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# THE POLITICAL ECONOMIST

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## WHAT'S INSIDE THIS ISSUE





## FROM THE CHAIR

### The Global Financial Crisis: What it Means for Political Economy

Economics-envy in political science is understandable and never more visible than in the subfield of political economy. Compared to political scientists who agree on neither method nor subject of study, economists are in general agreement on both. If a combination of deductive and inductive method is required for science to advance, economics may be the only real social science "discipline" that meets these criteria. Economists study markets, and they have well-developed theoretical and methodological tools with which to study them. That is not to say that there are not competing theories in economics, and behavioral economics has introduced heterodox assumptions about human motivation. But the size of the economics canon is large, and the terms of trade between political science and economics remain heavily in favor of economics, judging from the flow of citations and the other forms of interest one field takes in another.

The most recent global financial crisis, precipitated by the bursting of the asset-backed securities bubble in the U.S. in 2008, should put political science back in its comfort zone. Aside from the few economist Cassandras who have predicted 7 of the last 3 recessions, the economics profession as a whole has not been good at judging the difference between apparent and real prosperity. The post-mortem on this most recent market collapse has generated a rash of analyses, only some of which mainstream economics find compatible. If economists John Geanakoplos and Ana Fostel are right, boom-to-bust leverage cycles result when bad economic news, which should merely cause a market correction, instead precipitates a market overreaction by redistributing the ownership of assets and liabilities from optimists to pessimists. [1] In the first decade of the 2000s, optimistic investors bought a staggering number of asset-backed securities in mortgages and consumer loans (auto, credit-card, and student loans) on the assumption that people default on their loans randomly and independently.[2] At the same time, a growing group of pessimistic investors bet against the solvency of the loans by buying credit-default swaps which pay off with default. Bad news leads to tighter lending markets, losses by the most optimistic, leveraged buyers, and the transfer of assets into the hands of the pessimistic investors who demand more collateral, squeezing even a healthy amount of leverage out of the economy. Government regulators might have seen this coming if they had kept track of the ratio of collateral values to the down payment that must be made to buy them, but because those numbers are hard to get, the market relies on the easier but potentially misleading (debt + equity)/equity values for firms. Conclusion: perhaps financial markets do not self-equilibrate without lots of mess and damage in part because bad news triggers a cascade of unraveling bets that systematically favors investors who are psychologically prone to being pessimistic. This takes us to the edge of vast psychological waters without a boat to get across. But in fairness to economics, psychology has not yet developed a water-tight conveyance either.

The comparative advantage of political economists—those who take seriously the politics of markets--is not to size up investor behavior but to figure out how governments are likely to regulate markets, given the political constraints within which they operate. The scope for historical and comparative political analysis of market regulation is enormous. Our workhorse

1 John Geanakoplos, 2009, "The Leverage Cycle," Yale University Cowles Foundation Discussion Paper #1715 http://papers/ssrn.com/sol3/papers.cfm?abstract id=1441943##; see also Ana Fostel and John Geanakoplos "Leverage Cycles and the Anxious Economy," *American Economic Review,* Vol. 98 No.4 (2008), pp. 1211-1244.

2 Jeremy Stein, "Securitization, Shadow Banking and Financial Fragility," *Daedalus* (Fall 2010), pp. 41-51.

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## From the Editors

The *Political Economist* has long served as a forum for discussion of ideas and business among members of APSA's Political Economy Section. We hope to continue this tradition, even as we begin to expand activities beyond the traditional print newsletter. Here we would like to briefly summarize our plans for the next few years.

First and foremost, we will retain the existing format for the full newsletter. It is nice to have something to print out and read over lunch, and even if you are reading on a tablet, there is a coherence to the typeset product that we do not want to lose.

As you are by now aware, we will be distributing the full newsletter through APSA Connect, the association's new social-networking platform. Among other advantages, this provides the membership an opportunity to discuss content online—you should see a comment field on the page where you downloaded the newsletter. Each issue of the *Political Economist* should be the start of a discussion, not the end of it. We hope you will join in!

At the same time, we will be distributing selective content through the Monkey Cage, a blog run by political scientists that is widely read outside of the discipline. Journalists, policy makers, and others should be familiar with current research in political economy: collaboration between the *Political Economist* and the Monkey Cage can help us to meet this goal.

As to newsletter content, we plan two adjustments. First, in the spirit of fostering discussion, we will typically provide a few short pieces on a single theme, rather than one long article.

Second, each issue will include a "what to read" column on the same topic. Mark Copelovitch at the University of Wisconsin has graciously offered to edit this feature.

With luck, some of these changes will go off without a hitch. With non-zero probability, others will not. We hope that members of the section will let us know what they like and what they do not. With your help, we can retain the sense of excitement that has always accompanied a new issue of the *Political Economist*.

Substantively, this issue of the *Political Economist* focuses on the global financial crisis. Contributions from Jeffry Frieden, David A. Singer, and Ernest Zedillo provide different perspectives on the political economy of the crisis. They consider, respectively, macroeconomic, regulatory, and global (non)coordination as contributing factors. Mark Copelovitch contributes our first "what to read" column with brief reviews of books on the financial crisis.

Enjoy, and we welcome your feedback.


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models of collective action and median voter politics are attributed to economists (Olson 1965 and Downs 1957, respectively), but it was the political scientist E. E. Schattsneider (1960) who proposed a sort of exchange rate between these two tendencies before Peltzman (1976) introduced the idea to economics: interest groups that are likely to prevail in business-as-usual times may get shunted aside by populist politics when salience to voters is high. But the flurry of regulatory responses across the globe suggests a more nuanced set of questions squarely in the province of political science rather than economics: How are the costs of bailouts distributed, and what accounts for the patterns, both across countries and within countries? Across sectors? In the U.S., why were the CEOs of the bailed-out auto firms fired but the CEOs of the banks not? What accounts for the variation in regulatory responses across countries? Why did the international organizations charged with financial system stability play only an anemic role in financial crisis management? Political economy, which studies the sources and strategic uses of power, is well placed to move into the center stage of regulatory analysis.


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## Feature Essay

# A Classic Foreign Debt Crisis

Jeffry Frieden, Professor of Government, Harvard University

Much of the popular, and scholarly, analysis of the crisis has focused on its financial aspects: the breakdown of financial markets, the malfunction of financial innovations, the failure of financial regulation. This attention is certainly warranted. The descent into panic that started in 2007 began in the American market for asset-backed securities and their derivatives, and was transmitted throughout the world largely through financial channels.

Yet this approach to the crisis misses its broader and deeper causes. This was, quite simply, a foreign debt crisis, the result of a classic capital flow cycle. It demonstrates remarkable similarities with previous instances of capital flow cycles, and of debt crises, from Latin America in the 1980s and Mexico in 1994 to East Asia in 1997-1998 to other occurrences in Turkey, Russia, Argentina – not to mention Germany in the early 1930s or the United States many times in the nineteenth century.

Between 2001 and 2007 the United States borrowed from abroad between half a trillion and a trillion dollars every year. The aggregate amounts are hard to calculate, but probably come close to five trillion dollars and averaged about five percent of GDP per year – roughly similar to the percentages common in developing-country borrowing sprees. As capital flowed into the country, the American economy went down the well-worn path of other massive capital inflows. Large portions of the borrowed funds were spent on tradable goods, leading to a burgeoning of the country's trade deficit, which roughly doubled. The remainder went to nontradable goods and services, leading to a substantial increase in their prices. Housing was only the most prominent nontradable that experienced this effect, but the phenomenon was much broader. Between 2002 and 2007, in fact, durable goods prices declined 13 percent in the United States, while services prices rose by 25 percent. Whatever may have been happening with the nominal exchange rate, this was the functional equivalent of a real appreciation, as relative prices shifted in favor of nontradables producers and against tradables producers.

Foreign borrowing allowed Americans to consume more than they produced, and to invest more than they saved. It allowed the U.S. government to spend more than it took in in taxes. It fueled a debt-financed expansion of consumption – of importables and of nontradables. The expansion became a boom, the boom became a bubble, and the bubble eventually burst.

This familiar chain of events is typical of hundreds of instances of large-scale capital inflows, a fact made clear by Carmen Reinhart and Ken Rogoff's statistical survey of several hundred years of financial crises, *This Time is Different* (Princeton: Princeton University Press, 2009). Of course, there were plenty of differences between the American crisis and others of its type. Perhaps most important, capital did not stop flowing into the United States when the crisis hit. That is, the United States did not experience the sort of "sudden stop" that besets developing-country borrowers, and that often drives them into extraordinarily deep depressions. Imagine how much more serious the disaster would have been if American banks and firms, and the American government, had simply been unable to borrow from abroad after the summer of 2008. Similarly, the crisis did not lead to a collapse of the U. S. dollar. This may have been a mixed blessing, as a rapid decline in the value of the dollar would have spurred some of the macroeconomic adjustments the country needs. But in both instances, the United States benefited from its unique role as the world's most important economy; from the general perception that its financial markets, whatever their problems, still represent a safe haven in an even more problematic world; and from the key currency role of the U.S. dollar.

Too insistent a focus on the United States – justified in part by the American origin of the crisis – may obscure the broader international phenomenon of which it was a part. For a decade, the world economy was driven by what came to be called a pattern of global macroeconomic imbalances. One large group of countries – the United States, the United Kingdom, Ireland, much of Central, Southern, and Eastern Europe, some emerging markets – ran very large current account deficits and engaged in very similar debt-financed consumption booms. Another set of countries – led by Germany, Japan, China, and other East Asian nations – ran very large current account deficits and lent heavily to the big consuming nations.

In the abstract, and in a purely technical sense, there is nothing particularly troubling about these "imbalances" – which used to be called global capital movements. But they have turned out to be problematic for reasons not unlike that of other such experiences. Foreign borrowing seems often to cause borrowers and lenders to over-extend themselves, leading to eventual crises. And whether there is a full-blown crisis or not, accumulated foreign debts almost always give rise to conflict over how the burden of adjustment will be allocated. On one dimension, there is disagreement among countries, with debtor and creditor nations jockeying to shift as much as possible of the debt burden to others. On another dimension, there is strife within countries, as groups fight over who will pay the price of austerity and other adjustment measures. The current crisis is proving no different than previous ones on this account as well.

None of this is to take away from the significant particularities of the cur-

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## Feature Essay

# Is This Time Different?

David Andrew Singer, Massachusetts Institute of Technology

Political scientists across a wide range of theoretical and methodological perspectives have embraced and subsequently misinterpreted the conclusions in the recent book by Carmen Reinhart and Kenneth Rogoff (hereafter "R&R") ironically titled *This Time Is Different*. The book examines all financial crises over the past 800 years and catalogs their common characteristics. The authors' main conclusion—that "we've been here before"—emerges from the simple observation that large current account deficits, asset price bubbles, and excessive sovereign borrowing are common precursors of crises across countries and throughout time. The treasure trove of data presented in the book reveals that the macroeconomic status of the U.S. in 2007 was reminiscent of other countries on the verge of financial meltdowns, such as Mexico in 1994, Argentina in 2001, and the East Asian economies in the late 1990s.

Financial crises happen regularly throughout history; indeed, R&R's analysis makes the enduring pattern of boom and bust perfectly clear. However, the book *explains* very little about the patterns it presents. The authors "select on the dependent variable" by examining only cases of countries in crisis, and as a result they are unable to make causal inferences. Are large capital inflows the root cause of the current financial crisis, and did they cause earlier crises throughout history? With no variation in the dependent variable, we cannot discern whether the alleged macroeconomic triggers are the real culprits, or whether other factors are at work. Examinations of past financial crises tell us little about whether or when current account deficits lead to financial instability, or about the political and institutional factors that might militate against systemic market failures.

Focusing on the present period, a casual glance at balance of payments statistics around the world raises further questions. Several developed countries have current account deficits (and corresponding capital inflows) that are greater than that of the U.S. (when scaled to GDP). Some of these countries, including Ireland and the U.K., have clearly endured great hardship over the past two years, while others, such as Australia and New Zealand, are touted as paragons of stability. Spain, which also has a greater current account deficit than the U.S., is experiencing a severe recession, but its multinational banks are considered to be among the strongest in the world. Capital inflows alone appear to be an unreliable predictor of financial instability. This assertion is underscored by a related study by Reinhart and Reinhart (2008), mentioned briefly in R&R, which

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rent crisis. I am sure that future scholarship will help us understand better the mix of opaque financial innovations, agency problems in financial institutions, regulatory laxity and capture, and other components of the dynamic that contributed to the depth and breadth of the crisis. But the macroeconomic sources themselves also suggest some major analytical questions of direct relevance to those interested in political economy – none of which, to my knowledge, have been addressed convincingly by scholars. Herewith a simple catalogue:

1. What explains the division of the world into surplus and deficit countries? This was not a typical flow of capital from rich to poor nations: much of the capital flowed from poor to rich nations. Nor is it fully explained by demographic factors driving different savings rates, for in many instances the surplus savings of many surplus-saving countries are themselves the result of national policy. The same puzzles suggest themselves about the major borrowers: why did the United States and the United Kingdom shift so quickly from net creditors to net debtors?

2. What drove the striking macroeconomic and financial developments of the post-1995 period? To what mix of electoral, economic, technological, and special-interest constraints and opportunities were policymakers and financiers responding?

3. What was the relationship between purely financial developments and macroeconomic trends? Did finance drive macroeconomic policy, by enabling easy borrowing (and lending)? Did macroeconomic policies enable financial expansions? Or did some third set of factors drive both macroeconomics and finance?

4. Why was it so difficult for governments of the booming economies to begin adjustment before the crisis hit? From at least 2003, there was continual academic and policy discussion of the global imbalances, with a broad consensus that they were unsustainable and that they would cause serious problems. Yet virtually no government acted upon these warnings. General enjoyment of the good times is not a particularly convincing explanation, for there is ample evidence that politicians that preside over serious crises pay a major price. And yet a failure to adjust in time during a borrowing boom is the rule, not the exception.

Dismal as the outlook may be for the world economy, the current crisis provides scholars with an extraordinarily rich array of topics to investigate. Specialists in political economy have a particular advantage in bringing together the economic and political sides of the story, which have largely been considered in separation. We also have a particular duty, as scholars, to bring clarity to a set of issues that are poorly understood.

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finds that "capital flow bonanzas" are not statistically significant predictors of financial crises when the analysis is limited to developed countries.

An additional challenge for political scientists who argue that history is repeating itself is that the financial crisis in the U.S. defies historical analogies. Large capital inflows were the norm for years, helping to fuel the dot.com bubble in the late 1990s; when the bubble burst in 2000-2001, it wiped out approximately $5 trillion in market capitalization without triggering broader financial instability. When the financial crisis finally hit in 2007, it was *not* characterized by the defining feature of past financial crises: a sudden stop of capital inflows. On the contrary, investors flocked to the U.S.—the center of the storm—as a safe haven.

Despite the challenges of causal inference, many social scientists seem content to attribute the financial crisis to underlying macroeconomic imbalances. In my view, these arguments provide useful cover for financial regulators who might otherwise be held accountable for their rule-making. If systemic failure is the periodic and ineluctable result of global capital cycles, then there is little reason for regulators to enact tougher regulations. Why should central banks and regulatory agencies impose more stringent capital requirements and prohibitions against risky investments? If the roots of the crisis are macro-structural, regulators feel no incentive to alter the rules. How else can we explain why U.S. regulators, when facing the public or their overseers in Congress, speak of recent bank failures as if they were exogenous acts of nature? Why is it that only a precious few readers of this column can name the head of the Office of the Comptroller of the Currency (OCC), the regulator in charge of overseeing all nationally chartered banks, including many prominent institutions that collapsed or came dangerously close to failing during the crisis? After the dot.com fiasco, SEC chairman Harvey Pitt received a rather large dose of opprobrium as his tenure in Washington came to an abrupt end; but in today's political theater, regulators appear more like fire fighters than villains. Ten years from now, we will remember a short list of prominent characters from this difficult period: Ben Bernanke, Henry Paulson, Timothy Geithner, Larry Summers, and a few others. But it is a safe prediction that John Dugan, head of the OCC from 2005-2010, will not make the list.

Political theater aside, an undue emphasis on global capital cycles has the effect of obfuscating the role of government decisions as drivers of financial crises. After all, governments make decisions about their budgets—not just about how much to spend, but what to spend on. Choices about spending on education, infrastructure, and technology have important ramifications for export competitiveness and the balance of payments; and decisions about spending and taxation determine the extent of sovereign borrowing. Political scientists, of course, are well equipped to explain these decisions.[1] But just as important are the decisions made by policymakers and regulators regarding the manner in which capital flows are channeled through the financial system. A banking system that is required to finance mortgages exclusively through deposits will mediate capital inflows very differently from a banking system that can securitize its loans. The accumulation of government decisions regarding intermediation, capital adequacy, public ownership, lender of last resort, and financial transparency could be critical in determining whether capital inflows are channeled safely and productively, or whether they lead to another addition to R&R's database of crises.

From a research design perspective, a reasonable way forward is to test hypotheses about the *conditional* impact of capital inflows on the probability of financial crises in the developed world. The scope and quality of regulation are likely contenders for inclusion in such a model. The cases of Australia and Spain suggest that large capital inflows might be less destabilizing if the banking system faces strict capital requirements and prohibitions against non-traditional banking activities. Other possible conditioning variables include, *inter alia*, resource endowments, partisanship, and corporate governance.

Until we conduct more rigorous tests, social scientists will remain in the uncomfortable position of offering only speculation and conjecture. The availability of hundreds of years of data on previous crises should not give us a false sense of confidence about our capacity to explain. Indeed, we simply do not know whether this time is different or not.

1 See Broz (2010) for a first-cut analysis of the partisan drivers of capital flow cycles.

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## FEATURE ESSAY

# The Importance of Macroeconomic Policy Coordination

Ernesto Zedillo, Director of the Yale Center for the Study of Globalization, President of Mexico, 1994-2000

Without any pretence of originality, and admittedly superficially, what I want to do is to stress the importance of macroeconomic policy coordination - or lack thereof - in explaining both the outbreak of the crisis we have gone through and also the possibility that another big crisis might be brewing.

In truth, my remarks are about a problem bigger than macroeconomic policy coordination. They boil down to the question of global governance: the risks and opportunities of globalization, as well as providing for the global public goods that the world urgently needs already today and will need in the foreseeable future.

Of course it is not my intent to go into the technicalities of macroeconomic policy coordination, which I leave to the truly professional macroeconomists. However, I take it for granted that it is not terribly difficult to identify macroeconomic disequilibria and/or misalignments among national economies where avoidance of nasty consequences calls for some kind of preventive or corrective policy coordination across countries.

The point I want to make is that even if it is technically possible to identify those situations and the kind of interventions that are needed, in reality they are either seldom undertaken or when they are, it is only under rather stressful circumstances.

To understand why this is so, we economists must be humble and acknowledge that a good part of the answer lies outside the international economics framework we usually use when dealing with these kinds of issues. If we really want answers that are not only right in theory but that have some meaningful policy relevance, then we need to be more attentive to what other disciplines - like political science, international relations and history - have to say about questions of international collective action.

To put the topic in perspective, I must disclose that I belong to the group of people, like Jeff Frieden, who believe that ultimately the most important cause of the great crisis of 08-09 is to be found in the global macroeconomic imbalances. This is not to say that other circumstances - like certain features including perverse incentives built into the financial system - did not play a significant role.

Probably earlier and better than anybody else, Raghu Rajan explained - in a now memorable participation at the meeting of the Kansas City Federal Reserve at Jackson Hole, Wyoming in 2005 - how risky the financial system had become and of course now his new book has given us a uniquely lucid account of the crisis and what went wrong in the financial system.

Interestingly, however, Raghu, in his capacity as Chief Economist of the IMF during 2003-2006, was also one of the sharpest analysts warning of the dangers entailed in the global macroeconomic imbalances. I suspect that Raghu was one of the key intellectual forces who, from inside the IMF, pushed and got countries to agree on a new process of "multilateral consultations with systemically important countries" with a view to dealing with the global macroeconomic imbalances, a process that took place during 2006-2007.

Unfortunately, despite some hard work on the IMF's part, the 06-07 exercise did not make countries agree on a diagnosis of the problem and, least of all, on the actions to be taken by each player. Rather, too soon the institution abandoned the entire exercise, and this happened ironically as the tip of the iceberg of the global financial crisis - the collapse of the U.S. sub-prime market - started to show up in the summer of 2007.

My guess is that member countries came to regret that instead of encouraging the new IMF Managing Director and Raghu's successor to persevere in fulfilling the institution's multilateral surveillance duty, they charged Mr. Strauss-Kahn, with the highest priority at the start of his tenure, with the task of shrinking the IMF's capabilities. This happened just when the economic situation was about to become particularly demanding of those capabilities.

Apathy and even opposition towards policy coordination, of course, mutated into the exact opposite as the crisis unfolded - more evidently in the summer of 2008, and very dramatically after the collapse of Lehman Brothers in mid-September of that year. One needs to go back a quarter of a century - to the time of the Plaza Accord - to identify a period when the largest economies of the world endeavored to have the kind of coordination they tried to pursue anew in the face of the panic of the second half of September and early days of October, 2008.

Admittedly, some people, with the benefit of hindsight, criticize the quality and effectiveness of what the major economies' financial authorities decided at the time. I am of the view, however, that such criticism is for the most part unwarranted. The panic and collapse that was being confronted made ministers of finance and central bankers agree on unprecedented and massive policy interventions. These eventually enabled the light to be seen at the end of the dark, long, and dangerous tunnel we were in during the fall of 2008. In addition, and very significantly, they also provided a decisive antecedent for launching a more ambitious platform of policy coordination: the G20 at a leaders' level.

Actually, this was an idea that had been waiting to be entertained by leaders for a long time. I don't want to go into its intellectual provenance; suffice it to mention that a modality of what is today the G20 was proposed in the mid-1990s by the Commission on Global Governance that a few years earlier had been launched by Billy Brandt, who unfortunately died before the report was

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published. I made my own call in 2001 in the High-level Panel on Financing for Development appointed by Kofi Annan, which I chaired, and a few years later in the International Task Force on Global Public Goods that I co-chaired.

I was then very pleased to see the G20 coming to life, even if it was under the impulse of a terrible crisis. I was even more pleased when I looked at the outcomes of the first two meetings, and somewhat also of the third meeting. I will explain later why I say "somewhat."

The Washington Summit of November 15, 2008 yielded an accurate diagnosis of the crisis and started to outline some of the further actions that needed to be taken. Leaders were right on target when they said:

"Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption".

Also, their Washington commitment to reject protectionism and keep the global economy open was particularly meaningful at a time when global trade was literally collapsing - although some members of the G20 violated their commitment almost immediately, but not too aggressively.

The most remarkable outcome of the April 2009 London Summit was the allocation of significantly larger resources to the IMF which allowed the institution to put out fires before they spread in key countries like Turkey, Mexico and Brazil, without actually spending the money.

Ironically, some critics of the IMF have used the non-use of the resources allocated to the institution in London to support their old argument of the IMF's futility. Of course, what the 2009 events showed is that when properly endowed with resources and political support, the IMF works. The IMF is a useful global institution.

The Pittsburgh meeting of September 24-25, 2009 produced both good and not so good news. It acknowledged the importance of addressing the global imbalances, particularly at a time when the economic recovery was already in sight. Although the language stressing the importance of the global imbalances was subdued relative to that used in the Washington Communiqué, it is clear that the imbalances continued to be a central concern of leaders. In fact, so much so that they launched something that they called "Framework for Strong, Sustainable, and Balanced Growth," which among other things states that they will work together to "ensure that fiscal, monetary, trade and structural policies are collectively consistent with more sustainable and balanced trajectories of growth," and also will collectively "undertake macro prudential and regulatory policies to help prevent credit and asset price cycles from becoming forces of destabilization." One can call this statement of purpose, and its accompanying compact, impeccable.[1]

However, and this is the bad news, the way for implementing the framework agreed by the leaders seemed to me right away condemned to be ineffectual.

They adopted "a cooperative process of mutual assessment," a sort of peer review mechanism, giving the IMF - and to a much lesser extent the World Bank and other multilateral institutions - an essentially advisory and a secretariat role in the process.

My fears of ineffectuality were confirmed by the outcome of the St. Andrews G20 Ministerial Meeting on November 7, 2009, where more details about the process were revealed. No third party - which obviously should be the IMF - has been given the teeth to make countries at least submit consistent policy templates for macroeconomic adjustment, and least of all for enforcing what could eventually be considered the necessary contribution of each country toward rebalancing the global economy.

What was delivered both at the spring ministerial meeting and the G20 meeting of June 26-27, 2010 in Toronto suggests that the process implementing the framework is rather shallow and would hardly serve the purpose of having robust and effective "revised mutual assessment and policy recommendations for final consideration by the Leaders at their summit in November 2010."

It is not auspicious of leaders' willingness to do as they said repeatedly, up through the Pittsburgh meeting, that at the latest summit in Toronto they quietly dropped their goal - previously stated ad nauseam - of concluding the Doha Round. So I take for granted that on the key question of macroeconomic policy coordination, the November G20 meeting will deliver at best another wish list of good coordinated macroeconomic behavior without any institutional mechanism to make such behavior more likely.

One can hardly be optimistic about what could happen at and after the November Korea summit. Widening the G20 agenda now seems to be a clear trend. The Korean hosts, with some reason but with a high opportunity cost, are introducing so-called development issues that inevitably will continue diverting leaders' attention away from the unfinished agenda.

Increasingly, when addressing the crisis, leaders of the G20 prefer to focus on the failures of the financial system and ignore governments' own failure to adopt sensible and coordinated macroeconomic policies. Other than the extraordinary measures that were implemented during the darkest days of the crisis, in practice, coordination has not really been a strong international currency. Just consider the rather unilateral path followed by the var-

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1 The compact is that: G-20 members will agree on shared policy objectives. These objectives should be updated as conditions evolve.
G-20 members will set out our medium-term policy frameworks and will work together to assess the collective implications of our national policy frameworks for the level and pattern of global growth and to identify potential risks to financial stability.
G-20 Leaders will consider, based on the results of the mutual assessment, and agree any actions to meet our common objectives.

## What to Read

# Books on the Global Financial Crisis: An Annotated Field Guide

Mark Copelovitch, University of Wisconsin, Madison

Three years on from the start of the global economic crisis, hardly a day passes without the arrival of yet another highly touted book on what has come to be labeled the "Great Recession." Indeed, bookshops' shelves now buckle under the weight of a towering pile of bestsellers (and not-so-bestsellers) on the causes, consequences, and lessons of the crisis. Broadly, these books fall into three genres. First, there are the "current histories" – fast-moving, journalistic accounts detailing the exploits (or treachery) of Wall Street banks, government officials, and other relevant actors prior to and during the crisis. The best of these accounts include: *Fool's Gold* by Gillian Tett; *The Big Short*, by Michael Lewis; *In Fed We Trust*, by David Wessel; and *Too Big to Fail*, by Andrew Ross Sorkin. Second, there are the "crisis handbooks" – general interest volumes by prominent economists, all of whom claim to know precisely what caused the crisis and precisely what the solutions are to prevent a reoccurrence. The most prominent of these are: *Thirteen Bankers*, by Simon Johnson and James Kwak; *Crisis Economics*, by Nouriel Roubini and Stephen Mihm; and the updated version of *Return of Depression Economics*, by Paul Krugman. Political economy scholars are likely to be familiar with the main arguments of these volumes, since they are mostly pithier versions of previously published academic work or media articles by the authors. Finally, we have the "efficient markets" critiques (e.g., *The Myth of the Rational Market*, by Justin Fox; *How Markets Fail*, by John Cassidy) – books that blame investors' and policymakers' blind faith over the last decade in free market ideology and the efficient markets hypothesis as the primary cause of the crisis. An important subset of this last genre is the "Keynes was right after all" volume, epitomized by Robert Skidelsky's book, *Keynes: The Return of the Master* (but see also Richard Posner's fascinating article in the *New Republic*, "How I Became a Keynesian," September 23, 2009).

To be sure, there is much to learn from each of these genres, and the titles cited above are certainly worth the reader's time and effort. From the standpoint of research on the political economy of financial crises, however, these books are substantially less rewarding. In their attempts to sell copies and highlight colorful characters, the "current histories" spin neat and tight stories about the causes of our financial turmoil, most of which focus on the actions of a handful of villains (usually Wall Street bankers) or a few broad factors (deregulation, securitization, etc.) related to the complexities of modern financial markets. Consequently, books in this genre heavily discount or overlook entirely many of the longer-term trends and structural economic and political factors that have contributed to the onset and severity of the Great Recession. Similarly, while the "crisis handbooks" do emphasize many of these deeper political economy factors, their authors generally spend far too much time advancing grandiose proposals to reform both domestic policies and global financial governance – proposals that political scientists will readily identify as infeasible due to a wide variety of political factors that the

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ious financial reform initiatives, including the road that led to the Dodd-Frank Act in the U.S. Equally suggestive is the news that the President of France, the next G20 chair for a full year, put forward his own proposed agenda in which the question of global imbalances and their coordinated correction is not considered sharply and coherently - to put it mildly.

I am afraid that sooner rather than later the G20 leaders will come to regret their parsimony in honoring the commitment to rebalance the global economy. They seem to have found some solace in the correction that has occurred since 2007. They could be dangerously overlooking that most of the correction was due to the global recession and had very little to do with any significant improvement in the underlying structural conditions of the imbalances.

If anything, those structural conditions are now less propitious for preventing or correcting the global imbalances. There is not yet much structural change in the largest deficit economy - the U.S. - nor in the large Asian surplus economies; and the Euro area - other things being equal - is now also bound to become a large contributor to the imbalances on the surplus side of the equation. The inevitable adjustment in the large current account deficits of countries like Greece, Ireland, Portugal and Spain, will lead - I insist, *ceteris paribus* - to an even larger surplus in Germany and will make the Euro area a surplus generator.

Since the world as a whole must be in equilibrium, it follows that somebody must absorb the surpluses of the Asians and Europeans of this world. The question then is whether the U.S. can continue to be the borrower and spender of last resort.

Even if an affirmative answer to this question made eminent economic sense - which it doesn't - it would still remain to be seen whether that is also the case from the perspective of politics. If I have read Jeff Frieden's recent papers and book well, I cannot be anything but pessimistic about the severity of the storms ahead. I am afraid that the tail will wag the dog and it doesn't matter whether the economy is the tail and politics the dog, or the other way around. Either way, it will be ugly.

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authors (like most economists) fail to adequately take into account. In this regard, the current crisis is no different than previous ones (most notably the Asian financial crisis), in which global financial turmoil is followed by grand yet soon-to-be-discarded plans to reform the "international financial architecture." Finally, while the "efficient market" critiques are not without merit, they, too, tend to reduce the cause of the crisis to a single "magic bullet" – in this case, ideas and ideology – when in reality the truth is much more nuanced and complex.

That said, those in search of richer alternatives need dig only a bit further into the pile to be rewarded. What follows is a brief annotated bibliography of books – both new volumes and older ones worthy of review – that rigorously tackle the complexities of the global financial crisis and, in my opinion, provide a solid foundation for further thinking and research on the topic. While this list is certainly not exhaustive, I believe it is a useful starting point for scholars of political economy interested in developing a richer understanding of the causes, consequences, and policy implications of the Great Recession.

**Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises*** (Wiley, Fifth Edition, 2005; first edition, 1978).

This is the canonical volume on financial crises from one of the foremost economic historians of the twentieth century. Building on his renowned history of the Great Depression (*The World in Depression, 1929-1939*), Kindleberger leads the reader through discussions of the "big ten" financial bubbles in global economic history, from the Dutch tulip bubble in the 1600s, through the U.S. stock market bubble of 1995-2000. The book is rich in entertaining anecdotes, even as it clearly delineates the common features of all financial crises and rigorously analyzes possible policy responses at both the domestic and international levels. Although much from this volume has subsequently been reiterated elsewhere in more recent books and articles, the original remains very much worth reading. Indeed, this is the logical starting point for any serious scholar interested in understanding the current global financial turmoil.

**Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*** (Princeton University Press, 2009)

Perhaps the most widely lauded book to emerge from the current crisis, this volume is, in many ways, the quantitative companion to Kindleberger's elegant narrative history of financial crises. In fact, I would argue that Reinhart and Rogoff's true contribution is not this book (which, to be frank, is rather tedious to read) but rather the massive, rich database that they have constructed and made available to researchers. With impressive care and exhaustive detail, Reinhart and Rogoff have collected and measured the economic characteristics of countries and crises back to twelfth-century China and medieval Europe. Thus, *This Time is Different* documents the "remarkable similarities" of financial crises over time and across cases – most notably, the presence of "excessive debt accumulation" by governments, banks, corporations, or consumers. In separate chapters, the authors also analyze multiple types of crises (including sovereign defaults, banking crises, and exchange rate crises) in an effort to make clear precisely how and why "this time" is rarely (if ever) truly "different." As David Singer notes in his piece in this newsletter, this treasure trove of data is merely a starting point for political scientists: documenting similarities across crises (even in the rigorously detailed way that Reinhart and Rogoff have done) explains neither variation in the timing, frequency, and severity of crises nor the reasons why policymakers across countries and over time repeatedly adopt the types of policies that lead to crises. Nevertheless, *This Time is Different* is a magisterial contribution to the field that is required reading for political economists interested in the determinants, consequences, and responses to financial crises.

**Raghuram Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*** (Princeton University Press, 2009)

Though firmly in the "crisis handbook" genre, Rajan's volume stands out for two reasons. First, Rajan is one of the few economists who can credibly claim to have predicted the crisis, as evidenced by his well-known contrarian paper presented at the Jackson Hole conference in 2005. Consequently, Rajan's volume is a more credible handbook than many others' and therefore more worthy of detailed attention. Second, and more importantly, Rajan moves quickly past the "most proximate suspects" (the heroes and villains of the "current history" and "crisis handbook" genres) to emphasize deeper, underlying macroeconomic trends – the "fault lines" of the book's title – that led to the crisis. These include: 1) rising income inequality and wage stagnation in the U.S., which fueled policymakers' incentive to provide cheap credit (in the form of subsidized mortgages and lax monetary policy) to maintain middle class living standards; 2) macroeconomic imbalances between surplus and deficit countries in the world economy (on this, see more below from Martin Wolf); and 3) tensions between the different financial system models across countries (in particular, between the U.S./UK on the one hand and China/Japan on the other). Thus, Rajan eschews the neat, "magic bullet" explanations advanced by many other writers, concluding instead that there is plenty of blame to go around, with bankers, regulators, governments, households, and economists all sharing some responsibility for bringing about the current crisis. While this is less satisfying in one sense (to blame all is to blame none), it is much more in line with

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a political economy perspective of the world, in which variables interact, causal effects are conditional, and outcomes in the international economy are frequently the result of a complex web of interests, policies, and trends over many years.

**Martin Wolf, *Fixing Global Finance*** (Johns Hopkins University Press, 2008)

Wolf, the *Financial Times*' chief economics commentator, is widely acknowledged to be the preeminent newspaper columnist writing on global finance today. Wolf's knowledge, insight, and expertise are so valuable that one could arguably remain well briefed on developments in the global economy simply by reading his *FT* column on a regular basis. In fact, I would highly recommend an afternoon reading Wolf's columns from 2007 through 2010, in sequence, as an excellent way to get up to speed on the developments and policy debates surrounding the crisis, from the collapse of Bear Stearns and Lehman Brothers through the negotiation of Basel III and the recent IMF voting and lending reforms. In addition, Wolf's book, published in 2008, is also well worth the time. In contrast to the "genre" books mentioned earlier, Wolf focuses on how the macroeconomic policies of key countries (particularly the U.S. and China) have resulted in the "global imbalances" that lie at the heart of current tensions about exchange rates and "currency wars" in the global economy. In Wolf's view, these macroeconomic imbalances are both a precondition for financial crises and an ongoing impediment to exiting the Great Recession. From a political economy perspective, this argument is important, as it shifts our focus away from the microeconomics of finance (e.g., mortgage-backed securities, credit default swaps) toward deeper problems (exchange rate regimes, persistent payments imbalances) that must be addressed in order to rebuild the global economy. Not surprisingly, this leads Wolf to focus more than others on politics; indeed, in both his columns and in his book, Wolf exercises a well-trained eye for identifying how domestic politics and international relations shape economic policy and have constrained governments' ability and willingness to cooperate at the global level in addressing the causes and consequences of the crisis. Finally, *Fixing Global Finance* also contains an extremely useful introductory chapter on the "Blessings and Perils of Global Finance," which highlights the critical tradeoffs facing countries in a world of financial globalization. This reminder of the purposes of financial markets, the costs and benefits of international capital flows, and the various government policy options available to address the core problems of financial markets (incomplete/asymmetric information, moral hazard) are an extremely useful starting point for shaping discussions about the politics and policies of international finance.

**Jeffry A. Frieden, *Global Capitalism: Its Rise and Fall in the Twentieth Century*** (W.W. Norton, 2006).

*Global Capitalism* was published before the current crisis engulfed the world economy, and it is not, strictly, a book about financial crises. Nevertheless, it is required reading for those interested in understanding the political economy of financial crises, for two reasons. First, it is the best single-volume history of the modern world economy over the last 150 years. Given the rampant and often selective use of various past crises (the Great Depression, Japan in the 1990s, etc.) as analogies for explaining the current situation, it is clear that most observers lack the solid foundation of historical knowledge about the world economy that *Global Capitalism* provides. Second, *Global Capitalism* provides a rich, comprehensive discussion of how domestic and international political factors have systematically and repeatedly shaped national economic policy choices and global economic governance over the last two centuries. Frieden's conclusion – that the evolution of economic globalization ultimately depends upon domestic and international political factors as much (if not more) than economic variables – reminds us that scholars of international political economy are perhaps best positioned to analyze the complex questions and issues arising from the Great Recession. Frieden's actual book on the current crisis, *The Lost Decades: The Making of America's Debt Crisis and the Long Recovery* (co-authored with my colleague at Wisconsin, Menzie Chinn), will be published this coming September. Based on the brief preview already circulating, it looks to be another worthy addition to this reading list. In the meantime, a thorough reading (or re-reading) of *Global Capitalism* is certainly in order.

# General Announcements

## Section Awards

### William Riker Award

The **William H. Riker Award** is given for the best book on political economy. One copy of each book should be sent to each committee member by **March 1, 2011**.

**Award Committee Chair:**
Charles R. Shipan
University of Michigan
Political Science
5700 Haven Hall
505 S State Street
Ann Arbor MI 48109-3091

**Award Committee Member:**
Orit Kedar
Massachusetts Institute of Technology
Political Science
77 Massachusetts Ave., E53-429
Cambridge MA 02139-4307

**Award Committee Member:**
David Stasavage
New York University
Politics
19 West 4th Street
New York NY 10012

### Mancur Olson Award

The **Mancur Olson Award** is given for the best dissertation completed and accepted in the previous two years. One copy of each dissertation should be sent to each committee member by **March 1**, **2011**.

**Award Committee Chair:**
James N. Druckman
Northwestern University
Political Science
Scott Hall, 601 University Pl
Evanston IL 60208

**Award Committee Member:**
Jonathan Rodden
Stanford University
Political Science
616 Serra Street, Encina Hall
Stanford CA 94305

**Award Committee Member:**
Layna Mosley
Univ. of North Carolina, Chapel Hill
Political Science
361 Hamilton Hall, CB 3265
Chapel Hill NC 27599-3265

### Best Paper Award

The **Best Paper Award** is given for the best paper in Political Economy presented at the APSA meeting. Nominations should be submitted by **March 1, 2011**.

**Award Committee Chair:**
William T. Bernhard
Univ. of Illinois, Urbana-Champaign
Political Science
361 Lincoln Hall
702 South Wright Street
Urbana IL 61801

**Award Committee Member:**
Sarah M. Brooks
Ohio State University
Political Science
2140 Derby Hall
154 North Oval Mall
Columbus OH 43210

**Award Committee Member:**
David M. Primo
University of Rochester
Political Science
Harkness Hall 318
Rochester NY 14627-0146

### Michael Wallerstein Award

The **Michael Wallerstein Award** is given for the best published article in Political Economy in the previous calendar year. It is presented at the APSA meeting. One copy of a nominated article should be sent to each member of the committee by **March 1, 2011**.

**Award Committee Chair:**
Scott H. Ainsworth
University of Georgia
Political Science
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**Award Committee Member:**
B. Peter Rosendorff
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**Award Committee Member:**
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