

Cassandra Speaks Again

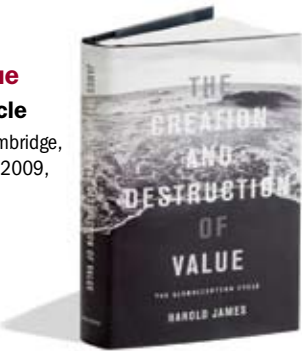
Harold James

The Creation and Destruction of Value The Globalization Cycle

Harvard University Press, Cambridge, Massachusetts and London, 2009, 484 pp., \$35 (cloth).

Harold James is the Cassandra of global capitalism. In his 2001 book, *The End of Globalization*, he chronicled how and why every historic effort to globalize trade and finance, from the 16th to the 20th centuries, ultimately failed. Globalization increased world welfare, but many groups were hurt or threatened by it, and a backlash overwhelmed those who had gained. The obvious implication was that the great globalization of the 1980s and 1990s was also doomed to collapse.

Like the Cassandra we know from Aeschylus, James was right, and he was ignored. As financial flows escalated explosively throughout the 1990s and the early years of the millennium, the gains were not shared as widely as they could have been, and glaring income disparities appeared and worsened. Grossly inadequate regulation of large financial institutions enabled risk taking to get out of hand without any timely or effective reaction. Official resistance to allowing any linkage between expansion of trade and finance and protection of labor standards or the natural environment, or to forcing any effective opening of industrial-country markets to imports from poor countries, induced a violent backlash against globalization. Nonetheless, the forces of progress pushed ahead undaunted. What would stop unfettered global finance from continuing to expand? This reviewer was not alone in concluding that the modern “international financial architecture . . . has proved capable of adapting to dramatic and often rapid changes in the global economy” (Boughton, 2002). In light of the financial meltdown of 2007–08 and



the economic collapse of 2008–09, that optimism seems less persuasive.

In this new book, James does not set out to brag about his prescience. His ambition is much larger: to take Joseph Schumpeter’s concept of “creative destruction”—the fundamental driving force of capitalism—and turn it inside out to explain why globalization

always fails. Schumpeter’s insight was that economic progress is driven by “industrial mutation . . . that incessantly revolutionizes the economic structure *from within*, incessantly destroying the old one, incessantly creating a new one” (Schumpeter, 1950—emphasis in the original). James’s insight is that creative destruction undermines the very values on which progress depends. Innovation and growth depend on finance, which inevitably and periodically explodes into financial crisis and economic collapse. At that point, “banks, businesses, and even individuals no longer trust each other . . . as monetary and ideal values are shaken.”

James develops this theme in six compact chapters. First, he summarizes the historical case he made in greater depth in his earlier book for a perpetual “globalization cycle,” most recently manifested in the collapse of the past two years. Second, he argues that our “Great Recession” has similarities to the Great Depression of the 1930s, but its roots look more like 1931 (global contagion) than 1929 (irrational financial markets). Third, he recounts in painful detail how this recession began, focusing on two “weekends that made history” in 2008: the rescue of Bear Stearns in March and the decision not to rescue Lehman Brothers in September. The latter decision was intended to demonstrate that bailouts were not inevitable. The effect was to destroy all confidence in financial stability and all trust in financial institutions and markets.

In the fourth chapter, James turns to solutions and draws the controversial conclusion that reregulation of finance is not the answer. Although the “conventional response to financial disorder is a demand for more regulation . . . , better answers . . . have always lain paradoxically in further technical change.” Specifically, he places his faith in “transparency and the spread of financial knowledge” to enable us to be the masters, not the slaves, of global finance.

Equally controversial is Chapter 5, which argues, among other things, that a run on the U.S. dollar, which China will likely initiate sooner or later, is “not as far-fetched as it may seem.” Although the mainstream view among macroeconomists is that China shares global interest in a stable dollar and a stable system, James reminds us that benign economic scenarios do not always drive history.

The beauty of James’s erudition and his skill as one of the leading financial historians of his generation emerge most clearly in the final chapter, “Uncertainty of Values,” where he argues convincingly for the connection between the destruction of monetary values and of knowledge about those values and the undermining of ideals, faith, and trust. “Indeed, the failure of a corporate ethic brought down the model of financial globalization.”

What does Cassandra warn us of now? To begin anew, we must first regain trust and find “communities of virtue.” Finding them will not be easy and will take time, and when we succeed, the reward will be only to resume the globalization cycle once more.

James Boughton
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“Advanced” Economies No More

Carmen M. Reinhart and
Kenneth S. Rogoff

This Time Is Different Eight Centuries of Financial Folly

Princeton University Press,
Princeton and Oxford, 2009,
463 pp., \$35 (cloth).



In 2005, the Bank for International Settlements remarked dryly: “Growing domestic and international debt has created the conditions for global economic and financial crises.” A year later, Anne Pettifor predicted in *The Coming First World Debt Crisis* that the “so-called First World will be mired in the levels of debt that have wreaked such havoc on the economies of so-called Third World economies since the 1980s.”

In a sea of irrational exuberance, forgotten history, and widespread greed, these and a handful of other lonely voices were right—as the world learned at great cost.

Carmen Reinhart and Kenneth Rogoff spent a good part of the past decade studying sovereign defaults. They have assembled an extraordinary amount of data spanning eight centuries—covering banking crises, defaults on domestic and external debt, currency crashes, and inflation in 66 countries. Reinhart and Rogoff present a sobering reminder that financial crises are a serial phenomenon—caused in no small part by the seductive “this-time-is-different syndrome,” the prevalent belief that to us, here and now, old economic laws of motion no longer apply. Their ambitious quantitative history of financial crises draws out sweeping parallels between financial crises, across times and continents; and between inflating away domestic debt, currency debasements, and defaults on external debt. These defaults are rarely a binary affair: partial and protracted defaults are common. Even though the tools may have changed, it is rare for governments to fully repay their debts.

Most “large reductions in external debt among emerging markets have been achieved via restructuring or default.”

After establishing a typology of financial crises, the authors turn their attention to sovereign external debt crises. They explain the basic economic theory of sovereign debt and set out the features that distinguish sovereign from corporate debt. Gunboat diplomacy is said to fail a cost-benefit test. But there is no mention that forcible collection efforts are also illegal under international law.

Reinhart and Rogoff define external debt as “the total liabilities of a country with foreign creditors.” Domestic debt refers to all “debt liabilities of a government that are issued under and subject to national jurisdiction, regardless of the nationality of the creditor and the currency denomination of the debt.” Under these definitions, a sovereign bond issued domestically and owed to a foreign creditor would count as *both* external and domestic debt. This overlap illustrates the increasingly fluid boundary between external and domestic debt and the need for greater clarity in the definitions.

Reinhart and Rogoff then shine the spotlight on the forgotten history of domestic debt. Particularly interesting are findings that the modern bias toward short-term debt is a product of the “inflation fatigue” of the 1970s and 1980s; domestic defaults occur typically only in more severe macroeconomic conditions than external defaults; and countries with sufficient domestic savings may use domestic debt as a substitute for external borrowing. The authors underscore that inflation is a form of de facto default on domestic debt, particularly if that inflation is coupled with financial repression. They explain why high levels of domestic debt may result in defaults at seemingly sustainable levels of external debt.

They debunk the widespread belief that growth allows countries to escape from high levels of debt. Graduating from the club of serial defaults takes a lot of time, and the dropout rate is high. Banking crises, an “equal-opportunity menace” for developing and advanced economies alike, occur with surprising frequency, especially in the world’s financial centers. And the rate of recidivism is even higher. A central finding is that modern banking crises increase real government debt by 86 percent on average—mostly indirectly, from lowered economic output and reduced tax revenues—which generally exceeds the cost of bailouts by an order of magnitude. The “true legacy of banking crises is greater public indebtedness,” which has been “a defining characteristic of the aftermath of banking crises for over a century.”

The authors cast doubt on the innocuous character of mounting U.S. debt prior to the current global economic crisis. In 2004–05, they note, the United States “was soaking up more than two out of every three” dollars saved by all the surplus countries in the world. History repeated itself. Once again, the belief that the United States differed from the rest of the world prevailed—handing its government, consumers, and corporations a blank check to borrow as if there would be no day of reckoning.

Reinhart and Rogoff marshal evidence that points to converging features of financial crises in developing and advanced economies. But they rule out as “hyperbole” the logical conclusion that the advanced economies soon will be indistinguishable financially from developing economies. In their view, the United States remains “a highly sophisticated global financial center.” Simon Johnson persuasively argued in *The Atlantic Monthly* last year that the United States is too close for comfort to an emerging market country. The old categorization into advanced and emerging economies is unlikely to survive the current crisis.

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Extreme Measures for Dire Poverty

R. Glenn Hubbard and William Duggan

The Aid Trap

Hard Truths about Ending Poverty

Columbia University Press, New York, 2009, 198 pp., \$22.95 (cloth).

In *The Aid Trap*, authors R. Glenn Hubbard and William Duggan, both of Columbia University's Business School, put forth a radical solution for ending extreme poverty. The authors believe that the current systems of development aid and the nonprofit sector in emerging economies keep the poor poor and that the only sustainable means for eliminating extreme poverty is a thriving business sector.

Traditionally, aid to developing economies is described as taking one of two forms: top-down or bottom-up. The authors of *The Aid Trap* find fault with both approaches. Top-down aid is often delivered to governments and siphoned off by corrupt leaders and bureaucrats.

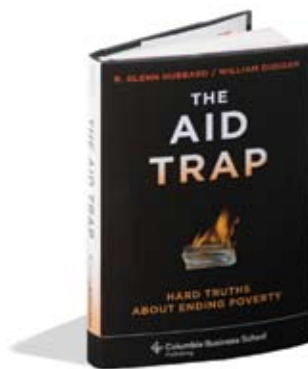
Bottom-up aid crowds out market-driven businesses by providing free but unsustainable services that create dependency. The authors cite the Millennium Development Goals and related "village development projects" as the current favorite but ultimately doomed fad of bottom-up aid distribution.

The authors praise the pro-business and wildly popular micro-lending boom; yet even microloans, they believe, have limitations. Microbusinesses typically remain micro, often because their growth is curtailed by governments that fear business-driven prosperity will cause foreign aid to dry up.

Hubbard and Duggan propose an alternative approach based on the Marshall Plan, which successfully revived the decimated business sector in western Europe following World War II. Hubbard and Duggan's modern-day Marshall Plan for developing countries would provide loans to local businesses whose governments agree to reform their business-suppressing policies. These loans would be repaid to local gov-

ernments, which would reinvest them in infrastructure that further supports business development. Growth of the business sector would generate income taxes needed to fund critical social services such as health care and education.

The authors rightfully refer to their plan as "strong medicine" for both developing and rich nations. Developing countries would have to opt in or forgo aid of any kind except for basic humanitarian assistance. Wealthy nations would have to adopt policies that support free and fair trade, which could eliminate, for instance, subsidies for some U.S. farmers who are producing surplus crops sent as food aid to poor countries.



In the short term, local businesses are favored over stronger foreign-owned businesses. Ultimately, however, poor nations develop thriving business sectors, which permits once-stronger foreign-owned businesses to return to their markets.

The plan, in theory, works. But herein lies the rub: no plan that requires even short-term but broad-based sacrifice across both wealthy and poor nations is ever likely to see the light of day in its pure form.

The authors open their book with the current worldwide economic crisis as an example of the power of the business sector to restore economic stability. "We see a global consensus among prosperous nations that a thriving business sector is the source of their prosperity. They know that their local businesses are the only hope to have enough good-paying jobs for

the majority of their people into the future. These nations are taking massive government action, not to replace the business sector but to revive it."

The problem with citing recent events in the global economy as evidence of how business can eliminate poverty is that it fails to acknowledge that the business sector also created the current economic crisis, which resulted in the elimination of millions of jobs worldwide.

No, business is not a panacea. Nor are bottom-up village development projects. Certainly, top-down aid that lines the pockets of the few rather than creating opportunity for the masses is not the answer.

Ultimately, the answer is as complicated as society and humanity itself. The end of extreme poverty will come when the mass of individual citizens around the world who desire and demand an end to the inhumanity of extreme poverty reaches the proverbial tipping point. Then, and only then, will extreme poverty be addressed with a broad-based, multipronged approach that meets the unique needs of individual developing countries, villages, and even families.

No single grand plan will end poverty. It will happen in ripples, in fits and starts, and over a fair amount of time. It will resemble parts of the Marshall Plan, the Millennium Development Goals, and top-down and bottom-up aid—which all contribute crucial pieces to the remedy: pro-business policies, universal access to education and health care, mass distribution of humanitarian aid and prevention and treatment of rampant diseases, and microenterprises free to grow large in an open, pro-business marketplace.

Still, I applaud Hubbard and Duggan's audacity. They dare to look at society's largest challenge—extreme poverty—and create a real template for change. That is a tremendous contribution to the solution.

Wendy Smith

Author, Give a Little: How Your Small Donations Can Transform Our World

Fair Game

Simon Kuper and
Stefan Szymanski

Soccernomics

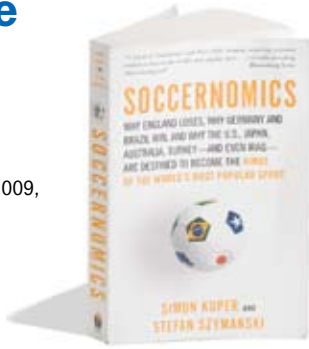
Nation Books, New York, 2009,
336 pp., \$14.95 (paper).

Are you getting ready for the soccer World Cup in South

Africa this summer? Did you know that a nation's income, population, and soccer experience are the main determinants of a team's survival of the first round of the World Cup? Don't rush off and check where your favorite national team stands. These three factors explain only 25 percent of the variation in goal differences; the remaining 75 percent is unexplained random noise or sheer luck—all courtesy of the power of econometrics.

This and many other surprising facts about the world of soccer are discussed in *Soccernomics*, by *Financial Times* writer Simon Kuper and Stefan Szymanski, a leading sports economist. They weave academic analysis and anecdotes from individual players, managers, and teams across the world into a highly readable and entertaining book about the most popular sport in the world. It would have been more fun in undergraduate economics to learn game theory through penalty kicks or regression analysis through soccer examples.

What do large financial institutions such as Lehman Brothers and soccer clubs have in common, and how do they differ? Both are subject to moral hazard (risky behavior is not penalized), because they are usually bailed out. Alas this not always the case—as the example of Lehman Brothers recently showed—but, surprisingly, soccer clubs seldom disappear. Yes, some clubs might go bankrupt (for example, Fiorentina, Leeds United), but according to Kuper and Szymanski, soccer clubs are among the most stable businesses



around. Even the few that are not bailed out often reappear with a new name, money, and the same fans and swiftly move up the ranks to the highest league again (Fiorentina, for example). Although banks make enormous profits in good times, soccer clubs are in general unprofitable. The authors find no correlation between league

position and profit. Yet, interestingly, soccer players' salaries explain almost all the variation in English Premier League positions. But the next time your favorite English team announces a multimillion-pound "transfer deal of the year," don't get too excited: spectacular transfers do not necessarily correlate with the team's subsequent league position in the standing.

We also learn that hosting the World Cup or European Cup reduces suicides in European countries, Norway is apparently the most enthusiastic soccer country in Europe, Iraq is among the best overperformers in world soccer, and 50 percent of British ticket holders don't take up their seats the next season. While bank customers usually stick with their bank unless there's a bank run, soccer fans don't seem to be very loyal. In addition, hosting large sports tournaments doesn't yield any profits or many economic benefits, but it does increase people's happiness—a finding drawn from the influential field of happiness economics. So even though South Africa is likely to lose money on the forthcoming World Cup, it might be a happier nation this fall—not to mention all the other participating African countries that could reap empowerment, pride, and happiness from the South Africa-hosted World Cup.

What are some of the limitations of the book? The empirical evidence is at times overly focused on England. Economists tend to be a skeptical species (except maybe when it came to rational expectations or efficient markets), so more evidence from other

countries would certainly help generalize some of the findings. Also, in general, the explanation of why poor countries do worse at sports—poor nutrition, exposure to disease, lack of networking, and organizational issues—is compelling. But it does not explain why African countries

Hosting large sports tournaments doesn't yield any profits or many economic benefits, but it does increase people's happiness.

do so well in the FIFA Under-17 and Under-20 soccer World Cups. Nigeria is the most successful U-17 team besides Brazil, with three titles, and the current U-20 world champion is Ghana.

One question for globalizers is when countries such as China and India will make their mark in the soccer world. Brazil, one of their cousins in the so-called BRIC countries—Brazil, Russia, India, and China—has the best national soccer team in the world; the other, Russia, made it to the European Cup semifinals two years ago.

Finally, a word of caution to any soccer manager with a large budget: don't buy the stars from the World Cup in South Africa. They tend to be overvalued. Buy players in their early twenties and players whose personal problems you can solve (both tend to be undervalued).

Soccernomics is highly recommended not only for soccer fans but for anyone who is interested in how economics tools apply to the wonderful world of soccer.

Heiko Hesse

Economist, IMF; former professional soccer player for Borussia Dortmund; and featured in the German documentaries

Die Champions and the forthcoming HalbZeit