

## Avoiding the worst: International economic cooperation and domestic politics

Jeffrey A. Frieden, 2 February 2009

*If the crisis turns into a new Great Depression, it will most likely be due to a breakdown of cooperation among the major economies. But sustaining international cooperation requires domestic support; ignoring the demands of poor and middle-class citizens for relief will inflame more extreme anti-globalisation views, making international cooperation much more difficult.*

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If the current crisis turns into a disaster on the order of the Great Depression, it will most likely be due to a breakdown of cooperation among the major economies. The history of the modern world economy – and especially of its collapse in the 1930s – makes clear that the principal powers have to work together if they are to maintain an integrated international economic order.

### International cooperation needs domestic support for openness

Yet governments are only able to make the sacrifices necessary to sustain international cooperation if they can rely, in turn, on domestic political support for an open world economy. National publics unconvinced of the value of international integration will not back policies – often costly and difficult policies – to maintain it. This can lead – again, as in the 1930s – to a perverse process in which global economic failure undermines support for economic openness, which leads governments to pursue uncooperative policies, which further weakens the global economy.

On both dimensions, international and domestic, we are in trouble. So far, despite high-sounding internationalist rhetoric, governments have responded to the crisis with policies that take little account of their impact on other nations. And the crisis has dramatically reduced domestic public support for globalisation, and for national policies to sustain it.

### Why reasonable governments do unreasonable things

On the international dimension, the threat is not so much of explicit protectionism but rather of nationally specific policies that impose costs on others, directly or indirectly.

These beggar-thy-neighbour policies are not normally the result of some inexplicable bloody-mindedness on the part of venal governments, or of purposeful antagonism toward rivals. They are, instead, desperate attempts to defend national economies from gathering storms. But they impose negative externalities on other countries, and in so doing can provoke hostile reactions that can drag all parties concerned into bitter conflict.

### Not out of arrogant nationalism but out of domestic desperation

Domestic constituents demand action, and governments have to respond, even at the expense of international cooperation. This can easily lead down a path toward conflict. Financial intervention to restore liquidity or solvency to the banking system can come at the expense of financial partners, sucking funds out of neighbours.

The early-October Irish blanket deposit guarantee, implemented with the perfectly understandable goal of avoiding a bank panic in a small and vulnerable economy, nearly induced a run on British banks as British depositors rushed to transfer funds from British to Irish banks. The current American financial bailout is drawing capital from the rest of the world – including from emerging markets that urgently need it – not out of arrogant nationalism but out of domestic desperation. And the buy-American provisions of the current stimulus package demonstrate the ease with which



Jeffrey A. Frieden  
Professor at Harvard University's  
Department of Government

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well-intentioned policies can turn into uncooperative predation.

The range of policies of this type – sincere national initiatives with counter-productive international implications – is virtually endless.

### Negative externalities galore

Support for troubled national firms can turn into anti-competitive subsidies to national champions. Currency depreciation, a common recommendation for difficult times, can put competitive pressure on trading partners, leading to round after round of “competitive devaluations.” Debt-averse governments can limit the size of their fiscal stimulus, thereby free riding on the deficit spending of neighbours. Countries with intolerable foreign debt burdens can seek debt write-downs that further cripple creditor-country financial markets. And all of these can interact to create powerful protectionist pressures. One country’s fiscal stimulus can “leak” into a neighbour, draw in a surge of imports from the neighbour, and provoke a bitter protectionist backlash.

Even with the best of intentions, governments can act in ways that drive wedges among countries, block cooperative responses to the crisis, and ultimately make everyone worse off. And despite today’s flowery rhetoric, there is little evidence that national policymakers are willing or able to take into account the international implications of their actions.

If this pattern continues, it will be a major obstacle to a rapid recovery.

### Will anyone speak for the rest of the world?

National governments rarely consider global consequences, because their constituents are domestic and national publics are very sceptical about the contemporary world economy.

Even before the crisis hit, there had been real erosion in popular support for globalisation. Economic integration has come to be associated with job losses, competitive pressures, and a worsening of income distribution in developed and developing countries alike. Nearly universally, the lower registers of the income distribution are most dubious about the benefits of international economic integration, and these doubts are particularly widespread in more unequal societies.

The crisis has heightened suspicion of a world economy that appears to be the source of much of our current predicament. There is increasing resentment that the expansion of the past ten years primarily helped the wealthy, while the poor and middle classes are being asked to sacrifice to deal with the hangover of the binge. This is coupled with similar resentment that governments appear to privilege the concerns of international banks and corporations. There is an advancing popular view that insulation will help reinforce national attempts to deal with the crisis.

National publics will increasingly resist making national sacrifices in order to honour international economic obligations. Meanwhile, concentrated interests who support globalisation – such as the international financial and corporate sectors – have been undermined by international economic weakness. Broad popular sentiment is increasingly widespread and powerful that national responses to the crisis must take priority over international obligations.

### Attention must be paid: Crisis’s impact on income distribution

The impact of the crisis on income distribution cannot be ignored, for it will determine much of the politics of government responses to the crisis. Ignoring the demands of poor and middle-class citizens for relief will inflame more extreme anti-globalisation views, making international cooperation that much more difficult.

These two dimensions, the international and the domestic, are closely interrelated. The less domestic support there is for globalisation, the harder it will be for national governments to reach cooperative agreements with partners. The less international cooperation there is, the greater the likelihood of a deterioration in the global economy. As in the 1930s, beggar-thy-neighbour policies, distributional conflicts, and international economic stagnation could feed on each other in a downward dance.

### Into the maelstrom?

Governments have to act consciously to counteract this dismal possibility.

At the domestic level, governments need to work out an equitable and politically sustainable

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allocation of austerity across the population.

This means ensuring that those sectors of society hit hardest by the crisis are not also the ones asked to bear the stiffest sacrifices. Societies with existing social safety nets will have to expand them and make sure they work for wider segments of the population than they were planned. Countries with weak or non-existent social programs for the victims of crises such as this will have to create them, and quickly. By the same token, basic principles of equity – and even more basic political realities – demand that those who received the main benefits of the boom have to bear their share of the costs of the bust. Governments that ignore the social and distributional implications of the crisis are likely to find themselves either driven toward extreme and counter-productive policies, or swept away.

Even sustaining existing social programs is extraordinarily difficult in such hard times. This is true of all governments, which face powerful fiscal pressures as tax revenues dry up and demands for spending soar. The difficulties are especially challenging for developing countries, many of which have lost whatever access they may have had to external sources of capital. Yet governments that do not provide effective relief to those hardest hit by the crisis face the prospect of dramatically increased social and political strife, which will only deepen the disaster.

At the international level, governments need to work just as consciously to coordinate not just words, but actions.

This will not happen of its own accord. So far, the solidarity of OECD central bankers has been impressive. However, this builds upon a long-standing tradition of the solidarity of central bankers, and upon decades of institutionalised collaboration, and can only take us a very short part of the way. There is nothing analogous on other dimensions.

#### **The free interplay of government policies will not spontaneously bring forth international cooperation**

Collaboration among governments has to be intended, designed, and monitored. This almost certainly requires some international institutional framework, some set of agreed-upon rules and ways of enforcing them. The governments of the major economic centres need to consult regularly on the international dimensions of the crisis, and of its resolution. They need to hold each other to account, and they need some reasonably independent mechanism to identify policies that risk driving governments toward conflict rather than mutual assistance. Other foreign policy goals can and should be linked to supportive efforts on the economic front.

#### **Conclusion**

If governments do not pay real attention to the domestic distributional impact of the emergency, and to the international implications of their national policies, the current calamity will feed on itself. The Great Depression of the 1930s was more a failure of national policy, and of international cooperation, than it was a failure of markets. Success in confronting the current crisis will similarly depend on socially responsive and viable national policies, and on globally responsive and viable international cooperation.

***Editors' note: This column is a Lead Commentary on Vox's Global Crisis Debate page; see further discussion on Vox's Global Crisis Debate page.***

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