# Alphabet Soup:
## The Political Economy of the Great Recession

**Daniel W. Drezner**

Glasshouse Forum

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Glasshouse Forum brings together concerned capitalists and researchers from different disciplines and provides an arena for critical reflection on the merits and demerits of capitalism.

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Glasshouse Forum is research-oriented and interdisciplinary. It is politically independent and maintains a pluralistic approach. It does not engage in lobbying activities, or make policy recommendations.

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# Alphabet Soup:
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## Glasshouse Forum's Executive Summary

The current global economic crisis, which began as a subprime crisis and developed into a general credit crisis, is the deepest since the Depression of the 1930's. There are many signs that we are now facing the beginning of a structural sea change. But what will it be like?

To get a better understanding of the medium-term effects of the crisis, Glasshouse Forum asked Daniel W. Drezner, Professor of International Politics at The Fletcher School, Tufts University, and author of the Glasshouse Forum report *White Whale or Red Herring? – Assessing Sovereign Wealth Funds*, to draft scenarios and make qualified estimates based on as much objective data and historical parallels as possible.

One structural cause of the crisis was the extent to which savings/investment balances were skewed beyond historical norms. Will the crisis force Americans to save more? Will capital exporters – Germany, China and Japan – consume more? How will these changes affect the global economy?

An immediate effect of the crisis has been to vastly expand the role of states in key sectors of the global economy. In the USA, the government has already taken on an expanded role in the finance, housing and automobile sectors – with healthcare on the horizon. How permanent will the state's role be in the post-crisis economy?

It is easy to envisage how the crisis could lead to populist outrage at the finance sector, or globalisation more generally. Will there be political support for continued trade liberalisation and economic globalisation, or will the course be reversed? Will the crisis lead to greater macroeconomic policy coordination, or a return to beggar-thy-neighbour policies? Will there be a rise in instability, diversionary war, or other forms of political violence?

Based on the evidence to date, Drezner sees three possible economic trajectories: paths "U", "L" and "W". Which path the economy follows will have profound effects on the macropolitical variables of concern.

In the "U-style" recovery, where economic growth rebounds fairly quickly, there would be a reverse of the deglobalisation trend, and therefore a decrease in the likelihood of greater political violence.

In an "L" economy, growth stays feeble or flat for several years to come, and there is no return to pre-2008 output levels. An L-shaped economic path would increase both protectionist and fiscal pressures on many states. The incentive to pursue beggar-thy-neighbour policies would increase, decreasing interdependence and lessening the constraints reducing interstate conflict. On the other hand, an L-shaped economic path is also somewhat more predictable. The lower the level of economic volatility, the more the likelihood that state elites can retain control without resorting to extralegal measures.

The most likely scenario, according to Drezner, is the "W" economy. The global economy could get stuck in a "policy uncertainty trap" and we would see several mini-booms and mini-busts as government officials try to calibrate their responses. The severity of the crisis, combined with the magnitude of the government response, could lead to an increase in overall volatility. This path has the opposite effects to those of an L-shaped path. Periods of economic growth would be likely to lessen protectionist pressures. On the other hand, economic volatility would be likely to trigger greater domestic instability - which could, potentially, spill across borders. There would also be an increased demand for expanded government insurance programmes and state regulation. Savings would increase to hedge against sharp downturns.

This study touches upon other Glasshouse Forum projects, particularly "A consumed society?" and "Globalisation and the middle class in the West".

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## Introduction

*"It's tough to make predictions, especially about the future."*

This aphorism by Yogi Berra seems nonsensical – until one starts to puzzle out the effects of the 2008 global financial crisis.[1] The most popular term in the United States to describe the subsequent downturn has been the Great Recession. Before we can get to the predicting, we must avoid refereeing some fierce disputes over how we got into this mess in the first place. Policymakers past and present are still debating the causes of the crisis, without resolution and with much at stake. Suddenly, Mr. Berra's statement seems a bit more trenchant.

What cannot be disputed are the costs of both the financial crisis and the follow-on recession. In September 2008, the acute phase of the crisis began with a one-two punch: the United States government rescues of AIG, Fannie Mae and Freddie Mac, and the parallel decision not to rescue Lehman Brothers. The latter decision led to a cascade effect across global financial markets, and the costs have been severe.[2] The International Monetary Fund (IMF) estimates that banks and other financial institutions lost more than $4 trillion in the value of their holdings as a result of the crisis.[3] An Asian Development Bank-commissioned report concluded that the global decline in asset values led to aggregate losses of *$50 trillion* in 2008 – more than a year's worth of global economic output.[4]

1) Dating the start of the crisis, and the subsequent recession, is tricky. While the acute phase of the crisis started in September 2008, the subprime mortgage crisis truly began in August 2007. Similarly, although the worldwide recession did not begin until the fall of 2008, the National Bureau of Economic Research backdated the start of the U.S. recession to December 2007.

2) Ingo Fender, Allen Frankel and Jacob Gyntelberg, "Three market implications of the Lehman bankruptcy", *BIS Quarterly Review* (December 2008): 6–7.

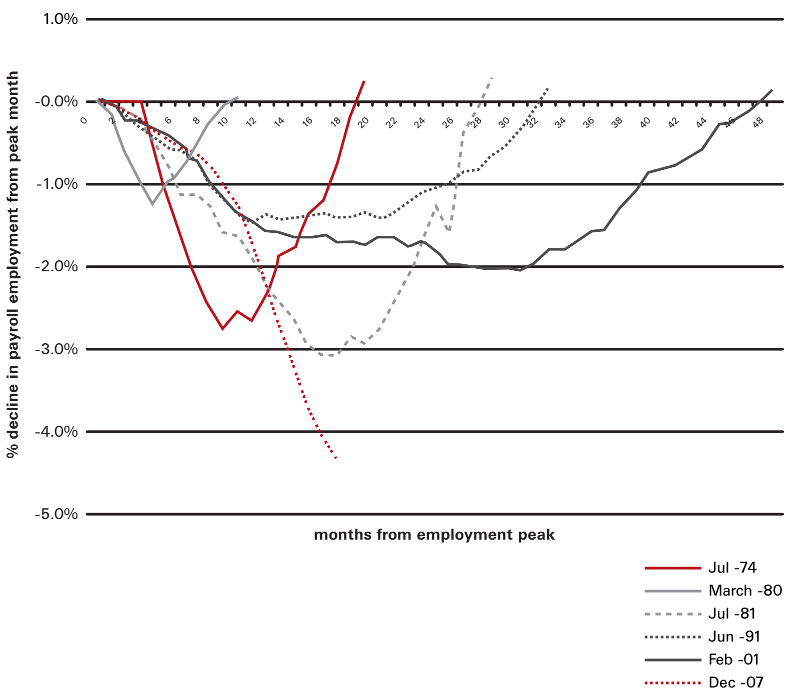
3) International Monetary Fund, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks*, April 2009. Accessed at http://www.imf.org/external/pubs/ft/gfsr/2009/01/index.htm, May 2009.

4) Claudio Loser, "Global Financial Turmoil and Emerging Market Economies", Asian Development Bank, March 2009, p. 7.

Soon after the acute phase of the financial crisis began, the effects on the real economy became visible. In the fourth quarter of 2008, the global economy shrank by approximately five percent; the American economy shrank by more than six percent. In the first quarter of 2009, the U.S. economy shrank an additional 5.3 percent. As Figure 1 demonstrates, the increase in U.S. unemployment rate from the start of the current recession has exceeded the effect from the previous five downturns.

**Figure 1:** *The Great Recession vs. the Last Five*

Source: Justin Fox, http://curiouscapitalist.blogs.time.com/2009/06/05/the-job-loss-torrent-slows-we-think/.






The United States government began increasing its debt burden by staggering amounts; its debt-to-GDP ratio is expected to double in the next four years. Pacific Rim economies suffered from drastic reductions in its exports. China's exports fell by more than 20 percent in the first quarter of 2009; Japan's exports fell at an annualised rate of nearly 70 percent. The least developed economies saw the withdrawal of private capital flows and the tightening of trade credit. After peaking in 2008, commodity prices subsequently crashed. They are now fluctuating wildly from month to month. China and Russia proposed an eventual end to the dollar as the world's primary reserve currency.[5] In the first half of 2009, political instability rocked nations as diverse as Mexico and Madagascar.

What will be the Great Recession's effects on key macroeconomic and macropolitical variables? Economists suggest that these trends reflect structural shifts that have to take place in the global political economy. OECD economies will be forced to address their fiscal imbalances. Jeffrey Sachs argues that the United States needs to rethink its tax policies: "the U.S., like Europe, will probably have to raise new revenues by a few percent of GDP if government is to carry out its expanded role".[6] Martin Wolf argues that the European Union needs to rethink its growth model: "the European economy gained an illusion of health from unsustainable spending in peripheral countries in its west, south and east... private demand will [need to] pick up in creditworthy economies, particularly Germany".[7] Michael Pettis believes that Pacific Rim economies need to rethink their trade imbalances, concluding, "future historians will mark 2008 as the year that the development model that has driven much of Asia's rapid growth for the past two decades went bankrupt".[8]

5) Zhou Xiaochuan, "Reform the International Monetary System", March 23, 2009. Accessed at http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=178, March 2009.

6) Jeffrey Sachs, "Paying for What Government Should Do", *Scientific American*, May 2009, p. 30.

7) Martin Wolf, "Feeble domestic demand is a chronic European ailment", *Financial Times*, May 26, 2009.

8) Michael Pettis, "Asia needs to ditch its growth model", *Financial Times*, May 19, 2009.

These are certainly possibilities, and one could debate whether they are desirable outcomes. That said, these kind of seismic shifts in national behavior are far from a foregone conclusion. Economic volatility and domestic political pressures could lead to very different policy outcomes.

Is the Great Recession the beginning of a structural change in the global political economy? If so, what are the effects of the financial crisis on the consumption/savings balance, the relationship between state and private ownership, the future of protectionism, global policy coordination, economic ideology, and the political stability of nation-states? This report will try to provide a better understanding of the medium-term effects of the crisis – i.e., the next two to five years. There is an element of hubris to this effort; simply put, many structural effects will not be observable until well after the fact. We do not know exactly when financial sectors will be restored to health, or when global economic growth will return to normal. Indeed, we cannot be entirely sure what "normal" looks like. At this stage, the best thing to do is to draft scenarios and make contingent, qualified estimates based on as much objective data and historical acumen as possible. These scenarios will devote a special emphasis on the United States, which remains the largest and more influential national economy in the world.[9]

## Pick Your Letter: Future Scenarios for the Global Economy

There are two big problems with predicting the near future of the global political economy. First, there is an endogenous relationship between the variables of concern in this report and the possible states of the global economy over the next two to five years. The issues of concern can also affect possible economic trajectories, and vice versa. For example, low or negative growth rates contribute to a greater likelihood of trade protectionism; it is also the case, however, that higher levels of trade protectionism will likely reduce future rates of economic growth. While the causal arrow runs in both directions, the more important causal effect is how macroeconomic fluctuations will affect the variables of concern.



Second, predicting how and when the global economy will recover from the Great Recession is a thankless task. Global growth forecasts have been revised so frequently over the past eight months that the utility of the entire exercise is now open to question. Consider the predictive powers of the International Monetary Fund and World Bank, for example. In November 2008, the Bank forecast global GDP growth in 2009 would be 0.9 percent, while the Fund pegged this year's growth at 2.2 percent. In January 2009, the IMF revised its forecast downward, to a growth rate of 0.5 percent; two months later, the Fund revised its 2009 forecast yet again, to -1.3 percent.[10] That same month, the Bank also revised its forecast, projecting a decline of 1.9 percent in global economic output.[11] Private sector analysts have not done any better. As Richard Posner and others have pointed out, economists are a lagging indicator in today's economy.[12] Or as the IMF dryly put it this past January: "The uncertainty surrounding the outlook is unusually large."

Based on the evidence to date, there are three possible economic trajectories. Predictions about how the global economy will perform over the next few years can be simplified into which letter of the Roman alphabet best characterizes global GDP growth over the next few years. There are three broad possibilities:

9) Stephen Brooks and William Wohlforth, *World Out of Balance* (Princeton: Princeton University Press, 2008).

10) International Monetary Fund, "World Economic Outlook Update", January 30, 2009. Accessed at http://www.imf.org/external/pubs/ft/weo/2009/update/01/pdf/0109.pdf, May 2009; International Monetary Fund, "Global Economic Policies and Prospects", staff note to G-20 finance ministers and central bank governors, March 2009. Accessed at http://imf.org/external/np/g20/pdf/031909a.pdf, May 2009.

11) World Bank, "Global Economic Prospects 2009", March 30, 2009. Accessed at http://siteresources.worldbank.org/INTGEP2009/Resources/5530448-1238466339289/GEP-Update-March30.pdf, May 2009.

12) Richard Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent Into Depression* (Cambridge: Harvard University Press, 2009).

***The "U" economy.*** This is not a "normal" recession, but the government response has not been normal either. The major G-20 governments have spent the last eight months providing government guarantees to financial institutions and cheap access to credit. This has been combined with large fiscal stimulus programs from the United States (an estimated 2 percent of GDP in 2009 fiscal stimulus spending), China (3.2 percent of GDP), and Japan (1.8 percent of GDP) with the European Union lagging behind (1.0 percent of GDP). The IMF estimates that the G-20 economies will inject an average fiscal stimulus of 1.8 percent of GDP this year.[13] There are "green shoots" in several of the key economies, particularly China and the United States.[14] If the current crisis follows the pattern of almost every post-Depression downturn in the developed world, then it will obey the Zarnowitz rule: deep recessions are almost always followed by steep recoveries.[15] Economic growth should therefore rebound quite quickly.

In a "U-style" recovery, growth itself would also act as a palliative on the more distressed aspects of the current global economy. A stronger economy, for example, would boost aggregate demand, reversing the slide in asset and commodity prices. Rapid growth would improve the problem of "toxic assets" for major financial centers. It would also improve the balance of payments position of commodity exporters. Most important, a robust return to growth would immediately improve the fiscal health of the OECD economies – the increased tax revenues would reduce projected budget deficits.

***The "L" economy.*** The current crisis is not like most post-Depression downturns in the developed world, because it is coming on the heels of a severe banking crisis. Furthermore, it is not clear how successful government efforts will prove to be. Recall that the financial crisis started in slow-motion fashion with the subprime mortgage crisis in August 2007. Over the next calendar year, central bankers and OECD governments tried to repair the damage. They arranged for government takeovers of affected financial firms, facilitated private sector takeovers, and passed major fiscal expansions to maintain consumption. None of these measures staunched the contraction of economic output, tightening of credit, and worsening of corporate and fiscal balance sheets. There is no guarantee that current government measures will work any better.



The Great Recession might resemble a structural recession like Japan's "lost decade" of the 1990's. Carmen Reinhardt and Kenneth Rogoff's recent research suggests that these kinds of crises in the developed world have less in common with other recessions than with past financial crises in the developing world.[16] Structural downturns triggered by a financial crisis are much more severe in their effects than a garden-variety recession.[17] Asset price drops are steep; on average, housing prices fall 35 percent over six years; equity prices plummet 55 percent over three years. The unemployment rate rises over seven percent for the next four years during a downturn of this magnitude. Because of the global nature of the current crisis, exports will be an unlikely pathway for an individual country to exit the recession. For the time period under study, this amounts to an "L" recession. After the initial 2008–9 contraction, growth stays feeble or flat for the next several years, and there is no recovery back to pre-2008 output levels.

13) International Monetary Fund, "Global Economic Policies and Prospects", Appendix I.

14) Ambrose Evans-Pritchard, "Global Investors see Chinese Green Shoots", *London Daily Telegraph*, February 18, 2009; Helen Power, "Fund managers see green shoots in world economy", *London Times*, May 20, 2009; Sarah O'Connor, "US hopes of 'green shoots' lift confidence", *Financial Times*, May 26, 2009; Vikas Bajaj and Keith Bradsher, "Developing Markets Appear to be in Bloom Again", *New York Times*, June 4, 2009.

15) Named after Victor Zarnowitz, a leading business cycle economist. See Michael Mussa, "World Recession and Recovery: A V or an L?" Paper presented at the fifteenth semiannual meeting on Global Economic Prospects, April 7, 2009.

16) Carmen Reinhart and Kenneth Rogoff, "Banking Crises: An Equal Opportunity Menace", National Bureau of Economic Research Working Paper 14587, December 2008.

17) Figures in this paragraph come from Carmen Reinhart and Kenneth Rogoff, "The Aftermath of Financial Crises", paper presented at the American Economics Association annual meeting, San Francisco, CA, January 2009.

***The "W" economy.*** The severity of the crisis, combined with the magnitude of the government response, could lead to an increase in overall economic volatility. The global economy could get stuck in a "policy uncertainty trap". In ordinary market periods, risks can be calculated and hedged against. In this extraordinary period, profound uncertainty remains about the exact value of toxic assets.[18] Policymakers want to wait for markets to partially clear on these assets to see how the real economy behaves over the next few months. Unless and until the pricing uncertainty over these assets is eliminated, however, agents in the real economy do not have enough information to form meaningful expectations about the future. This could lead to erratic fluctuations in asset prices, which would also lead to wild swings in the "animal spirits" of the global economy.

Another element of uncertainty that will confront central bankers and market participants over the medium term is when to clamp down on the provision of credit. If these officials tighten credit too soon, they will trigger a double-dip recession. If they tighten credit too late, they will permit an inflationary spiral. The history of central banking and global policy coordination suggests that this is an exceedingly difficult task to master in the best of times – and we are not living in the best of times.[19] It would not be surprising, therefore, if the ensuing few years consists of several mini-booms and mini-busts as government officials desperately try to calibrate their responses to fluctuations in the real economy. The effects of financial volatility and uncertainty on the real economy can be profound – lower average growth and higher average inflation, to name two.[20]

As will be seen, whether the economy follows the U, L or W path will have profound effects on the variables of concern.

### Macroeconomic Factors

One structural cause of the crisis was the extent to which macroeconomic variables – interest rates, savings rates, trade balances – were skewed beyond historical norms across the global economy. Interest rates had been at historic lows for much of the past decade. The



informal "Bretton Woods II" system enabled Americans to consume at much higher-than-usual rates.[21] Under this arrangement, the United States ran a massive current account deficit, helping to fuel the export-led growth of other countries. To fund this deficit, official creditors – central banks, sovereign wealth funds, and other government investment vehicles – purchased dollars and dollar-denominated assets. These creditors were concentrated in the Pacific Rim and energy-exporting countries.[22] These purchases contributed to the boom in asset prices, which further fueled American consumption, widening the trade deficit and reinforcing the cycle.[23]

The magnitude of these imbalances has been stunning, particularly when looking at China and the United States. During the Bretton Woods II era, consumption as a share of American gross domestic product rose to an all-time high of 72 percent, while China's consumption as a share of GDP plummeted to a global low of 38 percent of GDP. The U.S. savings rate turned negative, while

18) On the distinction between risk and uncertainty, see Frank Knight, *Risk, Uncertainty and Profit* (New York: Cosimo, 2005 [1921]).

19) For historical referents, see Liaquat Ahamed, *Lords of Finance: The Bankers Who Broke the World* (New York: Penguin, 2009); Robert D. Putnam and Nicholas Bayne, *Hanging Together: the Seven-Power Summits* (Cambridge: Harvard University Press, 1984); Michael Webb, *The political economy of policy coordination: international adjustment since 1945* (Ithaca: Cornell University Press, 1995).

20) Robert Engle, "The threat that won't go away", *Financial Times*, May 25, 2009.

21) Calling Bretton Woods II a "system" is something of a misnomer – it was the result of independent policy decisions made without any coordination. See Michael Dooley, David Folkerts-Landau, and Peter Garber, "An Essay on the Revived Bretton Woods System", NBER Working Paper No. W9971, September 2003; Benjamin Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit", Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, March 10, 2005; Barry Eichengreen, *Globalizing Capital*, second edition (Princeton: Princeton University Press, 2008), p. 210–218.

22) Diana Farrell, Susan Lind and Koby Sadan, "The New Power Brokers: Gaining Clout in Turbulent Markets", McKinsey Global Institute, July 2008.

23) Niall Ferguson and Moritz Schularick, "'Chimerica' and the Global Asset Market Boom", *International Finance* 10 (Winter 2007): 215–239.

Chinese savings approached 50 percent of GDP.[24] The United States current account deficit peaked in 2006 at close to $800 billion, or seven percent of GDP. This percentage vastly exceeded the previous peak of the U.S. current account deficit in the mid-eighties.[25] By 2007, the U.S. current account deficit equaled approximately 1.4 percent of *global* economic output, while China's current account surplus approached 0.7 percent of global GDP.[26]

The crisis itself has already forced some dramatic changes in behavior across the globe. Just as the spike in asset values caused Americans to save less, the fall in their value has caused personal savings to increase.[27] Data from the Bureau of Economic Analysis shows that the annual personal savings rate as a percentage of disposable personal income more than tripled from 2007 to 2008, rising from 0.55 percent to 1.77 percent. In the first quarter of 2009, the savings rate had increased by more than 200 percent, averaging 4.2 percent. In April 2009, the savings rate hit 5.7 percent, the highest level in 14 years.[28] While the United States is still running a sizeable trade deficit, the percentage of that deficit to GDP has roughly halved.

Some traditional capital exporters – Japan and oil exporters – have altered their balance of savings and consumption as well. With an annualized drop of over 70 percent in its exports, Japan has been running a trade deficit since August 2008. The fall in oil prices has also vastly shrunk the capital surpluses of the major oil-exporting economies such as Saudi Arabia. One private sector report suggests that these economies will reduce their savings by $300 billion in 2009 as compared to 2008.[29]

The previous two paragraphs suggest that macroeconomic imbalances are sorting themselves out, but there are several cautionary warnings here. Beyond the savings/consumption balance, several other macroeconomic variables still look askew. Short-term interest rates have gone from being low by historical standards to unusually low. Eventually, they have to return to historical averages. Economists are equally worried about the risks of short-term deflation and long-term inflation in the global economy. While several major economies, such as Japan, appear to have slipped into a deflationary spiral, the price of gold – an excellent barometer to measure worries about inflation – has spiked past $1000 an ounce earlier this year.



A second glance at the savings/consumption balance reveals additional concerns. The projected increase in the U.S. budget deficit counteracts the increase in American personal savings. The U.S. Congressional Budget Office projects the budget deficit in 2009 to equal 12 percent of GDP.[30] While Americans are saving more, the United States is saving less. From a global perspective, U.S. reliance on foreign creditors to finance current consumption has declined. As Figure 2 shows, however, governments across the board are increasing their borrowing, causing interest rates to rise.[31]

24) Nicholas Lardy, "China: Towards a Consumption-Driven Growth Path", Institute for International Economics Policy Brief PB06-6, October 2006; Barry Eichengreen, Charles Wyplosz, and Yung Chul Park, *China, Asia and the New World Economy* (New York: Oxford University Press, 2008), chapters 10, 11 and 14; Stephen Roach, "A Wake-Up Call for the U.S. and China: Stress Testing a Symbiotic Relationship", Morgan Stanley, February 18, 2009.

25) Michael Mastanduno, "System Maker and Privilege Taker: U.S. Power and the International Political Economy", *World Politics* 61 (January 2009): 121–154.

26) Steven Dunaway, "Global Imbalances and the Financial Crisis", Council on Foreign Relations Special Report no. 44, March 2009, p. 15–16.

27) Christian Broda, Piero Ghezzi, and Eduardo Levy-Yeyati, "The New Global Balance", Barclays Capital, March 23, 2009.

28) All data from http://www.bea.gov/interactive.htm, accessed May 2009.

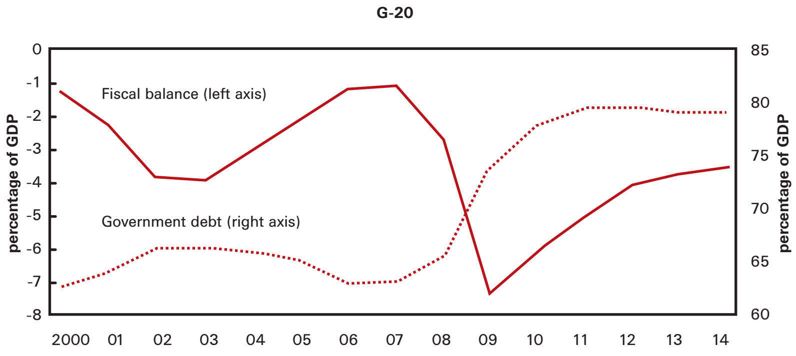
29) Broda, Ghezzi, and Levy-Yeyati, "The New Global Balance", p. 4.

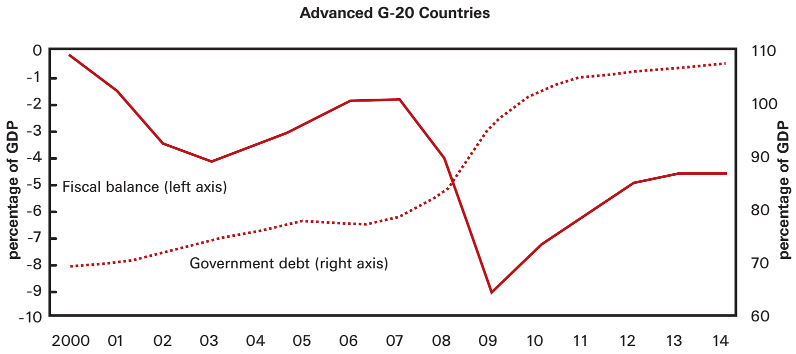
30) CBO figures accessed at http://www.cbo.gov/ftpdocs/100xx/doc10086/05-21-State_of_Economy_Testimony.pdf, May 2009.

31) Nelson D. Schwartz, "Rising Interest on Nations' Debt May Sap Growth", *New York Times*, June 4, 2009.

**Figure 2:** *Outlook for Public Finances in the G20 (in percent of GDP)*

*Source: International Monetary Fund, http://imf.org/external/np/g20/pdf/031909a.pdf, p. 35.*






Third, Chinese savings have yet to fall. Indeed, because their imports have declined more dramatically than their exports this calendar year, China is running an even larger current account surplus in 2009 than it did in 2008. Furthermore, a large portion of China's savings rate comes not from consumers, but the corporate sector. Chinese policies regarding exchange rates, corporate governance, currency convertibility, property rights, and corruption could have pronounced and immediate effects on the corporate decisions about what to do with their retained earnings. Beijing's policymaking during the crisis has a touch of schizophrenia. On the one hand, there are signs that China's domestic demand is fuelling growth; on the other hand, Chinese policy on export rebates seems designed to promote continued export dependence.[32]

The type of economic recovery will have a profound impact on the future consumption paths of different countries. A U-economy would likely have the smallest effect on consumption patterns. The more quickly growth trajectories return to normal, the less permanent the effect should be on savings and consumption patterns. The 2008 downturn would be dismissed as little more than a temporary blip.[33] Interest rates would rise back to historical norms, with inflation holding steady. An L-economy, in contrast, should lead to a more pronounced shift in the savings/consumption balance. During a low-growth era, individuals develop more pessimistic expectations about the future – and these expectations become self-fulfilling. Consumption would eventually increase, but the effect would fade much more slowly. Government debt-to-GDP ratios would skyrock-

32) James Kynge, "Chinese tap an inner dynamic to drive growth", *Financial Times*, May 11, 2009; Aaron Back and J.R. Wu, "China Unveils Tax Breaks", *Wall Street Journal*, November 13, 2008; "More support likely for China exports by year-end, analysts say", Xinhua.net, December 6, 2008.

33) The one permanent effect of even a U-style recession would be generational. Longitudinal analysis suggests that generations exposed to sharp downturns during their childhood years are more likely to save than generations accustomed to boom times. See Ulrike Malmendier and Stefan Nagel, "Depression Babies: Do Macroeconomic Experiences Affect Risk-Taking", working paper, University of California at Berkeley, August 2007.

et. Despite central bank efforts to keep capital cheap, both nominal interest rates and inflation rates would be expected to spike. A W-economy would have less immediate effect on savings, as consumers would react to the first upswing by increasing their consumption. As expectations of volatility became the norm, however, one would expect increased levels of saving as a hedge against sharp downturns. Inflation would likely rise, while interest rates would fluctuate rapidly.

## Public Attitudes Towards the Global Economy

Even before the acute phase of the crisis began, publics across the globe had demonstrated growing unease with the pace and trajectory of economic globalization.[34] The financial crisis merely exacerbated this sentiment. In a BBC poll taken on the eve of the April 2009 G-20 summit in London, 70 percent of those polled across 24 countries agree that "major changes" are required to the way the global economy is run, whereas less than 5 percent believe that no significant changes are needed.[35] Of course, consensus support for "major changes" does not necessarily translate into consensus on the precise contours of any such change.

It is easy to envisage how the crisis could fuel populist attacks at the finance sector, or globalization more generally. Within the United States, the outrage over the payment of bonuses to AIG executives was both deep and bipartisan.[36] The ensuing (and largely fruitless) debate consumed Washington for nearly two weeks, threatening the political viability of Treasury Secretary Timothy Geithner. The primary reason why the Obama administration has refrained from asking Congress to authorize additional bailout money for the banking sector is public hostility to the very idea of more bailouts. Even a president whose party controls both houses of Congress cannot command a majority of support on this issue.

Antipathy towards bailouts is timeless, but it could bleed over into elevated antipathy towards an open global economy. Hostility to globalization is hardly a new phenomenon. For decades, Americans have essentially adopted a mercantilist attitude towards international trade, and pronounced hostility to inward immigration and foreign direct investment.[37] As the trade deficit has soared and wage compression has increased, Americans – rightly or wrongly – have placed the blame on policies that promote freer trade and greater mobility of capital.[38] These attitudes could go global. The tight coupling of the global economy caused export-dependent economies to experience significant downturns because of the collapse in demand from the OECD nations.[39] This kind of downturn can increase hostility towards the economic interdependence that globalization creates. This hostility will be reinforced by the natural turn inward that takes place during sharp global downturns, as education, tourism, and media attention inevitably turns inward.[40] Governments could be forced to create the trade equivalent of currency reserves – that is to say, creating a protected space of domes-



34) See the February 2008 BBC World Service poll of 34 countries, accessed at http://www.worldpublicopinion.org/pipa/pdf/feb08/BBCEcon_Feb08_rpt.pdf, May 2009, and the April 2008 PIPA poll of 18 countries, accessed at http://www.worldpublicopinion.org/pipa/pdf/apr08/Free_Markets_Apr08_pr.pdf, May 2009.

35) BBC World Service, "Economic System Needs 'Major Changes': Global Poll", March 31, 2009, accessed at http://www.worldpublicopinion.org/pipa/pdf/mar09/BBCEcon_Mar09_rpt.pdf, May 2009.

36) Gallup poll, http://www.gallup.com/poll/116941/Outraged-Americans-AIG-Bonus-Money-Recovered.aspx, accessed May 2009.

37) Daniel W. Drezner, *U.S. Trade Strategy* (New York: Council on Foreign Relations, 2006); Drezner, "The Realist Tradition in American Public Opinion", *Perspectives on Politics* 6 (March 2008): 51–70.

38) See data at http://www.pollingreport.com/trade.htm, accessed May 2009.

39) Economist Intelligence Unit, "Shooting the rapids: What happens if the financial turmoil capsizes the global economy?", April 2008; Asian Development Bank, "The Uncoupling Myth: The G3 Slowdown and Developing Asia", in *Asian Development Outlook 2008* (Manila: Asian Development Bank, 2008). For an example of the decoupling argument, see Naazneen Barma, Ely Ratner and Steven Weber, "A World Without The West", *The National Interest* 90 (July/August 2007): 23–30.

40) See Daniel W. Drezner, "The Long Legs of the Crash", *Foreign Policy* 171 (March/April 2009): 99–100.

tic demand for national champions.

The hardening of public attitudes will have asymmetric effects on global policy coordination. Some government policies require the approval of legislatures, while others can be made by more politically insulated institutions (such as central banks). Some policies are inherently complex and opaque, while others will automatically trigger greater legislative oversight and media scrutiny.[41] One would therefore expect a greater receptivity to economic openness – and a greater willingness to engage in global policy coordination – when the policy decisions are politically insulated. To date, for example, central banks have coordinated their actions more than fiscal authorities, who have in turn coordinated more than trade officials. One would therefore expect to see greater cooperation in areas where central banks and independent regulatory agencies have greater autonomy of action. This suggests greater sustained openness for asset markets, but not for either product or goods markets.

The extent of a populist blowback against globalization is partly a function of the type of economy we will see over the medium term. A U-shaped recovery should be expected to have the most moderating effects on populist backlashes against globalization, as public attitudes about globalization would be largely unaffected. Both L and W economic trajectories, in contrast, would be expected to contribute to more marked shifts in attitudes towards the global economy. In both of these scenarios, greater emphasis will be placed on notions of "economic security" rather than entrepreneurship or liberalization. An L-shaped economy in particular would likely contribute to ever-worsening attitudes about globalization – and a temptation for governments to experiment with beggar-thy-neighbor policies.

### The State and Private Ownership

The financial crisis and the Great Recession threaten the ideas that underlie the global economic order of the past generation. The dominant theme of the past three decades has been a retreat of the state from the commanding heights of the economy.[42] Through privatization, liberalization and/or deregulation, governments increasingly accepted the idea that lightly regulated markets represent the most efficient form of resource allocation. Clearly, this is changing. In 2008, global markets in financial assets, food and energy were buffeted by a series of exogenous shocks. None of them appeared to be functioning terribly well in response. In all three sectors, national governments responded with greater intervention. In the world of ideas, the consensus among economists about the virtues of an open global economy is beginning to crack.[43] Even free market enthusiasts have been rattled by recent events. Former Federal Reserve chairman Alan Greenspan made headlines when he admitted that his faith in the "intellectual edifice" of self-correcting markets had "collapsed". Richard Posner has written that "*laissez-faire* capitalism failed us".[44]

The United States has been the most *laissez-faire* of the large economies; nevertheless, the recent trend has been direct state intervention in the afflicted sectors of the economy. Recent estimates have the United States government injecting approximately $15 trillion into the financial sector through two dozen different pledges and initiatives, exceeding America's gross national product.[45] The government has also taken on an outsized role in the housing and automobile sectors, with health care ostensibly on the horizon. At present, the United States government possesses either ownership

41) Daniel Kono, "Optimal Obfuscation: Democracy and Trade Policy Transparency", *American Political Science Review* 100 (August 2006): 369–384.

42) Daniel Yergin and Joseph Stanislaw, *The Commanding Heights* (New York: Simon and Schuster, 1997); Jeffry Frieden, *Global Capitalism* (New York: W.W. Norton, 2006).

43) Alan Beattie, "Washington's waning way: how bail-outs poison a free market recipe for the world", *Financial Times*, September 28, 2008; Christopher Hayes, "Free Traitors", *The New Republic*, October 8, 2008; Barrett Sheridan, "Why Barriers Don't Matter", *Newsweek*, December 8, 2008.

44) Edmund Andrews, "Greenspan Concedes Error on Regulation", *The New York Times*, October 23, 2008; Richard Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent Into Depression* (Cambridge: Harvard University Press, 2009), p. 236.

45) Damien Paletta, David Enrich, and Deborah Solomon, "U.S. Rescue Aid Entrenches Itself", *Wall Street Journal*, May 21, 2009.

stakes or operational control over Fannie Mae, Freddie Mac, AIG, Bank of America, Citigroup, JP Morgan, Chrysler, and General Motors. This is a not-insignificant slice of corporate America.

The United States is hardly the only government increasing state ownership in the economy. Other great powers are exploiting the crisis to reassert their control over "strategic sectors" of their economies.[46] The Russian government has taken advantage of the crisis to reclaim firms that were privatized in the previous decade.[47] China has accelerated its multi-year trend towards greater state control over the economy.[48] The decline in oil prices has encouraged authoritarian leaders in Venezuela and Iran to exert even more state control over the economy, in an effort to forestall political upheaval.[49] The global recession has encouraged all governments with sovereign wealth funds to redirect their investments inward to bolster sagging equity markets.[50] These funds will likely function more like development banks than cross-border investors, acquiring equity stakes in national champions.

The duration and scope of state ownership remains an open question – particularly in the United States. There are powerful ideational and structural factors that should constrain the extent of state ownership in the U.S. economy. The American "variety of capitalism" has a strong tradition of limited government interference in the economy.[51] Switching to a more coordinated market economy, as in continental Europe, would require taking over an entire series of interlocking institutions. Obama administration officials have evinced little interest in any steps towards outright nationalization: Treasury Secretary Timothy Geithner recently testified that, "It is not our objective and I would never support a programme designed to allow us to nationalise banks or other businesses as a matter of policy."[52] Furthermore, private financial actors have traditionally exerted a powerful political pull on any proposed state intervention into their sector, even during the height of a financial crisis.[53] The eagerness of financial institutions to return TARP funds suggests that they will strongly resist sustained efforts at greater state ownership.

If one reframes the question as one of control and regulation rather than explicit state ownership, however, the narrative changes.



Economic crises inevitably lead to a more active government response. While these moves are often intended to be temporary, there is a "ratchet effect" that makes politicians unwilling and unable to reduce the government's role over time.[54] Any government intervention eventually creates vested interests with a stake in continuing that intervention. The relevant bureaucracies grow attached to the power and prestige that comes with new regulatory arrangements; private sector actors like the rent-seeking opportunities created by regulatory barriers to entry. It is becoming clear, for example, that the Obama administration is growing comfortable with greater government control over Fannie Mae and Freddie Mac.[55] Furthermore, the longer the crisis continues, the more likely such interests will be created. Historically, the longer financial crises have lasted in the United States, the greater the scale and scope of subsequent government reform efforts.[56]

46) Ian Bremmer, "State Capitalism Comes of Age", *Foreign Affairs* 88 (May/June 2009): 40–55.

47) Clifford Levy, "In Hard Times, Russia Moves in to Reclaim Private Industries", *The New York Times*, December 8, 2008.

48) Derek Scissors, "Deng Undone", *Foreign Affairs* 88 (May/June 2009): 24–39.

49) Reuters, "Venezuela's state takeovers under Chavez", May 26, 2009. On the oil exporting economies in particular, see more generally Daniel W. Drezner, "Oil Dependence as Virtue", *The National Interest* 98 (November/December 2008): 8–16.

50) Monitor Group, "Weathering the Storm: Sovereign Wealth Funds in the Global Economic Crisis of 2008", April 2009, p. 17.

51) Peter Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001).

52) Quoted in Tom Braithwaite, "Geithner calls for sustaining strong US dollar", *Financial Times*, May 21, 2009.

53) Simon Johnson, "The Quiet Coup", *The Atlantic*, May 2009.

54) Posner, *A Failure of Capitalism*; Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (New York: Oxford University Press, 1987).

55) Charles Duhigg, "U.S. Likely to Keep the Reins on Fannie and Freddie", *The New York Times*, March 3, 2009.

56) Robert E. Wright, "Financial crisis and reform: Looking back for clues to the future", *The McKinsey Quarterly* (Winter 2009): 98–102.

The type of economic future will have important effects on the state's role in the economy. A U-shaped recovery would prevent the creation of entrenched interests eager to preserve the state's outsized role in the economy. An L-shaped trajectory would sustain the crisis further, creating feedback effects that would make current state interventions less likely to be temporary. A W-shaped trajectory would likely lead to a greater degree of state intervention, but of a different kind. With increased economic volatility, there would be demand for expanded government insurance programs as a means to cushion both citizens and firms against the vicissitudes of the marketplace. State ownership would not change, but state regulation would undoubtedly increase.

**Political Stability**

Despite the wars in Afghanistan and Iraq, the world has become a more peaceful place in recent decades. Mankind is currently experiencing the longest period of great power peace since the Peace of Westphalia. Indeed, the quantitative indicators for most forms of violent conflict have shown a downward trend. Coups, political killings, state failures, civil wars, traditional interstate wars, and combat deaths have all seen a secular decline for the past few decades.[57] Several factors have contributed to this trend. The spread and consolidation of liberal democracy, the growth of economic interdependence, and the empowerment of international institutions have increased the costs of extralegal violence.[58] Trading states are moderately less likely to go to war. High rates of growth make it possible for political actors to engage in nonzero-sum bargaining, rather than operating in a relative gains paradigm. A more *realpolitik* explanation is that the spread of nuclear weapons among the great powers in the system has provided a powerful dampening effect on international violence. Furthermore, the unparalleled military hegemony of the United States has deterred challengers from using force as a way to affect global order.[59] A unipolar world leads to fewer arms races and more peacekeeping missions.

The 2008 financial crisis will not alter the logic of nuclear deterrence – but it is having an enervating effect on the other factors that promote peace and stability. In terms of economic interdependence, the crisis itself sparked what can only be described as "deglobalization". The WTO estimates that world trade levels will fall by nine percent this year.[60] The "flight to safety" and "home bias" effects of the crisis have led to financial deglobalization, with private capital rushing away from the developing world in particular. On the policy front, the "bicycle" of economic liberalization has completely stalled out. Anti-dumping investigations increased by 31 percent in 2008, and by an *additional* 18.8 percent in the first quarter of 2009. There was a 19 percent jump in the number of applied duties in 2008, and an additional jump of 15.5 percent in the first quarter of 2009.[61] Despite a November 2008 G-20 pledge not to engage in any protectionist policies, the World Bank concluded that 17 of the 20 countries implemented a combined 47 measures to restrict trade at the expense of other countries.[62] Barriers to foreign direct investment are also on the rise.[63] Recovery plans and bailouts of the financial sector are likely to encourage more domestic lending, reducing cross-border capital flows even further.[64]

The relative decline in U.S. power is also a possible source of concern. To be sure, American primacy still exists, and by many met-

57) Data can be accessed at http://www.humansecurityreport.info/ and http://humansecuritybrief.info/.

58) John R. Oneal, "The Kantian Peace: The Pacific Benefits of Democracy, Interdependence, and International Organizations, 1885–1992", *World Politics* 52 (October 1999): 1–37.

59) William Wohlforth, "Unipolarity, Status Competition, and Great Power War", *World Politics* 61 (January 2009): 28–57.

60) WTO, http://www.wto.org/english/news_e/pres09_e/pr554_e.htm, accessed May 2009.

61) Data from Chad P. Bown at http://people.brandeis.edu/~cbown/global_ad/monitoring/2009-05-11-Bown-GAD-Monitoring.htm, accessed May 2009.

62) Elisa Gamberoni and Richard Newfarmer, "Trade Protection: Incipient but Worrisome Trends", World Bank Trade Note #37, March 2, 2009.

63) David Marchick and Matthew Slaughter, "Global FDI Policy: Correcting a Protectionist Drift", Council on Foreign Relations Special Report No. 34, June 2008.

64) Broda, Ghezzi, and Levy-Yeyati, "The New Global Balance".

rics American power remains unparalleled.[65] Still, even prior to the financial crisis, the trend lines for American power were not promising.[66] The military campaigns in Iraq and Afghanistan appeared to be symptoms of "imperial overstretch". The crisis has somewhat exacerbated the relative decline of the United States and the relative rise of China; the projected date when China's GDP is expected to march America's keeps creeping closer to the present.[67] Even optimists about American power acknowledge that China's rise will pose significant challenges to American power and the global governance structures created by the United States.[68] Historically, power transitions between waxing and waning hegemons have not gone smoothly. Most important, the perception of a power shift is, in many ways, ahead of the actual power shift. One February 2009 poll suggests that a plurality of Americans already believe that China is more powerful than the United States.[69]

In a low-growth world without an intervener of last resort, conflict of all kind could be on the rise. As the financial crisis deepens developing country elites will organize more anti-democratic *coup d'etats*. The crisis will have a leveling effect on income inequality – and one way for privileged elites to respond is to support regime changes as a means of protecting their wealth.[70] There should also be an increase in political instability, or other forms of political violence such as labor riots. Simmering ethnic tensions are transformed into ancient hatreds. Regimes in oil-exporting economies suddenly short of cash might launch diversionary wars or domestic crackdowns to cement their political control. Governments close to cracking up might actually crack up. Flush economic times can mask political weaknesses; dire economic times expose them to a harsh light. The Global Peace Index report for 2008 suggests that the downturn has caused within-country and cross-border violence indicators to rise.[71]

The future trajectory of the economy will have pronounced effects on these macropolitical variables. A U-shaped recovery should reverse the deglobalization trend, and therefore decrease the likelihood of greater political violence. An L-shaped economic path would increase both protectionist and fiscal pressures on many states. The incentive to pursue beggar-thy-neighbor policies would increase, decreasing interdependence and lessening the constraints reducing interstate conflict. On the other hand, an L-shaped economic path is also somewhat more predictable. The less economic volatility, the more likely that state elites can retain control without resorting to extralegal measures. A W-shaped economic path has the reverse effects of an L-shaped path. Periods of economic growth would be likely to lessen protectionist pressures. On the other hand, economic volatility would be likely to trigger greater domestic instability – which could, potentially, spill across borders.

## Futures Past

Unfortunately, social scientists are much better at post-mortems than predictions. Furthermore, the social scientists who get the big prediction right are often less likely to get the next prediction right.[72] With this caveat, it is my strong belief that the global economy will be experiencing a W-shaped recovery for the medium turn – mini-booms followed by mini-busts. In a W-world, the primary thing pol-

65) Brooks and Wohlforth, *World Out of Balance*.

66) National Intelligence Council, *Global Trends 2025: A Transformed World* (Washington: Government Printing Office, 2008); Fareed Zakaria, *The Post-American World* (New York: W.W. Norton, 2008); Paul Starobin, *After America* (New York: Viking, 2009).

67) Mathew J. Burrows and Jennifer Harris, "Revisiting the Future: Geopolitical Effects of the Financial Crisis", *The Washington Quarterly* 32 (April 2009): 27–38; Quentin Peel, "A wider order comes into view", *Financial Times*, April 9, 2009.

68) Daniel W. Drezner, "The New New World Order", *Foreign Affairs* 86 (March/April 2007): 34–46; Tyler Cowen, "Last Man Standing", *The Wilson Quarterly* (Spring 2009).

69) Gallup poll taken February 9–12, 2009, accessed at http://www.pollingreport.com/trade.htm, May 2009.

70) Daron Acemoglu and James Robinson, *Economic Origins of Dictatorship and Democracy* (New York: Cambridge University Press, 2006), pp. 65–75.

71) Institute for Economics and Peace, *Global Peace Index 2009*. Accessed at http://www.visionofhumanity.org/images/content/GPI-2009/2009-GPI-Results-Report-20090526.pdf, June 2009.

72) Philip Tetlock, *Expert Political Judgment* (Princeton: Princeton University Press, 2005).

icymakers and citizens have to fear is uncertainty itself. As recognition of greater economic volatility seeps into the behavior of consumers and producers, we should start to see the policy and behavioral effects outlined in Table 1. The effects of those behaviors depend on which historical analogy resonates the most.

**Table 1**

| | The "U" path | The "L" path | The "W" path |
|---|---|---|---|
| Savings/consumption balance | Unchanged | Higher savings rate in United States | Higher savings rate in United States |
| Interest rates | Increase over time | Below-normal rates, followed by above-normal rates | Fluctuating rates |
| Inflation | Mild increase | Strong increase | Moderate increase |
| Attitudes towards the global economy | Renewed but reduced support for globalization | Backlash against globalization | Backlash against globalization |
| Role of the state in the global economy | Temporary increase followed by decrease | Permanent increase in state intervention | Permanent increase in state regulation |
| Protectionism | Status quo | Increase in barriers | Increase in "hidden" barriers |
| International political stability | Largely unchanged | Increase in likelihood of conflict | Largely unchanged |
| Domestic political stability | Mild increase in instability | Mild increase in instability | Marked increase in instability |

The long-term effects of the Great Recession will emanate in part from these effects, and they will be decidedly mixed. On the one hand, the obvious result will be a reduction in global output. Inflation and interests rates will shoot up, state intervention will increase, and hidden barriers to trade will also be on the rise. This suggests a return to the kind of global political economy last seen in the late 1970's and early 1980's – a mixture of post-Keynesianism and neomercantilism. For anyone who remembers that era, this does not seem like a great outcome – until one considers the alternatives.



A W-path, combined with pre-existing tensions over exchange rates and fiscal policy, has led some free traders to warn that the world will slide into a replay on the 1930s. These fears are likely exaggerated, however.[73] Despite the wobbling of the multilateral trading system, key players also recognize the folly of returning to beggar-thy-neighbor policies. More importantly, the protectionist barriers placed on many economic sectors will run into a countervailing force – the reduced transportation and communication costs of international trade. Regardless of government policies to the contrary, it will continue to become cheaper to trade goods and services across borders.

Over the longer term, a W-path evokes a different historical era, one with more troubling implications. In the decades before the First World War, governments tried to close off barriers to international exchange, but were swamped by technological forces that facilitated trade even more.[74] At the same time, these cross-cutting effects made governments at the time very nervous and more insecure.[75] The effects of that insecurity came to fruition in 1914. The probability of revisiting that era a century later is decidedly small. On the other hand, the world economy has experienced a series of low-probability events in the past eighteen months. Never say "never again".

73) Bruce Stokes, "Protectionism in the Offing?", *National Journal*, December 13, 2008; Dan Ikenson, "A Protectionist Fling", *Center for Trade Policy Studies Free Trade Bulletin* No. 37, March 12, 2009.

74) Kevin O'Rourke and Jeffrey Williamson, *Globalization and History* (Cambridge: MIT Press, 1999).

75) David M. Rowe, "World Economic Expansion and National Security in pre-World War I Europe", *International Organization* 53 (Spring 1999): 195–231.

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