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GLOBALIZATION CYCLES

Abstract

Mark Twain is reputed to have remarked that history does not repeat itself, but it often rhymes. While the Global Financial Crisis of 2008-2009 was not a catastrophe on the order of World War I, there is a broad similarity in the sequelae to both of these events – a failed attempt to return to pre-trauma normalcy, followed by a process of international economic disintegration in the face of changed geopolitical realities. In this essay, I explore three questions that this similarity raises. Does globalization inherently foster domestic or international dynamics that eventually lead to political backlash? If so, are these dynamics inevitable, or can complementary economic policies nurture a stable globalization? And finally, since policies are endogenous, when are policy approaches and institutions that complement and support globalization likely to arise?

JEL Classification: F52, F53, F60, N20, N40

Keywords: Globalization, deglobalization

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Around the turn of the millennium, some may have believed that the world had attained, if not the end of history, then at least the end of *economic* history.[1] Broadly speaking, the "Washington Consensus" ruled and the "Great Moderation" prevailed. The Uruguay Round of trade negotiations, with 123 contracting parties, achieved the high-water mark in multilateral trade negotiations, birthing in 1995 the last great multilateral institution, the World Trade Organization (WTO). Exactly four years later, following years of seeking deep internal market integration, the European Union (EU) launched its single currency, the euro. In parallel, EU negotiations with a group of former Soviet bloc countries, now capitalist democracies, drove toward a major enlargement.

The prior prevalence of divergence in emerging and developing economies (Pritchett 1997) turned strongly toward convergence. China implemented far-ranging economic reforms in preparation for Permanent Normal Trade Relations with the United States (2000) and WTO entry (2001). Countries in emerging Latin America and Asia reformed in the wake of late-1990s crises. GDP growth in sub-Saharan Africa, which averaged 2.5 percent per year over 1992-1999 – not fast enough to keep up with population growth – better than doubled to 5.8 per cent per year over 2000-2007, according to the International Monetary Fund's *World Economic Outlook* database.

Buoyant global credit growth and a boom in commodity prices underpinned all this. The credit-cycle upswing crashed in 2008, however, sparking the worst global recession in decades. Strong globally coordinated policy responses – notably by the United States and China – prevented a reprise of the Great Depression of the 1930s. But initial hopes of a quick, durable return to pre-crisis conditions have faded. With slower overall economic growth unable any longer to offset underlying tensions due to structural economic change, demographics, and persistent income inequality, voters in many countries have started to turn against prevailing norms of economic policy, including those that have promoted globalization.

While the Global Financial Crisis of 2008-2009 was not a catastrophe on the order of World War I, there is a broad similarity in the *sequelae* to both of these events – a failed attempt to return to pre-trauma normalcy, followed by a process of international economic disintegration in the face of changed geopolitical realities. This similarity is history rhyming rather than repeating (in the phrase commonly attributed to Mark Twain), but it does raise three questions about possible cycles in globalization (also a theme of O'Rourke 2018):

- Does globalization inherently foster domestic or international dynamics that eventually lead to political backlash?
- If so, are these dynamics inevitable, or can complementary economic policies nurture a stable globalization?
- And finally, since policies are endogenous, when are policy approaches and institutions that complement and support globalization likely to arise?

[1] I use this phrase in a somewhat different sense than Romer (1994) did.

Obviously, these are very difficult questions to answer – all I will do here is offer some observations and guesses. Answers that are more complete would have to rely on rigorous and systematic analysis based on insights from a range of social sciences, not just economics.

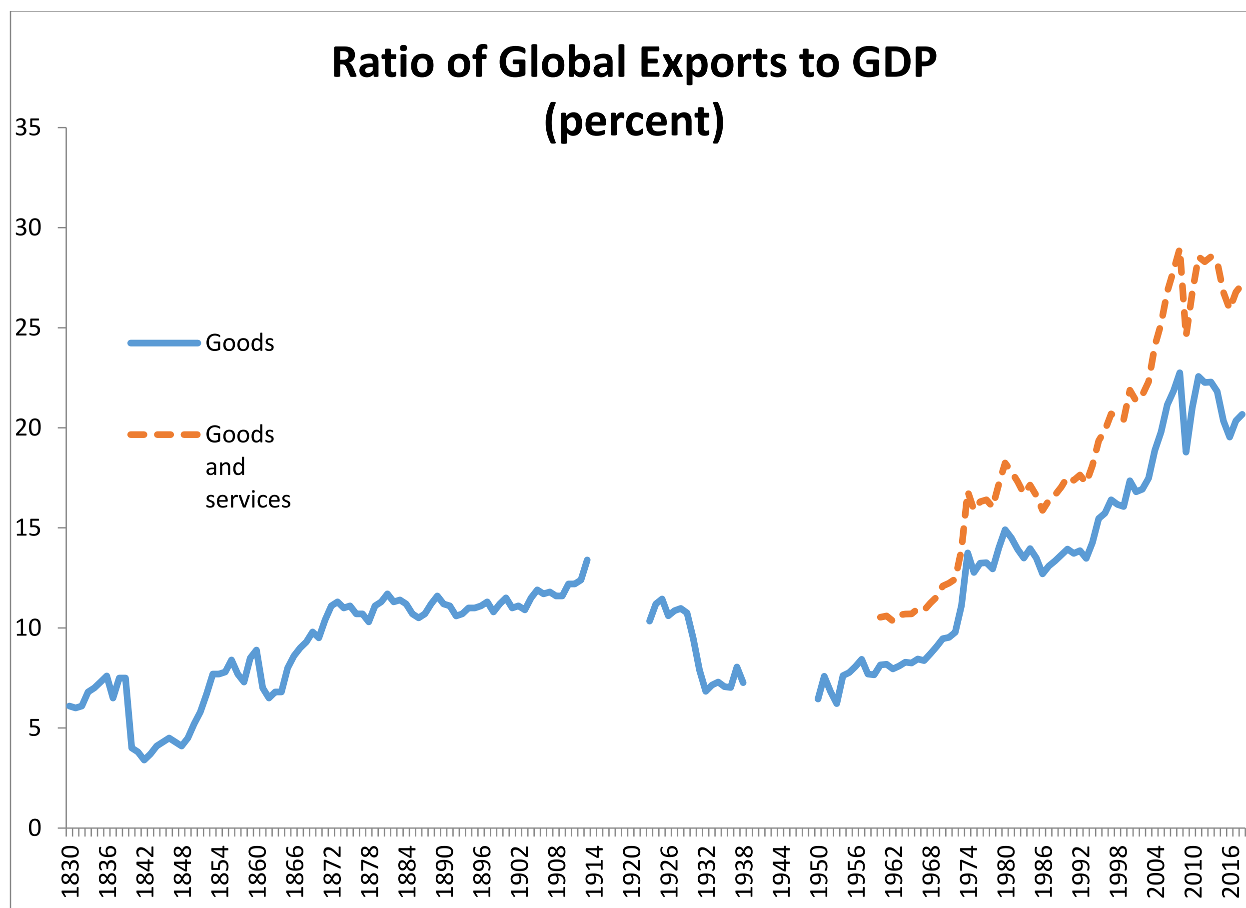
Economic Openness and Policy Constraints

A fundamental feature of the modern global economy is that markets transcend national boundaries, whereas economic policy remains vested at the national level and is overwhelmingly responsive to domestic political imperatives. In short, markets are global but policy is national. Conflicts arise – threatening a backlash against globalization – when globalization constrains policies, or when globalization's distributional effects are too big for national policy to offset.

Three trilemmas summarize key policy constraints that globalization implies. The well-known *monetary trilemma* (Milton Friedman first applied the term) asserts that when the economy is open, monetary policy is constrained to focus on either exchange-rate stability or domestic (price and output) stability. But a separate threat to monetary policy is that a foreign-sourced currency, possibly a privately produced digital currency such as Facebook's proposed Libra, supersedes the currency that the domestic government issues. Dirk Schoenmaker's (2013) *financial trilemma* constrains national financial stability policies: in an open economy, these can become ineffective unless closely coordinated with foreign financial regulators. Here, too, privately issued digital currencies pose a challenge. Finally, there is the *political trilemma* (Rodrik 2000) , under which deep external economic integrated will inevitably clash with participatory politics unless the nation-state is given up in favor of global federalism (or some other form of binding international coordination). This trilemma constrains a range of policy tools, including, notably fiscal policy – but also other policies such as competition policy. For example, if voters demand a large government to shield them from various economic shocks, that will be harder to deliver if capital can flee abroad beyond the reach of home tax authorities. Because economies that are more open will feel global shocks more acutely, the last example shows how globalization also creates more demand for protective government policies.

Governments typically have responded to these policy constraints in a number of ways. One way is to limit sovereignty through international agreements or conventions. Another is to limit the scope of globalization in some way or ways. Each of these two approaches arises in a particular historical setting, both of them subject to and creating dynamic conditions that may lead to demands for different approaches. Even a regime that is successful on its own terms can generate side effects that fuel destabilizing political changes, undermining the regime. Changes over time have occurred with respect to international agreements as well as a range of aspects of integration with external markets.

One result has been cycles in globalization (and within those, changes over time in the aspects of globalization that countries pursue). The evolution of global trade gives a vivid picture of expansion through World War I, contraction in the interwar period after a failed attempt to restore the pre-war order, followed by renewed expansion after World War II and a more recent leveling off (see Figure 1). Similar swings characterize international capital flows and immigration (Catão and Obstfeld 2019).



Source: Catão and Obstfeld 2019.

Coping with Globalization: Alternative Approaches

The regime that governed the classical gold standard (roughly 1870-1914) featured effectively fixed exchange rates (through the widespread monetary peg to gold), open capital markets, but no active monetary or fiscal policies in the modern sense (consistent with the monetary trilemma). The global price level was hostage to the world's demand for and supply of gold. Financial regulation and oversight of payments systems were national and rudimentary – including in countries with central banks – allowing a level of financial instability that certainly worsened cyclical downturns, even when the underlying cause lay outside the financial system (consistent with the financial trilemma). As famously chronicled by O'Rourke and Williamson (1999), global trade expansion, international migration, and flows of capital to the then-emerging markets (including many of today's but also North America and the Antipodes) set up a convergence dynamic (for goods and factor prices) that led to political demands for tariffs and immigration restriction. Here was the political trilemma in action, as countries came to resist deep integration in response to interest-group pressures. At the same time, some trade pacts at the time sought to address domestic fears of "unfair" foreign competition though inter-governmental agreement on labor-market regulations and social insurance (Huberman and Meissner 2010). This approach involved a sacrifice of national sovereignty, though an agreed one, and in the interest of expanding mutual market access. That capital markets generally escaped restriction, and the gold

standard remained largely unquestioned, reflected the still predominant political power of the wealthy, investing classes.

Tooze and Fertik (2014) have argued persuasively that this system also gave rise to a destabilizing geopolitical dynamic that fed directly into international tensions, and thus, the First World War. For example, capital flows into Russia facilitated a more rapid industrialization and buildup of military capability. France, the premier lender to that country (Feis 1930; Berger 2003), signed an alliance with Russia in 1893. The threat that Germany and Austria-Hungary therefore came to perceive helped destabilize the European balance of power. Imperialistic rivalries in the struggle for raw materials aggravated tensions further, as argued at the time by Hobson (1902) and Lenin (1917).

The attempt to restore the pre-war gold standard in the 1920s foundered in the face of the Great Depression. However, strains were evident even before 1929, given the political and geopolitical changes that the war had caused (Tooze and Fertik 2014). The Great Depression sparked a radical move in the direction of economic sovereignty, and away from openness. Tariffs proliferated as did exchange controls, and by 1936, the major countries had abandoned the international gold standard in favor of what Hayek (1937) and Robbins (1937) derided as "monetary nationalism." Tentative efforts to reduce tariffs and limit fluctuations in major exchange rates were overwhelmed after a second world war broke out in 1939.

Allied military and financial collaboration during Second World War facilitated a purposeful, internationalist approach to postwar monetary planning. In an insightful account, Ikenberry (1992) describes how officials from the U.S. Treasury effectively blocked the U.S. State Department's proposals to reconstruct a *laissez-faire* world monetary and trade system in favor of arrangements that would allow more systematic intervention by national governments to stabilize their home economies, supported, if necessary, by credits from an international financial institution. This was also the position of the U.K. Treasury, where Keynes oversaw the negotiations.

Fully flexible exchange rates (the nationalistic solution) never received serious consideration (Irwin 2019), but the proposed Bretton Woods system (1944) allowed for devaluation in situations of "fundamental disequilibrium," thereby opening the door to Keynesian stabilization, as opposed to the passive policy posture under the gold standard. Presumed restrictions on capital mobility were a key part of the mix – without these, speculation on potential exchange-rate parity changes would render the system unstable, a trilemma that Keynes understood well. Although countries did not take up rules for the postwar trading system until much later in the 1940s, the goal of Bretton Woods was to "embed" a liberal trading order within a framework that would allow governments the policy autonomy to respond to domestic downturns (Ikenberry 1992; Obstfeld and Taylor 2017). Thereby, these safety valves could protect the system from political reactions that might bring a return to conditions of the mid-1930s. Thus, as Ikenberry (1992, p. 319) notes, the marriage of Keynesian ideas solved a key dilemma of the time:

> The Bretton Woods agreement articulated a middle position between a nineteenth-century style free trade system and regional or national capitalist arrangements. The policy views of the monetary experts [from the U.S. and U.K. Treasuries] were intellectually synthetic and politically robust: they not only provided a respectable position between extremes and set the stage for political compromise between the British and American governments, but they also

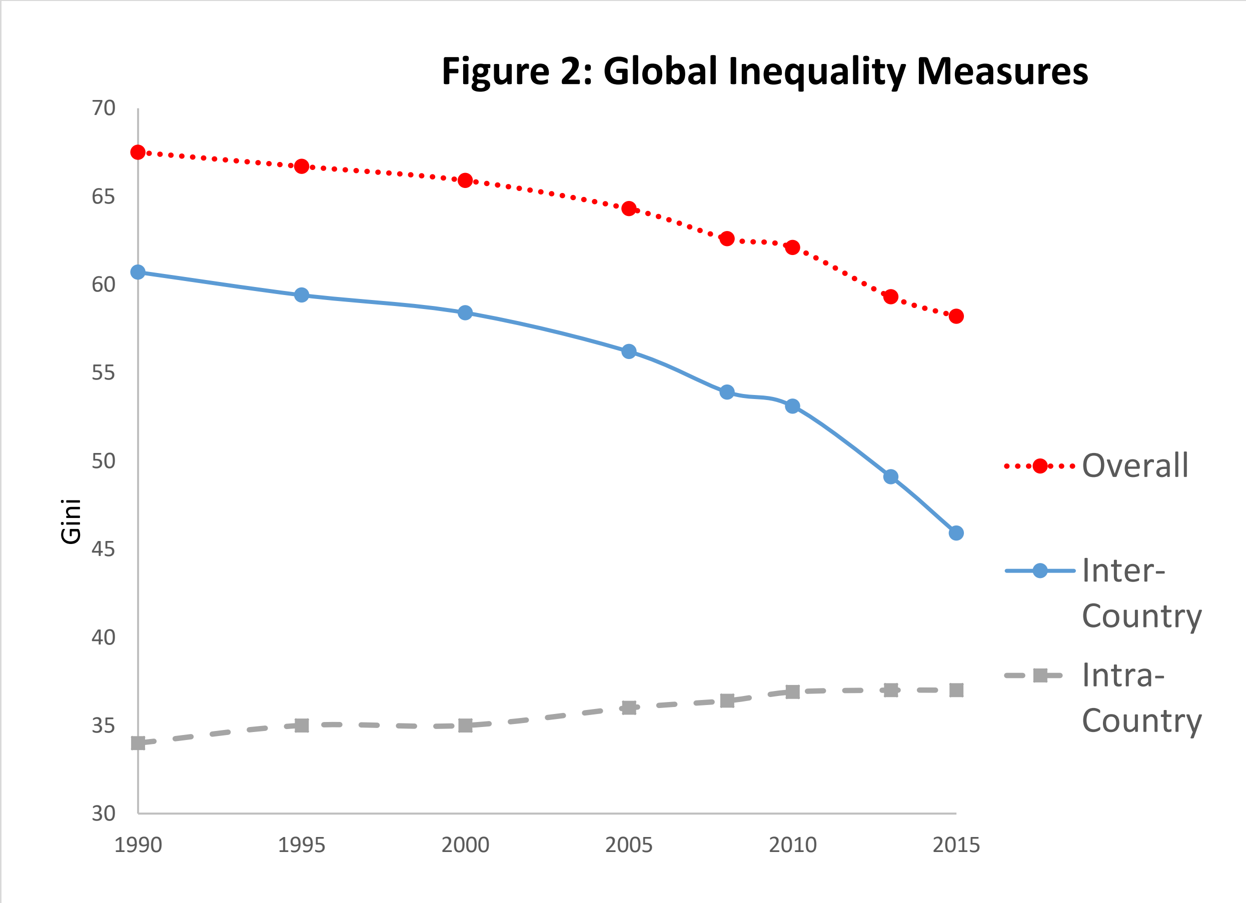
foreshadowed and perhaps enabled a broader sociopolitical reordering of coalitions within postwar Western capitalist democracies.

The Bretton Woods framework was a successful incubator for recovery in Western Europe and Japan, and for a recovery of global trade (Figure 1). The return of European currencies to current-account convertibility in 1959 was a key achievement supporting multilateralism in trade. Also within that framework, a set of European countries created a common market and launched a process of mutual economic integration, one that required increasing delegations of sovereignty in a range of sectors and policies. The very success of Bretton Woods in promoting foreign exchange markets and international transactions, however, opened the door to disguised capital movements. The logic of the monetary trilemma then dictated that as the scope of cross-border capital mobility increased, while other tensions over exchange rates and international reserves grew, currency markets would become unstable (Obstfeld and Taylor 1998). Systematic speculation started in the early 1960s and grew, eventually causing the system's collapse, in phases, in the early 1970s. The industrial countries turned to a nationalistic solution for regaining national monetary sovereignty, the one that had not been seriously entertained in 1944, floating exchange rates.

The Bretton Woods experience in the 1960s and early 1970s illustrates a general dynamic pattern. Whether or not a policy regime attempts to address policy trilemmas through restrictions on international transactions, markets will evolve to take advantage of any profit opportunities, whether these be the result of arbitrage opportunities or simply of technological developments. In turn, these market evolutions can be quite destabilizing, leading to dislocations in monetary policy, in financial stability, and in the political sphere. In particular, when financial trade is restricted, profit seeking will find and accentuate vulnerabilities, magnifying the effects of any policy-imposed distortions. For example, policies like the United States' Regulation Q and Interest Equalization Tax drove dollar borrowing offshore and contributed to the rise of the London Eurodollar and Eurobond markets. The growth in the resulting financial distortions can create considerable pressure for liberalization – encouraged, of course, by financial-sector interests.

The widespread use of floating exchange rates meant that capital controls were no longer necessary to ensure monetary stability in advanced economies. Countries progressively dismantled them over the 1970s (although arrangements for stabilizing intra-European cross exchange rates led countries such as France and Italy to maintain controls for longer). Rich countries' domestic financial systems also saw liberalization in the 1970s, and increasingly after the 1980s, poorer countries embraced markets more tightly. Importantly, China, starting from the base level of a centrally planned economy, embarked on market-based transformation starting in 1978, achieving a very rapid increase in living standards over the next 40 years.

Countries did delegate policy sovereignty in various ways to support globalization – for example, through adherence to the WTO and through the Basel process of regulatory convergence. These developments are understandable as responses to the political and financial trilemmas.



Source: Catão and Obstfeld 2019, from calculations supplied by François Bourgignon based on Bourguignon (2015).

Hyperglobalization, Crash, and Backlash

The 2000s saw advanced and emerging economies linked closely together in a world of what Subramanian and Kessler (2013) have characterized as "hyperglobalization." In the real economy, global value chains proliferated due to lower policy trade barriers and transport costs, as well as technological advances and loose financial conditions (World Bank 2019). In finance, regulatory arbitrage and easy liquidity drove gross international financial flows to unprecedented levels, helping to fuel (and in turn fueled by) asset-price bubbles. Commodity prices soared. Emerging and developing economies boomed in the new millennium, their growth accelerating compared with that of advanced economies.

In a prescient speech delivered in June 2006, Jeffry Frieden (2008) pointed to stresses due to globalization and the danger that these would lead to political backlash, notably in the United States, absent positive action to "sustain domestic political and economic conditions that allow enduring support for international commitments." The title of his speech was a question: Will Global Capitalism Fall Again? We know now just how relevant that question was.

The Global Financial Crisis of the late 2000s and the ensuing recession were culminations of unsustainable financial trends. Despite a policy response that prevented a much worse slowdown, the

crash also highlighted decades-long unsustainable trends in the labor markets of advanced economies. Under the pressure of technology advance and globalization, deindustrialization had been eliminating prized manufacturing jobs and polarizing labor markets. Median wages were stagnant. A perception that few shared in the benefits of growth was undermining the prevailing policy consensus. Ironically, the very success of that consensus in driving policy reform and growth the poorer countries helped to sap support for globalization in richer countries. Figure 2 illustrates the striking divergence between the evolution of overall global inequality (as measured by the world Gini coefficient) and that of average intra-country inequality.

In the new millennium, import penetration, notably from China, led to considerable regional distress, notably in the United States but also in Europe (Colantone and Stanig 2019). The fortunes of major urban agglomerations and other areas diverged. Advanced economies struggled to regain traction after the crisis, plagued by low productivity growth and, in several countries, further crises and excessive fiscal austerity. The result was a political backlash throughout Europe and in the United States. The most dramatic consequences were the Brexit vote in the United Kingdom and the Trump presidency in the United States, but nationalistic movements made progress throughout Europe as political polarization grew.

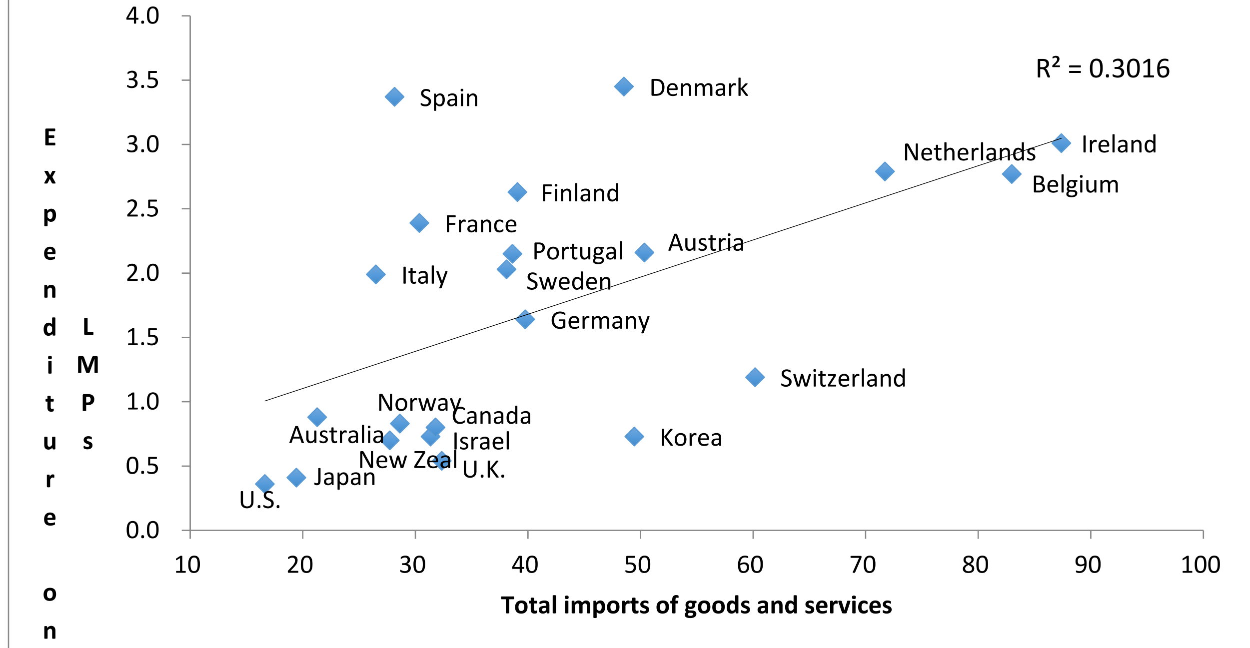
The policy assault on free trade *per se* was most evident in the United States, where President Trump had vowed to restore manufacturing – while at the same time undertaking aggregate fiscal policies bound to lead to a bigger external deficit and therefore a relative expansion of the U.S. nontradable sector. Perhaps the most contentious theater of the president's trade war has been U.S.-China commerce. There, it is evident the roots of trade conflict go beyond economics: they also reflect geopolitical rivalry. China's rapid economic growth, enabled by access to world markets, has allowed it to challenge U.S. political influence globally. That tension raises the stakes in the trade conflict, tempting the United States to challenge China's advance toward the technological frontier. The result has been another impetus away from globalization, toward regionalization.

Addressing Threats to Trade

Backlash against trade has been milder in Europe compared with the United States, and indeed, the EU has recently been able to proceed on trade agreements with Canada, Japan, and Mercosur. Some observers point to the more developed welfare states of Europe as a mechanism that can dampen the effects of trade shocks through several mechanisms, including redistribution and the easing of labor-market adjustment to trade-induced structural change. Furthermore, US labor markets have become less flexible in comparison with Europe's.

Political scientists and economists have long noted that economies that are more open have larger governments (for example, Rodrik 1998). More extensive government safety nets may encourage trade liberalization, but at the same time, more openness creates a greater demand for government intervention to help those who are hurt by trade. Figure 3 shows that among industrial economies, trade openness (measured by imports as a share of GDP) has a strong positive correlation with government sending on labor-market policies. Espinoza, Ostry, and Zhang (2019) offer recent supportive estimates that account for the endogeneity of economic openness.

For addressing the backlash against trade, advice that Padoa-Schioppa (2010) applied to the Global Financial Crisis a decade ago certainly fits:



Source: Catão and Obstfeld 2019.

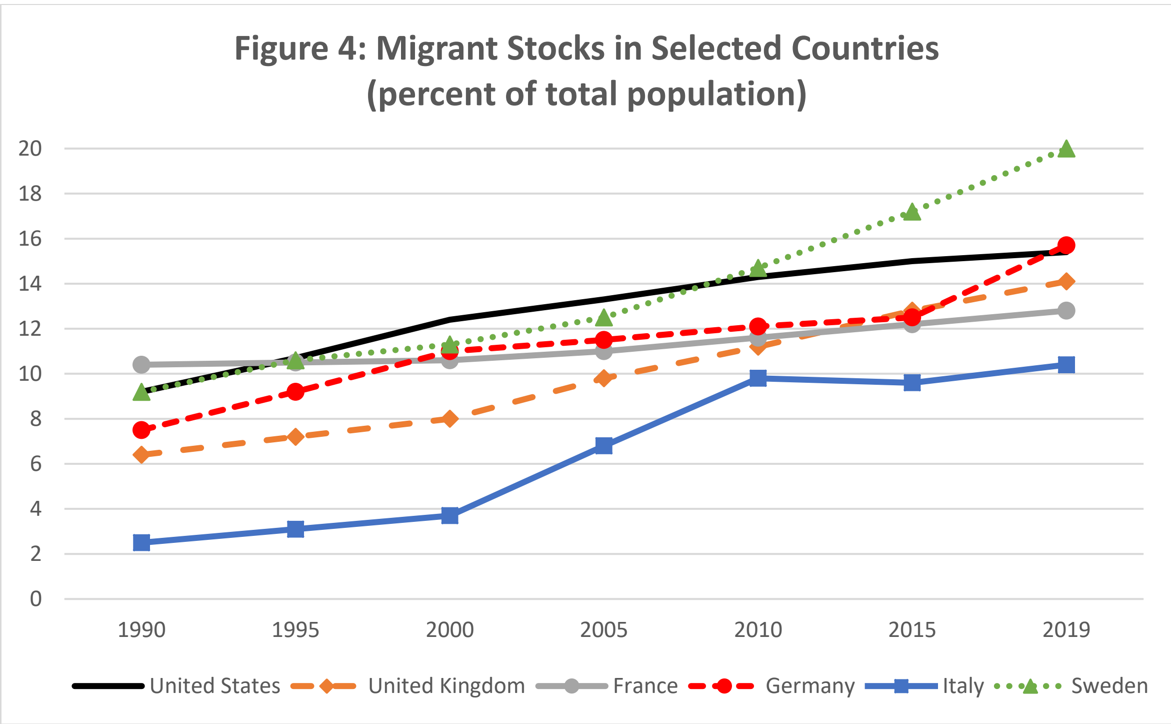
> The exit from the configuration that led to [the crisis] should be a government which, of course, respects economic freedom, but at the same time exerts its role forcefully and is not prostrate before the twin idols of the market and the nation-state.

However, voters have to choose such a government, an outcome endogenous to the political system and dependent on a range of initial conditions. And this likelihood faces obstacles.

Important research by Alesina and Glaeser (2004) suggests that a key barrier to a more extensive welfare state in the United States is racial heterogeneity. Unfortunately, these attitudes have been inflamed in some quarters by the current US political environment, and it remains far from clear that US voters will swing in a direction friendlier to institutional innovations that might eventually generate more support for international trade.

And what about Europe? Not all is well there, either. In light of the current European tensions over immigration, we cannot discount the possibility that those same tensions eat away at the European welfare state, with consequences for attitudes toward trade. As Alesina and Glaeser (2004) wrote 15 years ago:

> One natural implication of our conclusion that fractionalization reduces redistribution is that if Europe becomes more heterogeneous due to immigration, ethnic divisions will be used to challenge the generous welfare state.



Source: Migration Data Portal based on UN Department of Economic and Social Affairs Population Division data; accessed December 3, 2019.

Figure 4 shows how the shares of migrants have risen since 1990 in a selection of European countries and the United States. The number has more than doubled in the United Kingdom, Sweden, and Germany, quadrupled from a very low level in Italy, and risen by 67 percent in the United States. France, which had the most migrants in 1990, has seen a smaller increase of 23 percent over the last two decades. The threat to the European welfare state from ethnic fragmentation adds to the secular challenges due to demographic change (slower population growth, longer lifetimes) and low productivity growth.

Managing Financial Openness

While capital flow levels have receded from the extreme heights reached prior to the Global Financial Crisis, this has not been a result of explicit restrictions targeting private international capital movements. Rather, other factors affecting demand and supply conditions in financial markets have been at work, including post-crisis regulatory changes aimed at curbing banking risk, as well as the collapse of bubbles and the expectations that helped fuel them. Another factor has probably been the (limited) attempts by some richer countries to ring-fence their banking systems in the interest of financial regulatory effectiveness (a response to the financial trilemma). But such initiatives have not for been mostly the result of public outcry against free cross-border movement of capital.

Collaborative work among national regulators on financial stability has been one of the great successes of the floating exchange rate era. While obviously not 100 percent effective, and still a work in progress, work by the Basel Committee and the Financial Stability Board has certainly prevented even worse

problems than we have had. No doubt, one reason for progress has been the ability to work at a more discreetly technocratic level in comparison with the very public and political debates over trade. The result has been some delegation of regulatory sovereignty, not through formal treaty, but through global consensus among regulators – that is, "soft" rather than "hard" law. The post-crisis period has seen further important progress in this program.

Nonetheless, financial asset trade may not escape the harsh glare of politics forever. President Trump has hoped to reduce the US current account deficit through trade tariffs, a strategy doomed to fail unless tariffs rise to prohibitive levels. However, taxing the capital inflows that *finance* the US current account deficit *would* have first-order macroeconomic effects lowering it – while, in my view, inflicting immense collateral damage on the US and world economies. The rationales of lowering the deficit and weakening the dollar underlie the bipartisan legislation introduced in 2019 by Senators Josh Hawley, Republican of Missouri, and Tammy Baldwin, Democrat of Wisconsin, which would tax US capital inflows to limit the trade deficit to no more than ½ percent of US GDP.[2]

So far, such measures seem unlikely. Yet there are areas where financial openness still poses threats and where, conversely, corrective collective action – well communicated to the public – could shore up public support for the type of delegation of national sovereignty that an effective multilateral response would require (helping to navigate the political trilemma).

One area for deeper multilateral cooperation is in limiting the socially disruptive capital flows associated with tax avoidance and evasion, as well as the money laundering that fuels those activities along with corruption and terrorism. To prevent a race to the bottom in capital taxation – which would shift the burden of social protection finance entirely onto immobile factors, notably labor – countries need to agree a regime of minimal capital taxes, and also prevent digital and other companies from escaping taxes in countries where they do business, but are located remotely. The OECD has recently put forward proposals covering both of these areas.[3]

Conclusion

Globalization can elevate the *need* for state action, but also may limit state action. Thus, globalization may be subject to cycles, expanding when economic conditions are more vibrant and accommodative, but then contracting when adverse shocks motivate nations to deploy economic tools that are inconsistent with free and open markets. Because globalization can foster economic convergence among nations, but also sharpen political and economic competition, it may also eventually upset the geopolitical equilibrium that nurtured convergence, and perhaps especially, equilibria characterized by a hegemonic leader.

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[2] See https://www.baldwin.senate.gov/imo/media/doc/FINAL%20ONE-PAGER%20The%20Competitive%20Dollar%20for%20Jobs%20and%20Prosperity%20Act.pdf

[3] Espinoza, Ostry, and Zhang (2019) provide evidence that both trade and financial openness compromise a government's ability to tax capital. On the OECD proposals, see https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf and https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf

The current conjuncture features both forms of destabilization, manifested in the domestic politics of a number of countries as well as in the US-China rivalry and Europe's attempt to position itself with respect to that conflict. Will globalization's retreat be limited and perhaps temporary; or are we headed toward a much grimmer outcome, as happened during the first half of the 20th century? A positive recovery will require national political systems to converge on constructive multilateral approaches that navigate the key trilemmas while addressing the very real domestic problems that the recent hyperglobalization accentuated.

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