

Sinking Globalization

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TORPEDOED

Ninety years ago this May, the German submarine U-20 sank the Cunard liner Lusitania off the southern coast of Ireland. Nearly 1,200 people, including 128 Americans, lost their lives. Usually remembered for the damage it did to the image of imperial Germany in the United States, the sinking of the Lusitania also symbolized the end of the first age of globalization.

From around 1870 until World War I, the world economy thrived in ways that look familiar today. The mobility of commodities, capital, and labor reached record levels; the sea-lanes and telegraphs across the Atlantic had never been busier, as capital and migrants traveled west and raw materials and manufactures traveled east. In relation to output, exports of both merchandise and capital reached volumes not seen again until the 1980s. Total emigration from Europe between 1880 and 1910 was in excess of 25 million. People spoke euphorically of "the annihilation of distance."

Then, between 1914 and 1918, a horrendous war stopped all of this, sinking globalization. Nearly 13 million tons of shipping were sent to the bottom of the ocean by German submarine attacks. International trade, investment, and migration all collapsed. Moreover, the attempt to resuscitate the world economy after the war's end failed. The global economy effectively disintegrated with the onset of the Great Depression and, after that, with an even bigger world war, in which astonishingly high proportions of production went toward perpetrating destruction.

It may seem excessively pessimistic to worry that this scenario could somehow repeat itself--that our age of globalization could collapse just as our grandparents' did. But it is worth bearing in mind that, despite numerous warnings issued in the early twentieth century about the catastrophic consequences of a war among the European great powers, many people--not least investors, a generally well-informed class--were taken completely by surprise by the outbreak of World War I. The possibility is as real today as it was in 1915 that globalization, like the Lusitania, could be sunk.

BACK TO THE FUTURE

The last age of globalization resembled the current one in numerous ways. It was characterized by relatively free trade, limited restrictions on migration, and hardly any regulation of capital flows. Inflation was low. A wave of technological innovation was revolutionizing the communications and energy sectors; the world first discovered the joys of the telephone, the radio, the internal combustion engine, and paved roads. The U.S. economy was the biggest in the world, and the development of its massive internal market had become the principal source of business innovation.

China was opening up, raising all kinds of expectations in the West, and Russia was growing rapidly.

World War I wrecked all of this. Global markets were disrupted and disconnected, first by economic warfare, then by postwar protectionism. Prices went haywire: a number of major economies (Germany's among them) suffered from both hyperinflation and steep deflation in the space of a decade. The technological advances of the 1900s petered out: innovation hit a plateau, and stagnating consumption discouraged the development of even existing technologies such as the automobile. After faltering during the war, overheating in the 1920s, and languishing throughout the 1930s in the doldrums of depression, the U.S. economy ceased to be the most dynamic in the world. China succumbed to civil war and foreign invasion, defaulting on its debts and disappointing optimists in the West. Russia suffered revolution, civil war, tyranny, and foreign invasion. Both these giants responded to the crisis by donning the constricting armor of state socialism. They were not alone. By the end of the 1940s, most states in the world, including those that retained political freedoms, had imposed restrictions on trade, migration, and investment as a matter of course. Some achieved autarky, the ideal of a deglobalized society. Consciously or unconsciously, all governments applied in peacetime the economic restrictions that had first been imposed between 1914 and 1918.

The end of globalization after 1914 was not unforeseeable. There was no shortage of voices prophesying Armageddon in the prewar decades. Many popular writers earned a living by predicting a cataclysmic European war. Solemn Marxists had long foretold the collapse of capitalism and imperialism. And Social Darwinists had looked forward eagerly to a conflagration that would weed out the weak and fortify the strong.

Yet most investors were completely caught off guard when the crisis came. Not until the last week of July 1914 was there a desperate dash for liquidity; it happened so suddenly and on such a large scale that the world's major stock markets, New York's included, closed down for the rest of the year. As *The Economist* put it at the time, investors and financial institutions "saw in a flash the meaning of war." The Dow Jones Industrial Average fell by about 25 percent between January 1910 and December 1913 and remained flat through the first half of 1914. European bond markets, which had held up throughout the diplomatic crises of the 1900s, crashed only at the 11th hour, as the lights went out all over Europe.

Some economic historians detect the origins of the deglobalization that followed World War I in the prewar decades. They point, variously, to rising tariffs and restrictions on migration, a slight uptick in inflation starting around 1896, and the chronic vulnerability of the U.S. economy to banking crises. To this list, it might be added that the risk of further Russian and Chinese revolutions should have been fairly apparent after those of 1905 and 1911, respectively.

The trouble is that none of these problems can be said to have caused the great conflagration that was World War I. To be sure, the prewar world was marked by all kinds of economic rivalries--not least between British and German manufacturers--but these did not suffice to cause a disaster. On the contrary, businessmen on both sides agreed that a major war would be an economic calamity. The point seemed so obvious that war came to be seen by some optimistic commentators as all but impossible--a

"great illusion," in the famous phrase of the author Norman Angell. Even when the war broke out, many people optimistically clung to the illusion that it would soon be over. Economist John Maynard Keynes said that it "could not last more than a year."

With the benefit of hindsight, however, five factors can be seen to have precipitated the global explosion of 1914-18. The first cause was imperial overstretch. By 1914, the British Empire was showing signs of being a "weary Titan," in the words of the poet Matthew Arnold. It lacked the will to build up an army capable of deterring Germany from staging a rival bid for European hegemony (if not world power). As the world's policeman, distracted by old and new commitments in Asia and Africa, the United Kingdom's beat had simply become too big.

Great-power rivalry was another principal cause of the catastrophe. The problem was not so much Anglo-German rivalry at sea as it was Russo-German rivalry on land. Fear of a Russian arms buildup convinced the German general staff to fight in 1914 rather than risk waiting any longer.

The third fatal factor was an unstable alliance system. Alliances existed in abundance, but they were shaky. The Germans did not trust the Austrians to stand by them in a crisis, and the Russians worried that the French might lose their nerve. The United Kingdom's actions were impossible to predict because its ententes with France and Russia made no explicit provisions for the eventuality of war in Europe. The associated insecurities encouraged risk-taking diplomacy. In 1908, for example, Austria-Hungary brusquely annexed Bosnia. Three years later, the German government sent the gunboat Panther to Agadir to challenge French claims to predominance in Morocco.

The presence of a rogue regime sponsoring terror was a fourth source of instability. The chain of events leading to war, as every schoolchild used to know, began with the assassination of the Austrian Archduke Franz Ferdinand in Sarajevo by a Bosnian Serb, Gavrilo Princip. There were shady links between the assassin's organization and the Serbian government, which had itself come to power not long before in a bloody palace coup.

Finally, the rise of a revolutionary terrorist organization hostile to capitalism turned an international crisis into a backlash against the global free market. The Bolsheviks, who emerged from the 1903 split in the Russian Social Democratic Party, had already established their credentials as a fanatical organization committed to using violence to bring about world revolution. By straining the tsarist system to the breaking point, the war gave Lenin and his confederates their opportunity. They seized it and used the most ruthless terrorist tactics to win the ensuing civil war.

PARALLEL UNIVERSE

There are obvious economic parallels between the first age of globalization and the current one. Today, as in the period before 1914, protectionism periodically challenges the free-trade orthodoxy. By the standards of the pre-1914 United Kingdom, in fact, the major economies are already shamelessly protectionist when it comes to agriculture. Then, the United Kingdom imposed no tariffs on imported

agricultural goods, whereas now the United States, the European Union, and Japan all use tariffs and subsidies to protect their farmers from foreign competition.

Today, no one can be sure how stable the international monetary system is, but one thing is certain: it is no more stable than the system that preceded World War I. Although gold is no longer the basis of the monetary system, there are pegged exchange rates, just as there were in 1914. In Europe, there is a monetary union--essentially a deutsche mark zone. In eastern Asia, there is a dollar standard. Both systems, however, are based on fiat currencies. Unlike before 1914, the core central banks in New York and Frankfurt determine the volume of currency produced, and they do so on the basis of an opaque mixture of rules and discretion.

Today, technological innovation shows no sign of slackening. From nanocomputers the size of a pinhead to scramjets that can cross the Atlantic in an hour, there seems no limit to human ingenuity, given sufficient funding of research and development. That is the good news. The bad news is that now technology also helps the enemies of globalization. Before 1914, terrorists had to pursue their bloody trade with Browning revolvers and primitive bombs. These days, an entire city could be obliterated with a single nuclear device.

Today, as before 1914, the U.S. economy is the world's biggest, but it is now much more important as a market for the rest of the world than it was then. Although the United States may enjoy great influence as the "consumer of first resort," this role depends on the willingness of foreigners to fund a widening current account deficit. A rising proportion of Americans may consider themselves to have been "saved" in the Evangelical sense, but they are less good at saving in the economic sense. The personal savings rate among Americans stood at just 0.2 percent of disposable personal income in September 2004, compared with 7.7 percent less than 15 years ago. Whether to finance domestic investment (in the late 1990s) or government borrowing (after 2000), the United States has come to rely increasingly on foreign lending. As the current account deficit has widened (it is now approaching 6 percent of GDP), U.S. net overseas liabilities have risen steeply to around 25 percent of GDP. Half of the publicly held federal debt is now in foreign hands; at the end of August 2004, the combined U.S. Treasury holdings of China, Hong Kong, Japan, Singapore, South Korea, and Taiwan were \$1.1 trillion, up by 22 percent from the end of 2003. A large proportion of this increase is a result of immense purchases by eastern Asian monetary authorities, designed to prevent their currencies from appreciating relative to the dollar.

This deficit is the biggest difference between globalization past and globalization present. A hundred years ago, the global hegemon--the United Kingdom--was a net exporter of capital, channeling a high proportion of its savings overseas to finance the construction of infrastructure such as railways and ports in the Americas, Asia, Australasia, and Africa. Today, its successor as an Anglophone empire plays the diametrically opposite role--as the world's debtor rather than the world's creditor, absorbing around three-quarters of the rest of the world's surplus savings.

Does this departure matter? Some claim it does not--that it just reflects the rest of the world's desire to have a piece of the U.S. economic action, whether as owners of low-risk securities or sellers of underpriced exports. This is how Harvard economist

Richard Cooper sees it. Assuming that the U.S. economy has a trend rate of growth of 5 percent a year, he argues that a sustained current account deficit of \$500 billion per year would translate into external liabilities of 46 percent of GDP after 15 years, but that then U.S. foreign debt would "decline indefinitely."

Well, maybe. But what if those assumptions are wrong? According to the hsbc Group, the current account deficit could reach 8 percent of GDP by the end of the decade. That could push the United States' net external liabilities as high as 90 percent of GDP. When the United Kingdom accumulated net foreign debts of less than half this percentage, it was fighting World War II. In the war's aftermath, the resulting "sterling balances" owned by the rest of the world were one of the reasons the pound declined and lost its reserve currency status.

A sharp depreciation of the dollar relative to Asian currencies might not worry the majority of Americans, whose liabilities are all dollar-denominated. But its effect on Asia would be profound. Asian holders of dollar assets would suffer heavy capital losses in terms of their own currencies, and Asian exporters would lose some of their competitive advantage in the U.S. market. According to Michael Mussa of the Institute for International Economics, lowering the U.S. deficit to 2 percent of GDP over the next few years would require a further 20 percent decline in the dollar. The economists Maurice Obstfeld and Kenneth Rogoff estimate that the fall could be as much as 40 percent. And the University of California at Berkeley's Brad de Long has pointed out that,

[i]f the private market--which knows that with high probability the dollar is going down someday--decides that that someday has come and that the dollar is going down now, then all the Asian central banks in the world cannot stop it [emphasis in original].

That day may be fast approaching. In the words of Federal Reserve Board Chairman Alan Greenspan last November, "the desire of investors to add dollar claims to their portfolios" must have a limit; a "continued financing even of today's current account deficits ... doubtless will, at some future point, increase shares of dollar claims in investor portfolios to levels that imply an unacceptable amount of concentration risk."

The domestic effects of a dollar crash would be felt most sharply by the growing numbers of Americans with large mortgage debts who would suddenly face a rise in interest rates. The growth in the share of variable-rate mortgages in the volume of total household debt is seen by some as a sign that the U.S. mortgage market is growing more sophisticated. But it also increases the sensitivity of many American families to rises in the rates. The federal government has a pretty large variable-rate debt, too, given the very short maturities of a large proportion of federal bonds and notes. That fact means that higher rates could quickly affect the deficit itself, creating a dangerous feedback loop. And, of course, higher rates would be likely to lower growth and hence reduce tax revenues. In short, today's international fiat-money system is significantly, and dangerously, crisis-prone.

Another cause for concern is the fragility of China's financial system. This Asian miracle is unlikely to avoid the kind of crisis that marked the Asian miracles of the past. To get a sense of the dangers, consider China's Soviet-style domestic banking

system and its puny domestic stock market: how can such rapid growth in manufacturing possibly be sustained with such inadequate financial institutions?

Pre-1914 globalization was remarkably susceptible to the international transmission of crises--what economists call "contagion." So is globalization nowadays. As Andrew Large of the Bank of England pointed out last November, the "search for yield" in an environment of low interest rates is encouraging investors, banks, and hedge funds to converge on similar trading strategies, raising "the prospect of one-way markets developing and market liquidity evaporating in response to a shock."

GHOSTS FROM THE PAST

As the economic parallels with 1914 suggest, today's globalization shows at least some signs of reversibility. The risks increase when one considers the present political situation, which has the same five flaws as the pre-1914 international order: imperial overstretch, great-power rivalry, an unstable alliance system, rogue regimes sponsoring terror, and the rise of a revolutionary terrorist organization hostile to capitalism.

The United States--an empire in all but name--is manifestly overstretched. Not only is its current account deficit large and growing larger, but the fiscal deficit that lurks behind it also is set to surge as the baby boomers retire and start to claim Social Security and Medicare benefits. The Congressional Budget Office (cbo) projects that over the next four decades, Social Security, Medicaid, and Medicare spending will rise to consume at least an additional 12 percent of GDP per year. The cbo also estimates that the transition costs of President George W. Bush's planned Social Security reform, if enacted, could create a budget shortfall of up to two percent of GDP a year for ten years. Add that to the fiscal consequences of making the president's first-term tax cuts permanent, and it becomes hard to imagine how the country will manage to stem the rising tide of red ink.

The U.S. empire also suffers from a personnel deficit: 500,000 troops is the maximum number that Washington can deploy overseas, and this number is simply not sufficient to win all the small wars the United States currently has (or might have) to wage. Of the 137,000 American troops currently in Iraq, 43 percent are drawn from the reserves or the National Guard. Even just to maintain the U.S. presence in Iraq, the Army is extending tours of duty and retaining personnel due to be discharged. Such measures seem certain to hurt re-enlistment rates.

Above all, the U.S. empire suffers from an attention deficit. Iraq is not a very big war. As one Marine told his parents in a letter home,

compared to the wars of the past, this is nothing. We're not standing on line in the open--facing German machine guns like the Marines at Belleau Wood or trying to wade ashore in chest-deep water at Tarawa. We're not facing hordes of screaming men at the frozen Chosun Reservoir in Korea or the clever ambushes of Vietcong. We deal with potshots and I.E.D.'s [improvised explosive devices].

He was right; the Iraq war is more like the colonial warfare the British waged 100 years ago. It is dangerous--the author of that letter was killed three weeks after he

wrote it--but it is not Vietnam or Korea, much less the Pacific theater in World War II. Yet the Iraq war has become very unpopular very quickly, after relatively few casualties. According to several polls, fewer than half of American voters now support it. And virtually no one seems to want to face the fact that the U.S. presence in Iraq--and the low-intensity conflict that goes with imperial policing--may have to endure for ten years or more if that country is to stand any chance of economic and political stabilization.

Then there is the second problem: great-power rivalry. It is true that the Chinese have no obvious incentive to pick a fight with the United States. But China's ambitions with respect to Taiwan are not about to disappear just because Beijing owns a stack of U.S. Treasury bonds. On the contrary, in the event of an economic crisis, China might be sorely tempted to play the nationalist card by threatening to take over its errant province. Would the United States really be willing to fight China over Taiwan, as it has pledged in the past to do? And what would happen if the Chinese authorities flexed their new financial muscles by dumping U.S. bonds on the world market? To the historian, Taiwan looks somewhat like the Belgium of old: a seemingly inconsequential country over which empires end up fighting to the death. And one should not forget Asia's most dangerous rogue regime, North Korea, which is a little like pre-1914 Serbia with nuclear weapons.

As for Europe, one must not underestimate the extent to which the recent diplomatic "widening of the Atlantic" reflects profound changes in Europe, rather than an alteration in U.S. foreign policy. The combination of economic sclerosis and social senescence means that Europe is bound to stagnate, if not decline. Meanwhile, Muslim immigration and the prospect of Turkey's accession to the European Union are changing the very character of Europe. And the division between Americans and Europeans on Middle Eastern questions is only going to get wider--for example, if the United States dismisses the European attempt to contain Iran's nuclear ambitions by diplomatic means and presses instead for military countermeasures.

These rivalries are one reason the world today also has an unstable alliance system (problem number three). Nato's purpose is no longer clear. Is it just an irrelevant club for the winners of the Cold War, which former Soviet satellites are encouraged to join for primarily symbolic reasons? Have divisions over Iraq rendered it obsolete? To say the least, "coalitions of the willing" are a poor substitute.

None of these problems would necessarily be fatal were it not for the fourth and fifth parallels between 1914 and today: the existence of rogue regimes sponsoring terror--Iran and Syria top the list--and of revolutionary terrorist organizations. It is a big mistake to think of al Qaeda as "Islamofascist" (as the journalist Christopher Hitchens and many others called the group after the September 11, 2001, attacks). Al Qaeda's members are much more like "Islamobolsheviks," committed to revolution and a reordering of the world along anti-capitalist lines.

Like the Bolsheviks in 1914, these Islamist extremists are part of an underground sect, struggling to land more than the occasional big punch on the enemy. But what if they were to get control of a wealthy state, the way Lenin, Trotsky, and company did in 1917? How would the world look if there were an October Revolution in Saudi Arabia? True, some recent survey data suggest that ordinary Saudis are relatively

moderate people by the standards of the Arab world. And high oil prices mean more shopping and fewer disgruntled youths. On the other hand, after what happened in Tehran in 1979, no one can rule out a second Islamist revolution. The Saudi royal family does not look like the kind of regime that will still be in business ten years from now. The only monarchies that survive in modern times are those that give power away.

But is Osama bin Laden really a modern-day Lenin? The comparison is less far-fetched than it seems ("Hereditary Nobleman Vladimir Ulyanov" also came from a wealthy family). In a proclamation to the world before the recent U.S. presidential election, bin Laden declared that his "policy [was] bleeding America to the point of bankruptcy." As he explained, "al Qaeda spent \$500,000 on the [September 11 attacks], while America, in the incident and its aftermath, lost--according to the lowest estimate--more than \$500 billion. Meaning that every dollar of al Qaeda defeated a million dollars, by the permission of Allah." Bin Laden went on to talk about the U.S. "economic deficit ... estimated to total more than a trillion dollars" and to make a somewhat uncharacteristic joke:

[T]hose who say that al Qaeda has won against the administration in the White House or that the administration has lost in this war have not been precise, because when one scrutinizes the results, one cannot say that al Qaeda is the sole factor in achieving those spectacular gains. Rather, the policy of the White House that demands the opening of war fronts to keep busy their various corporations--whether they be working in the field of arms or oil or reconstruction--has helped al Qaeda to achieve these enormous results.

Two things are noteworthy about bin Laden's quip: one, the classically Marxist assertion that the war in Iraq was motivated by capitalist economic interests; and two, the rather shrewd--and unfortunately accurate--argument that bin Laden has been getting help in "bleeding America to the point of bankruptcy" from the Bush administration's fiscal policy.

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A doomsday scenario is plausible. But is it probable? The difficult thing--indeed the nearly impossible thing--is to predict a cataclysm. Doing so was the challenge investors faced in the first age of globalization. They knew there could be a world war. They knew such a war would have devastating financial consequences (although few anticipated how destructive it would be). But they had no way of knowing when exactly it would happen.

The same problem exists today. We all know that another, bigger September 11 is quite likely; it is, indeed, bin Laden's stated objective. We all know--or should know--that a crisis over Taiwan would send huge shockwaves through the international

system; it could even lead to a great-power war. We all know that revolutionary regime change in Saudi Arabia would shake the world even more than the 1917 Bolshevik coup in Russia. We all know that the detonation of a nuclear device in London would dwarf the assassination of Archduke Ferdinand as an act of terrorism.

But what exactly can we do about such contingencies, if, as with the Asian tsunami, we cannot say even approximately when they might occur? The opportunity cost of liquidating our portfolios and inhabiting a subterranean bunker looks too high, even if Armageddon could come tomorrow. In that sense, we seem no better prepared for the worst-case scenario than were the beneficiaries of the last age of globalization, 90 years ago. Like the passengers who boarded the Lusitania, all we know is that we may conceivably sink. Still we sail.