MACRO FIRST:
POLICY COORDINATION AFTER THE GREAT RECESSION

Daniel W. Drezner*
The Fletcher School of Law and Diplomacy
Tufts University

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* Fletcher School of Law and Diplomacy, Tufts University. E-mail: daniel.drezner@tufts.edu.
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Introduction

By any measure, the 2008 financial crisis – popularly labeled the Great Recession – qualifies as a big enough crisis to affect the world trading system. The International Monetary Fund (2009) estimates that banks and other financial institutions lost more than $4 trillion in the value of their holdings as a result of the crisis. An Asian Development Bank-commissioned report (Loser 2008) concluded that the global decline in asset values led to aggregate losses of *$50 trillion* in 2008 – more than a year's worth of global economic output. In the fourth quarter of 2008 alone, the global economy shrank by approximately five percent. By any conceivable metric, the 2008 financial crisis triggered the largest global economic downturn since the Great Depression on the 1930s.

The benefits of an open global economy for rich and poor alike are considerable (Bradford, Grieco and Hufbauer 2006; Broda and Weinstein 2006; Dollar and Kraay 2002; Wolf 2004). If maintaining an open global economy is an explicit policy goal, then the Great Recession has left global policymakers with something of a Hobson's choice. On the one hand, the recession has had an enervating effect on efforts to promote trade liberalization. For those who subscribe to the "bicycle theory" of trade, the stalling out of the Doha round sparks fears of further backsliding against the status quo of relatively unrestricted trade flows. An obvious policy choice would therefore be to jumpstart the traditional trade agenda. This agenda includes: a redoubling of efforts to complete the Doha round; completing Russia's accession into the World Trade Organization; a renewed effort to develop comprehensive solutions to the "Singapore issues" of government procurement, trade facilitation, investment, and competition policy; negotiations to address the "trade and" issues of labor standards, environmental protection, and consumer health and safety issues; and expanding the WTO's purview over the cross-border exchange of services. For most negotiators, these are the principal issues on the trade agenda.

At the same time, the Great Recession has exposed the ways in which trade is enmeshed with macroeconomics – and the need for greater policy coordination in the latter area. For the purposes of this paper, macroeconomic policy coordination is defined as the mutually-agreed adjustment of fiscal, monetary, or exchange rate policies in order to decrease volatility and increase growth. Coordination activities can range from mutual surveillance and disclosure of intended policies to interventions in foreign exchange markets to joint announcements and actions with regard to fiscal policy. The notion behind policy coordination is that the mutual management of these policies can prevent countries from pursuing contradictory approaches that cancel each other out. In literature reviews on the topic, even policy skeptics acknowledge that even modest levels of macroeconomic cooperation can be welfare-enhancing (Webb 1994; Willett 1999; Mooslechner and Schuerz 1999)

Although economists tend to dismiss any link between trade policy and macroeconomic policy, they are connected via multiple political mechanisms. For the global economy to remain relatively open, there needs to be a sufficient degree of exchange rate and macroeconomic policy coordination among the great powers. From a global governance perspective, however, the institutions promoting policy coordination are far weaker than those promoting trade liberalization. A renewed focus on enhanced surveillance of existing macroeconomic policies, a sustainable exchange rate regime, a reduction of large-scale macroeconomic imbalances, some measure of fiscal policy coordination and a consensus-based international monetary system could promote global macroeconomic stability. It would also generate large positive externalities on the trade front. It might therefore be prudent for foreign economic policymakers to focus more on macroeconomic policy coordination than trade liberalization – even if they are most concerned about the latter.

This question is hardly a trivial exercise. Although the crisis has triggered heated debates over the relative merits of economic globalization, even mainstream critics of the Washington Consensus (Rodrik 2007:2) acknowledge that, "globalization, in some appropriate form, is a major engine of economic growth." The economic opportunity costs of renewed protectionism would be massive – as would the effect on international security and stability. Trade liberalization is not a magic bullet for peace and prosperity, but openness to trade is strongly correlated with democracy, peace, prosperity, and the rule of law (Oneal and Russett 1999).

This paper argues that for the second era of globalization to continue to sustain itself, leaders should focus more on macroeconomic policy coordination than trade liberalization. Neither policy goal will be easy – indeed, the bargaining core for both issues is very small. If political capital is a scarce resource, however, then it should be husbanded for macroeconomics rather than trade. Simply put, the indirect benefits of policy coordination outweigh the direct benefits of further liberalization.

The rest of this paper is divided into seven sections. The next section considers the possibility that benign neglect on trade policy at the present moment would trigger a massive increase in protectionism. The third section examines the political linkages between macroeconomics and trade. The fourth section sketches out a simple theory of the conditions under which macroeconomic cooperation is likely. The fifth section briefly reviews the past century of policy coordination. The sixth section makes the case for why macro should go first; the final section summarizes and considers next steps.

Does neglecting trade liberalization translate into Smoot-Hawley II?

At first glance, the emphasis on macroeconomic policy coordination would seem to be misplaced in an era that is increasingly receptive to traditional forms of protection. Without renewed efforts at continued liberalization, the argument runs, a slippery slope of protectionism could trigger a sequel to the beggar-thy-neighbor policies of the

Depression era. These concerns, coupled with an implicit acceptance among policymakers and commentators of the "bicycle theory," merit closer examination.

To be sure, the Great Recession triggered both real and rhetorical concerns about the revival of protectionism. The real concerns emerge from the combined effects of the recession and the policy response to it. The downturn sparked what can only be described as "de-globalization." Export engines were hit by massive losses in their trade flows. China's exports fell by 20% in the first quarter of 2009, and Japan's exports fell by 70%. Entrepôt economies like Singapore saw their economies shrink by a fifth during the same time period. At the global level, the World Trade Organization (2009) estimates that world trade levels will fall by nine percent this year – the first year-on-year fall in postwar economic history. Beyond conventional trade figures, the recession also led to a drying up of cross-border capital flows. The downturn led to a crackdown on cross-border economic migration, causing labor remittances to dry up. The "flight to safety" and "home bias" effects of the crisis have led to financial deglobalization, with private capital rushing away from the developing world in particular. The World Bank estimates that net private capital inflows into the developing world will fall by two-thirds between 2007 and 2009.

On the policy front, the "bicycle" of economic liberalization has completely stalled out. Despite repeated pledges to the contrary in multiple G-8 and G-20 communiqués, the Doha round of trade talks have no forward momentum. States are also exploiting WTO-legal means of raising trade barriers. Anti-dumping investigations increased by 31% in 2008, and by an *additional* 18.8% in the first quarter of 2009. There was a 19% jump in the number of applied duties in 2008, and an additional jump of 15.5% in the first quarter of this year (Bown 2009). Despite a November 2008 G-20 pledge not to engage in any protectionist policies, the World Bank concluded that 17 of the 20 countries implemented a combined 47 measures to restrict trade at the expense of other countries (Gamberoni and Newfarmer 2009). Barriers to foreign direct investment are also on the rise (Marchick and Slaughter 2008). Recovery plans and bailouts of the financial sector are likely to encourage more domestic lending, reducing cross-border capital flows even further (Broda, Ghezzi and Levy-Yeyati 2009).

On the rhetorical front, some commentators are concerned that these data are merely the first steps along a slippery slope of greater protectionism. Just as Smoot-Hawley followed the 1929 stock market crash, analysts are now worried that the financial crisis will trigger a big backslide on trade liberalization (Dadush 2009; Erixon and Sally 2009). "Green sanctions" that could come with uncoordinated efforts to combat global warming would certainly provoke concern (Brainard and Sorkin 2009). Furthermore, the bicycle metaphor suggests that the absence of forward progress automatically means moving backwards. The bicycle theory of trade asserts that unless trade liberalization moves forward, the natural tendency for states is to creep towards protecting vital economic sectors. If these measures take the form of regulatory standards rather than more blatant barriers, they are politically easier to execute (Kono 2007). Even without the "big bang" of a Smoot-Hawley, the drift towards closure causes the bicycle to slow down and eventually topple over.

A related concern is whether the consensus among economists regarding the virtues of economic openness is beginning to crack. This would echo what happened during the Great Depression, when mercantilist thought and policy made a partial comeback. Several of the advanced industrialized economies responded to the Depression era by replicating the mix of trade and currency policies that held sway during the classical mercantile system (Hirschman 1945; Frieden 2006:206; Ahamed 2009). John Maynard Keynes (1936) became increasingly attracted to mercantilist ideas as the depression worsened. He argued that in a world of fixed exchange rates and wage rigidities, mercantilist trade policies made economic sense as a means of boosting domestic employment. Keynes' fondness for mercantilism was connected to his desire for governments to retain the ability to promote full employment at home.[1] He preferred an open trading system, but he also preferred domestic policy autonomy over unregulated capital flows. As the current era of globalization has imposed stronger strictures on national policymakers, Keynes' arguments about mercantilism resonated for social democrats attached to the notion of "embedded liberalism" (Ruggie 1982; Guerrieri and Padoan 1986; Kirshner 1999). As the Great Recession began, reputable economists began recommending this mercantilist policy responses in the absence of global coordination.[2]

A collapse of the international trade architecture would be devastating – but the odds of it happening have been grossly exaggerated. The overwhelming cause for the decline in global trade levels is the drop in economic output. Bown (2009) estimates that the increase in anti-dumping cases affects less than 0.45% of the total value of imports among the G-20 economies. While Gamberoni and Newfarmer (2009) concur that protectionism has been on the rise, they also concur that the actual effect of these measures on trade flows have been minimal. Dadush (2009) has estimated the effect on world trade flows if governments raised their applied tariffs to the maximum bound tariff rate permitted by the WTO, and found that world trade would decline by 7.7%, with a welfare loss of approximately $350 billion. These are significant numbers, but they pale in comparison to the losses incurred from a sustained global economic slowdown.

Furthermore, the ideational and institutional contrast to the 1930's could not be more different. Despite some fraying, the consensus among economists for free and open trade remains robust – a marked contrast to the immediate aftermath of the 1929 stock market crash. The most important international institution governing trade during the Great Depression was the League of Nations. In a relative sense, the World Trade Organization is a much more powerful actor, with a robust dispute settlement mechanism. Both waxing and waning great powers have demonstrated their willingness to comply with

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[1] Keynes (1936: 338) was under no illusions, however, about the systemic effects of every country pursuing such mercantilist policies: "a senseless international competition for a favorable balance which injures all alike." Such policies, he allowed, would also lead to a greater likelihood of war.

[2] Dani Rodrik, "Some unpleasant Keynesian arithmetic," December 4, 2008, and "Does mercantilism work in a Keynesian world?" December 5, 2008. Dani Rodrik's weblog. Accessed at http://rodrik.typepad.com/dani_rodriks_weblog/2008/12/some-unpleasant-keynesian-arithmetic.html and http://rodrik.typepad.com/dani_rodriks_weblog/2008/12/does-mercantilism-work-in-a-keynesian-world.html.

WTO strictures during the Great Recession.[3] The WTO in turn is backstopped by a cluster of regional trading agreements – NAFTA, the European Union, MERCOSUR, ASEAN – that govern the most important economic regions. As the global economy started to recover in the summer of 2009, so did global trade; June 2009 saw the greatest monthly increase in trade levels in the past year.[4] While the bicycle theory is an attractive metaphor, the existence of strong multilateral economic institutions adds an additional element. These institutions function like a kickstand – even if the bicycle comes to a stop, the kickstand prevents it from toppling over.

The political links between trade policy and macroeconomic policy

In strictly economic terms, macroeconomic policy and trade policy are unrelated. There is a long and voluminous literature demonstrating that trade has little to no effect on aggregate employment levels (Hoekman and Winters 2005). Economists have traditionally argued that there is little connection between trade *policy* and the trade *balance*. A country's fiscal policy and savings/investment balance determines the latter; in theory, either a fiscal deficit or a savings deficit triggers a trade deficit. In practice, the evidence for this is a bit murkier (Erceg, Guerrieri and Gust 2005). The different specialties of international economics and macroeconomics talk past each other. The one thing they do agree on is that trade policy and macroeconomics are not linked within the neoclassical paradigm.

There are clear political and policy linkages between trade restrictions and macroeconomic policy, however. The most direct link is through protectionist policies embedded in fiscal expansions or bailouts. The state is shouldering a greater burden for boosting economic growth and helping out national champions in key sectors such as automobiles and finance. In order to secure legislative approval for these measures, governments face political pressure to ensure that the benefits from any fiscal outlays and financial bailouts remain contained within national borders. This was the genesis of the "Buy American" program that was attached to the fiscal stimulus package passed in February 2009. The measures provide a 25 percent cost margin for procuring American-manufactured goods over foreign producers (Dadush 2009). In response, China's central government instituted a "Buy China" policy in its own fiscal stimulus, requiring that contracted firms use only Chinese products or services unless they were not available within the country.

The link between trade deficits and fiscal expansion is akin to a Prisoner's Dilemma game. States running large current account deficits worry that export engines like will free ride off of their own fiscal expansions, boosting the growth prospects of these exporters without any serious fiscal expenditures on their part. In late 2008, for example, other European governments were upset with Germany's inaction on the fiscal front. German Finance Minister Peer Steinbrück's exacerbated the issue by condemning the

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[3] Lucy Hornsby, "Enthusiastic WTO embraces WTO despite Rulings," Reuters, August 13, 2009; Michael Wines, "China Warms to New Credo: Business First," *New York Times*, August 14, 2009.
[4] "World Trade Posts Biggest Rise in Over a Year," Reuters, August 26, 2009.

"crass Keynesianism" of other economies' fiscal programs.[5] If this fear persists, there is a danger of radically suboptimal policy outcomes. Either national governments will underprovide fiscal stimulus in the hopes of free-riding off of other states, or any new Keynesian boosts will come attached with protectionist provisions to ensure that the benefits remain within national borders.

Poor macroeconomic coordination leads to negative trade response through an alliance of protectionist interests and a mass public hostile to trade (Rajan and Zingales 2003; Drezner 2006). Even if there is only a minimal economic connection between trade policy and the trade deficit, opponents of trade expansion will make a *political* connection between the two. In the United States, as the trade deficit widened between 1999 and 2004, public support for free trade declined across the board (Kull 2004). Trade deficits appear to foster a *realpolitik* response in public opinion, causing individuals to value relative gains over absolute gains (Drezner 2008). Experimental survey results confirm the strong bias in favor of relative gains concern. Informal surveys by Robert Reich (1990) found a high degree of relative gains concern among Americans vis-à-vis Japan in 1990 – the peak of Japan's perceived threat to U.S. economic hegemony. Richard Herrmann, Philip Tetlock and Matthew Diascro (2001) asked whether respondents would support a foreign economic policy that benefited the United States more than its trading partner, benefited both countries equally, or benefited the trading partner more. Among the mass sample, the distribution of gains significantly affected responses. 64% of Americans supported a policy that benefited the United States more; when the partner benefited more, support fell to 38%. Mass responses were also more protectionist when the trading partner was described as either wealthy or strong. Using real world countries, respondents were more likely to favor restricting trade against Japan than either England or India. Herrmann, Tetlock and Diascro (2001:202) conclude, "A larger percentage of the general public than of the elite think about trade as if they were intuitive neorealists…. And more of them are sensitive to the factors neorealists say should affect policy calculations." David Rousseau (2002) conducted a similar survey, and found majorities opposing trade agreements that resulted in small economic gains for the United States but significant economic gains by other major powers. Consistent with realism, opposition increased when the proposed trade partner was a country viewed as an economic challenger, such as China or Japan.

Stepping back, macroeconomic policies and trade policies are also linked via the substitutability of foreign economic policies (Most and Starr 1984). In a downturn, political leaders will face pressure to enact policies that are perceived to bolster the domestic economy, even if such policies are known to be detrimental to other economies. The menu of possible policy responses includes fiscal expansions, currency devaluations, and trade restrictions. These measures vary widely in their effects and externalities. Nevertheless, if external or institutional circumstances constrain a government from enacting some of these options, then they might be forced to adopt the measures they can adopt. If policy coordination is not an option at the global level, some states will choose protectionism as a second-best response.

[5] Steinbrück quoted in Stefan Theil, "'It Doesn't Exist!'" *Newsweek*, December 15, 2008.

Recent theoretical and historical research confirms the link between macroeconomic imbalances and trade restrictions. Itai Agur (2008) develops a trade negotiation game in which a country running a large trade deficit triggers suspicions about the benefits of continued liberalization. Countries with sufficient market power will choose to eschew a multilateral approach in favor of a regional trade agenda that allows the deficit country to retain rents from trade diversion. Agur's model explains the correlation between the rise in the U.S. trade deficit and the shift in emphasis in U.S. trade policy. Once the United States began running large deficits in the 1980s, it began pursuing a regional trade agreement with Canada. The widening of the current account deficit encouraged the "competitive liberalization" approach of the Bush administration, but even that approach lost political support as the deficit continued to widen.

Eichengreen and Irwin (2009) find a related conundrum between monetary and trade policies during the Great Depression. When the financial dimensions of the Depression began in 1931, countries that chose to keep their currencies nominally pegged to gold did not have a monetary policy option to reinflate their economies. In response, these countries imposed higher tariffs and greater numbers of non-tariff barriers in an attempt to boost domestic production. Eichengreen and Irwin found a direct correlation between the decision to go off the gold standard and trade protectionism. The earlier countries abandoned gold, the less likely they were to impose restrictions on imports. As they demonstrate, Smoot-Hawley was not the only factor responsible for the protectionism on the 1930s. The absence of macroeconomic policy coordination in the aftermath of the 1931 banking crises was the more important trigger for the collapse in world trade.

A realistic theory of macroeconomic policy coordination

While the benefits that macroeconomic coordination to trade can be significant, the adjustment costs are equally significant. Genuine coordination requires that the major economies alter their policies from the pre-existing status quo, in the belief that the gains from such coordination outweigh the costs. These costs cannot be dismissed lightly, however. Deficit countries would be required to engage in fiscal cutbacks, which impose huge political costs on affected segments of the populace. Surplus countries are often required to lower interest rates, which carry their own costs for central banks averse to inflation.

Previous work (Drezner 2007) suggests that although globalization increased the rewards for coordination, the distribution of economic power and preferences will make macroeconomic policy coordination a rare occurrence. The diffusion of economic power in the system makes coordination more difficult. A great power concert is a necessary condition for effective cooperation in macroeconomic policy. As the number of actors increases, the likelihood of creating a concert of common preferences among them necessarily declines (Axelrod and Keohane 1985; Barrett 2007). Furthermore, while in the past coordination has been attempted between relatively like-minded regimes from the developed world, any new efforts at coordination will need to incorporate the BRIC economies – Brazil, Russia, India and China (Wilson and Purushothaman 2003). The

BRIC economies are achieving great power status while still having low per capital incomes, which will likely contribute to greater preference divergence could emerge among the great powers.

Beyond the diffusion of power, the high adjustment costs of macroeconomic adjustment will also make coordination much more difficult – particularly when compared to trade. The effects of most trade policies are sectoral in nature, while macroeconomic policy has broad-based effects on national economies. Policy adjustments will tend to involve incurring short-term costs in return for medium-term benefits. Therefore, for adjustment to take place, politicians and policymakers must be willing to risk short-term unpopularity in return for uncertain rewards in the future. Risk-averse politicians will often eschew this tradeoff – unless their macroeconomic policymaking institutions are well insulated from domestic political pressures.

In this situation, adjustment costs for all states are very high. The spread of democratization and nationalization across the globe has imposed serious constraints on the ability of governments to accept costly adjustments in return for greater cooperation in the global economy. The effect of these trends has been to multilateralize Robert Putnam's (1988) "two-level game" problem. One of the supposed bargaining advantages of democracies in international relations is that domestic constraints can be translated into bargaining advantages in world politics. When more countries are consolidated democracies, however, then a unilateral bargaining advantage turns into a lack of multilateral cooperation. When all of the major actors have powerful domestic constituencies that increase the adjustment costs for international policy coordination, the bargaining core disappears (Drezner 2007). Even smaller and weaker states face huge domestic costs for accommodation. In the fall of 2008, for example Iceland's financial system neared collapse. Even though Iceland was at the mercy of official creditors, its government was leery of making the necessary policy adjustments because of domestic concerns (Jónsson 2009). If Iceland was this recalcitrant at making policy changes, the major economies will be even more set in their ways.

One possible outcome is the simple absence of any international cooperation. Another outcome is the creation of "sham global governance." Governments will agree to a notional set of global policies with weak or nonexistent monitoring or enforcement schemes. Sham arrangements are useful to states of all stripes, because they permit governments to claim the *de jure* existence of coordination, even in the absence of effective policies. These standards act to relieve or redirect any domestic or civil society pressure for significant global policy changes. They also create path dependencies in governance institutions that cast a shadow over future governance efforts (North 1990).

If this analysis is correct, then macroeconomic cooperation should be a rare event in the global political economy. On the whole, governments will prioritize the appeasement of domestic interests over the benefits of global coordination. When coordination does take place, it is likely to be more form than substance. Because central banks are more likely to be politically insulated than fiscal authorities, monetary and exchange rate policies are more likely to make adjustments than fiscal policy.

A brief history of macroeconomic policy coordination

While the benefits of fiscal and monetary cooperation at the global level might seem clear, the historical record is at best mixed. To put it gently, international macroeconomic policy coordination has not had a glorious history over the past century. Using any conceivable metric – extent of cooperation, legitimacy of global governance structures, efficiency of outcome – global cooperation on trade has far outpaced cooperation on macroeconomics.

Because fiscal policy is a more recent tool in the policy arsenal, monetary and exchange rate coordination were the primary mechanism through which states tried to coordinate policy. The classical gold standard was the heyday of this type of cooperation, functioning reasonably well from 1870 to the First World War. Standard estimates suggest that the functioning of the gold standard increased trade flows between 30 and 70 percent (Frieden 2006; Eichengreen 2008). Of course, this period was also unusual for another reason. The limited extent of the democratic franchise, combined with the low degree of political organization of the working class, made it easier for governments to make the painful domestic adjustments necessary to keep the gold standard functioning.

From the 1920s on, the history of macropolicy coordination is notable more for its failures than its successes. During the twenties, the problems of German reparations and Allied debts to the United States created a daisy chain of imbalance issues. Furthermore, attempts at coordination proved costly because the agreed-upon policies were not necessarily the optimal set of policies. When Great Britain went back on the gold standard in 1925, for example, it did so at the pre-war standard, even though British prices had nearly tripled in the interregnum. Maintaining prewar parity necessitated several brutal years of deflation (Frieden 2006; Ahamed 2009).

The U.S. Federal Reserve did try to assist European countries out of their macroeconomic strictures by keeping U.S. interest rates low during the mid-twenties. This helped Europe's balance of payments, but also was one of the triggers for a stock market bubble. Benjamin Strong, the Fed chairman at the time (quoted in Ahamed 2009: 240), explained the limits of U.S. cooperation when he warned his British counterpart that, "there would be times when speculative tendencies would make it necessary for the Federal Reserve Banks to exercise restraint by increased discount rates, and possible rather high money rates in the market. Should such times arise, domestic considerations would likely outweigh foreign sympathies." When the Fed attempted to pop the asset bubble, the 1929 stock market crash ensued.

This was a theme that repeated itself in myriad variations during the interwar period; when governments were forced to choose between policy adjustments to accommodate international interests or unilateral steps to bolster domestic standing, they inevitably chose the latter (Simmons 1994; Frieden 2006). As previously noted, the Depression era consisted of a long string of coordination failures, beginning with the ill-fated 1933

London Conference. The tragedy of the noncoordination was that, by 1936, most countries had taken the necessary macroeconomic steps – expansionary monetary and fiscal policies – in response to the Depression. By doing so haphazardly, however, the governments involved wreaked much more financial damage than if they had acted jointly five years earlier (Eichengreen and Irwin 2009).

During the Bretton Woods era, the combination of fixed exchange rates and the International Monetary Fund was designed to ensure coordination on monetary policy. In practice, things worked a little differently. During the late forties, when both Europe and Japan appeared to be unable to restart their economies, the United States acted outside the multilateral system. With the Marshall Plan in Europe and the Dodge Line in Japan, the United States possessed the necessary power to unilaterally ensure policy coordination (Mastanduno 2009). Futhermore, the very notion of "embedded liberalism" was to ensure that governments had sufficient policy space to obviate the need for coordination beyond exchange rates (Ruggie 1982). As American power waned and capital controls were lifted, the logical contradictions of the Bretton Woods regime became more evident, existing policy coordination mechanisms failed to correct the problem. By 1971, when the United States closed the gold window, all of the great powers had chosen to ameliorate domestic interests rather than coordinate action at the global level (Gowa 1984).

The end of Bretton Woods altered the nature of international policy coordination in such a way as to increase the domestic adjustment costs. As Michael Webb (1994:9) observes, "we see a move away from coordination of policies that have limited direct consequences for domestic economic and political conditions – especially balance of payments financing – and toward coordination of policies that are critically important for domestic politics and economics – monetary and fiscal policies." The mechanism for attempting this coordination was the Group of Seven meetings and summits that began in 1975 in Rambouillet, France (Putnam and Bayne 1987). Throughout the next two decades, a pattern repeated itself. Other G-7 countries would pressure the United States to scale back its fiscal deficits. In turn, the United States would pressure other countries – particularly Japan and Germany – to expand their domestic consumption in order to act as locomotives of growth. Not surprisingly, these policy debates boiled down to which country would absorb the adjustment costs necessary to ensure policy coordination (Andrews 2005).

The effect of the G-7 process on policy coordination was mixed. The most common outcome on the macro front was a stalemate. As surplus countries, Japan and Germany were well situated to resist external pressure to adjust (Webb 1994; Andrews 2005). As the country responsible for the world's reserve currency, the United States was able to borrow more cheaply than other countries, blunting political pressure to change policy (Kirshner 1995; Mastanduno 2009; Helleiner and Kirshner 2009). At most of the meetings, domestic politics proved to be a powerful constraint on the ability of the great powers to cooperate (Putnam and Bayne 1987; Putnam 1988). Efforts to revive the global economy through a "locomotive" strategy via fiscal expansion in the late seventies yielded a modestly successful result. During the early eighties, communiqué after

communiqué pledged the G-7 countries to pursue "prudent fiscal and monetary policies" – at the same time as the United States was running record budget deficits and pursuing a tight monetary policy. The acme of the G-7's success came in the mid-1980's, when the member governments agreed to intervene to bring down the dollar's value. The 1985 Plaza Accord and the 1987 Louvre Accord helped to bring the dollar down and ensure a "soft landing" at the same time. Parallel efforts at coordination – such as the U.S.-Japan Structural Impediments Initiative or the European "snake" of the seventies – yielded little in the way of macroeconomic adjustments (Bergsten and Noland 1993; Schoppa 1997; Moravcsik 1998).

During the era of the Washington Consensus, the demand for policy coordination was relatively low. It is telling that, when the Asian financial crisis hit, the United States took the only aggressive macroeconomic response outside of the region. By cutting interest rates rapidly to function as a market for distressed goods, the U.S. did expedite the regional recovery. In Europe, the creation of the euro surely counts as an example of successful coordination. The Growth and Stability Pact that was attached to the creation of the common European currency, however, was less successful. Within a year of the euro's birth, five of the eleven member countries were not in compliance; by 2005, the three largest countries in the eurozone were ignoring the pact. Dominguez (2006:76) notes that, "the failure to follow agreed-upon rules for fiscal policy suggests that the decisionmakers in the member countries look first at what policy suits their own country, and only second at what policy suits Europe as a whole."

The most lasting legacy of the 1990s was the emergence of the informal "Bretton Woods II" regime. In truth, calling Bretton Woods II a "regime" is something of a misnomer – it was the result of independent policy decisions made without any coordination among the key actors (Dooley, Folkerts-Landau and Garber 2003; Bernanke 2005; Eichengreen 2008). Under Bretton Woods II, the United States ran a massive current account deficit, helping to fuel the export-led growth of other countries. This enabled Americans to consume at much higher-than-usual rates. To fund this deficit, official creditors – central banks, sovereign wealth funds, and other government investment vehicles – purchased dollars and dollar-denominated assets. These creditors were concentrated in the Pacific Rim and energy-exporting countries (Farrell, Lind and Sadan 2008). These purchases contributed to the boom in U.S. asset prices, which further fueled American consumption, widening the trade deficit and reinforcing the cycle (Ferguson and Schularick 2007). For Pacific Rim economies, the arrangement allowed the export sector to thrive by boosting foreign consumption while keeping national currencies undervalued vis-à-vis the dollar.

A structural cause of the Great Recession was the extent to which macroeconomic variables – interest rates, savings rates, trade balances – were skewed beyond historical norms across the global economy (Thompson 2007; Mastanduno 2009; Dunaway 2009). During the Bretton Woods II era, consumption as a share of American gross domestic product rose to an all-time high of 72%, while China's consumption as a share of GDP plummeted to a global low of 38% of GDP. The U.S. savings rate turned negative, while Chinese savings approached 50% of GDP. The United States current account deficit peaked in 2006 at close to $800 billion, or seven percent of GDP. This percentage vastly

exceeded the previous peak of the U.S. current account deficit in the mid-eighties. By 2007, the U.S. current account deficit equaled approximately 1.4% of *global* economic output, while China's current account surplus approached 0.7% of global GDP. Interest rates were at historic lows for much of the past decade.

Policymakers were not unaware of these imbalances – but they were equally unable to agree on the necessary adjustments to address them. An IMF-led effort beginning in 2006 got nowhere, because China vetoed every effort to discuss the issue. The U.S.-China Strategic Economic Dialogue did succeed in getting China to modestly revalue its currency. This success was minimal, however. The yuan stayed undervalued relative to other major importers, China's trade surplus continued to grow, and the U.S. trade deficit exploded. As previously noted, China and other exporters had strong incentives to allow the status quo to persist. American policymakers became convinced that the depth and efficiency of their financial markets allowed them to run such large deficits (Greenspan 2007; Fox 2009). This economic conviction evaporated during the Great Recession (Eichengreen 2009).

Stepping back, the degree of macroeconomic coordination over the past century appears to have been modest. As expected, domestic adjustment costs were large enough to impede most efforts to coordinate. Sham coordination was far more common than genuine coordination. Most successes in global policy coordination occurred when two of the following three conditions held. First, when there was a state powerful enough to "go it alone," coordination was usually a matter of the hegemon unilaterally providing the necessary public goods to facilitate coordination (Kindleberger 1973; Gruber 2000). Second, when countries were being asked to take actions that boosted their domestic economies, they were willing to coordinate policy. Contractionary fiscal or monetary policies have proven to be far more difficult to coordinate than expansionary actions. Third, policymakers needed to be right on the economics. Agreements to coordinate on an unsustainable set of policy prescriptions – such as the interwar gold exchange standard, Bretton Woods, or the Growth and Stability Pact – had a short half-life. One promising trend is that more recent crises have led to greater levels of coordination than in the past. This might be a function of policy learning from the debacles of the interwar period.

Why prioritize macroeconomics?

The history and analysis suggests that macroeconomic policy coordination has been far more difficult than trade policy coordination in the past. If a policymaker is interested in sustaining an open global economy, why should priority be placed on macroeconomics rather than trade liberalization? There are two significant reasons. First, while trade liberalization has been easier to date, there is reason to believe it will be more difficult than macroeconomics going forward. Second, the indirect benefits of macroeconomic policy coordination for trade are not insignificant, whereas the indirect benefits of trade liberalization on macroeconomic policy are minimal.

The process of trade liberalization has become increasingly sclerotic in recent decades (Drezner 2006). The expanding number of WTO negotiation participants has certainly raised the transaction costs of negotiating. The topics of trade negotiations have also shifted. Trade rounds have shifted much of their focus away from tariff reduction to ensuring that disparities in subsidies and national regulations do not interfere with international trade. This happened because GATT and the WTO succeeded in reducing border-level trade restrictions. For most areas of merchandise trade, tariffs and quotas have been at low levels since completion of the Uruguay round of negotiations in 1994. Crudely put, all of the politically easy steps to liberalize trade have already been taken. All that remains are the issues that carry massive adjustment costs (Diego-Fernández 2008).

One obvious residual “hard area” is agricultural subsidies. Even beyond that historically intractable issue, however regulation and services are increasingly important in trade negotiations. Trade policy is increasingly enmeshed with regulatory standards. Because most of these regulations were originally devised for domestic audiences, these policies will be far more difficult than tariffs or quotas to reconcile with international agreements (Drezner 2007). The domestic political cost of changing these regulations will be formidable; those with a vested interest in the status quo will lobby fiercely against any proposed change. Furthermore, the United States and European Union face a trade-off between advancing regulatory harmonization strictly as a means to advance the trade agenda or doing so as a means to export developed country preferences on labor, environmental, and consumer health and safety standards. Not surprisingly, for developing countries, the inclusion of regulatory questions in the WTO agenda remains a nonstarter.

The expansion of tradable activities is also impinging on longstanding service sectors, such as accounting, medicine, education, and the law. Many of the services that are rapidly becoming tradable—airlines, education, telecommunications, utilities—have been traditionally run by state-owned enterprises. This means that economic globalization will affect professions, workers, and state-run institutions that have been set in their ways of doing business for centuries (Rajan and Zingales 2003; Blinder 2006). Because globalization will affect more nontradable sectors with high degrees of asset specificity, the adjustment costs of regulatory coordination in these areas will be extraordinarily high. The use of political voice in the medium run will guarantee some large bumps in the road ahead (Hirschman 1970; Drezner 2007).

Given this political environment, it is worth examining whether the spillover effects of macroeconomic policy coordination outweigh the rewards of continued liberalization. There are several benefits of successful macroeconomic coordination on the trade front. The most direct benefit comes from ensuring sustainable and balanced economic growth. Greater global growth and reduced business cycle volatility translate into growth in global trade as well. Second, successful coordination acts as a constraint on protectionist pressures in major economies. Particularistic interests will always have a stake in protecting their own sectors. The absence of sizeable trade deficits, however, prevents these groups from converting trade into an issue that engages the mass public. Third,

coordination offers reassurance to tradeable sectors that domestic pressures – and external volatility – will not impede the development of long-term contracts with other trading states. This permits profit-seeking to invest in assets specific to trading relationships as a way to increase efficiency.

The spillover effects from macroeconomic cooperation on trade are clear. Indeed, looking at the historical record, it seems clear that when macroeconomic policies are in deadlock – the Depression era and the 1970s – are also the periods when protectionism has peaked. While prudential fiscal and monetary policies can blunt protectionism, however, the positive externalities of trade liberalization are more circumscribed. Trade liberalization has often contributed to macroeconomic imbalances, but it has failed to push policymakers into coordination in that policy arena. From an efficiency perspective, if the political adjustment costs are roughly equivalent, macroeconomic policy coordination looks like the sounder policy pathway.

Conclusion: what now?

Even if the benefits of macroeconomic cooperation are significant for trade, both the political model and the historical narrative paints a depressing picture. Are the odds for successful coordination greater now than before?

The tentative answer is yes, for two reasons. First, the crisis itself has already forced some dramatic coordination behavior across the globe. All public policies are subject to the tyranny of the status quo – until an exogenous shock presents the ability to foment change (Kingdon 1984). And there have been some significant changes in macroeconomic policy coordination. On the governance front, for example, the Group of Twenty (G-20) countries has clearly supplanted the G-7 as the focal point for negotiating over policy coordination. Comprising 85 percent of global economic output, 80 percent of global trade, and 66% of global population, the G-20 is clearly more representative than the G-7 (Beeson and Bell 2009).

On the monetary front, central bank coordination has been robust since October 2008. Since the collapse of Lehman Brothers, the largest central banks repeatedly and jointly announced rate cuts. The G-7 economies plus Switzerland agreed to unlimited currency swaps in order to ensure liquidity would be maintained in the system. Soon afterward, the United States extend its currency-swap facility to Brazil, Singapore, Mexico and South Korea. The European Central Bank expanded its swap arrangements for euros with Hungary, Denmark and Poland. China, Japan, South Korea and the ASEAN economies broadened the Chang Mai Initiative into an $80 billion swap arrangement to ensure liquidity. The International Monetary Fund created a Short-Term Liquidity Facility, designed to establish quick-disbursing financing for countries facing temporary liquidity problems. The IMF also negotiated emergency financing for Hungary, Pakistan, Iceland, and Ukraine. In response, the G-20 pledged to boost IMF reserves to promote additional lending.

On the fiscal front, the G-20 pledged a joint fiscal expansion equivalent to two percent of global GDP. They will likely not achieve that mark – but, led by China and the United States, they will come close (IMF 2009). The April G-20 communiqué also called for the multilateral economic institutions to conduct surveillance of G-20 members, to ensure that they commit to their pledges. This hardly guarantees compliance, but it lowers the transaction costs of policy coordination. While the United States is still running a sizeable trade deficit, the percentage of that deficit to GDP has roughly halved in the past calendar year. Some traditional capital exporters – Japan and oil exporters – have moderated their trade surpluses as well (Broda, Ghezzi, and Levy-Yeyati 2009).

Cooperation during the crisis can have a path dependent quality. If the G-20 establishes a reputation for reasonably effective governance, the gains from coordination increase while the costs decline (Willett 1999; Beeson and Bell 2009). No one will confuse the emergent G-20 process with the World Trade Organization in terms of legitimacy or effectiveness. Just as the WTO had its origins in the more modest GATT, however, the G-20 – in combination with the IMF – has the ability to create coordination mechanisms that could prevent dysfunctional macroeconomic policies in the future. If the G-20 accumulates more legitimacy, policymakers can use its reputation to bypass domestic political roadblocks (Drezner 2003) – just as the last generation of policymakers used the GATT/WTO regime to reduce domestic audience costs (Goldstein 1996). Furthermore, the crisis itself has temporarily resolved the long-standing Keynesian-monetarist debate in favor of the former. If all the major players are Keynesians now, the embrace of common ideas will increase the likelihood of sustainable cooperation (Hall 1989; Goldstein and Keohane 1993; Willett 1999; Blyth 2002)

Clearly, the global economy is not yet free of the Great Recession. Short-term interest rates have gone from being low by historical standards to unusually low. Eventually, they have to return to historical averages. Economists are equally worried about the risks of short-term deflation and long-term inflation in the global economy. The massive jump in the U.S. budget deficit – 11.2 percent of GDP, the highest level since the Second World War – counteracts the increase in American personal savings. Chinese savings have yet to fall. Indeed, because their imports have declined more dramatically than their exports this calendar year, China is running an even larger current account surplus in 2009 than it did in 2008. Beijing's policymaking during the crisis has a touch of schizophrenia. On the one hand, there are signs that China's domestic demand is fuelling growth; on the other hand, Chinese policy on export rebates seems designed to promote continued export dependence (Roach 2009). Bretton Woods II has not disappeared (Dooley, Folkerts-Landau and Garber 2009) – continued coordination efforts will be necessary to prevent continued economic volatility.

The economic and political benefits from freer trade are formidable. If the Great Recession threatened a direct collapse of the world trading system, then political effort should be expended to prevent closure. Surveying the effects of the downturn, however, reveal the relative sturdiness of existing trade institutions. The best ways to facilitate further trade openness are no longer direct but indirect. If political capital is a scarce resource, then it should be devoted to stronger mechanisms for macroeconomic policy

coordination. Such a political strategy will yield a higher return than doublig down on further trade liberalization.

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