Globalization in an Age of Crisis:
Multilateral Economic Cooperation in the Twenty-First Century

Free Trade and Multilateralism in Historical Perspective

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The purpose of this paper is to analyze how the multilateral trading system has been sustained over time, or not as the case may be. The hope is that history may provide us with lessons regarding what the challenges will be in maintaining a basically open and multilateral trading system in the years ahead, particularly in the aftermath of the global economic crisis of 2008-9, and in light of the major ongoing structural changes in the world economy. The paper will focus on three potentially inter-related topics. The first is the two-way interaction between multilateral trade relationships and geopolitical stability: for example, we cannot ignore the two world wars and their aftermath on the basis that these were abnormal events, since they had such a profound impact on world trade in the 20th century. The second is the role of long-term shifts in comparative advantage in changing the domestic and international politics of trade. The third is the determinants of the way in which the international trading system responds to severe economic and financial shocks. Sometimes these have had profound and long-run effects, whereas in other cases shocks appear to have little impact on the fundamental nature of the system.

This document is not a first draft, but a discussion paper. It outlines our preliminary thoughts and discusses some of the issues that we intend to examine.

Free Trade and Multilateralism

We have been asked to look at both free trade and multilateralism, but these are not the same thing, and there are different dimensions to a multilateral trade system.

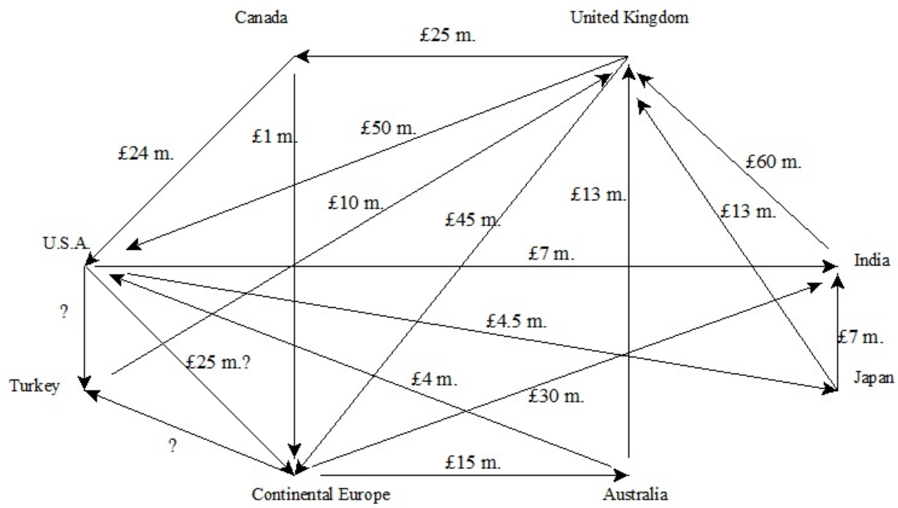

Figure 1. World Pattern of Settlements, 1910

Source: Saul (1960, p. 58).

One dimension is symbolised by Figure 1, which gives a stylized representation of the world trade settlements system in 1910. As can be seen, the international trading system on the eve of World War I was as a multilateral one, in the sense that countries ran up trade surpluses with some partners which they then used to finance deficits with other. For example, India ran a large trade deficit with the UK, but ran surpluses with continental Europe, the US, Japan and China. The UK, meanwhile, used its surpluses with India and other countries to finance its deficits with continental Europe and the US. While this was a multilateral trading system, it was not a free trade system, in the sense that several major economies had quite protectionist trade policies: the United States, the Latin American republics, and the white settler Dominions, as well as several countries in Europe.

One polar opposite to a multilateral trading system, in this sense, is a bilateral trading system in which pairs of countries engage in what essentially amounts to barter trade, balancing trade on a bilateral basis. This is not just a theoretical curiosum, since something along these lines has been observed on several occasions over the past century. During the Great Depression of the 1930s, many countries sought to balance trade on a bilateral basis and used import restrictions to reduce trade deficits. At other times Communist countries resorted to barter-style arrangements, in order to keep their domestic price systems insulated from world market conditions, and so did the Nazis when dealing with their informal empire in Southeastern Europe during the 1930s. More prosaically, Western European countries typically had inconvertible currencies after 1945, and it took the establishment of the European Payments Union and the restoration of currency convertibility to resurrect a properly multilateral trading system during the 1950s. The economic advantages of multilateralism in this sense are obvious and large, since they are the same as the advantages of trade financed by money relative to barter.

Another polar opposite to a multilateral trading system is a mercantilist trading system, in which states use military force to monopolize certain trades for themselves, for example the trade between a colony and a mother country. This was of course common before the 19th century. A less dramatic example of this phenomenon developed in the interwar period, which saw the leading European nations relying more and more on trade with their empires, formal or informal (Table 1).

Trade of	Share of	1929	1932	1938	1929	1932	1938
United Kingdom	British Commonwealth, colonies, protectorates, etc.	30.2	36.4	41.9	44.4	45.4	49.9
United States	Phillippines	2.9	6.1	4.8	1.6	2.8	2.8
France	French colonies, protectorates and mandated territories	12	20.9	25.8	18.8	31.5	27.5
Belgium	Belgian Congo	3.9	3.8	8.3	2.6	1.3	1.9
Netherlands	Netherlands overseas territories	5.5	5	8.8	9.4	5.9	10.7
Italy	Italian colonies and Ethiopia	1.5	1.1	1.8	2.1	3.6	23.3
Portugal	Portuguese overseas territories	7.9	10.4	10.2	12.7	13.9	12.2
Japan	*Korea and Formosa*	12.3	26.2	30	16.8	21.6	32.9
	Kwantung	6	4	1.6	4.8	6.8	13.7
	Manchuria	1.9	2.7	9	2.5	1.5	8.1
	Rest of China	5.8	4	4.4	10.9	7.3	8
	Total Japanese sphere of influence	26	36.9	45	35	37.2	62.7
Germany	*Bulgaria, Greece, Hungary, Romania, Turkey, Yugoslavia*	4.5	5.5	12	5	3.9	13.2
	Latin America	12.2	11.2	15.6	7.8	4.3	11.5
	Total German sphere of influence	16.7	16.7	27.6	12.8	8.2	24.7

Table 1. The share of formal and informal empire trade, 1929-1938 (percent)

Source: League of Nations (1939), pp. 34-5.

Another polar opposite to a multilateral trading system is the situation obtaining in war, when states try to prevent their enemies from exporting (in the case of a war waged by mercantilists) or importing (in more modern wars). Furthermore, the fear of such embargos, or pre-emptive embargoes in anticipation of war, can be an important factor leading to war in the first place. The postwar multilateral trading system, which was first a regional one involving the OECD, and later became a world trading system with the collapse of communism and liberal reforms throughout the developing world, was based on the GATT and the WTO. More fundamentally, however, it was based on the principle embodied in the Atlantic Charter whereby the UK and US would "endeavor, with due respect for their existing obligations, to further the enjoyment by all States, great or small, victor or vanquished, of access, on equal terms, to the trade and to the raw materials of the world which are needed for their economic prosperity." (Of course this principle was waived in the case of both cold and hot wars in the late 20th century.) This dimension of multilateralism relies on the confidence of countries that they can rely on the market to provide them with essential food and raw materials. Moves by several countries to carve out sources of exclusive supply of grains or other commodities in recent years indicate a decline in such confidence.

Another dimension of a multilateral trading system is the commitment on the part of both the GATT and the WTO to the principle of non-discrimination in trade as embodied in the most favored nation clause. Again, multilateralism defined in terms of non-discrimination is not the same thing as free trade, since the MFN clause is consistent with high as well as with low tariffs, and has moreover on occasion proved an obstacle to trade liberalization because of the free rider problem – notably during the 1930s. The MFN clause has been central to international trade negotiations since its partial incorporation into the Cobden-Chevalier Treaty of 1860. The subsequent 15 years saw the development of what might be regarded as a nascent European free trade system as a result of a series of bilateral trade treaties whose concessions were then generalized via the MFN clause.

And finally, both the GATT and the WTO have been based on a commitment to multilateral trade negotiations, rather than to trade liberalization based on bilateral deals as in the late 19th century. Of course, despite this, bilateral and regional trade arrangements have proliferated since the 1990s, in part because liberalization through the now 150+ member WTO has become increasingly difficult.

What is striking about the international trading system today is that it is a global one, and also a multilateral one in all these various ways. Under this system, world trade has flourished. This makes the period since the opening of the BRICs, and the collapse of Communism, unique in world history. The question this paper addresses is: what will be the challenges in maintaining this system in the years ahead?

Economic Crises, Trade Shocks, and the Multilateral System

One way of answering the above question is to look at previous periods of crisis in the world economy, and ask whether or not these crises led to structural transformations in the nature of the international trading system – both pro-multilateral and anti-multilateral. The first thing that we need to do, then, is to identify such periods of crisis.

In considering international trade in the long run, the first thing to note is that the volume of world trade has increased secularly for nearly two centuries with little interruption. Figure 2 presents the volume of world trade from 1850 to 2009. While some small dips are evident, focusing exclusively on the fluctuations would miss the big picture: despite temporary setbacks due to crises, world trade has consistently expanded over time.

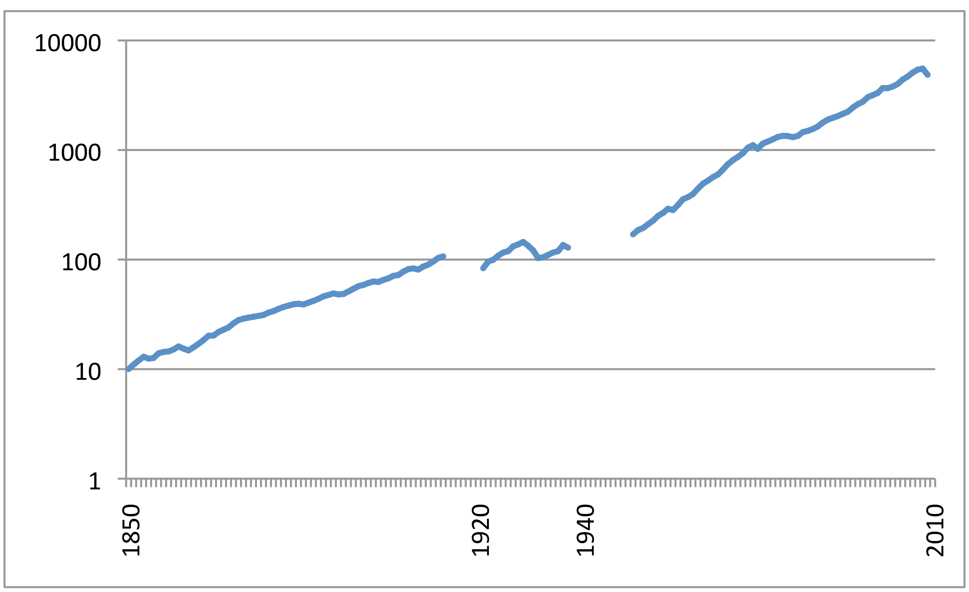

Figure 2. The Volume of World Trade, 1850-2010

Sources: Lewis (1981), United Nations (1962), World Trade Organization (2010).

Figure 3 presents the annual percentage change in the volume of world trade. Over the past 160 years, there have only been 16 years in which world trade volume actually fell. The longest and most severe fall was during the three years of the Great Depression (1930-32). In two other periods, trade volume declined in two consecutive years (1861-62, 1981-82), but to a much smaller degree. The remaining 11 instances were single year declines in world trade, the most significant of which were 2009, 1974, and 1937.

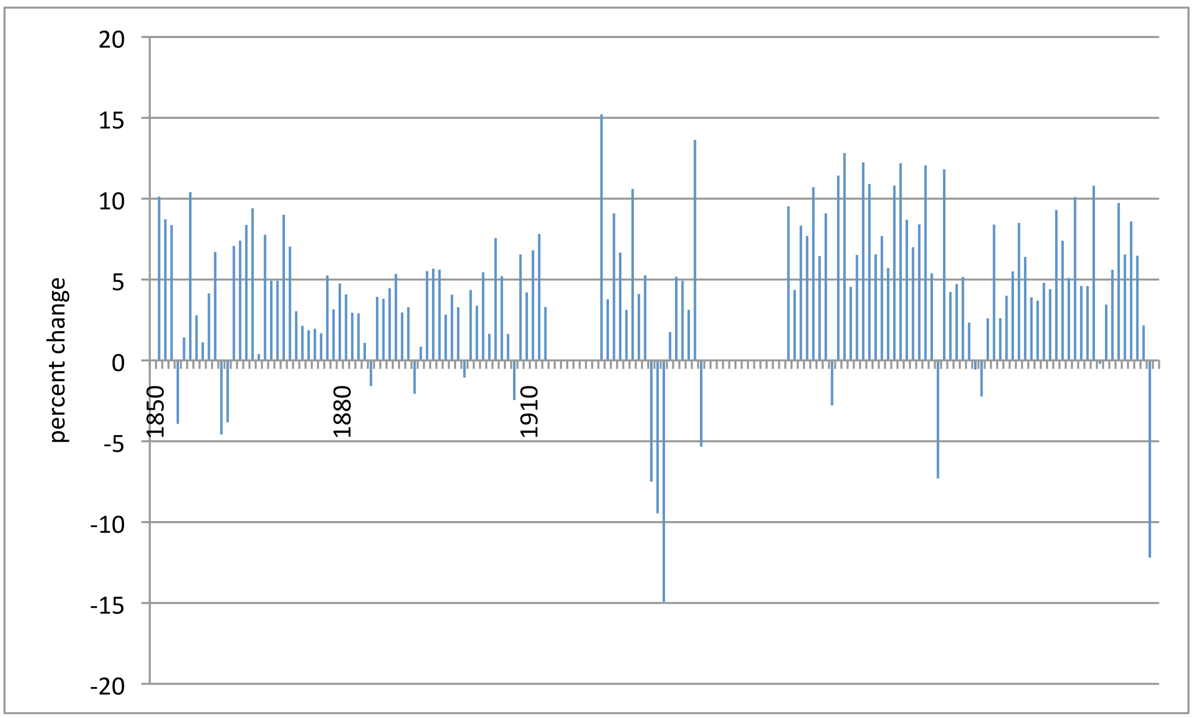

Figure 3. Percentage Change in World Trade Volume, 1850-2010

Sources: See Figure 2.

Most of the periods of declining trade are associated with a financial crisis. (For the dating of world financial crises, see Bordo et al. 2001.) Financial crises are banking and/or currency crises, and they must strike some of the larger countries (United States, United

Kingdom, in particular) in order to have an impact on overall world trade. (They are also associated with what Barro and Ursua (2009) refer to as "consumption collapses.") Of course, financial crises in individual countries would have a disruptive effect on that country's trade, but not necessarily on world trade as a whole. Furthermore, not all major financial crises have resulted in a decline in world trade. For example, the world experienced a fairly severe financial crisis in 1873, yet it never led to a decline in world trade volume, although world trade grew very slowly in 1875-78.

Table 2 lists all of the recorded declines in world trade volume and attempts to characterize the underlying shock that caused the disruption. As noted, financial crises are – in most instances – the proximate cause of the decline in trade. From our understanding of these crises, it seems appropriate to view these financial crises as exogenous to world trade and commercial policy. Most of these financial crises, while producing a worldwide recession, have not led to structural changes in the world trading system. In particular, the trade and financial shocks of 1885, 1900, 1908, 1938, and 1958 did little to change trade policies around the world. (Some of these were just recessions without a financial crisis, such as 1885? and 1958.)

There seems to be only two "real" or supply-side shocks, both of which disrupted the supply of intermediate goods enough to have significant consequences for world trade. Interestingly, they were both associated with regional wars which led to the supply of a key export good being restricted on world markets. In 1973, following the Yom Kippur War of October 1973, the OPEC oil embargo led to a sharp rise in world oil prices that helped push the world economy into recession. The American Civil War and the North's blockade of the South slashed America's foreign trade and deprived British textile mills of raw cotton in the early

1860s. In addition, the Great Depression and the Volcker disinflation shocks involved some elements of a financial crisis, but can perhaps be better characterized a severe monetary shock.

Name	Year(s)	Percentage Decline in Trade	Type	
	1854	-3.9		
Civil War	1861-62	-8.2	War/real shock	
	1885	-1.6	Financial crisis	
Barings Crisis	1892	-2.1	Financial crisis	
	1900	-1.0	Financial crisis	
Panic of 1907	1908	-2.5	Financial crisis	
World War I			Global War	
Great Depression	1930-32	-28.8	Financial crisis/ monetary shock	
	1938	-5.3	Financial crisis/ monetary shock	
	1958			
World War II			Global War	
OPEC oil shock	1974	-7.3	War/real shock	
Volcker disinflation	1981-82	-2.8	Monetary shock	
	2009	-12.2	Financial crisis	

Table 2. Declines in World Trade Volume since 1850

Two of the episodes of declining world trade are associated with a global war: World War I, and World War II. Although we do not have data on world trade stretching back as far as the 18th century, it seems safe to assume that world trade declined during the Revolutionary and Napoleonic Wars of 1792-1815 as well (O'Rourke 2007). Similarly, World War I and II were so disruptive that it is difficult to get peak to trough changes in the volume of world trade during this period. However, as Glick and Taylor (2009) have noted, military conflict is frequently associated with a loss of world trade, which can have significant welfare effects.

The key question raised by war is whether it brings institutional or policy changes to commercial policies that affect the future path of world trade. The wars of 1792-1815 led to the dismemberment of the great mercantilist empires, with their heavy restrictions on multilateral trade, and to the suppression or neutering of the great East India monopoly trading companies. They were thus a major step towards a more multilateral international trading system. Similarly, World War I broke up some colonial empires and produced a number of new states, particularly in Europe. However, this cut both ways when it came to trade, since newly independent states had independent tariff codes, thus raising trade barriers in some sense. On balance, new borders would mean new barriers in the interwar period.

The two world wars resulted in much greater government intervention in trade, which was slow to unwind after the war. They also led to attempts to erect multilateral institutions to keep the peace and to help promote open markets internationally, but with very varying degrees of success. The League of Nations had an economic as well as a security mandate, but it was as unsuccessful in its attempts to promote international trade cooperation as it was in preventing military aggression.

In contrast, after World War II the United States led efforts to form the General Agreement on Tariffs and Trade (GATT), which has been shown to have had a substantial effect in reducing trade barriers and increasing the volume of world trade (Goldstein, Rivers, and Tomz 2007).[1] However, this does not mean that world trade became more liberalized immediately after World War II than after World War I, because after World War II most countries delayed current account convertibility for many years. Furthermore, the spread of communism after 1945, and decolonization a decade later, both led to inward-looking trade policies (often involving current account inconvertibility) in most of the world (if the world is measured by population as opposed to GDP). By contrast, after World War I, most advanced economies succeeded in restoring the gold standard by the mid-1920s, with ultimately disastrous results.

One issue which we will address is therefore the political underpinnings of why one major world war produced a successful change in the institutional foundations of the multilateral system, whereas the other did not. And what was it about the international political system of the time that meant that the wars of 1792-1815 had such a liberalizing effect on world trade, relative to what had gone before? Hegemonic stability theory provides on way of thinking about these issues, although it has often been criticized as being excessively simplistic by economic historians and political scientists (e.g. McKeown 1983). Since we are heading towards an increasingly multi-polar world, the intellectual and practical stakes are high here.

Policy Responses to Trade Shocks

Wars and other trade shocks can change the entire institutional foundation of the international trading system, but they can also have less dramatic effects, changing trade policy

[1] See however Rose (2004a, b) for a contrary view.

in one direction or another while leaving the institutional foundations essentially unchanged. Not all of the trade shocks documented above had significant effects on commercial policy. We will assess what determines whether a shock triggers a major policy response or not. Wars seem to fairly systematically produce important import-competing constituencies, which agitate in favor of protection once peace has resumed (Findlay and O'Rourke 2007). To take another example, the Great Depression was a negative monetary shock that produced a large change in trade policies and a movement in the direction of protectionism that proved difficult to reverse. However, the 1937 monetary shock (that produced a "recession within Depression") and the Volcker monetary shock of the early 1980s did not do so, the latter only producing temporary trade restrictions that soon expired (VERs, antidumping duties, and the like). Thus, we hope to distinguish between those shocks that produced a trade-policy backlash and those that did not, and to uncover the reasons why.

What determines the response of the international trading system to shocks?

Geopolitical environment

There is a clear distinction between the competitive mercantilistic international non-system of the period before 1792, and the Europe which was constructed at Vienna; similarly there are clear geopolitical distinctions between the early and later 19th century, the multi-polar interwar period, and the bipolar world which emerged after 1945 (and which is rapidly being replaced with a more multi-polar system). Any account of how the international trading system responded to various shocks, including wars, has to take these differences in the geopolitical environment into account.

International institutional environment

Closely related to the first consideration is the question of the institutional underpinnings of the international trading system. Arguably the current institutional system has proven its worth during the present economic crisis, while the much weaker institutional system of the interwar period collapsed under the strain. Whether these differences are due to the institutional systems themselves, or to the geopolitical realities underlying them, seems like a question worth exploring.

Macroeconomic and exchange rate environment

Perhaps the exchange rate regime matters in determining the policy responses to severe economic crises. There were flexible rates in 1937 and the 1980s, and also in 2008, unlike the situation in the early 1890s and the early 1930s. More flexible rates meant greater macroeconomic policy flexibility, and less reliance on trade suppression.

Another macroeconomic consideration is whether governments facing a severe downturn use monetary or fiscal policy, or neither. In the early 1930s they initially used neither (see above), and those which remained passive the longest ended up being the most protectionist (Eichengreen and Irwin 2010). In 2008-9 governments responded to the crisis with both monetary and fiscal policy, and the use of fiscal policy gave them an incentive to coordinate policies (since otherwise there was the temptation to free ride off other countries' stimulus packages). By 2010, as stimulus gave way to austerity, the focus switched more to monetary policy. This led to a greater on emphasis exchange rates, and to a more zero-sum way of thinking about policy.

Long run trends in comparative advantage

There is another type of shock that can lead to trade friction across countries: long-run changes in comparative advantage across countries that shift the pattern of trade, such as the great grain invasion of the 1870s and the rise of industrializing countries in the 1970s and 1980s (Japan, Korea, and others). These are not sudden crises, but can affect longer-run trade policy: for example, the shift towards agricultural protection in countries like France and Germany in the 1870s and 1880s has turned out to be (thus far) more or less a permanent one.

They can also influence the response of policy makers to crises. Arguably, the fact that agricultural prices had been under pressure during the 1920s was one reason why the trade policy response to the Great Depression was so virulent: the road to Smoot-Hawley starts in 1928, well before the economic crisis hit. The confluence of long-run changes in comparative advantage and economic crisis also played a role in Britain's historic departure from free trade in 1932. While its comparative advantage in textiles and steel eroded in the late nineteenth and early twentieth century with the rise of the United States and Germany, domestic political support for free trade was largely unaffected. However, support for the policy rapidly dissipated after World War I, when high structural unemployment and an overvalued exchange rate led to severe macroeconomic problems for the British economy.

Similarly, the United States found that domestic support for liberal trade policies diminished considerably when it confronted new international competition in manufactured goods in the 1970s and 1980s, also a time of difficult macroeconomic adjustment. By contrast, the economy had largely adjusted to the shift in comparative advantage by the 1990s and support for trade agreements picked up.

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