



THE FUTURE OF GLOBALIZATION: A TRANSATLANTIC PERSPECTIVE

by Harold James

Are we at a turning point in the development of globalization? Is the twenty-first century going to be very different from the late twentieth century? Martin Wolf wrote on March 28, 2008, in the *Financial Times*:

“Remember Friday, March 14, 2008: it was the day the dream of global free-market capitalism died. For three decades we have moved towards market-driven financial systems. By its decision to rescue Bear Stearns, the Federal Reserve, the institution responsible for monetary policy in the US, chief protagonist of free-market capitalism, declared this era over. It showed in deeds its agreement with the remark by Josef Ackermann, chief executive of Deutsche Bank, that ‘I no longer believe in the market’s self-healing power.’ Deregulation has reached its limits.”

Until very recently, globalization appeared to be quite robust. It seemed easily to have survived the shock of 9/11. There has been no repeat of the contagious emerging market crises of 1997-98. The credit market anxieties of 2007 produced little echo in Asian emerging markets, with the result that many commentators began to speak of a “decoupling.” The resilience of the world economy is sometimes, but erroneously, interpreted as a demonstration of the inexorable character of globalization. In reality, there are great vulnerabilities.

Many of the former advocates of globalization in the business and political world of the advanced industrial countries are now deeply worried, because in their countries globalization seems to be responsible both for job losses and pay reductions, as well as for apparently illegitimate rewards for the owners of scarce resources, in particular superstars with a reputation, whether sports or entertainment stars, or CEOs who market themselves like superstars. Whereas until recently the most dramatic effects of globalization were seen in the market for unskilled labor, and consequently most policy thinkers simply saw better training as an answer, it has become clear that skilled service jobs (most conspicuously in computer software but also in medical and legal analysis) can also be “outsourced.” Consequently, the gigantic Western middle class--the great winner of the twentieth century--is now extremely alarmed by the prospect that it might be overtaken by an even larger (and harder working) middle class in emerging market countries. The result is not only a political backlash, but also an intense populist concern in the rich industrial countries with corporate governance, corporate abuses, and the excesses of executive pay. The new backlash naturally terrifies business leaders, who want to devise some appropriate response that will not hurt them too much. Events such as the World Economic Forum, formerly parodied as the fiesta of pro-globalization fanatics, are now packed with presentations by globalization critics and choruses about corporate social responsibility. It is hard to find defenders of classical rule-bound liberalism at events such as Davos: the readiness with which global captains of business embrace their opponents reminds me rather of the way in which the Florentine ruling and banking house of Medici sponsored the most vociferous and radical critic of commercial culture, the Dominican friar Girolamo Savonarola.

In other words, the world’s globalizers are suffering a collective loss of nerve. They are right to be uncertain and nervous. There is nothing inexorable about globalization. Past episodes ended badly. One of the comfort blankets that modern people sometimes clutch is the idea that there was only ever one big simultaneous world depression, produced by such an odd confluence of causes as to be quite unique: the legacy of World War I and of the financial settlement of reparations and war debt; the chaotic banking system of the largest economy of the world, the United States; and inexperience in handling monetary policy in a world that was still pining for metallic money. Since these circumstances were so unique, they can’t occur again. Historians should say that this reasoning may be quite wrong.

A great deal of the historically informed literature on globalization makes the point that there were several previous eras of

increased worldwide integration that came to a halt, and were reversed, with painful consequences. The most familiar precedent for modern globalization is that of the late nineteenth and early twentieth centuries, that ended definitively with the interwar Great Depression. But there were also earlier epochs of integration: the Roman empire, the economic rebound of the late fifteenth and early sixteenth centuries (the economic backdrop to the Renaissance), or the eighteenth century, in which improved technology and increased ease of communications opened the way to global empires (for Britain and France). All of these previous globalization episodes ended, almost always with wars. Globalization is often supposed to have produced a universalization of peace, since only in a peaceful world can trade and an interchange of ideas really flourish. But in practice globalization of goods and capital and people often leads to a globalization of violence.

The world of the new millennium is very different from the world of the 1990s, in which the “globalization paradigm” best captures the movement of world events.

In the world of globalization, small states do best, because they are more flexible and can adjust easily to rapidly changing markets. The winners of the 1990s were small states such as New Zealand, Chile, and Dubai, or in Europe, Ireland, the Baltic Republics, Slovenia, and Slovakia. But such states are vulnerable, and the historical stage of the past is littered with small and successful globalizers that lost out because of power politics: the Italian city states of the Renaissance, the Dutch Republic, or in the twentieth century, Lebanon or Kuwait.

In today’s world, it looks as if the new winners are big states with large population and rapid growth: Brazil, Russia, India and China--the so-called BRICs (which might be termed Big Really Imperial Countries). Recently, Russian Foreign Minister Sergei Lavrov argued that “for the first time in many years, a real competitive environment has emerged on the market of ideas” between “different value systems and different models”. In other words, there is a newly vibrant power-driven and authoritarian model of development.

The BRICs project power more easily, but they also need to project power to compensate for their weaknesses. Three obvious flaws that afflict these big globalizers much more than the small globalizers who had done so well earlier are: First, how can these highly populous countries integrate their poor and ill-educated underclass (in China and India mostly rural) as they engage with world markets? Second, China and Russia have financial systems that lack transparency, while Brazil and India are financially underdeveloped: these flaws put further integration in the world economy at risk and make for a vulnerability to financial crisis. Third, Russia is already facing massive demographic decline and an ageing and sickening population; China faces the near certainty of a Japanese-style demographic downturn from the 2040s as a belated legacy of the one-child policy. Flawed geopolitical giants have in the past been a source of instability (Germany before World War I is an obvious analogy). There are good reasons to see them presenting increased risk in the twenty-first century future.

In a world in which there is a new preference for power, even moderate size states, such as the traditional big European states or Japan, are not big enough to act effectively on their own. The helplessness is especially visible in current debates over European energy policy. Britain, France or Germany (let alone the much smaller central European countries) cannot tackle issues such as the pipeline without a collective negotiating stance. The resulting sense of impotence adds to the political paralysis, especially in countries that emphasize the centrality of democratic control. There is a curious echo of the mood at the previous turn of the century. In 1891, the German economist Gustav Schmoller wrote:

“Anyone far sighted enough to realize that the history of the twentieth century will be shaped by the competition between the Russian, British, American, and perhaps also the Chinese world empires and by their aspirations to make all other, smaller states dependent on them will also see in a central European customs association the nucleus that will save from destruction not only the political independence of these states but also the superior and ancient culture of Europe.”

What about financial globalization? There are two aspects which make me think that the intrusion of power into the globalization process has major consequences. One is the emergence of a new form of concentrated wealth in the form of the Sovereign Wealth Funds (SWFs). The central driver of late-twentieth-century globalization were the capital markets. But in the new millennium, capital markets are no longer effectively an arena in which outcomes result from the interplay of millions of independent guesses, decisions or strategies. Instead, the central banks of emerging markets and new sovereign wealth funds provide so much of the market that they have come to dominate it. When entities of such a size make decisions, they are bound to act in a strategic way. All the parties begin to suspect political manipulation.

Even without the politics, the simple size of the SWFs makes them a major actor in financial markets. With a capital of at least \$2.5 trillion, they are larger than the world total of hedge funds, and are large enough to move global markets. They have in part funded the big expansion of global stock markets over the past five years. The total world stock market capitalization was only \$20.4 trillion in September 2002, but is currently \$63 trillion (October 2007). In effect, the flow of savings from emerging markets has driven the global equities boom that followed the collapse of the dot-com bubble, so that big emerging market states are directing the capital flows that are used to finance payments and budget deficits of the world’s industrial economies.

The second concerns the setting in which financial institutions operate. Again, we can and should learn from the past, and in particular from episodes when globalization collapsed. In 1931 a small country crisis in Austria, following the collapse of the Vienna Creditanstalt, set off ripples that brought financial crises to all of central Europe, and then to Britain and the United States.

The risks that blew up the early-twentieth-century version of financial globalization are even more acute at the beginning of the twenty-first century. There has been a rapid proliferation of small offshore financial centers that practice new forms of financial intermediation. The most striking, but not the only example, is Iceland.

In the new millennium, a rapid financial liberalization meant that Icelandic banks expanded very rapidly into international activities. As recently as 2001, foreign loans were less than 4 percent of bank lending. There was a sharp crisis of confidence in the summer of 2006. But at that time, the rating agency Moody's referred to the banks' assets as consisting of "high-quality external foreign investments." Bank profits were high; and the risk-based capital adequacy calculations showed a steady improvement. Despite the tremors of 2006, foreign money continued to pour in through 2007, though the current account deficit fell from the record level of 27 percent in 2006 to 13 percent.

The Icelandic Big Three banks grew so quickly that they became impossible for the domestic government to rescue. In 2007, the assets of Glitnir amounted to \$47.4 billion, of Landsbanki \$49.1 billion, and of Kaupthing \$63.6 billion. Compare this to the GDP of Iceland of \$15.6 billion (2006). But Iceland is not alone. Switzerland's UBS had at the end of 2007 assets of \$2018 billion, again round about five times Swiss GDP (\$413.9 billion). Germany? Deutsche Bank had assets of Euro 2,020 billion, only slightly less than the German GDP (2,420 billion).

In a world of pure financial globalization, such figures should not matter, as long as the risks are properly assessed and the assets are sound. The calculation changed on March 14, 2008, as a response to the bailout of Bear Stearns. Bear Stearns showed Americans, as Northern Rock had shown the British, that in the end the government was so nervous about the possibility of financial panic that it would stand behind the entire banking system. This has brought a relatively rapid restoration of confidence. We now know that the really bad problems of big countries will be socialized, as they were in Japan in the 1990s. In Japan, this cost 15 percent of GDP; the estimates are that it will be some 7 percent of U.S. GDP.

International banks located in smaller centers are in a much more difficult position than over-stretched investment banks at the core. Their host governments simply cannot afford a Bear Stearns type of bailout, since it would involve not a percentage but a multiple of GDP. Financial crisis and the need for bailouts has brought back the state, but it is the big and powerful state.

In the interwar period, there was some political recognition of the particular problems of small countries and their capacity to pose a systemic threat. The newly established Bank for International Settlements did give a small loan to Austria in 1931, but it did not cover even the very first and grossly under-estimated calculation of the Creditanstalt losses. But the BIS did not have the size or the legitimacy to undertake bigger rescue operations.

In the aftermath of the contagious Asian crises of 1997-98, which bore some similarities to the central European debacle of 1931, critics on both the right and the left criticized the big bailouts orchestrated by the IMF. As a consequence, the IMF has been scaling back on its activities, and it is widely perceived as being marginal to global financial stability. The result is that there is--as in the early 1930s--no politically realistic way of preventing small inadequately regulated offshore centers developing into a risk for the whole world economy. The risks of globalization have increased.

Both the rise of the SWFs and the new importance of big countries as the last backstop of the financial system have changed the way electorates and politicians view globalization. The pendulum is indeed swaying away from the marketplace, which has inherently democratic qualities, and toward big states and big power. And in many parts of the world that means a new authoritarianism.

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