Industrial Performance Center

Massachusetts Institute of Technology

Working Paper Series

Historic Imbalances and Great Debates: Do the Economists See It Coming?

Suzanne Berger

MIT-IPC-06-007

September 2006

292 Main Street, E38-104
Cambridge, MA 02139-4307
P 617-253-7522
web.mit.edu/ipc/www

Historic Imbalances and Great Debates: Do the Economists See It Coming?

Suzanne Berger
Massachusetts Institute of Technology
szberger@mit.edu

Comment prepared for the session
"Global Imbalances: Lessons from History"
Federal Reserve Bank of Boston Conference
Chatham MA • June 15-16, 2006

In August 1914 the first great wave of globalization crashed to an abrupt and totally unexpected end, as the outbreak of war suspended trading in all major markets. A financial journalist on the scene recollected a year later:

> It came upon us like a thunderbolt from a clear sky. At the end of July, 1914, any citizen of London who was asked what a moratorium meant would probably have answered that there was not such a word. Possibly he might have said that it was a large extinct woolly beast with big tusks. If he was exceptionally well-informed in matters of finance he would have replied that it was some sort of device used in economically backward countries for blurring the distinction between *meum* and *tuum*. On the second of August we had a moratorium on bills of exchange. On the sixth of August we had a general moratorium. /…The machinery of credit broke down in both hemispheres, and London , as its centre, had to be given time to arrange matters under the new conditions. After all, you cannot have credit without civilization, and at the beginning of last August civilization went into the hands of a Receiver, the God of Battles, who will, in due course, bring forth his scheme of reconstruction. [1]

How the current account imbalances in the international economy of the first globalization (surpluses of near 9 percent of GDP in Britain and very large as well in France, Germany, and Netherlands) (Bordo 2005) would have been resolved is a question that now can never be answered definitively. Even once the God of Battles had settled scores, national barriers to the flow of capital, labor, goods and services across borders did not come down for another seventy years. The general lesson of this tragedy is one that shakes credence in any kind of irreversibility of globalization or triumph of interests over politics. But within the confines of the globalization story as it played out before the war, there are lessons to be gained from observing the processes of economic and

---

[1] Withers. (1915) pp. 1-3.

political strain and adjustment. A return to the earlier period suggests, too, that there are lessons to be learned from the debates of economists and from considering whether, at the end of the day, their analyses and quarrels turned out to have identified the most important dangers to the openness and stability of the international economy or not.

Today's debates over the international flows of capital, goods, and services center around the puzzle of privilege—the possibility for some countries to enjoy "an excess return on assets relative to liabilities allowing them to sustain larger trade deficits in equilibrium"--- as Christopher Meissner and Alan Taylor define it in their contribution to this conference (p.5). Why do foreigners, at apparently such low rates of return, continue to invest so heavily in the United States? Why do American investments abroad apparently earn higher returns than others derive operating in the same countries? How sustainable is a state of affairs in which the US current account deficit is about 7 percent of GDP with a resulting debt that over time will place a large share of the country's capital stock in foreign hands? Absent any agreement on the basic mechanisms and relationships underlying this situation, and even any agreement on the existence or not of a serious problem for public policy, scenarios of readjustment diverge widely.

The mystery at the heart of economists' debates over capital flows during the first globalization (1870-1914) was the mirror reverse. It was why investors from advanced economies poured capital into peripheral and underdeveloped economies like Tsarist Russia, the Ottoman Empire, Argentina and Paraguay, even when their savings might have earned about the same returns at home in environments better insulated against dramatic reversals of fortune. Even though the British were far better positioned to do well overseas than investors from other countries, for at least the years after 1900, the British "savvy investor" abroad (Eichengreen 2006)would not have done better than his more conservative compatriot who kept his money home. As Edelstein (1982) and Davis and Huttenback (1986) show, rates of return on British investments at home and abroad in the period 1870-1913 varied considerably over time and even from decade to decade and ultimately the rates of yield for domestic, empire and other foreign investment converged. [2]

For France, which was second only to Britain in the magnitude of the capital it sent abroad, there is the same puzzle of why so much savings were invested overseas, and this question stirred up rancorous divisions among economists that spilled over into political debates over instituting capital controls. (Berger 2003; Cameron 1961) For many liberal economists at the time, there was no issue at all: people invested abroad because the returns were higher than on domestic issues. (Théry 1908; Brion 1912; "Testis" 1907) But even the mainstream economists of the day, who saw nothing more at work than the expected differences between investing in an old economy with a stagnant demography and investing in large emerging dynamic economies like Russia, calculated that the differences between returns at home and abroad were small. Paul Leroy-Beaulieu (1905), a celebrity economist of the day, made the case for buying foreign securities reasoning that it was just too risky for anyone but experts and the very rich to invest in domestic industries; and as for portfolio investment,

[2] Meissner and Taylor display the Davis and Huttenback calculations in Figure 6 in their paper, and the Edelstein calculations on slide 14.

though the rate of return on foreign issues was only a half point higher than on domestic securities, "disdain for a half percent is turning your nose up at wealth."[3] Returns varied widely by period: calculations on the rates of return of French investment abroad show some of the same patterns as the British: those investors who seized overseas opportunities early often did a lot better than latecomers. But as the advice of Leroy-Beaulieu to the neophyte investor implied, for much of the time, the gap between the rates over any number of years was not so great in either direction that individuals could readily figure out whether their best investments would be at home or abroad. Indeed, by some estimates, the French would have done better investing in France. Harry Dexter White (1933) calculated 1899 yields on French foreign and domestic securities relative to the price of issue and found the yield on domestic securities was higher (4.28%) than on foreign (3.85%) and similar conclusions for the period emerge in Lévy-Leboyer(1977) and Lévy-Leboyer and Bourguignon (1985).[4]

If massive French capital exports were not simply the response to clearly advantageous rates of return, what does explain them? As the economists and politicians who challenged the liberal view saw it, the basic error of the liberals was thinking of the world as one in which individuals face an array of rates of return and then choose. "Lysis" ---who launched the great debate over the outflow of French capital---argued that it was the institutions of French capitalism that shaped the choices and responses of investors. Far from

[3] Leroy-Beaulieu (1905) pp. 107-8.

[4] For Germany, Richard Tilly (1991) calculated that over the period 1874-1914, the annual rate of return on Prussian government issues (consols) was 4.3%; on domestic industrial shares,9.35%; and on foreign securities traded on the Berlin exchange, 6.7%. For Germany as for Britain and France, the averages reflect great fluctuations over different periods.

reflecting the absence of good investment opportunities in France, bank-led export of capital, he argued, was one of the principal *causes* of slow growth and industrial stagnation. Commercial banks channeled individual savings into foreign investment--- because the banks had only weakly-developed links to domestic industry (unlike German banks), and because French banks earned large commissions from the sale of foreign securities and from manipulating the margins between the rates at which they negotiated foreign loans and the prices at which they sold them to customers. Between 1897 and 1903, for example, a third of the Credit Lyonnais' profits came from the sale of Russian securities. From this perspective, individual investors choose only among the institutional options they find already in place. So the real issue was the structures of French capitalism and the institutions of French commercial banking.

Another camp in the debate over capital exports argued that money flowed out of France because the government used foreign investment as a lever to increase its power in international politics. As one economist explained (Brion 1912), capital exports were a kind of substitute for French weaknesses---for the sluggish economy, for inadequate military capabilities; they were "the latest form of French influence in the world." To take the case of Russia, which absorbed a quarter of all French overseas investment--after the 1870 Franco-Prussian war, French diplomacy was preoccupied with trying to build alliances that would break France's international isolation. (Kennan 1984) French governments of every political stripe saw loans to Russia and foreign direct investment in that country as ways of advancing the cause of a Franco-Russian alliance. So French governments did whatever they could to promote these flows. French officials even collaborated with Tsarist agents in France in bribing economic journalists to write glowing accounts of the prospects of the Russian economy, even at such unpropitious moments as during the 1905 revolution. (Raffalovitch 1931) As loan followed loan and French politicians and senior civil servants began to grasp the disastrous state of Russian finances, they also realized that French holdings of Russian assets had become so large that the ruin of the debtor would be a disaster for the creditor (Girault 1973)---a dilemma still quite familiar to us today. Whatever the enthusiasm of the French state for investments as an instrument of influence abroad, the role of government as a determinant of capital outflows seems a weak explanation because governments had extremely limited powers in this domain. The government could veto the listing of foreign issues on the Paris exchange, but investors found this easy enough to circumvent by going to Brussels or even Berlin. And as for positive inducements for investing at home or abroad, the government basically had no levers at its command.

As the economists' debates over the drivers of capital outflows continued—market forces? institutions? government?---they fed into party politics and into a set of legislative proposals for capital controls. As nationalist passions heated up, it seemed that refusing to allow German securities to list on the Paris exchange was not enough; laws were introduced to require any foreign borrower of French funds to commit to buying goods from France (or to buy more goods or particular goods from France rather than from Germany—this latter proposal provoked by Argentina's use of a French loan to buy Thyssen arms.) These legislative projects were defeated. Both with respect to the decisions of private investors and with respect to the use of French reserves to support the gold standard, France before World War I kept its borders open.

Against a rising tide of nationalism, the political defense of French openness turned out to depend on two improbable allies: the economic liberals, for obvious reasons; and the French Socialist Left. The Left's commitment to free trade, to open borders for immigration, and to capital mobility is difficult to understand on any purely interest-based account. Unlike Britain, where food prices depended significantly on imports, the French workers still ate French bread. French workers found themselves competing with immigrants for jobs in sectors like construction and mining. And as the Left clearly understood, the heavy flow of capital abroad weakened job creation at home and also created the prospect of new competitors in the future. Yet in the debates and parliamentary votes on openness, the Left rejected controls. Even when the Socialist leader Jean Jaures opposed new loans to Russia in 1907 at a time of particularly harsh Tsarist repression, he insisted that Socialists had no principled objection to investing capital abroad: "It would be impossible, and not at all desirable, to forbid French capital to participate in this movement, at a time when the whole world is caught up in this process of economic growth and transformation." [5]

What sustained the Left's commitment to France's role as a provider of capital in the international economy was first, the belief that the gold standard and open borders were necessary foundations of a capitalist economic order. As Polanyi expressed it (1944): "where Marx and Ricardo agreed, the nineteenth century knew not doubt." Equally important, the Left's support for open

[5] Jean Jaures, speech to the Chamber of Deputies, February 8, 1907, *Journal Officiel*, p. 338.

frontiers for capital mobility derived from its internationalism: the basic idea that nationalist autarchy was antithetical to a program of uniting workers across borders and assuring a decent life for people around the world. These socialist convictions meant that the brotherhood of workers should be extended to include even Italian and Polish immigrants, whose presence in the French job market might drive down wages; even Russian workers, whose jobs in a French-owned factory in Russia replaced jobs that might have been created at home. And in fact, the Socialist Left voted against increasing trade protection, against immigration restrictions, and against capital controls. This internationalism of convictions was anchored by the alliances that the Socialists had made with Republicans and economic liberals in the violent political battles of the turn of the century (Church-State conflict, the Dreyfus Affair) against Right-wing nationalists.

This Left internationalism was one of the earliest and permanent casualties of World War I. By the end of the war in France, across the political spectrum, nationalism had conquered the field.[6] When issues involving the use of French reserves to support the gold standard, or capital mobility, or trade, or immigration returned to the political agenda in the 1920's, the political alliances that had sustained openness in the first globalization could not be recreated. Nationalist economic policies, a retreat of French investment behind the protective barriers around French colonies (in contrast to the prewar situation where only 5 percent of overseas holdings were in French territories), political backlash against foreign economic interests---all these made the prewar

[6] For the Communist Left, of course, internationalism became synonymous with defense of the Soviet Union.

economists' debates over capital accounts very distant and irrelevant. With the collapse of the political alliances that had once sustained openness, the French in the interwar period were never again politically able to engineer the necessary domestic adjustments that would have allowed their reserves to be systematically mobilized to support a gold exchange standard. (Bordo 2005)

Keynes in 1919 described the illusions about the relations between politics and economics that the war had demolished. The English had regarded internationalization of the economy as

> "normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable. The projects and politics of militarism and imperialism, of racial and cultural rivalries, of monopolies, restrictions, and exclusion, which were to play the serpent to this paradise, were little more than the amusements of [the Englishman's]daily newspaper, and appeared to exercise almost no influence at all on the ordinary course of social and economic life, the internationalisation of which was nearly complete in practice."

Some of the French who had participated in the debates before the War about capital flows also looked back on their own earlier positions as naïve, and on the nationalists whom they had once held in contempt as having been, at the end of the day, the realists.

As in the political alliance between the economic liberals and the internationalists underpinning the French commitment to open borders for capital flows in the years of the first globalization, so, too, in the United States today the politics that preserve economic openness depend on compromises among unlikely allies, and these alliances are fragile and under increasing strain. Over the last three years, the volume of public concern and anger over outsourcing, offshoring, and foreign takeover of US assets (CNOOC, Dubai

Ports) has turned up dramatically. The factual basis for much of this public anxiety may be thin: why the agitation about the 1000 percent plus rise in imports of Chinese bras after the end of textile quotas when no bras are any longer manufactured in the US? Why the political backlash over offshoring of jobs when the Bureau of Labor Statistics finds so few US jobs that have been terminated because of transfer overseas? Or over the outsourcing of R &D to China and India, when, even setting aside the prominent cases of fraud and theft of intellectual property, careful research in the field shows that capabilities for innovative research in these dynamic emerging economies are still embryonic? (Berger 2005) But the fact is that public concerns about outsourcing and offshoring have now taken off on a political life of their own, with little direct or immediate connection to the underlying economic realities. As Figure 1 shows, the rise and fall of media attention to the shifts of capital and employment across borders now has little relation (at least in the short term) to the rise or fall of job creation or layoffs.

If a great political backlash and China scare is in the making, what can be done about it? First, one might wonder about the impact of readjustment of real exchange rates and the value of the dollar on the order of some of the scenarios envisaged in current debates about global imbalances, with a concomitant pressure for expansion of the U.S. tradeable goods and services industries. If, as Meissner and Taylor suggest (p.30) the smoothness of capital account reversal depends in large measure on building productive capacity in debtor countries, we need to examine the prospects for this in the U.S. Would creating more manufacturing jobs in the United States let off some of the protectionist steam that has built up along with the expansion of the balance of trade deficit? Will it actually be possible to rebuild manufacturing sector jobs? Or have the industries that once provided them now been so beaten up by competition or broken up by modularity, the fragmentation of production, and the relocation of production around the world that they cannot be recreated in the United States? If the expansion of the tradeable sector of the economy is not to take place in manufacturing but in services, how much room is there for growth? And which groups in the population are likely to be able to qualify for such jobs? The record of success of programs designed to retrain workers is so dismal, that the new workers for these new jobs in tradeable services would almost surely mainly be new entrants to the job market (coming out of somehow-improved U.S. secondary and tertiary institutions.) If the strategies of adjustment to rebalance current account deficits and trade deficits are supposed to generate along the way more public support for globalization, there still remain quite a few problems to be solved.

Second, and lastly, if the current debates among economists over the sources of the current global imbalances and the scenarios and strategies of readjustment run the risk, as their predecessors did in the great debates over capital flows in the first globalization , of focusing on the economic fundamentals and missing the political clamor rising outside in the streets, what *should* economists focus on to try to forestall the worst political outcomes? Here, my modest proposal would be to consider the public policies that might serve to bolster the system against surges of protectionism and the strategies that would allow us to pay for them. Anxieties about globalization today are certainly fueled by the fact that losing a job means losing health care for the family, often retirement benefits, and ---over the past few years—the likelihood of having to settle for a new job paying less than the old one. There are already a large number of proposals on the table, like wage insurance, and even some on the books, for dealing with these issues; most of them remain very partially implemented if at all. What it would take to move ahead on these fronts undoubtedly belongs to another subfield in the economics discipline than the one in which debates over dark matter rage (Hausman and Sturzenegger 2005) . But there are certainly few intellectual or political challenges as important as figuring out how to accommodate the policies that could consolidate broad public support for economic openness in America within a federal budget that needs to be brought out of deep deficit.

References

Berger, Suzanne. 2003. *Notre Première Mondialisation: Lecons d'un échec oublié*. Paris: Seuil.

Berger, Suzanne. 2005. *How We Compete*. New York: Doubleday.

Bordo, Michael D. 2005. "Historical Perspective On Global Imbalances." NBER Working Paper 11383.

Brion, Maurice. 1912. *L'Exode des Capitaux Francais à l'Etranger.* Paris: Arthur Rousseau.

Cairncross, A.K. 1953. *Home and Foreign Investment, 1870-1913*. Cambridge: Cambridge University Press.

Cameron, Rondo. 1961. *France and the Economic Development of Europe, 1800-1914. Conquests of Peace and Seeds of War.* Princeton: Princeton University Press.

Davis, Lance E. and Robert A. Huttenback. 1986. *Mammon and the Pursuit of Empire. The Political Economy of British Imperialism, 1860-1912*. Cambridge: Cambridge University Press.

Edelstein, Michael. 1982. *Overseas Investment in the Age of High Imperialism, The United Kingdom 1850-1914.* New York: Columbia University Press.

Eichengreen, Barry. 2006. "Global Imbalances: The New Economy, the Dark Matter, the Savvy Investor, and the Standard Analysis," *Journal of Policy Modeling* (forthcoming).

Girault, Rene. 1973. *Emprunts Russes et Investissements Français*. Paris: Armand Colin.

Hausmann, Ricardo and Federico Sturzenegger, "Global imbalances or bad accounting? The missing dark matter in the wealth of nations", Kennedy School of Government, December 2005 (unpublished paper)

Journal Officiel. February 8, 1907.

Kennan, George. 1984. *The Fateful Alliance.* Manchester: Manchester University Press.

Keynes, John Maynard. 1919. *The Economic Consequences of the Peace*. http://socserv2.socsci.mcmaster.ca/~econ/ugcm/3113/Keynes/peace.htm. Accessed 6/4/06.

Lysis[pseudonym of Eugene Letailleur]. 1912. *Contre l'Oligarchie Financière en France.* Paris: Albin Michel.

Leroy-Beaulieu, Paul. 1905. *L'Art de Placer et Gérer Sa Fortune*. Paris: Delagrave.

Lévy-Leboyer, Maurice, "La Balance des Paiements et l'Exportation des Capitaux Français," in M. Lévy-Leboyer, ed., *La Position Internationale de la France.* 1977. Paris: Editions de l'École des Hautes Etudes en Sciences Sociales.

Lévy-Leboyer, Maurice and François Bourguignon. 1985. *L'Economie Française au XIXe Siècle.* Paris. Economica.

Raffalovitch, Arthur. 1931. *"…L'Abominable Vénalité de la Presse…" D'Après les Documents des Archives Russes (1897-1917).* Paris: Librairie du Travail.

Testis [pseudonym of Raphael-Georges Lévy]. 1907. *Le Rôle des Etablissements de Crédit en France. La Vérité sur Les Propos de Lysis*. Paris: Revue Politique et Parlementaire.

Théry, Edmond. 1908. *Les Progrès Economiques de La France. Bilan du régime douanier de 1892.* Paris: L'Economiste Europeen.

Tilly, Richard, "International Aspects of the Development of German Banking," in R. Cameron and V. Bovykin, eds., 1991. *International Banking*. Oxford: Oxford University Press.

White, Harry Dexter. 1933. *The French International Accounts, 1880-1913*. Cambridge: Harvard University Press.

Withers, Harley. 1915. *War and Lombard Street*. London: Smith, Elder & Co.