

**Global Shifts<sup>1</sup>**  
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Shifts happen. We are currently witnessing a major shift in the balance of economic, financial and political power from the advanced countries to emerging markets – from West to East, or from the West to the Rest. This is, of course, not the first time that we have observed this kind of global shift. The rise of the West from the 15<sup>th</sup> century and its concomitant, the decline of China, was itself an earlier instance, if mirror image, of this kind of shift. (See Figure 1.) The industrial revolution, which gave rise to what is sometimes called “The Great Divergence” (the growing divergence in manufacturing capability and in capacity to project power between the first countries to industrialize, principally in Europe, and other regions) marked another global shift. It is no coincidence that the first industrial nation, Great Britain, came to control fully a quarter of the world’s population and land mass by the end of the 19<sup>th</sup> century.<sup>2</sup> There was the shift in economic power from the pioneer industrializer, Britain, to followers like Germany that contributed to the economic and geopolitical tensions helping to set the stage for World War I. There is Charles Kindleberger’s thesis that that Great Depression of the 1930s was a consequence of the global shift in power from Britain to the United States, one that left an exhausted Britain incapable of managing the world economy and an inexperienced United States unwilling to do so.<sup>3</sup> There is the shift after World War II toward the two great superpowers, the United States and the Soviet Union, and the dominance of the U.S. over the Western world (Figure 2). There is then the relative decline of the United States owing to catch-up growth, first in Europe, next in Japan, and finally in East Asia and elsewhere, which gradually closed the per-capita-income gap. The current shift toward emerging markets like China and India (Figures 3 and 4) is usefully seen in this light.

This paper examines these earlier shifts in economic and political power and asks what light they shed on the implications of today’s global shift. I inquire into the sources of the shift, describe the tensions to which it gave rise, and ask how those tensions were managed. The answer to this last question, in two words, is “not well.” Global shifts have almost always fanned economic conflict, created problems for economic management, and heightened diplomatic tensions. Sometimes they have erupted into military conflict. While the same need not be true this time, there is reason to worry that the current global shift is a source of economic and political risks. It is past due time to start thinking about both the nature of those risks and mechanisms for managing them.

The causes and consequences of changes in economic fortune, both relative and absolute, probably constitute the central question of all of economic history, if not all of economics. One paper can do justice to neither the topic nor the literature. Rather than attempting to be comprehensive, I focus on a number of specific cases, those mentioned in the opening paragraph. While this requires me to touch on aspects of nearly a millennium of human history, my focus is mainly on the last two centuries, the period since the establishment of the Bank of Finland, the

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<sup>1</sup> Prepared for the Bank of Finland’s 200<sup>th</sup> anniversary symposium, Helsinki, May 5-6, 2011.

<sup>2</sup> And to “rule the waves.”

<sup>3</sup> As originally advanced in Kindleberger (1973).

event providing the occasion for this symposium. Coverage of these episodes is also necessarily selective and designed to highlight the themes sounded above.

## 1. The Rise of the West

Economic historians are unanimously of the view that Ming China was the leading economic power in 1400. No other country constructed the equivalent of the Great Wall or the Grand Canal. No other state or empire had a standing army with a million troops. China was known for its technological prowess and precocity – for its mastery of gunpower, printing, paper-making, and compasses. It was known for the long-distance commercial voyages of the great admiral Zheng He which served commercial purposes (many of his ships had private cabins for merchants) and also sought to extract tribute from other lands bordering the Indian Ocean.

Two factors then combined to set on foot a global shift. First, the Ming Dynasty turned inward. Zheng He's fleet was dismantled. Limits were placed on the size of newly-constructed ships. By the end of the 15<sup>th</sup> century, subjects of the Chinese empire were forbidden to construct ocean-going ships or to leave the country. The overland route west, the Silk Road, was all but closed to traffic. The Chinese met early European incursions by limiting contact to a handful of treaty ports.

Why the Mings turned inward is disputed. One view is that curtailing contact with the outside world was a low-cost way of dealing with piracy and the Uighurs. Another is that from the middle of the 15<sup>th</sup> century the Mings had bigger problems close at hand, like their border dispute with what is modern-day Vietnam. Still another is that this was the ill-advised decision of a clutch of conservative officials concerned about the impact on China of foreign influence.

But there is little disputing the consequences. China's inward turn created space for other powers. Lack of contact with foreign ideas, the absence of foreign competition, and the smothering effects of tradition set China up for a long period of economic stagnation.

The coincident factor was improved Western sailing, navigation and military technology. The key innovation was the caravel, a sailing ship developed by the Portuguese and then the Spanish that combined lateen (triangular) rigging, making it very maneuverable and able to sail up rivers, with square sails that made it very fast and able to cross oceans. Lateen sails came from the Arab lands, square ones from Northern Europe; the Iberians were strategically placed between the two influences. New navigational techniques developed by Arab, Indian and Jewish astronomers but systematized by the Portuguese allowed European ships to go anywhere. Finally, the Portuguese were quicker than others to adapt the use of canon to ocean-going vessels.

Why Portugal, one might ask? As with the Internet, public-sector R&D played a role. Prince Henry the Navigator of Portugal founded a maritime academy that fostered many of these innovations. He established an observatory at Sagres to construct accurate tables on the sun's declination.<sup>4</sup> The early voyages down the west coast of Africa were sponsored by the

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<sup>4</sup> From 1500 or so there was a growing accumulation of navigational data in a variety of countries (Spain, France, England), all of which saw the publication of practical pamphlets and guides on the subject.

Portuguese crown (just as Columbus' pioneering trans-Atlantic voyage was underwritten by Ferdinand and Isabella of Spain). The result was the Age of Exploration (sometimes referred, in less politically-correct terms, as the Age of Discovery), in which the Portuguese and Spanish found their way around Cape Horn to Asia and then across the Atlantic to the Americas.<sup>5</sup>

While the Portuguese had a head start, the Spanish had a larger economy. The two quickly came into conflict over trading posts, trade rights, and other commercial prerogatives. There was an effort to divide the spoils – to create separate spheres of influence not unlike the Western and Soviet blocs during the Cold War or the possibility, sometimes mooted today, of Chinese and U.S. spheres of influence in Asia and the West. The first such effort, the Treaty of Tordesillas signed by Spain and Portugal in 1494, divided the newly discovered territories of Africa and the Western Hemisphere. The dividing line ran north-south along a meridian roughly down the middle of the Atlantic before bisecting what became modern-day Brazil. This was followed in 1524 by the Treaty of Zaragoza, which similarly divided Asia and the Pacific along a north-south meridian running roughly through the middles of Japan and Australia.<sup>6</sup>

An unintended consequence of this spheres-of-influence strategy may be to permit the regional hegemon to grow fat and lazy. So it is said of Spain and Portugal following the conclusion of the two treaties.<sup>7</sup> This made room for hungry upstarts: England and the Netherlands. The Iberians were followed into the Indian Ocean by first the Dutch and then the English: the Dutch ended up controlling trading rights with much of modern-day Indonesia, the English with India. In the Western Hemisphere the Iberians were flanked to the north by the Dutch and, more importantly, English and French, who built their commercial empires on the basis of shipping and finance but in addition had manufactures (woolens) to export.

The upstarts also relied on strong institutions – national champions that enjoyed public-sector support. In 1602 the Dutch States General established the world's first joint-stock company, the Dutch East India Company, granting it not just a monopoly of trade with Asia but also the power to establish fortified trading posts, negotiate treaties, and wage defensive wars.<sup>8</sup> The company established a centralized hub in Batavia (now Jakarta), organized nearly 5,000 voyages, and paid its shareholders an annual dividend approaching 20 per cent for two centuries.<sup>9</sup> At virtually the same time Queen Elizabeth granted a royal charter to the (English) East Asia Company, which like its Dutch competitor acquired monopoly rights and, eventually, a

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<sup>5</sup> Why Europe, more generally, one might ask? Was the Renaissance conducive to the systematization of knowledge? Did the Black Death, by raising land-labor ratios, create surplus agricultural production that could be traded and higher living standards? These questions presumably deserve more than a footnote.

<sup>6</sup> The prod for this treaty was the conflict between the two countries over Malacca and the surrounding "spice islands" (the source of the region's valuable spices). Portugal arrived first, establishing a fort at Malacca in 1511. Spain then arrived in the Moluccas from the east in 1521 as part of Magellan's famous attempt to circumnavigate the globe, and Charles V sent another expedition to colonize the islands. There followed a year of fighting between the two countries. In 1524 the two kingdoms agreed to resolve the issue by drawing another meridian that would divide the world into two equal-sized hemispheres. To get it right, each crown appointed three astronomers, three pilots, and three mathematicians.

<sup>7</sup> See Kindleberger (1994) and Landes (1998).

<sup>8</sup> This, recall, was the age of mercantilism, when states sought to monopolize the trade of a region so as to generate monopoly profits which could then be used to strengthen the state's finances and its ability to wage war.

<sup>9</sup> Now there's a risk premium for you.

modern board of directors.<sup>10</sup> Using Surat in India as a transit point between the Spice Islands and Europe, the East Asia Company was responsible for Britain establishing its foothold in India. These two trading concerns, as joint-stock companies and public-private partnerships, were important institutional innovations. They were the agents of the power shift from Southern to Northern Europe and of Europe's growing influence and control over much of Southern Asia.

This situation – two aspirants infringing on the turf of two established powers, and the Europeans all seeking to establish exclusive access to the minerals, precious metals, and high-value crop-lands of other regions (spice- and sugar-growing land in particular) – was a recipe for conflict among the imperialists and between the Europeans and the indigenous peoples with whom they made contact.<sup>11</sup> In addition to nimble sailing ships and canon, the Europeans had on their side metallurgy (which furnished them with efficient swords and daggers) and infectious disease (which desimated previously isolated indigenous populations). In turn the imperialists were weakened by almost continuous internecine conflict. The rising Northern European powers fought for space and influence with both their Iberian predecessors and one another. When the English arrived in the Bandas and Moluccas, islands where cloves and nutmeg were grown, the Dutch drove them out by force.<sup>12</sup> The Dutch fought with Sultan Agung, who headed a powerful state in central Java, over the establishment of Batang. They took Ceylon from Portugal along with most of that country's Indian forts and trading stations. Similar stories could be told about the Western Hemisphere. Cooperation would have meant more surplus for the Europeans and indigenous peoples alike. But it was not to be.

The Dutch and English, having come into conflict over foreign policy and commercial interests (it is not clear that there was a clear separation between the two matters in this period), skirmished in Europe as well. The Dutch also attracted the enmity of France, which sided with England in its mid-17<sup>th</sup> century conflict with the United Provinces and then used import tariffs to protect its infant sugar and cloth industries from Dutch competition.<sup>13</sup> In the 18<sup>th</sup> century the French and English clashed over control of North America in the French and Indian Wars.<sup>14</sup> Military means were used repeatedly to bolster trade and create mercantilist preserves free of foreign competition. One worries that it could happen again.

## 2. The Great Divergence

The industrial revolution transformed the world economy by launching per capita incomes on a sustained upward path unlike anything seen previously. It also constituted a global shift *par excellence*. It widened the gap in economic and military capabilities between European countries whose ambitions had been restrained by a fragile balance of power. It also transformed the conduct of warfare. Within Europe, Germany's comparative advantage in the production of steel and, by implication, the construction of railways gave it a decisive advantage over France in the Franco-Prussian War of 1870-71. In the colonies, the invention of the Gatling gun, another

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<sup>10</sup> A Royal African Company was later formed to take charge of trade in slaves, ivory and gold in Africa.

<sup>11</sup> The scramble for scarce resources and associated possibility for conflict will resonate, presumably, with Chinese officials concerned about their country's dependence on imported raw materials.

<sup>12</sup> Helped importantly by their native allies.

<sup>13</sup> This, from the mid-17<sup>th</sup> century, being the age of high mercantilism.

<sup>14</sup> Leading to the Seven Years' War in Europe and indirectly, it is often said, to the French Revolutionary Wars.

byproduct of the industrial revolution, gave the Europeans a powerful advantage in their effort to secure colonial control of additional portions of Africa and Asia.<sup>15</sup>

Thus, it is no coincidence that the industrial revolution was followed by the new imperialism of the second half of the 19<sup>th</sup> century: by the partition of Africa by the European powers and their further colonial expansion into Asia. Crude Marxian accounts sometimes explain this new wave of colonialism and imperialism as a function of the voracious appetite of 19<sup>th</sup> century industrial economies for raw materials and the desire of governments to secure exclusive access to the same.<sup>16</sup> But modern economic histories cast doubt on the notion that empire paid: any benefits to the imperialists, including those associated with favored access to raw materials, were swamped by military and other costs.<sup>17</sup>

What industrialization did was greatly enhance the ability of industrial nations to project power and control other lands.<sup>18</sup> With the railway and the steamship (practical for ocean-going voyages in the second half of the 19<sup>th</sup> century, not incidentally coincident with the new imperialism), it became possible to deploy military force more quickly. Machined canny (now breech rather than muzzle loaded) and rifles (notably the caplock rifled musket) were for the 19<sup>th</sup> century what steel swords and daggers had been for the 16<sup>th</sup> and 17<sup>th</sup>. These innovations were decisive, for example, in the First Opium War of 1839-42.<sup>19</sup> With the Great Divergence in per capita incomes, it became possible for the industrial powers to raise larger and better equipped standing armies. European control of the interior of Africa or India might have been paper thin, but it would have been unimaginable in the absence of industrialization. Like 21<sup>st</sup> century Europeans who prefer to take part of their higher living standards in the form of increased leisure time, their 19<sup>th</sup> century predecessors sought to take a part in the form of colonial conquest.

This desire was a source of frustration to countries late to the great global game, Germany in particular. With the growth of its industry, and its comparative advantage in military-relevant heavy industry in particular, Germany became as capable as any European power at mobilizing and projecting force. But the process of industrialization reached critical mass later than in Britain or France.<sup>20</sup> German unification had to wait for Bismarck to incorporate the southern states. Thus, by the time Germany emerged as an industrial and military power of the first rank, the process of colonial partition was largely complete.

Germany therefore had to content itself with a few remaining scraps in West Africa, East Africa and the Pacific. It pushed against French and Spanish control in North Africa, precipitating the First Moroccan Crisis in 1905 by insisting that France adopt an open door policy for its protectorate, to little avail. It was left to advance its expansionist aims in and around Europe, notably attempting to expand its influence over the declining Ottoman Empire by completing the Berlin-Baghdad Railway, something that in turn became a geopolitical

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<sup>15</sup> The descendant of the hand-cranked Gatling gun was the automatic Maxim gun, invented in 1884.

<sup>16</sup> An interpretation that has obvious implications for China's actions in Africa and elsewhere in the developing world. There is also the more sophisticated variant of the hypothesis due to Eric Williams (Williams (1966).

<sup>17</sup> For the balance sheet see Davis and Huttenback (1986).

<sup>18</sup> David Landes in his 1998 book and earlier writings makes this argument most forcefully.

<sup>19</sup> See for example Hacker (1977).

<sup>20</sup> The classic account being Clapham (1936).

flashpoint.<sup>21</sup> Some accounts describe Germany's ambitions in terms of the need of an industrial economy to secure a reliable supply of energy and raw materials (oil in the case of the Ottoman Empire), something that will resonate with observers of China today. Most, however, understand it more in terms of naked imperial ambition.<sup>22</sup> Be this as it may, the result was the tensions and tangled alliances that set the stage for World War I.

Finance was enlisted not just in the construction of the Berlin-Baghdad Railway but more widely in the effort to advance geopolitical goals. Then like now, that influence might be more subtle than overt. Modern observers alarmed by the rise of sovereign wealth funds wonder whether those funds' governmental masters are encouraging them to invest in ways that are geopolitically expedient as well as economically remunerative. Before World War I, they saw governments, like those of France and Germany, encouraging private lending to Czarist Russia or the Ottoman Sultan with the goal of alliance building. Hints were dropped that the government would take it as a favor if an investment bank underwrote bond issues on behalf of such borrowers on favorable terms.<sup>23</sup> Sometimes governments might intervene directly to encourage or halt issuance on behalf of foreign governments. Between 1897 and 1901, for example, the French government intervened with the *Crédit Lyonnais*, discouraging it from issuing bonds on behalf of the Russian government until the Russian and French general staffs had agreed on the particular strategic railways to whose construction the proceeds would be put.

Employing finance for military and strategic purposes meant that it was not always allocated in ways that maximized returns. The fact that the French and German governments regularly intervened in the operations of the Paris and Berlin markets, whereas the British government employed a more hands-off attitude, helps to explain why the rate of return on French and German lending was generally lower than comparable returns on British overseas investment.<sup>24</sup> While financial might creates strategic opportunities for governments, in other words, exploiting those opportunities also has costs.<sup>25</sup>

With governments intervening in private financial affairs before the fact, they also felt some compulsion to come to the aid of the bondholders if and when things went wrong. Gunboats might then be dispatched to collect payments from defaulting debtors. Just how But while Mitchener and Weidenmier (2005) argue for the importance of these "supersanctions," they identify just 6 episodes of direct military intervention out of 43 default episodes spanning the 19<sup>th</sup> century. Other authors argue that when governments intervened militarily in response to default, they were in fact using financial events as a pretext for intervention desired on other grounds. They suggest that other mechanisms – ex ante monitoring by investment banks with reputations to protect and ex post exclusion from the bond market by a cohesive cartel of issuers – were more important for enforcing contracts.<sup>26</sup>

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<sup>21</sup> See Jastrow (1917).

<sup>22</sup> Something to which today's China, which prefers to keep a relatively low-key profile internationally, has not obviously fallen prey.

<sup>23</sup> For accounts of the practice see Feis (1930).

<sup>24</sup> This point is argued and documented in Fishlow (1986).

<sup>25</sup> Something for the managers of sovereign wealth funds to bear in mind.

<sup>26</sup> See inter alia Mauro, Sussman and Yafeh (2006) and Flandreau and Flores (2007).

### 3. The Rise of the United States

The other global shift at this time was the rise of the United States. From an economic speck at the outset of the 19<sup>th</sup> century, the U.S. by 1914 had grown into the world's largest economy and leading exporter. But while economic change was rapid, political adjustments lagged behind. The North American colonies had been settled by Europeans who had sought to distance themselves from the Old World. George Washington in his farewell address had emphasized the desirability of "as little political connection as possible" with foreign nations (while at the same time acknowledging the value of "extending" commercial relations).

Isolationist instincts, in other words, ran deep. Even the Monroe Doctrine, which warned the European powers against attempting to advance their colonial ambitions in the country's Latin American backyard, can be interpreted in isolationist terms: it promised as a quid pro quo that the U.S. would not participate in wars among the European powers. The notable exception was U.S. occupation of the Philippines resulting from the Spanish-American War. That the precipitating event that led the U.S. to disregard its long-standing tradition of non-interventionism was an incident on an island, Cuba, a scant 90 miles from the rising power's shores is perhaps worth recalling (Taiwan being only 81 miles from the Chinese mainland).<sup>27</sup> In defeating the Spanish, the U.S. in fact took control not just of the Philippines but also Guam and Puerto Rico. Whether this was a momentary fall from grace or an emerging economic power for the first time displaying geopolitical ambitions is disputed.<sup>28</sup>

But there is no question that the U.S. was, by this time, seeking to more actively assert its economic interests. Before long it was seeking to alter the structure of international markets so that they worked to its advantage (or at least didn't disadvantage it to the same extent). A long-standing bone of contention was that the trade credit required by U.S. exporters and importers was almost entirely denominated in sterling and sourced in London. This put U.S. producers and merchants at a competitive disadvantage; not only did they have to pay two commissions, one to their local bank and the other to its London correspondent, but they also bore the exchange risk. One of several rationales that combined in 1913 to cause the establishment of the Federal Reserve System (overcoming another deep-seated American aversion, this one to concentrated financial power) was the desire to create a market in securitized trade credits ("trade acceptances") denominated in dollars and sourced domestically.<sup>29</sup>

Almost immediately the Fed took steps to develop this market, passing the necessary regulations while discounting acceptances and purchasing them outright. As a result of this initiative (and as a byproduct of disruptions to the London market caused by World War I), in a scant ten years the acceptance market in New York matched its rival in London in both size and liquidity.<sup>30</sup> The dollar became as a true international currency; by the mid-1920s central banks

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<sup>27</sup> Cuba not having achieved independence in the second decade of the 19<sup>th</sup> century, it was effectively exempted from the Monroe Doctrine.

<sup>28</sup> On the first view, see Bemis (1962); proponents of the second include Kennedy (1987), Mead (1987) and Nye (1990).

<sup>29</sup> As emphasized by Broz (1997).

<sup>30</sup> The relevant document is provided by Eichengreen and Flandreau (2010).

around the world held as large a fraction of the foreign exchange reserves in dollars as in sterling.<sup>31</sup>

The U.S. competed with Britain throughout the 1920s in seeking to bring more countries into its financial orbit. As governments prepared to return to the gold standard, the Fed, in the person of Benjamin Strong, influential governor of the Federal Reserve Bank of New York, encouraged them to contract stabilization loans in New York rather than London.<sup>32</sup> Receiving a stabilization loan was the first step in establishing ongoing relations with a financial center. But while the governor himself may have been strongly internationalist in orientation, the U.S. otherwise reverted to its previous stance of quasi-isolationism following the war. The Congress famously refused to approve President Wilson's request to join the League of Nations. Not wishing to become entangled in the reparations dispute, the U.S. did not join the Bank for International Settlements in 1930 (although it did provide finance for its early operation). The country's diplomats did little to slow the progress of German rearmament or otherwise to do anything to prevent the war clouds from gathering over Europe.

U.S. tariff policy was inappropriate for what was now the world's leading trading nation, a country with an interest in the maintenance of an open trading system that should have led by example. Here the greater villain was probably the Fordney-McCumber Tariff of 1922 rather than the Smoot-Hawley Tariff of 1930, but neither helped.<sup>33</sup> The mistake was to allow trade policy to be politicized. Herbert Hoover ran for the presidency in 1928 on a platform that promised to raise tariffs on imports of farm products, agricultural prices having been depressed for much of the decade. Once the tariff bill got to the Congress, there was nothing to prevent members from adding all manner of protection for manufactures so as to build as wide a coalition as possible.<sup>34</sup>

Yet to say that the United States disregarded the case for international economic cooperation would not be accurate. The Fed famously kept interest rates low in order to encourage capital to flow toward Britain and aid that country's efforts to return to gold in 1924-5. It made a credit line available to the Bank of England.<sup>35</sup> It hosted a meeting of central bankers on Long Island in 1927, where other countries holding sterling as reserves committed not to taking gold from the British. In the summer of 1931, with the spread of the financial crisis, President Hoover offered a moratorium on inter-allied war debt payments in order to facilitate a moratorium on German reparations.

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<sup>31</sup> This from a starting point in 1914 where the dollar accounted for a negligible proportion of global reserves (Eichengreen and Flandreau 2009). Elsewhere I have suggested what the U.S. accomplished in ten years – moving from a point where its currency played no international role to one where it was the leading invoicing, investment and reserve currency – may also be possible for China (Eichengreen 2011).

<sup>32</sup> Chandler (1958) and Clarke (1967) document his efforts.

<sup>33</sup> With the U.S. not a member of the League of Nations, the League's efforts to negotiate a tariff truce in the 1920s were to little avail.

<sup>34</sup> See Schattschneider (1935). The Fordney-McCumber Tariff had similarly been intended to raise depressed farm-gate prices but had also been expanded to provide protection for manufactures by the time it was passed by the Congress. When efforts turned to rolling back tariffs in the 1930s, a change in institutions, in the form of the Reciprocal Trade Agreements Act, made a substantial difference.

<sup>35</sup> One that, in the event, was not drawn.

So what should we make of Kindleberger's claim that the Great Depression was a result of the failure of the rising power, the United States, to adequately support the system? There is some truth to the assertion that as a newcomer to international economic and financial diplomacy the U.S. was slow to recognize its responsibility. Most of the international cooperation in which it engaged in the 1920s was the doing of the exceptionally internationally-minded Federal Reserve Bank of New York; it is harder to point to comparable actions by other branches of government. The Hoover Moratorium came too late to halt the spreading crisis. For ten years the Congress and the Executive Branch had steadfastly denied the existence of a link between inter-allied debts and German reparations and further denied the destabilizing impact on the international system. They denied that their tariff policy made it harder for debtors to earn the export revenues needed to make those payments. When gold flowed toward the United States after 1929, it failed to cut interest rates to assist other countries feeling the squeeze. When the financial crisis exploded in 1931, they failed to provide emergency assistance in the form of 1924-5-style credit lines.

The implicit contrast is with the aftermath of World War II, when the U.S. acknowledged its responsibility as steward of the system by extending the Marshall Plan. Part of the explanation is that the new power was not yet so powerful. The U.S. still accounted for just 24 per cent of global GDP in 1929.<sup>36</sup> By 1950 its share had risen to 27 per cent. The contrast would be even starker if one went back to 1947, the year of Secretary Marshall's speech, output in other countries still being depressed.<sup>37</sup> Limited size meant limited resources for preserving the system. Given its own limited international reserves, for example, the U.S. was in no position to unilaterally cut interest rates or extend large amounts of emergency financial assistance on its own in 1931.<sup>38</sup>

If there were limits on the ability of the U.S. to take stabilizing action unilaterally, then the latter required international cooperation.<sup>39</sup> It is worth looking back on the obstacles to cooperation in this earlier period when one contemplates the prospects for cooperation between the United States and China to stabilize the international economic and financial system. In the 1930s, conceptual disagreements (different diagnoses of the nature of the economic problem in different countries) hindered the development of an international consensus. Powerful special interests pushed back against national initiatives that might have had global benefits but worked to their own narrow disadvantage. Noneconomic disputes (over inter alia German rearmament) made cooperation on economic matters more difficult. This list points to some of the things to worry about in periods of global shift.

#### **4. U.S. Loss of Dominance after World War II**

As noted, the situation in the aftermath of World War II was very different. U.S. policy makers now acknowledged that the country's economic ascendancy conferred on it a

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<sup>36</sup> Calculated from Maddison (1995).

<sup>37</sup> It would be starker still if one excluded from the calculation the Soviet Union, which was not part of the market system that the U.S. was putatively responsible for stabilizing (the Soviet Union having cut itself off from the international system but also having grown rapidly over the intervening period).

<sup>38</sup> Indeed it was forced to raise interest rates, in the teeth of the slump, when the UK went off the gold standard in 1931.

<sup>39</sup> As I have argued elsewhere; see Eichengreen (1992).

responsibility for shaping and managing the international system. To be sure, deeply entrenched isolationist instincts were not dead: there was significant Congressional opposition to the Marshall Plan, for example, and the U.S. refused to ratify the charter of the International Trade Organization. But the fact that there existed a well defined rival, the Soviet Union, and that the allegiance of other regions, starting with Europe, hung in the balance did much to concentrate U.S. attention and efforts.

Thus, the U.S. as dominant power in the Western alliance was able to push through its vision of how the international economic and financial system should be structured at the Bretton Woods Conference in 1944.<sup>40</sup> It provided free foreign access to its capital markets despite the fact that no other country was willing to do the same. It now extended Marshall aid, “that most unselfish act by any great power in history” in the words of Winston Churchill. It encouraged the Europeans to integrate with one another as a way of addressing fears over German reindustrialization while ignoring the fact that regional integration could discriminate against U.S. exports.

But there was no intrinsic reason why the U.S. should have remained so dominant indefinitely. The second half of the 20<sup>th</sup> century saw yet another global shift, less dramatic perhaps but undeniable. This was the period of catch-up growth when first Western Europe, then Japan, and finally other parts of East Asia began closing the gap in per capita incomes and productivity vis-à-vis the United States. In 1992, before widespread talk of the rise of China or emerging markets generally, the U.S. share of global GDP had already fallen to less than 20 per cent.<sup>41</sup> This was a shift back to a world where no one country was able to exert adequate stabilizing influence unilaterally – where stabilizing action required international cooperation.

Such a shift creates obvious risks for the global system. The leading power is accustomed to acting unilaterally rather than seeking the advice and consent of rising powers. It will be susceptible to problems of imperial overreach in which the maintenance of military commitments abroad creates an economic burden that ultimately makes it more difficult to maintain those commitments.<sup>42</sup> There was discussion and analysis of these dangers already in the 1960s, although such discussion has surely intensified now that China is not merely catching up with the United States but poised to surpass it in terms of absolute size of its economy.

It may be a prejudice shaped by one’s own intellectual preoccupations, but the arena in which these problems manifested themselves most visibly, in my view, was international finance. In the 1950s, the decade of the dollar shortage, the U.S. had been free to go its own financial way. It could pretty much dictate the conditions, geopolitical as well as economic, under which the International Monetary Fund would or would not assist other countries.<sup>43</sup> But as early as 1960 it was becoming clear that the U.S. was no longer able to dictate terms. Other countries were growing faster, and they were accumulating financial resources even more rapidly. 1960 was the first year when U.S. monetary liabilities to foreigners exceeded U.S. gold

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<sup>40</sup> The Soviet Union attended but did not advance an agenda.

<sup>41</sup> From 27 per cent, recall, in 1950 – figures again from Maddison (1995).

<sup>42</sup> This is the famous and famously disputed thesis of Kennedy (1987).

<sup>43</sup> Thus, the U.S. famously refused to approve IMF assistance to Britain in 1956 until the latter promised to withdraw its troops from Suez.

reserves. This created a “balance of financial terror” or shared consciousness of interdependence not unlike that resulting from China’s vast holdings of U.S. treasury securities today.<sup>44</sup>

The U.S. and its European partners responded by negotiating the Gold Pool and a network of bilateral swap lines. (Japan was not yet part of these agreements.) But these were essentially holding actions – defensive steps to prop up an increasingly anachronistic system. There was reluctance on the part of the power in relative decline to recognize that an international system in which it issued the only true international currency was in need of fundamental reform. Under Treasury Secretary Douglas Dillon, who had also worked in Washington, D.C. in what were, for the United States, the glorious 1950s, U.S. policy was to deny the need for reform. Dillon’s emphasis lay in getting other countries to assume more of the defense burden (to get West Germany to pay more of the cost of U.S. troops stationed there).<sup>45</sup>

While this changed when the more open-minded Henry Fowler took the reins at treasury, subsequent discussions were still hindered by the kind of complications that arise in periods of global shift. The French, feeling themselves in ascendancy, regarded the Americans as overbearing and enjoyed making their financial lives as difficult as possible.<sup>46</sup> French insistence on a European veto led to the requirement of 85 per cent supermajority support before Special Drawing Rights could be created, and this hurdle in turn prevented earlier and more ample issuance of SDRs to supplement dollar liquidity. When it became clear that the dollar would have to be devalued, the fact that there was not one but a significant number of surplus countries financing the U.S. balance-of-payments deficit made it hard to negotiate that devaluation: each European country, and also Japan, preferred the others to do the revaluing, and absent a mechanism to ensure collective action no one was willing to go first. It took the unilateral imposition of a ten per cent tariff surcharge by President Nixon in August 1971, a device that was distasteful to virtually everyone but the president himself, to precipitate the necessary steps.

Against this backdrop it is not surprising that the 1970s was not a heyday of international cooperation. In the absence of meaningful progress on global reform, there was a retreat into regionalism, cooperation being easier with smaller numbers.<sup>47</sup> There are obvious parallels with the current situation in which an ongoing shift in economic and geopolitical power that complicates efforts to cooperate globally leads countries to also pursue cooperative initiatives regionally, most visibly in Asia but also in other parts of the world.

The result was a global system for which no one took responsibility and whose operating characteristics were not well understood. In a world awash with liquidity there was a tendency toward inflation and overborrowing. When this reached a crisis point, stabilization followed, first in the U.S. and UK, then in France, and finally in Latin America. Because action was taken nationally, at different points in time, exchange rates could move sharply. The problem in the first half of the 1980s was an over-strong dollar that created politically pressure to

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<sup>44</sup> The phrase is from Summers (2004).

<sup>45</sup> In Dillon’s view, the U.S. assuming this burden, while Germany and Japan continued to free ride, constituted an unfair economic advantage for the latter.

<sup>46</sup> For example, they withdrew from the Gold Pool in 1967.

<sup>47</sup> Thus, building on six years of experience with the Snake, the members of the European Community established the European Monetary System in 1979.

protect a U.S. manufacturing belt that was being hollowed out by increasingly powerful foreign competitors in Europe and Asia. Baldwin (1987) refers to the New Protectionism of the 1980s as the product of “significant structural changes in world production that have brought about a decline in the dominant economic position of the United States, a concomitant rise of the European Community and Japan to international economic prominence, and the emergence of a highly competitive group of newly industrializing countries.”

The response was two international agreements at the Plaza and Louvre, the first to push down the dollar and, when this was too successful, a second to support it. For readers concerned about periods when there are shifts in global economic power, two aspects of these agreements are noteworthy. First, they were agreements of the G5 countries: the U.S., UK, France, Germany and Japan. This was the first time that Japan as a rising power was acknowledged as a co-equal. Indeed, the second of these two agreements, at the Louvre, developed out of bilateral discussions between U.S. and Japanese finance officials. Second, the grouping in question, the G5, was both small and ad hoc. One is reminded of the formation of the G20 in response to the rise of new powers and the recognition that larger forums for decision making, like the IMF, might be unwieldy.

This ongoing shift away from U.S. dominance and toward a more multi-polar world was interrupted in the 1990s by two events: the collapse of the Soviet Union and the early difficulties of transition in the former Soviet bloc, and a series of economic and financial crises in emerging markets.<sup>48</sup> What with the former Soviet Union in shambles, Europe awkwardly attempting to digest newly-reunified Germany, Japan mired in a financial crisis, and no new powers yet on the scene, this was America’s “uni-polar moment.” The First Gulf War in 1990-1 was United Nations authorized and fought by a coalition of 34 countries, but it was fundamentally a U.S.-led affair. While the IMF was prominent in the Mexican rescue in 1994-5 and the response to the Asian crisis of 1997-8, U.S. treasury officials played a decisive role in negotiating the terms and amounts of emergency finance in both cases.<sup>49</sup> There were complaints about U.S. domination of the IMF, intense complaints in the case of Asia, but no significant reform of quotas, voting rights, and composition of the executive board that might have diminished America’s role. When the G22 was formed to draw lessons from the crisis, the working group on crisis management was chaired by a U.S. treasury official. It is hard to imagine the U.S. being equally dominant in crisis management in less uni-polar times (like today).

The shift in global economic and political power toward emerging Asia resumed subsequently because growth in emerging Asia resumed subsequently. Rapid growth resumed because the fundamental prerequisites for catch-up remained in place: export orientation, high saving rates, government initiatives to eliminate bottlenecks, and well-educated labor forces. Asian policy makers drew appropriate lessons from the crisis: they reduced their economies’ vulnerability by avoiding large current account deficits and real exchange rate overvaluation,

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<sup>48</sup> There was also the fact of relatively favorable U.S. economic performance in the 1990s, this being the beginning of the “new economy” era when the payoff to earlier investments in new information and communications technologies materialized (see Frankel and Orzag 2002).

<sup>49</sup> It provided a supplementary line of credit to Mexico through the Exchange Stabilization Fund and a back-up line of credit to South Korea three years later. On the role of the U.S. in the Mexican and Asian crises, respectively, see General Accounting Office (1996) and Blustein (2001).

applying less pressure of demand, strengthening the supervision and regulation of banking systems, and accumulating foreign reserves as a buffer against shocks. The process of catch-up was further accelerated, of course, when the U.S. fell back as a result of its own financial crisis.

Fast-forward ten years, and it is clear that this global shift had implications for how the next crisis was managed. The G20 had clearly supplanted the G7/8 as the premier venue for coordinating a response. In 2010 it was chaired by an emerging-market country, South Korea, that ten years earlier was just recovering from its own crisis. The Basel Committee on Banking Supervision and its newly-minted partner, the Financial Stability Board, had been expanded to include emerging market members. The advanced countries had conceded that quotas and voting in the IMF should be revised to enhance the voice and influence of emerging markets, and steps were taken in that direction. Indeed the presumption that the managing director of the Fund should be European had given way to an expectation that the next one would be from an emerging market. It is sometimes argued that periods of global shift are when institutions for organizing international economic collaboration are least effective because declining powers are overrepresented and those arrangements consequently lack legitimacy in the eyes of rising markets. It can be argued that this is true at the moment because institutional reform has not been fast enough. But at least the need has been acknowledged.

## **5. Implications**

Shifts in global economic and financial power create unfamiliar circumstances, and unfamiliar circumstances create risks. In the 1960s and 1970s the rising powers, Europe and Japan, complained of destabilizing economic impulses emanating from the United States. This source of economic risks has been around for a long time, in other words, although its form continues to mutate. But now, in addition, the U.S. and other advanced economies must worry about the risk of adverse shocks arising out of events in China and other emerging markets. The day when the Chinese economy was too small and isolated to have a first-order impact on the rest of the world is long past, in other words. Policy analysts in the U.S. and other advanced countries need to worry about the impact on their own economy of a sharp economic slowdown in China, of a sudden drop in property prices in that country's major cities, or of an outbreak of labor unrest. These are not matters on which U.S. policy planning has traditionally focused. It now should.

The current global shift also has implications for how such problems must be managed when they arise. If the aftermath of World War II was an era of hegemonic stability when the U.S. as dominant power had the capacity to act unilaterally to stabilize the European and Japan economies and more generally to manage the international financial system, while the fourth quarter of the 20<sup>th</sup> century was an era of hegemonic cooperation when the dominant power could no longer act unilaterally but still took the lead role in organizing collective action, then the first quarter of the 21<sup>st</sup> century will have to be an era of “nonhegemonic cooperation.”<sup>50</sup> Neither the U.S. nor China will have the resources to manage global economic problems by itself, and neither will have the capacity to dictate terms. The alarming rendition of this scenario notes that it resembles Kindleberger's account of the interwar years when neither the rising nor declining power was able to exert adequate stabilizing influence unilaterally or even organize international

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<sup>50</sup> The concept of “hegemonic cooperation” is developed by Keohane (1984).

cooperation. The more reassuring interpretation notes that, unlike the interwar years, there now exist multilateral institutions in which both major powers participate that are expressly designed to deal with economic risks.

How well we cope with this global shift will hinge, therefore, on the adequacy of those institutions and groupings. At the IMF, increases in resources, the creation of new lending facilities, and experimentation with new surveillance instruments such as spillover reports are positive developments. But the slow pace of governance reform continues to undercut the legitimacy of the institution and therefore the effectiveness of its advice. And the fact is that the Fund still has no mechanism for compelling adjustment by countries that do not borrow from it, whether these are chronic surplus countries like China or chronic deficit countries like the U.S. that issue debt in their own currency. The advent of the G20, which gives both large and middle sized countries and advanced and emerging markets alike a seat at the table, is similarly a positive development. But the G20 also has a legitimacy problem; it has no written constitution and its membership is arbitrary (who appointed these 20 countries to run the world?). In the absence of commitments for members, it is prone to degenerate into a talk shop.

In principle, these design flaws can be fixed. The Articles of Agreement of the IMF could be amended to provide for automatic penalties for chronic surplus countries.<sup>51</sup> The composition of the executive board could be changed to further enhance the representation of emerging-market countries, and G20 membership could be reconfigured to match that of the executive board.<sup>52</sup>

In a world of sovereign states and especially in a world without a single dominant power, international collaboration also requires a shared diagnosis of problems. When one contemplates issues like the sources of the Chinese current account surplus or the U.S. deficit, it is clear that consensus remains elusive. Here there is an important role for entities like the IMF, which can act as impartial arbitrator. Thus, the need for governance reform to lend the Fund the legitimacy and the need for intellectual consensus are inextricably linked.

Part of this intellectual consensus must be appreciation on the part of the once dominant power that, if it can no longer take adequate action unilaterally, then power-sharing through legitimate institutions is preferable to clinging to the past. Here the United States has shown the foresight to be an advocate of reforming IMF quotas and executive board representation and of shifting the focus of international collaboration to the G20 from the G7/8. Europe has been somewhat less enthusiastic about increasing emerging-market representation in the IMF executive board. And the French presidency in 2011 will be revealing of how seriously Europe takes the G20 process. That same intellectual consensus must entail recognition on the part of the rising power that it has a responsibility for the stability of the international system. Chinese officials, when pressed over their international economic policies, observe that theirs is still a poor country ill positioned to make sacrifices on behalf of the rest of the world. Global shifts have come to grief over less.

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<sup>51</sup> For one such design see Eichengreen (2010a).

<sup>52</sup> As I suggest in Eichengreen (2010b). But saying that these things can be fixed is not the same as saying they will.

One of the indisputable lessons of history is that with shifts in economic power come shifts in military power. For half a century China has concerned itself mainly with disputes on its borders; it has therefore concentrated on developing land-based forces, something that prevents it from projecting power across long distances. China, it is said, has not had a naval tradition since Zheng He, giving the U.S. navy free rein in the Pacific and even the East China Sea and limiting the scope for conflict between the two countries. But the idea that China is incapable of challenging the U.S. at sea may ultimately become yet another casualty of the shift in the balance of economic power between the two countries. China may still lag behind the U.S. in the number and sophistication of its warships (submarines may be a different story) but, as with many things Chinese, change is now coming faster than many experts anticipated as recently as five years ago. China's decision in 2009 to dispatch a naval force to escort Chinese shipping through the Gulf of Aden in order to protect it from Somali piracy, is a case in point.

An obvious place where economic and political risks come together is energy security. China is painfully aware of its dependence on imported energy. Late 19<sup>th</sup> century Germany and late 20<sup>th</sup> century America were both accused of using military means to enhance their energy security. China has already taken other steps, mainly in the form of direct foreign investment, in the effort to secure its energy supplies. Some imagine a scenario in which it could go further, threatening or even using military force to install friendly governments in Eastern Siberia, elsewhere in East Asia or even elsewhere in the world.

Of course, there are other more benign ways of ensuring energy security.<sup>53</sup> These include eliminating subsidized energy prices for households and state enterprises to limit consumption and developing new technologies to reduce dependence on imported fossil fuels. It all comes down to the economics. And the politics.

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<sup>53</sup> See for example Cooper (2005).



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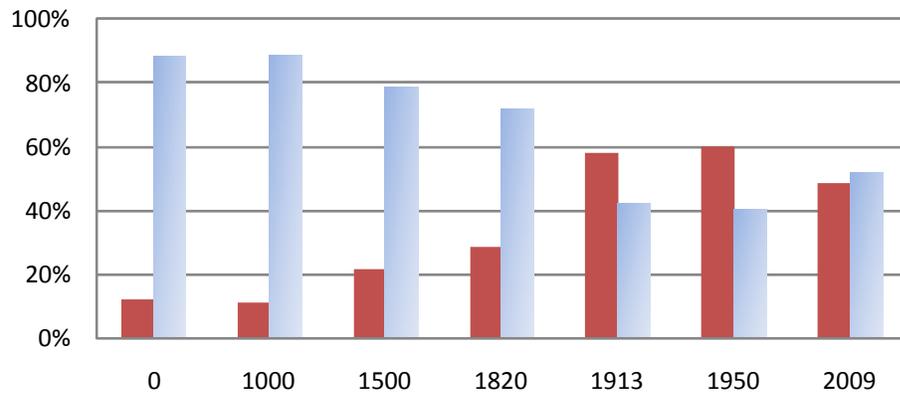
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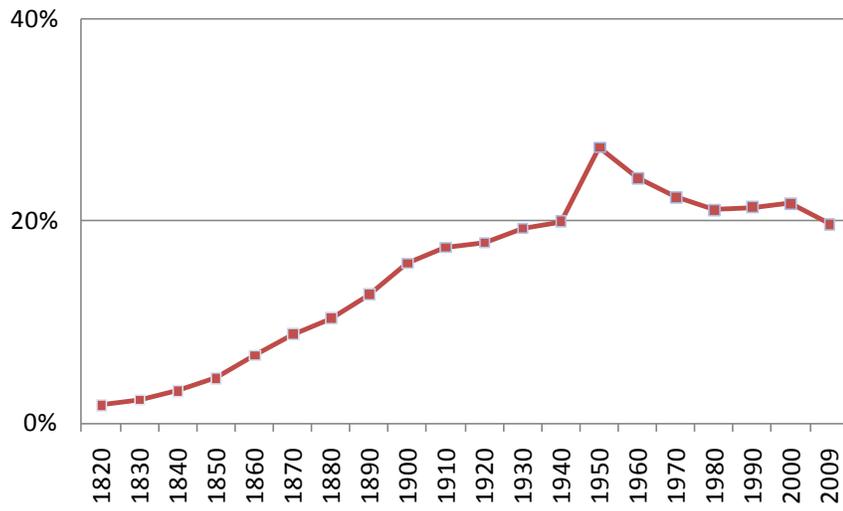
**Figure 1. Developed and Emerging Economies' Share of World GDP**



*Note:* Red bars for “developed countries,” blue bars for “emerging economies.” “Developed countries” comprised of U.S., Canada, Japan, Australia, New Zealand and Western Europe. “Emerging economies” comprised of rest of the world.

*Source:* Angus Maddison, “The World Economy,” World Bank (WDI) for 2009.

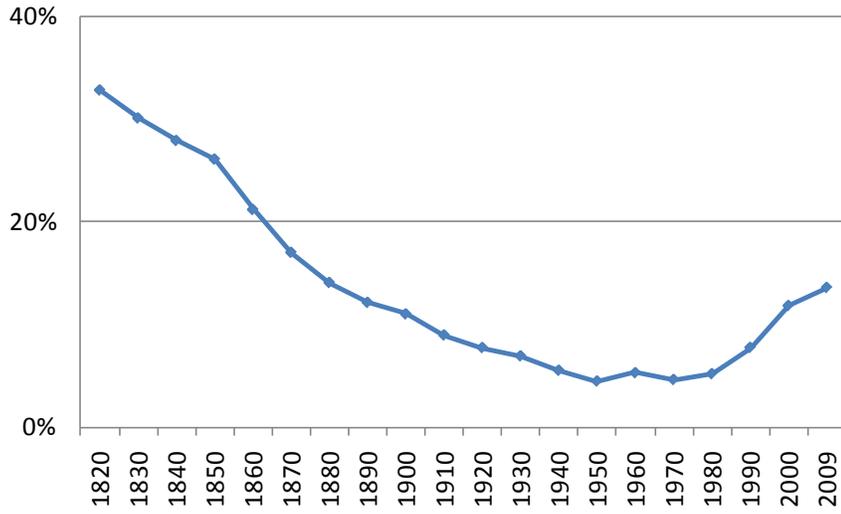
## Figure 2. USA's Share of World GDP



Source: Angus Maddison, "The World Economy," World Bank (WDI) for 2009.

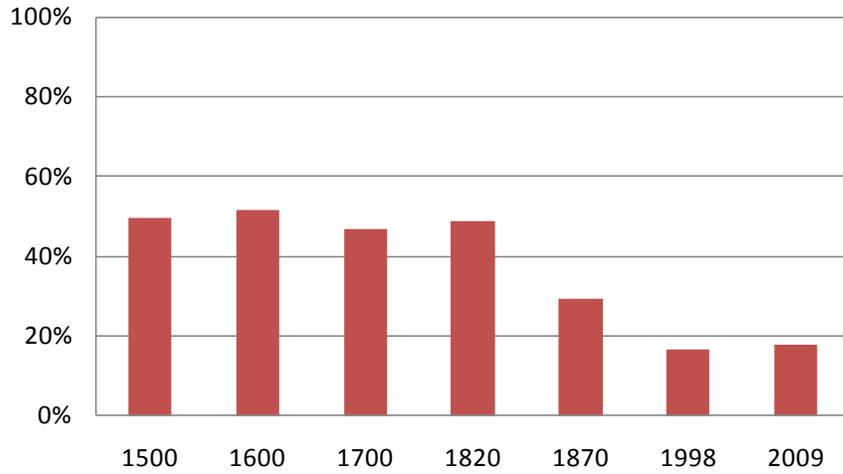
Some data for intermediate years that were not available is interpolated.

**Figure 3. China's Share of World GDP**



Source: Angus Maddison, "The World Economy," World Bank (WDI) for 2009.  
Some data for intermediate years that were not available is interpolated.

**Figure 4. “Chindia’s” Share of World GDP**



Source: Angus Maddison, “The World Economy,” World Bank (WDI) for 2009.