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Power and Plenty in 2030

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Prepared for the session on "The World in 2030. Educated guesses from a long-run perspective", 15th World Economic History Congress, Utrecht, August 2009.

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1. Introduction

There are three reasons why Ronald Findlay and I decided to call our 2007 history of international trade "Power and Plenty". The first and most important is that Peter Dougherty and Richard Baggaley at Princeton University Press thought that it would be a good idea, but there were two important intellectual reasons as well. More narrowly, "Power and Plenty" refers to the mercantilist belief that plenty was necessary for states because it provided them with the sinews of power; and conversely, that power was necessary in order for states to be able to secure plenty. The first of these two assumptions seems uncontroversial even today, since potential military power stems ultimately from countries' productive capacity per person, and their populations. The second assumption is much more controversial, even though it remained widespread into the 20th century. An "optical illusion" is what Norman Angell called it in his famous book written shortly before the outbreak of World War I, and shattering the illusion was the primary purpose of that book (Angell 1909).

More broadly, "Power and Plenty" refers to our belief, supported by 1000 years of evidence, that globalization is as much a political, and a geopolitical, phenomenon as it is a technological one. One immediate implication is that predicting the future of globalization is a foolhardy exercise, especially for economists, since it necessarily involves making implicit or explicit judgements about the future of the international political system, judgements which we are ill-equipped to make. Another implication is that globalization is potentially reversible: while technologies are typically not forgotten, political choices have led to the world becoming less integrated in the past, and might well do so again in the future.

I am therefore going to do two things in this paper. First, I will speculate about the geopolitical environment within which the future of globalization will be determined. Second, in so doing I will keep an eye on how trends in plenty will influence power in the 21st century, and will speculate about ways in which power may have feedback effects upon plenty, if we are not careful. Above all, however, I will be stressing how unknowable the future of globalization is, and how it will depend upon the choices which politicians make, for better or for worse, over the coming years. Indeed, the choices which they make in the next two or three years could be more important for the rest of the century than one might wish.

I will begin by making some comments about the role which unpredictable shocks and path dependence, on the one hand, and long trends on the other, may play in determining future geopolitical trends, and the course of globalization. About unpredictable shocks we can say relatively little, but I will say more about some of the long run trends which one can safely predict will be important over the next few decades. Key areas of uncertainty will also be flagged. I will next discuss ways in which power may come to be seen as important in ensuring plenty, if faith in the multilateral trading system starts to wane; talk about some of the domestic political pressures to which governments will be subjected in the future and which will also be important in determining the future course of the international economy; and emphasise how important the current crisis may be in determining the future of globalization over coming decades.

2. Trends and shocks

It is instructive to speculate about what an observer in 1945 or 1950 (and there is a big difference even between these two years, separated by just half a decade!) might have been reasonably able to predict regarding the shape of the global political and economic system in 1975. World War II had clearly produced two main victors, the USA and USSR, and the observer might not, perhaps, have been surprised to find the geopolitical system in 1973 dominated by the two superpowers. Nor, perhaps, would the Cold War have been so surprising, even from the perspective of 1945, although one has to wonder how many observers in May 1945 foresaw the extent to which Eurasia would have become communist – and hence ruled by governments hostile to international trade – just five years later. Another major shift in the international balance of power – and a force for deglobalization during much of the late 20th century – was decolonization. In retrospect, the decline of European colonialism seems an inevitable consequence of Europe's loss of relative plenty and military power, but one wonders how many Europeans saw it coming in 1945 or even 1950, by which time the Dutch had already been evicted from Indonesia, and the French were facing stiff military opposition in Indochina.

The Yom Kippur war of 1973 which triggered the first oil shock, thus bringing Europe's Golden Age of economic growth to a shuddering halt, might not have come as an enormous surprise to an observer in 1950: the seeds of the Middle Eastern conflict which has poisoned international relations for decades had already been planted. On a more positive note, Marshall Aid and the formation of the OEEC were both foretastes of the European integration to come, and which was bolstered in 1973 by the first enlargement of the EEC.

By 1950, then, a lot of the major themes underlying international relations in 1973 were predictable at some very general level. However, just five years earlier, in 1945, everything was still to play for, or at least it must have seemed that way: the future of Europe, the future of China, the future of the Middle East all hung in the balance in 1945, or so one might reasonably have thought at the time.

And what would an observer in 1973 have made of today's world? He or she would surely be far more disoriented than their colleague of the late 1940s, although oil and the Arab-Israeli conflict continue to play a malign role in international relations. By 1973 Nixon had visited China, but Mao's death, and a lot of political manoeuvring, would be required before Deng Xiaoping could take over as Chinese leader and open its economy to the outside world. Was it really predictable that the Soviet Union would so utterly collapse under the weight of its own internal contradictions? *Ça se discute.* And even if one makes that case, the Chinese example suggests that there was nothing inevitable about the break-up of the Soviet empire, and the eastward enlargement of the European Union – just as the future of countries such as Georgia and the Ukraine seem up for grabs today. The world would be a very different place in 2009, were it not for Mikhail Gorbachev.

Sometimes history runs along railway tracks in ways that allow one to clearly identify underlying trends, at least ex post. Sometimes it jumps the tracks, in entirely unpredictable ways. So the shape of the world in 2030 is, in all honesty, entirely unknowable, and this is an important lesson of history. As the experience of the past decade or two shows, there is nothing more dangerous for the economy than when market participants allow themselves to believe that there is no such thing as Knightian uncertainty.

As economic historians, we are trained to take path dependence seriously – the decisions that people take can really matter. Very big shocks to the system – such as the First World War, or the Great Depression – have had long run effects on the world economy that would have been quite unpredictable at the time. This is why the last three chapters of *Power and Plenty*, dealing with the 19th century, the interwar period, and the late 20th century, in each case start with an examination of the world military conflict which preceded, and structured, the subsequent period, in ways with which we are all familiar. This is also why the ways in which today's politicians respond to today's world economic crisis matter so much, not just for the economic outlook over the next few years, but potentially for the shape of the world economy in decades to come.

3. Long run trends

Some long run trends seem fairly predictable, and there is therefore widespread discussion of them today. Most predictable of all is the continued convergence of much of the developing world, notably in Asia, on the core economies of Europe and North America. Of course, not even this outcome, which seems a racing certainty, can be entirely taken for granted. As Figure 1 shows, the late 20th century saw both convergence and divergence of various regions of the world vis à vis the United States, which can reasonably be taken to have represented the world technological frontier at the time. The figure plots regional GDP per capita as a percentage of the US level, and shows clearly the convergence experienced by Western Europe, Japan, and the Tiger economies of East Asia. The figure shows that China joined the convergence club in the late 1970s, as did India in the 1980s and (especially) the 1990s, after initially diverging for three decades.

FIGURE 1 ABOUT HERE

The figure also makes it clear that there were disappointments as well as successes: the failure of India and China to converge before they opened themselves up to world markets; the relative collapse of the USSR, Eastern Europe and the

Middle East from the mid-1970s onwards; and above all the abysmal performance of Latin America and sub-Saharan Africa. The timing of the Indian and Chinese growth spurts shows clearly the importance of policy in bringing about convergence, and suggests the possibility that policy might in the future again block it: in particular, if either of these countries were to turn inwards again, or find themselves barred from world markets, their potential growth rates would presumably fall substantially. In the Chinese case, there is the additional uncertainty created by that country's increasingly anomalous political system, as well the risk of conflict with Taiwan or elsewhere.

Continued convergence is therefore not certain, but let us assume that the next century is indeed characterised above all else by the continued unravelling of the enormous asymmetries created by the Industrial Revolution two centuries ago, and that Asia will regain its rightful economic and political stature on the world stage. There are a number of consequences which would seem to flow from such a scenario, and which have been widely discussed in recent times. The first is that the balance of political and military power will shift eastward, and that both India and China will become more assertive in pushing their own interests internationally, including by military means if necessary. The second is that Sino-Indian relations will come to be increasingly important for the world as a whole: Robert Kaplan (2009) sees Sino-Indian rivalry in the Indian Ocean as a defining feature of 21st century geopolitics. The third is that the world's international economic institutions will no longer predominantly reflect European and American interests: they will either be representative of the world as a whole, or they will cease to be relevant. As the experience in the recent Doha round of trade talks, and the G-20 summits, shows, this is something which is already happening.

A fourth consequence is that developing country demand will put pressure on existing supplies of oil and other raw materials, driving up prices. It would be more than unfortunate if today's leaders took the slump in oil prices created by the depression as a signal that last year's fears about dwindling oil supplies are no longer relevant: fuel scarcity will be a key trend during the century ahead. A fifth, related consequence is that there will be increasing international tension regarding carbon emissions and climate change, since India and China cannot be allowed to absent themselves from the international effort to avert a catastrophe, but have every right to accuse the West of hypocrisy on the issue. A sixth consequence is that a growing number of countries, including China, will become increasingly dependent on international markets for supplies of food and raw materials. Readers can probably think of other consequences for themselves.

Related to the rise of various third world giants will of course be the relative decline of the United States and its allies. American relative decline seems to be already well underway, after the brief hubris of its unipolar moment. The limits of American military power can be seen in Iraq and Afghanistant, and were brutally underscored by Russia's 2008 invasion of Georgia. Indeed, the latter conflict also highlighted the decline in American soft power after two terms of George Bush, since the Americans were not even able to condemn Russian behaviour in a particularly convincing manner. The United States will remain the world's leading economy for some time to come, especially if the definition of 'leading' encompasses technological progressiveness rather than mere scale. And yet, American dependence on foreign oil and foreign capital implies that in the economic and political domains, it has to take account of the interests of capital- and oil-exporting countries, interests which do not necessarily coincide with its own. One key question mark hanging over the next few years is the extent to which the US will be able to wean itself off such imports. As regards capital, the Federal government will clearly be borrowing a lot of money, and so private savings rates will have to considerably increase if the country is not to become an even bigger net borrower. As regards oil, the current crisis ought in principle be an opportunity to invest in alternative energy sources, but in practice it seems to be making politicians more hesitant about carbon taxes, or other measures which might hurt firm profitability.

Since this congress is taking place in Europe, I may as well say something about the continent, although it is far from clear that authors from elsewhere would regard this as particularly necessary. Depending upon how long it lasts, the current economic crisis could turn out to be an existential moment for the Union. Internally, the crisis could lead to a dramatic deepening of European integration, as the problems caused by our fiscal, banking, and regulatory fragmentation become increasingly glaring. Or, it could lead to the opposite: to an insidious unravelling of the Single Market, as struggling governments try to look after their own. Externally, the crisis could either lead to a strengthening of the world's multilateral institutions, or to increasing economic (and non-economic) nationalism. In the latter case, Europe would no longer have anything useful to say to the world, since multilateralism is what Europe stands for politically.

A second trend, which is probably more predictable than the first, is that the world will face growing resource scarcity over the course of the next century: of oil, of water, of various obscure but essential metals, and of a healthy environment. The last point is crucial, since it provides a counter to those who might hope for further major discoveries of carbon-based fuels: if such fuels do not in fact turn out to be scarce over the course of the next century, it will become the job of policy to make them so, economically speaking, through appropriate taxation. In some ways, the world will become more Malthusian, not in the technical sense of fertility becoming a positive function of living standards, or of living standards being driven down to subsistence levels, but in the broader sense of the natural environment once more placing firm constraints in a greater range of areas on what human societies can and cannot do. Economists and economic historians have in recent years increasingly emphasised how the Industrial Revolution was above all a means by which the West broke free from Malthusian constraints, through constant technological progress (which one may hope will still continue), but also by substituting "inorganic" energy sources such as coal for "organic" energy, and by adding the vast land resources of the New World frontier to the cramped endowment of Europe (Wrigley 1988, Pomeranz 2000). As the frightening spike in world food prices last year showed, if ever we come to depend on our land endowment for fuel as well as food in the future, as was the case before the 19th century, the consequences could be catastrophic. We will need solutions other than biofuels to the problem of shrinking fossil fuel supplies.

If countries and economic agents accept that rising fuel prices are a signal that we have to change our behaviour, and adapt accordingly, then there will be greater investment in alternative energy sources, in fuel-efficient public transportation, in research and development into more efficient modes of private transport, and so on. On the other hand, countries might try to insulate themselves from rising prices, and thus from the international market, for example by trying to carve out privileged sources of supply for themselves. This scenario, which is obviously extremely dangerous, is part of a broader set of risks which will be discussed in the next section.

Rising oil prices will have unpleasant geopolitical consequences from a Western perspective, as we saw in 2008. When oil prices rise, some of the most unpleasant regimes in the world benefit, including Russia which as we know has no scruples in using its command of fuel supplies as a geopolitical weapon. If Europe develops alternative sources of supply, including the proposed Nabucco pipeline linking Europe to the Caspian Sea, and unifies its energy market so that the Russians can no longer divide and conquer the continent (on whose market, let us not forget, it is more dependent than the EU is on it), this would greatly help in stabilising the marchlands between the EU and Russia. On the other hand, if major European countries such as Germany and Italy continue to put their own interests above the interests of Europe as a whole, by privileging bilateral energy relationships with Russia, then Europe will deserve whatever is coming to it. Unfortunately, the ultimate victims may be in Ukraine or Georgia, rather than in the EU itself.

The discussion thus far has been largely focussed on the East-West axis, but there is also the North-South axis to be considered. The good news seems to be that one potentially destabilising element in North-South relations, namely Southern population growth and resultant migration pressures, seems to be moderating of its own accord (Hatton and Williamson 2009). Unfortunately, the benign effects of the demographic transition which is underway look set to be swamped by the extremely alarming consequences of global warming, which may turn out to be the dominant security threat over the coming century. As several recent reports have pointed out, drought has already fuelled conflict in several regions of the world, including Sudan, and this trend seems set to continue. The possibility that rising sea-levels might lead to the collapse of states such as Bangladesh, with major consequences for neighbouring states, has also been widely flagged.

Of particular interest in a longer-run historical context is the possibility that the melting polar ice-cap will open up a northern passage between the Atlantic economies and East Asia (along the northern shores of either Russia or Canada), thus greatly reducing traffic along the Suez Canal and around the Cape. At one level it might seem that this would be good for international trade, while strengthening the competitive position of Korea, China and Japan. At another level, we are already seeing signs of potential conflicts over who should control these sea-lanes, and the Arctic mineral resources that may become accessible in time. The moves of Greenland towards independence from Denmark could inject another dangerous element of instability into this equation unless the island is firmly anchored into some durable security arrangement, since Greenland is clearly incapable of ensuring its own security.

4. The big risk: a Malagasy future?

One of the most worrying news stories of last year was that involving Korea's Daewoo Logistics leasing almost half of Madagascar's arable land on a 99 year basis. According to initial reports, the land was to be leased for around $12 an acre, but an article in the Financial Times subsequently reported that in fact Daewoo was planning to lease the land at zero cost, with increased employment opportunities for the locals being the sole payoff which would accrue to the African island.

The alarming aspect of this story was not the fact that Daewoo's behaviour was pretty obviously exploitative. Rather, it was the Korean motivation for the deal: "We want to plant corn there to ensure our food security. Food can be a weapon in this world," said Hong Jong-wan, a manager at Daewoo. "We can either export the harvests to other countries or ship them back to Korea in case of a food crisis."
In turn, this rationale can be explained by the fact that "[Food-importing countries] have lost trust in trade because of the price crisis this year" (in the words of Joachim

von Braun, director of the International Policy Food Research Institute in Washington).

All of this should send shivers down the spine of anyone with a sense of history. Markets are a political institution. The deal they represent is straightforward: if you are willing to pay the going price, then you can buy what you need. When countries start to doubt whether that deal will remain valid going forward, and in consequence act to carve out sources of supply for their own exclusive use, the geopolitical consequences can be catastrophic.

According to a seventeenth century textbook,

> [Divine Providence] has not willed for everything that is needed for life to be found in the same spot. It has dispersed its gifts so that men would trade together and so that the mutual need which they have to help one another would establish ties of friendship among them.[1]

This optimistic view of international trade as a force for peace is appealing, but international trade also leads to mutual interdependence, and thus to vulnerability, as suggested by the Daewoo statements cited above. When nations start focussing on these vulnerabilities, rather than on the mutual benefits of trade, it is time to start worrying.

The uneven spread of industry during the 19th century interacted with the globalization of the time to produce an extreme specialisation involving industrial producers on the one hand, and primary commodity producers on the other. The vulnerabilities which this implied were one factor among several which ultimately led to war, and the collapse of that period’s globalization. According to Avner Offer, a key element in the sequence of decisions which led to World War I was the fact that

[1] Cited in Hirschman (1977), pp. 59-60.

both Germany and Britain were increasingly dependent on overseas imports of food and raw materials. “The economies of both Britain and Germany came to depend on hundreds of merchant ships that entered their ports every month. Overseas resources, the security of the sea lanes and the economics of blockade affected the war plans of the great powers and influenced their decision to embark on war.”[2]

British planners, initially concerned about their own vulnerabilities, started to focus on German vulnerabilities and the potential of blockades as a weapon against Germany. German commanders similarly came to the conclusion that their dependence on imports meant that a long-drawn out war was not in their interests, and that an overwhelming attack on France was thus to be preferred. And at the other end of Eurasia, concerns about the continuing availability of raw materials would play an important role in prompting Japanese aggression during the 1930s.

When the international division of labour breaks down, or when planners fear that it will break down in the future, the temptation to grab resources inevitably strengthens.[3] The last thing we should want is for such worries to become commonplace in the context of the multipolar world of the 21st century, whose rising powers are heavily dependent on strategic imports, just as their predecessors were in the past. In addition, there is the issue of how the inhabitants of countries like Madagascar will react to such land grabs. The news that one of the first actions of Andry Rajoelina, the leader of Madagascar’s coup, was to cancel the Korean land deal is hardly surprising, and suggests a further potential source of international tension in the decades to come.

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[2] Offer (1989), p. 1.

[3] When creditor nations find themselves confronted with the prospect of a reserve currency whose long term prospects are uncertain, to say the least, the temptation to buy such resources is further increased.

5. Domestic politics and globalization backlashes

The brief survey of long run trends above reveals a plethora of ways in which the world is becoming a more dangerous place. But even if our leaders get the geopolitics right, there is still the possibility that domestic political systems will lead to a major anti-globalization backlash in the years ahead. Indeed, this might have been the case, even if the current world economic crisis had not intervened.

Nineteenth century history provides a useful cautionary tale here. Prior to that date, intercontinental trade had largely involved goods characterised by a high ratio of value to weight, since these were the goods which could bear the very high costs of transport of the time. As such, they were largely (if not exclusively) non-competing: they did not displace domestic producers to any great extent, and the tariffs that may have been levied upon them were imposed more to raise revenue, thus increasing the plenty and power of the state, than to protect domestic interest groups. (Indian cotton textiles are an important exception that proves the rule.)

From the 1840s onwards however, the transport revolutions of the nineteenth century led to a historic and dramatic decline in international transport costs. For the first time in history, it now became economical to transport such bulky and low-value commodities as wheat between continents on a regular basis. Such ‘competing’ commodities could be produced worldwide, on continents with very different endowments of land, labour and capital. European landowners now found themselves in direct competition with farmers on the Great Plains, the Argentine pampas, Russia, Australia and the Punjab. Not surprisingly, European rents and land prices plummeted, in Britain (which remained open to free trade) by roughly 50 percent. O'Rourke and Williamson (1994, 1999) show that almost all of this decline can be directly attributed to falling transport costs, which in turn led to falling agricultural prices.

As we know, in most European countries there was a protectionist backlash, with countries such as France and Germany imposing high agricultural tariffs, which were typically extended to the industrial sector as well. What is striking is how quickly this backlash occurred. It was well underway by the late 1870s, only three or four decades after the decline in international transport costs had really gotten underway. The tariffs which were imposed were sufficiently high as seriously to impede the integration of international agricultural markets (Federico and Persson 2007), and can be seen as the direct precursors of today's EU Common Agricultural Policy.

The lesson of the late 19^{th} century Atlantic economy is that globalization can come under severe political pressure when it links together continents with very different factor endowments. This lesson is not contradicted by the experience of the post-1945 period. As Findlay and O'Rourke (2007, Chapter 9) stress, until the 1980s and 1990s post-war globalization was a mainly regional phenomenon, linking together OECD economies which were very similar in terms of economic development, capital-labour ratios, and living standards. Trade between them was largely intra-industry in nature, rather than being driven by strong factor endowment differences between trading partners. It thus involved fewer distributional consequences than late nineteenth-century trade, which made it politically easier to sustain. It is telling that OECD economies *were* endowed with very different ratios of labour to land, and that agriculture was conspicuously absent from the waves of trade liberalisation achieved under the auspices of the GATT. This suggests that potential losers from free trade remained as powerful politically as they had been a century earlier.

In recent decades the nature of globalization has radically changed, with the collapse of communism in much of the world, and both India and China opening up to international trade. The spread of industrialisation across the Third World has meant an increase in the South's share of manufactured exports, and a dramatic switch in the composition of North-South trade, with the South shifting from an almost exclusive reliance on exporting primary products to exporting larger volumes and a wider range of manufactured goods. As in the nineteenth century, globalization is once again linking together continents with very different factor proportions, the South having lower capital-labour ratios and less skilled workforces than the North. Rather than exporting complementary, and often non-competing, primary commodities, the South is now exporting potentially competing manufactured goods. The obvious question which arises is whether the present-day equivalent of late nineteenth-century European farmers, namely unskilled workers in the OECD economies, will eventually press for and obtain a rolling back of international economic integration.

It is certainly true that there has been a dramatic and well-documented distributional shift against unskilled workers and in favour of the more highly skilled in many OECD economies. The extent to which this shift is due to globalization, rather than to biased technological change, remains an extremely controversial topic. What is not in doubt, however, is that voters hold views about trade (and other dimensions of globalization as well, notably immigration) which are exactly what would be predicted if trade were hurting northern unskilled workers in classic Heckscher-Ohlin fashion. A considerable political science literature, building on the important contribution of Scheve and Slaughter (2001), has shown that individual voter attitudes towards trade are indeed consistent with Heckscher-Ohlin theory. That is, in rich (skill-abundant) countries, unskilled workers are much more protectionist than skilled workers, but this effect gets weaker in poorer countries, and disappears or even reverses in the poorest countries. Perceptions matter in politics: if unskilled workers in rich countries believe that they are being hurt by globalization, this could be sufficient to produce an anti-trade backlash, regardless of the accuracy of these beliefs.

The 2005 French referendum on the so-called European Constitution, when unskilled workers voted against what they saw as a pro-market, pro-globalization accord, should serve as a wake-up call for politicians in this regard. Precisely the same cleavage between middle-class and working-class voters appeared in the 2008 Irish referendum on the Lisbon Treaty, with blue-collar workers yet again being overwhelmingly opposed to further European integration. The possibility of a populist backlash against globalization seems to be rising all the time now, as voters discover more and more facts about the operation of tax havens, the consequences of 'regulatory arbitrage', and the risks of unrestricted international capital flows. The obvious danger is that the additional pressures created by the macroeconomic crisis will be exploited by interests which have been becoming increasingly hostile to 'globalization' in any case. If the leaders of democratic societies wish to retain the benefits of open international markets, they will need to take greater notice of the interests of those who are being left behind.

However, the late nineteenth century offers another, more positive lesson for today's policymakers: by adopting appropriate domestic economic policies, they can defuse anti-globalization political pressures and maintain a consensus in favour of free trade. The late nineteenth and early twentieth centuries saw the widespread adoption across European countries of a range of regulations and insurance schemes designed to protect ordinary workers, especially in those countries more open to international trade. For example, a range of labour market regulations was introduced across Europe, prohibiting night work for women and children, prohibiting child labour below certain ages, and introducing factory inspections. The period also saw the widespread introduction of old age, sickness and unemployment insurance schemes. In countries such as Belgium, governments incorporating both labour and business interests reached agreements whereby business would support the introduction of such a 'labour compact', in return for labour supporting the maintenance of free trade. Similarly, post-1945 economic growth in Europe and elsewhere was largely based on an implicit 'grand bargain' between labour, capital and government, involving the provision of modern welfare states to insulate workers from the risks of the market economy.

The lesson for today is that if workers feel that their interests are being furthered by governments implementing appropriate domestic economic policies, then they are not necessarily hostile to international trade. This is an important lesson from history, since western economies are now at a critical juncture as regards the political legitimacy of the market. In the past year we have seen public anger in Germany and elsewhere regarding tax evasion in Liechtenstein and other tax havens, outrage about executive pay and bonuses, and large tax bailouts to financial institutions as a result of a financial crisis that originated in United States but has since spread around the world, causing economic devastation. The fact that these bailouts will in many jurisdictions coincide with cutbacks in the public services on which poorer people disproportionately rely will also arouse justifiable anger. Some of this has nothing to do with globalization, while some is linked at least in part with the consequences of international capital mobility in its current form. Taken together with longer-run concerns about competition from China and elsewhere, and rising unemployment which will increase protectionist sentiment, it seems clear that we could be headed for a political ‘perfect storm’, unless governments can provide voters with reassurances that the market economy in general, and the international market economy in particular, can be made to work for them. Intelligent supporters of the market will favour, rather than oppose, reflation, regulation and redistribution in the months and years ahead.

6. The economic crisis of 2008 and the 21st century

If ever proof is needed that ‘history matters’, the Great Depression provides that proof. A series of policy errors, induced by the gold standard mentality, turned a severe recession into a worldwide depression, with catastrophic consequences. The Depression led directly to the election of Hitler, which in turn precipitated the horrors of World War II and the Holocaust, and the emergence of the bipolar world which was discussed earlier. It also led to the widespread introduction of barriers to trade, to a wave of defaults, and to the shutting down of international capital markets for several decades.

In the 12 months since world industrial production peaked, in April 2008, world industrial output and trade fell as rapidly as they did in the first 12 months following the June 1929 peak (Eichengreen and O’Rourke 2009). On the other hand, the policy response this time around has been much more aggressively reflationary, and at the time of writing there are signs that this may be bearing fruit, in that the period of freefall is at an end, and there are even some signs of bottoming out. Whether this marks the beginning of a durable recovery is as yet uncertain, however.

Continuing contraction in the real economy and rising unemployment risk feeding back to financial institutions, causing a second wave of financial crises which would in turn cause further problems for the real economy. The American consumer is retrenching, and it is still unclear as to who will emerge to replace him once governments stop filling the hole in demand he has left behind. There is a danger that governments will not intervene to clean up their banks decisively enough, leading to stagnation of the sort experienced in 1990s Japan; and a danger that financial regulation will also be long-fingered, implying even bigger risks in the future.

The threat to the international economy is obvious. As unemployment rises, the way in which we view exports is turned on its head. From being a necessary evil, required to pay for imports, they now become a valuable source of demand, while imports become a threat to local employment. Even worse, when governments consider reflating their economies through fiscal stimuli, they may worry that their own expenditures will merely serve to boost incomes elsewhere by sucking in imports. As the Irish Minister for Defence put it on January 4, 2008:

‘We tried the fiscal stimulus approach in response to the oil shock in the late seventies. The increased spending power given to the Irish consumer largely leaked out on increased imports and left us in an even worse position. There is absolutely no evidence to suggest that the same thing would not happen again… From Ireland's point of view, the best sort of fiscal stimulus are those being put in place by our trading partners. Ultimately these will boost demand for our exports without costing us anything.’

The incentive for individual countries to pursue protectionist policies is obvious, and a lot of the available historical evidence suggests that interwar protectionists were not completely irrational. For example, Clemens and Williamson (2004) find that in countries particularly badly hit by the Crash, high tariffs were associated with faster rather than with slower growth, other things being equal. One can well imagine that policymakers of the time would have been aware of this, without the benefit of regression analysis, and reacted accordingly.

However, the historical record also gives policymakers at least three compelling reasons not to give in to this protectionist temptation. The first is that interwar protection was beggar-thy-neighbour, and that what might have been individually rational was collectively damaging, even in the short term. The second is that these beggar-thy-neighbour policies had disastrous political consequences, for example undermining the more liberal elements in Japanese politics, and strengthening militarism there. The third is that interwar tariffs and quotas created or strengthened powerful import-competing interests in many countries, which often succeeded in locking in protectionism well into the late twentieth century, when it was certainly a long time past its sell-by date, whatever its impact on individual economies when pursued in isolation in the 1930s.

The main lesson of the interwar period is that if these dire consequences are not to come about, then getting the macroeconomics right is crucially important (Eichengreen and Irwin 2009). Thus far the policy response has been about as good as could have been expected, and this is the main reason to be cautiously optimistic about the future direction of the international economy.

7. Two scenarios

It seems clear that there are reasons both for optimism and for pessimism when looking ahead to the next quarter century. In a pessimistic scenario, the current economic crisis is allowed to drag on for far too long, perhaps exacerbated by premature tightening of fiscal and/or monetary policy in key economies. This will heighten protectionist pressures, pressures which as pointed out above are on the rise anyway. One obvious danger in Europe is that the ECB may be more hawkish than the Fed and Bank of England, leading to an overvalued Euro exchange rate: history shows that overvalued exchange rates are a potent force for protectionism. Alternatively, with the United States running out of 'fiscal room', a worsening economic environment there could lead to further stimulus packages being explicitly linked to protectionist measures of one sort or another. Presumably the WTO would not immediately collapse, but in a pessimistic scenario it would gradually become less relevant to member states, and more ineffectual.

The danger would then be that eventually – not in the next five or ten years, but perhaps by 2030 – this weakening commitment to multilateralism would start to collide with some of the longer run trends identified above, notably resource scarcity and an increasingly multipolar world. In such a context, countries might start to seriously worry about the ability of the market to provide them with the food and raw materials necessary for their survival, and in the worst of all scenarios they might start to link such worries with broader concerns about strategic rivalries. The bottlenecks and chokeholds on international trade which played such an important role in economic history in the past would make a dramatic comeback. We can easily imagine the ways in which Russo-European relations could be soured in such circumstances, but Kaplan (2009) points out that there is tremendous potential for Sino-Indian conflict in the Indian Ocean. On the one hand, "Zhang Ming, a Chinese naval analyst, has warned that the 244 islands that form India's Andaman and Nicobar archipelago could be used like a "metal chain" to block the western entrance to the Strait of Malacca, on which China so desperately depends" (*ibid.*). On the other hand, the Chinese response to their dependence on Malacca, which is to build a series of ports in Bangladesh, Pakistan and Burma, is heightening India's fears of being encircled by its main Asian rival. The similarities with Anglo-German rivalry before 1914 are unnerving. Other potential flashpoints obviously include the Suez Canal and the Arctic; while the Malagasay example highlights the potential for a 21st century ‘scramble for Africa’, with all the risks which that implies, if faith in multilateral trade is allowed to collapse.

There are also more benign scenarios which one could envisage. A successful international policy response to the crisis could prove to ordinary voters that multilateral action works, and that other countries represent opportunities rather than threats. A process could be set in motion, as the Chinese are suggesting it should, towards setting up a more symmetric international monetary system. Franco-German calls for a more effective international regulatory framework might bear fruit. Together with the refoundation of the world’s multilateral institutions, including setting up an inclusive and democratically legitimate version of the G-20, all of this might help strengthen world governance at a time when future geopolitical trends make this absolutely necessary. In turn, such political structures could help the world deal collectively with the energy and resource problems which will inevitably become more important as the century progresses.

Nothing is set in stone. The choices politicians make matter, for better or for worse. They will matter more than usual over the next five years, and will play an important role in determining which of these two scenarios is more likely to characterise the world in 2030.

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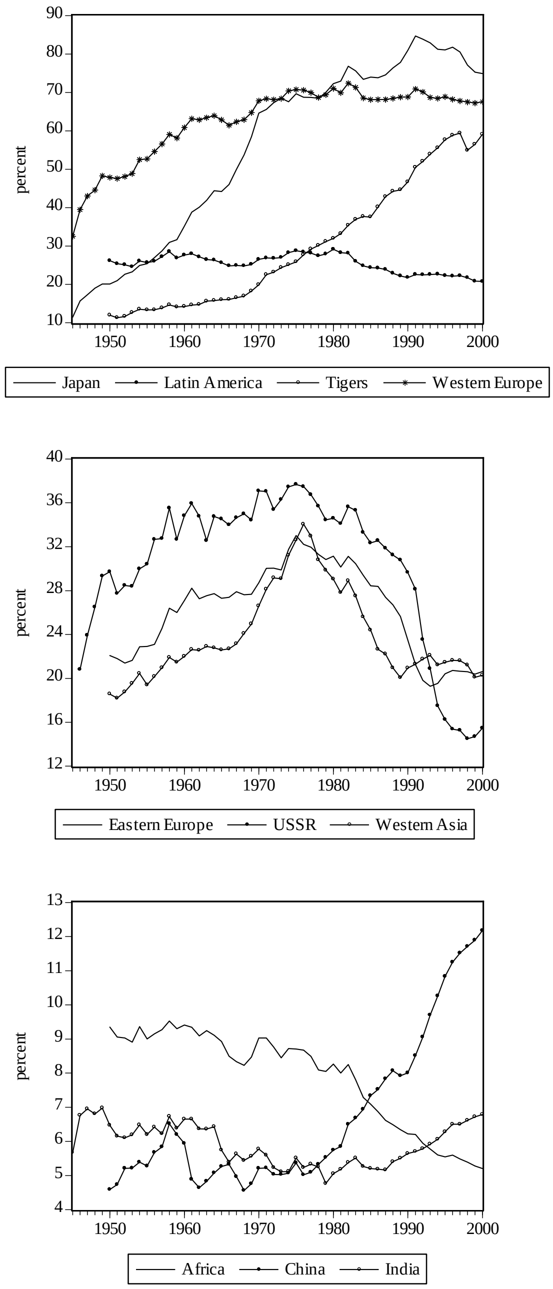

Figure 1. Regional GDP per capita, 1945-2000

(percent of USA)

Source: Maddison (2003).

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