* 96, No. 2 (May), pages 189-194.

Bordo, Michael. 1993. The Gold Standard, Bretton Woods, and Other Monetary Regimes: A Historical Appraisal. *Federal Reserve Bank of St. Louis Review* 75, No. 2 (March/April) pp. 123-199.

Fordham, Benjamin. 1998. *Building the Cold War Consensus: The Political Economy of U. S. National Security Policy, 1949-1951.* Ann Arbor: University of Michigan Press.

Freeman, Richard B. 1995. Are Your Wages Set in Beijing? *Journal of Economic Perspectives* 9, No. 3, pages 15-31.

Frieden, Jeffry. 2006. *Global Capitalism: Its Fall and Rise in the Twentieth Century*. New York: W. W. Norton and Company.

Graham, F. D. 1922. International Trade Under Depreciated Paper, The United States 1862-1879. *Quarterly Journal of Economics* 36, No. 2 (February), pages 220-273.

Ruggie, John. 1982. International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order. *International Organization* 36 (2), pages 379-415.

Trubowitz, Peter. 1998. *Defining the National Interest: Conflict and Change in American Foreign Policy*. Chicago: University of Chicago Press.

NOTES

[1] I am aware that the existence of markets may not be a sufficient condition for the existence of capitalism, but I hope to be excused for relaxing definitional rigor in the interest of rhetorical symmetry.

[2] The United States went off gold in 1862 due to the war, and prices rose by over 150 percent during the war. Between 1865 and 1879 the country was embroiled in political conflicts over whether and how to return to gold. Gold supporters eventually won out, and by 1879 prices were down 65 percent from their wartime peak, to below where they had been in 1862. The experience received a great deal of attention in the United States in the 1920s, when the operation of gold and paper standards were a topic of economic interest; the figures used here come from Frank Graham's influential paper on the subject (Graham 1922).

[3] Quoted in Frieden 2006, page 152.

[4] Quoted in Frieden 2006, page 176.

[5] Quoted in Frieden 2006, page 153.

[6] Leon Fraser, as quoted in Frieden 2006, page 249.

[7] Ruggie 1982 is the classic statement of this point.

[8] Bordo 1993 provides a comparison.

[9] This is hardly a radical view. Ben Bernanke, who is probably as close to the economic-policy mainstream as possible, recently noted that "the social and political opposition to openness can be strong... [M]uch of it arises because changes in the patterns of production are likely to threaten the livelihoods of some workers and the profits of some firms... The challenge for policymakers is to ensure that the benefits of global economic integration are sufficiently widely shared--for example, by helping displaced workers get the necessary

training to take advantage of new opportunities--that a consensus for welfare-enhancing change can be obtained." The full speech is available at: http://www.federalreserve.gov/boarddocs/speeches/2006/20060825/default.htm

[10] That is, if one believes that Heckscher-Ohlin considerations dominate such effects; different expectations might flow from a specific-factors (Ricardo-Viner) view. In either case, there will be losers.

[11] Freeman (1995) is an excellent summary of the issues.

[12] From Autor, Katz, and Kearney (2006), which summarises much of their work.

[13] For an excellent summary of the global implications, see Ahearne and von Hagen 2005.

[14] Fordham (1998) and Trubowitz (1998) are excellent studies of the process.

[15] Made even murkier by the fact that the facilities already belonged to a foreign corporation, albeit a British one.

[16] Sue Myrick at http://www.msnbc.msn.com/id/11494815/page/2/

WILL GLOBAL CAPITALISM FALL AGAIN?

by Jeffry Frieden

In this lecture, given at Bruegel's Annual Meeting in June, 2006, Jeffry Frieden focuses on why the first era of globalisation could not be restored, and why it was ultimately replaced by a system based on the rules of Bretton Woods. He argues that the economic requirements of the 19th century's global economy were incompatible with the politics of post-WWI societies. In the battle between harsh economics and politics, politics won. The historical experience of global capitalism shows, he argues, that whatever globalisation's benefits, persuasion alone will not suffice to make it politically sustainable. Frieden ultimately calls for the legitimate political governance of globalisation as well as appropriate domestic policies to compensate those who lose out in the process.

JEFFRY FRIEDEN is a professor in Harvard University's Department of Government. His teaching and research focus on the politics of international monetary and financial relations. His most recent book, *Global Capitalism: Its Fall and Rise in the Twentieth Century*, (New York: Norton) was published in 2006.

BRUEGEL ESSAY AND LECTURE SERIES provides a compact record of the views of scholars and practitioners as they write for, or lecture at Bruegel events. The series provides the reader with a grounding in the main arguments of a current topic for debate, adding thought-provoking insights.