

PERSPECTIVES

**THE RETURN OF GEO-ECONOMICS:
GLOBALISATION AND NATIONAL SECURITY**

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S E P T E M B E R 2 0 1 0

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**The return of geo-economics:
Globalisation and national security¹**

Mark Thirlwell

Globalisation, international economics and national security

Inevitably, thinking about our national security environment requires grappling with a wide range of issues. These include those found in the traditional security sphere as well as such non-traditional security challenges as natural disasters, climate change and pandemics. It also involves understanding the changing international economic environment, including the far-reaching implications of globalisation. In particular, I think it's extremely hard to argue with the proposition that the current international environment is one that is marked by an increasingly dense entanglement of issues related to international economics, national security and foreign policy. Or to put it slightly differently, there seems to be a growing tendency (for good or ill) for governments to view issues of international economics through the prisms of national security and foreign policy as well as though the default one of economic policy.

To take an obvious example, the onset of the global financial crisis (GFC) was viewed not just as an economic catastrophe, but also as a major security challenge.² Other recent examples of this tendency to mingle economics and geo-politics would include the repeated disagreements between Beijing and Washington over China's exchange rate policy; the debate in many developed economies over the appropriate policy response to the rise of so-called State Capitalism in general and of inward investment by Sovereign Wealth Funds (SWFs) and State Owned Enterprises (SOEs) in particular; and the growing focus on issues of resource (energy, food, and water) security and the implications of climate change.

¹ This *Perspectives* was delivered as a presentation to the National Security College at the Australian National University on 19 June 2010. A significantly revised version was also given as a speech at the Lowy Institute on 23 June 2010.

² See for example Mark Mazzetti, Global economy top threat to US, spy chief says. *New York Times*, 12 February 2009. See also David Rothkopf, *A world transformed: the great hollowing out and the rise of new threats. The security consequences of the current global economic crisis*. Congressional Testimony to the Armed Services Committee of the US House of Representatives. Washington DC, Carnegie Endowment for International Peace, 11 March, 2009.

Perhaps the most important example, however, is the huge amount of attention that is now paid to the ongoing ‘great overtaking’ – the steady surpassing in terms of the level of GDP of various countries in the developed world by emerging economies – a development frequently described as the rise of the BRICs. The most recent of these ‘overtakings’ occurred when China’s economy, measured in US dollar terms, overtook that of Japan during the course of this year. And of course the one pretty much everyone is waiting for is the date when (or if) China’s GDP surpasses that of the United States. Indeed, there’s a whole mini-industry devoted to identifying potential dates.³ The crisis-inspired replacement of the G7 by the G-20 as the world’s new peak economic body is a particularly potent symbol of the consequences of this ongoing shift in economic – and hence geo-political – power.⁴ The elevation of the G-20 is also a nice example of how finance and markets have become high politics.⁵

One concept that has previously been used to try to encompass the various connections between international economics, geopolitics and security is the idea of geo-economics. The heyday of geo-economics was back in the 1990s, when analysts argued that the end of the Cold War had reduced the importance of military power relative to economic power, and that as a result there would be a greater focus on the latter. The term was fashionable for a while, but then largely dropped out of use. Today, the great shifts in wealth and (hence) national power that are currently underway mean that a version of the idea is due for a comeback.

My basic proposition today, then, is that if you want to try to understand many of the most important strategic developments facing the world over the next couple of decades, then you are going to need to devote a reasonable amount of time to thinking about what’s going on in the international economy.

War and commerce in the long run

Sure, as someone who has, in effect, the job of selling the usefulness of international economic analysis, I would say that, wouldn’t I? And that’s obviously one possible response to my suggestion.

³ The most famous of these are probably the BRICs studies by economists at Goldman Sachs: see Dominic Wilson and Roopa Purushothaman, *Dreaming with BRICs: the path to 2050*. Goldman Sachs Global Economics Paper No.99, 2003. For a more recent update see Jim O’Neill and Anna Stupnytska, *The long-term outlook for the BRICs and N-11 Post Crisis*. Goldman Sachs Global Economics Paper No. 192, December, 2009.

⁴ At the conclusion of the Pittsburgh Summit of G-20 leaders held in September 2009, the final communiqué stated that ‘Today, we designated the G-20 as the premier forum for our international economic cooperation...’.

⁵ This point is made by Mathew J Burrows and Jennifer Harris, Revisiting the future: geopolitical effects of the financial crisis. *The Washington Quarterly* 32 (2) 2009.

Another one is: well, what's new about any of that? Economics, national power, foreign policy and even war have long been intimately connected. That's fair comment. In their magisterial survey of trade and the world economy over the course of the second millennium, Ronald Findlay and Kevin O'Rourke begin by noting that:

*' . . .the greatest expansions of world trade have tended to come . . . from the barrel of a Maxim gun, the edge of a scimitar, or the ferocity of nomadic horsemen. . . . For much of our period the pattern of trade can only be understood as being the outcome of some military or political equilibrium between contending powers.'*⁶

Figure 1: Strategic trade theory in action, seventeenth century-style



Dutch Attack on the Medway, June 1667 by Pieter Cornelisz van Soest, painted c. 1667.

Source: Wikimedia Commons.

Similarly, in his survey of the quest for economic primacy, Charles Kindleberger notes that, in the majority of cases, success was associated with conflict. According to Kindleberger, wars 'are often turning points in the rise of one country to world economic primacy and the decline of another.'⁷ So, for example:

'One means of pulling down a country enjoying economic primacy is to invade its monopolies The processes may involve war, especially when interlopers seek to invade a trade

⁶ Ronald Findlay and Kevin H O'Rourke, *Power and plenty: trade, war and the world economy in the second millennium*. Princeton, Princeton University Press, 2007, pp xviii-xix.

⁷ Charles P. Kindleberger, *World economic primacy, 1500-1990*. New York, Oxford University Press USA, 1996, p 46.

*monopoly: Genoa against Venice in the Levant; the Dutch and British against the Portuguese in Asia; French, Dutch and English in the Spanish and Portuguese monopolies in the New World. The outcome of the armed conflict may determine whether economic hegemony is maintained or changes . . .*⁸

For one more example, here is Paul Kennedy making a similar point about the rise and fall of ‘Great Powers’:

*‘ . . . the process of rise and fall among the Great Powers – of differentials in growth rates and technological change, leading to shifts in the global economic balances, which in turn gradually impinge upon the political and military balances . . .’*⁹

The connection between commerce and the power of the state was particularly explicit during the Age of Mercantilism, which spanned a large chunk of the sixteenth, seventeenth and eighteenth centuries. Trade policy was largely about ensuring an excess of exports over imports in order to secure a surplus of the precious metals that were deemed to be crucial to maintaining national wealth and power. It was designed to exploit colonial markets for the benefit of the home power: colonial produce was typically transhipped via home ports before re-export, there were strict controls on the use of foreign shipping, and most long-distance trade was in the hands of state-sanctioned monopolies. Commercial policy involved explicit beggar-thy-neighbour strategies, including the application of military force, to undermine rival powers, and the objective of commercial policy was often to seize and then defend lucrative markets or trading areas – such as the competition for control over the Southeast Asian spice trade.¹⁰ Given this environment, it is no surprise the struggle for economic supremacy was often resolved by war: during the Anglo-Dutch Wars, the practical application of the seventeenth-century version of strategic trade theory involved exploits such as Dutch naval expeditions up the River Medway (Figure 1).¹¹

⁸ Ibid. p 44.

⁹ Paul Kennedy, *The rise and fall of the great powers: economic change and military conflict from 1500 to 2000*. London, Fontana Press, 1990, p xxii.

¹⁰ Richard E Baldwin and Philippe Martin, *Two waves of globalization: superficial similarities, fundamental differences*. NBER Working Paper no. 6904. Cambridge MA, National Bureau of Economic Research, 1999. Angus Maddison, *Monitoring the world economy, 1820-1992*. Paris, Development Centre of the Organisation for Economic Co-operation and Development, 1995. Angus Maddison, *The world economy: a millennial perspective*. Paris, Development Centre of the Organisation for Economic Co-operation and Development, 2001. For a more nuanced view of the evolution of mercantilist thought than the brief outline sketched here, see chapter 2 in Douglas A Irwin, *Against the tide. An intellectual history of free trade*. Princeton, Princeton University Press, 1996.

¹¹ For an interesting comparison of mercantilism with modern strategic trade theory, and an application to the seventeenth century Anglo-Dutch struggle for commercial supremacy, see Douglas A Irwin, Strategic trade policy and mercantilist trade rivalries. *American Economic Review* 82 (2) 1992.

Under mercantilism, far from international commerce being a source of peace, it was a spur to conflict, as states sought to muster financial strength in order to deploy military force that, in turn, was intended to secure greater wealth for the states. Here, for example, is Adam Smith in *The Wealth of Nations*, summarising the security consequences of the pursuit of this policy, as cited by Jacob Viner:

*'Commerce, which ought naturally to be, among nations, as among individuals, a bond of union and friendship, has become the most fertile source of discord and animosity. The capricious ambition of kings and ministers has not, during the present and the preceding century, been more fatal to the repose of Europe, than the impertinent jealousy of merchants and manufacturers. The violence and injustice of the rules of mankind is an ancient evil, for which, I am afraid, the nature of human affairs can scarce admit of a remedy. But the mean rapacity, the monopolizing spirit of merchants and manufacturers, who neither are, nor ought to be, the rulers of mankind, though it cannot perhaps be corrected, may very easily be prevented from disturbing the tranquillity of any body but themselves.'*¹²

By the latter part of the eighteenth century, critics of mercantilism like Smith had already begun to make the case for free trade, although they only really started to influence policy during the following century. Still, the change in economic orthodoxy heralded by Smith, David Ricardo and others, along with the economic break point that is the industrial revolution, means that from the nineteenth century onwards the relationship between 'power and plenty' was rather less blunt than had been the case during the mercantilist period. That said, even in the aftermath of the industrial revolution and following the gradual spread of more modern economic ideas about the role of trade, the relationship between economic and other forms of power remained extremely close. As William Easterlin reminds us, 'the onset and spread of modern economic growth has increasingly dominated world political relations, upsetting the balance of power between developed and less developed areas as well as within the developed group itself.' Easterlin goes on to note that the 'early spread of modern economic growth shifted the balance of power sharply in favour of the countries experiencing it and away from those that did not. The result was a wave of colonial expansion up to World War I.'¹³ After all, the nineteenth century, which witnessed the first Age of Globalisation, was also an Age of Empire.¹⁴

¹² Adam Smith as cited in Jacob Viner, Power and plenty as objectives of foreign policy in the Seventeenth and Eighteenth Centuries. *World Politics* 1 (1) 1948.

¹³ See chapter three in Richard A Easterlin, *Growth triumphant: the twenty-first century in historical perspective*. Michigan, The University of Michigan Press, 1998.

¹⁴ Eric Hobsbawm, *The age of empire, 1875-1914*. London, Abacus, 1989

Figure 2: Growth and technology brings military advantage



An early Maxim gun in operation with the Royal Navy. Source: Wikimedia Commons

One passage that sums up the interaction of economic growth, technological change, and the shifting balance of military power as applied to this period is found in Hilaire Belloc's *The Modern Traveller*:

*'Whatever happens, we have got
The Maxim Gun, and they have not'.¹⁵*

The good news is that, in the period following the end of the Second World War that has been shaped by the advent of the modern international trading system – the rules-based system overseen first by the GATT and now by the WTO – the relationship between international economics and international politics has grown steadily more placid. Nevertheless, the linkages have always been there.

In summary, then, I am happy to concede that there has always been a significant degree of overlap between the various strands of policy – international economic, foreign and security – described here. Nevertheless, there have still been significant shifts in the relative importance

¹⁵ Hilaire Belloc, *The modern traveller*. Whitefish, Montana, Kessinger Publishing, 2007.

of these linkages over time, and in the attention that we pay to them. My proposition, then, is that we are once again in a period where those linkages have become relatively more important compared to the recent past, and that, as a result, we are going to end up paying them more attention than we have been used to.

The rise, fall and rise again (?) of geo-economics

One concept that in the past has been used to capture at least some of the overlap between international economics, foreign policy, and security described above is the idea of ‘geo-economics.’ I think that the term originated in an article by Edward Luttwak published in the journal *The National Interest* in 1990.¹⁶ Luttwak’s starting point was the proposition that ‘the waning of the Cold War is steadily reducing the importance of military power in world affairs’ such that ‘. . .the methods of commerce are displacing military methods . . .’. But, he argued, while the *methods* may have changed, the driving role of the nation state meant that the underlying logic (the logic of conflict) had not, since ‘states are inherently inclined to strive for relative advantage against like entities on the international scene, even if only by means other than force.’ According to Luttwak, ‘geo-economics’ is ‘the best term I can think of to describe the admixture of the logic of conflict with the methods of commerce’.¹⁷

It’s certainly true that the connections between economic power and national power were receiving a great deal of attention at the time, not least due to a US perception that its economic position was under challenge from an economically successful Japan. So, for example, according to a 1993 article by Samuel Huntington:

*‘In the coming years, the principal conflicts of interests involving the United States and the major powers are likely to be over economic issues. US economic primacy is now being challenged by Japan and is likely to be challenged in the future by Europe.’*¹⁸

At this point, it’s worth emphasising that the term geo-economics was not coined by a traditional economist. In fact, it’s probably fair to say that many economists were not particularly convinced by the idea. For example, in his review of Luttwak’s subsequent (1993) book *The Endangered American Dream*, Raymond Vernon may be willing to concede that ‘National economic security is the growth subject of the Washington think tanks’.¹⁹ But while Vernon’s starting point for explaining this result is the same as Luttwak’s – the end of

¹⁶ Edward Luttwak, From geopolitics to geo-economics: logic of conflict, grammar of commerce. *The National Interest* (20) 1990.

¹⁷ Ibid.

¹⁸ Samuel P Huntington, Why international primacy matters. *International Security* 17 (4) 1993.

¹⁹ Raymond Vernon, Unclear and present danger: review of 'The endangered American dream'. *The National Interest* (34) 1993.

the Cold War – the story he tells is rather different. Vernon’s story is that the end of the decades-long standoff between the US and USSR meant that ‘Geo-politicians, having for so long occupied center stage among the foreign affairs elite, find their audiences dissipated, their status challenged.’ In other words, unemployment loomed. But, Vernon continues, there is a solution available: if ‘we can expect the continuation of warfare, even if it takes the form of economic rivalry’ then ‘the state that wishes to emerge triumphant needs the services of the geo-economist. And where best to find the well-prepared geo-economist than from the ranks of the underemployed geo-politicians.’²⁰ Vernon’s is, of course, very much an *economist’s* argument.²¹

Vernon also notes some important problems with the approach itself, pointing out that looking at the world only through Luttwak’s geo-economic lens either misses key features of the international economy or distorts them: other economic trends apparent at the time, including a rapid increase in cross-border mergers and acquisitions and the emergence of a globalised manufacturing sector pointed to a *decline* in the economic importance of national borders, for example, and as such did not mesh particularly well with the idea of an upsurge in fierce, state-based competition.

Despite these real shortcomings, geo-economics, or at least variations on the idea, did become fashionable in the US during the Clinton administration, when a ‘whole industry of councils on competitiveness, “geo-economists” and managed trade theorists . . . sprung up in Washington’.²² In particular, the general idea of countries competing with each other in world markets, in a manner akin to the competition for market share and profits between corporations, became popular.

Once again, many economists were unhappy with this development. In a now famous article written for *Foreign Affairs* in 1994, Paul Krugman described this focus on national competitiveness as a ‘dangerous obsession’ which produced three risks: (1) the wasteful spending of public money in a futile quest to boost ‘competitiveness’; (2) an increased possibility of trade wars and protectionism; and (3) the prospect of bad public policy more

²⁰ Ibid.

²¹ While economists are usually quite happy to apply this kind of argument (that people respond rationally to incentives) to others, they tend to be much less comfortable when it is applied to them. See for example some of the pained responses to one of the secondary arguments advanced in Paul Krugman, How did economists get it so wrong? *The New York Times Magazine*, 6 September 2009. Krugman’s main contention was that ‘the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth.’ But he also goes on to suggest that: ‘The renewed romance with the idealized market was, to be sure, partly a response to shifting political winds, partly a response to financial incentives.’

²² Paul Krugman, Competitiveness: a dangerous obsession. *Foreign Affairs* 73 (2) 1994.

generally, since, according to Krugman, ‘a government wedded to the ideology of competitiveness is as unlikely to make good economic policy as a government committed to creationism is to make good science policy, even in areas that have no direct relationship to the theory of evolution.’²³

As a general point, economists tend to prefer to think of the world in terms of positive-sum outcomes, while strategic thinkers appear to be more attracted to thinking about the world in zero-sum terms. This difference in outlook probably goes some way to explaining the different reception afforded to the idea of geo-economics by the two groups. Or to cite Samuel Huntington again:

*‘Economists argue that in economic competition what counts are absolute not relative gains; to economists this is a self-evident truth. It is, however, self-evident to almost no one but economists . . . Why are economists out in left field? They are there because they are blind to the fact that economic activity is a source of power as well as well-being. It is indeed probably the most importance source of power . . . and will be increasingly important in determining the primacy or subordination of states.’*²⁴

Similarly, here’s Paul Kennedy:

*‘. . . so far as the international system is concerned, both wealth and power are always relative and should be seen as such.’*²⁵

For a recent example of this distinction between different ways of viewing the world, consider the attention paid to the news this year that the Chinese economy had become larger than Japan’s when measured in US dollar terms. The *economic* significance of that shift was actually pretty trivial – China has long had a larger economy than Japan when output is measured on purchasing power parity basis.²⁶ Instead, the underlying focus was often on what the change implied about shifts in global power.²⁷

So, it might well have been to economists’ relief that geo-economics turned out to largely be a creature of the early and mid-1990s. But why didn’t it last? Returning to Vernon’s argument

²³ Ibid. See also Paul Krugman, A country is not a company. *Harvard Business Review* 1996.

²⁴ Huntington, Why international primacy matters.

²⁵ Kennedy, *The rise and fall of the great powers: economic change and military conflict from 1500 to 2000*, p xxv. The emphasis is in the original.

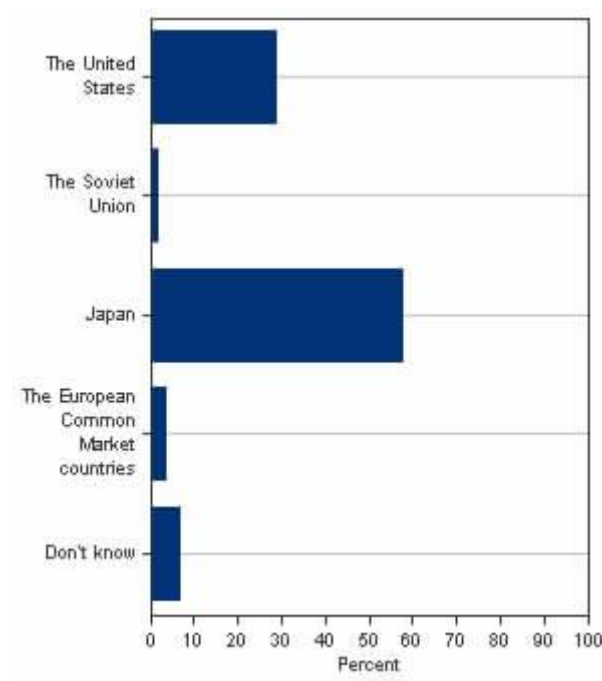
²⁶ Lindsay Whipp and Jamil Anderlini, Chinese economy eclipses Japan's. *Financial Times*, 16 August 2010.

²⁷ Jamil Anderlini, China's jump signals shift in global power. *Financial Times*, 16 August 2010.

for a minute, one possibility is that many of those potentially unemployed geo-politicians were, in the end, able to find more traditional forms of employment after all, so reducing the need for geo-economics as an alternative source of work.

Perhaps more fundamentally, a big part of the initial attraction associated with the idea came from the anxiety felt by many in the world's leading economic power – the United States – about the security of its position as the world's economic top dog. Thus, for example, according to a *Times Mirror* survey conducted in January 1989, some 58% of Americans polled identified Japan as the world's leading economic power, as opposed to just 29% opting for the United States itself (Figure 3).²⁸

Figure 3. 'Today, which one of the following do you think is the world's leading economic power?' (results for January 1989)



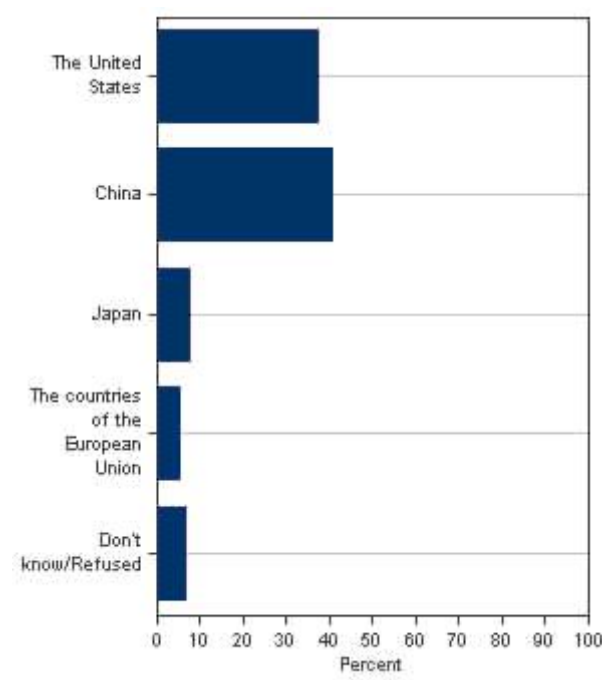
Source: The Pew Research Center for the People & the Press Poll Database.

As the nineties wore on, the bursting of the Japanese property bubble at the start of the decade (the market had peaked in 1991) and the long period of economic malaise that followed, meant that it became increasingly apparent that Americans searching for a credible international economic challenger were going to have to look elsewhere: Japan's challenge was fading fast. And as the supposed competitive threat from Japan started to recede, so did the attractions of geo-economics.

²⁸ The other responses were 4% for the economies of the European Common Market countries, 2% for the Soviet Union, and 7% for don't know. Source: *The Pew Research Center for the People & the Press Poll Database*. See <http://people-press.org/questions/?qid=209049&pid=51&ccid=50#top>.

It follows, then, that at least one important reason for a return of the ideas around geo-economics today is the advent of what is widely assumed to be a new and credible challenger for the United States for that coveted number one spot. The challenger this time around is, of course, China, and US relative economic insecurity is indeed once again on the rise, fuelled in no small part by the global financial crisis. So, for example, according to an April 2010 poll by the Pew Global Attitudes Project, while 38% of those asked continued to pick the United States as the world's leading economic power, 41% opted for China (Figure 4).²⁹

Figure 4. 'Today, which one of the following do you think is the world's leading economic power?' (results for April 2010)



Source: The Pew Research Center for the People & the Press Poll Database.

Six reasons why geo-economics is making a comeback

While the shifting balance in global economic power, symbolised in particular by the economic rise of China, is the most important explanation for the return of geo-economics, it is not the only one. In fact, I think there are at least six reasons to anticipate a return to some form of geo-economics:

1. The arrival of a multi-polar world economy, symbolised by the rise of China

²⁹ Of the rest of those polled, 8% chose Japan, 6% opted for the countries of the EU, and 7% were don't knows / refused to answer. Source: *The Pew Research Center for the People & the Press Poll Database*. See <http://people-press.org/questions/?qid=1765357&pid=51&ccid=50#top>.

2. Globalisation and the *Pax Mercatoria*
3. The dark side of globalisation
4. The rise of State Capitalism
5. The Age of Financial Crises
6. The Age of Scarcity

For the remainder of this paper, I will take a look at each of these in turn, although I'm going to spend the bulk of my time on the first two.

#1. The rise of a multi-polar world economy

I've already argued that the biggest driver of the return of geo-economics is the reality of the ongoing shift in the balance of global economic power. For many a strategic thinker, the connections between changing economic and political power appear to be obvious, since 'all of the major shifts in the world's *military-power* balances have followed alterations in the *productive* balances.'³⁰

Typically, the focus on this shift, particularly when it comes to geo-strategic analysis, is on bilateral developments – which right now means the relative economic gains made by China at the (supposed) expense of the United States.

There are at least two potential issues worth raising with respect to this argument.³¹

First, the assumption that China's gain *must* be to the detriment of the United States. For a positive-sum minded economist, any assessment of the impact of China's rise on the US would want to set any potential negative effects against the growth of a dynamic new market for US exporters, the arrival of a big new source of cheaper imports for US consumers, and the benefits arising from the presence of a major supplier of low-cost external financing:

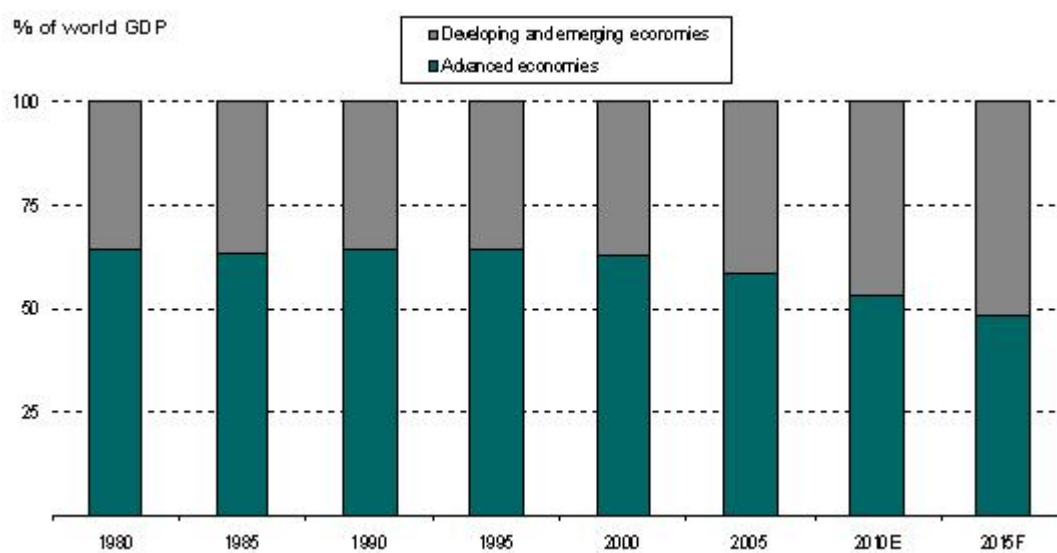
³⁰ Kennedy, *The rise and fall of the great powers: economic change and military conflict from 1500 to 2000*, p 567. Italics in original.

³¹ Another might involve a more critical assessment of the extent to which China really is a credible challenger at this point in time, but that is a subject that would require a different paper.

remember, since money is fungible, all those Chinese purchases of US T-bills have been, in effect, helping fund the US military.

Second, the bilateral focus is, at least in some ways, a bit misleading. The bigger picture here is the onset of rapid catch-up growth in many of the world's largest emerging markets – the *Great Convergence* – which has seen the geographic distribution of economic weight in the world economy start to shift away from the advanced economies and toward the developing world (Figure 5).

Figure 5: The rise of emerging markets in world output, 1980-2015F



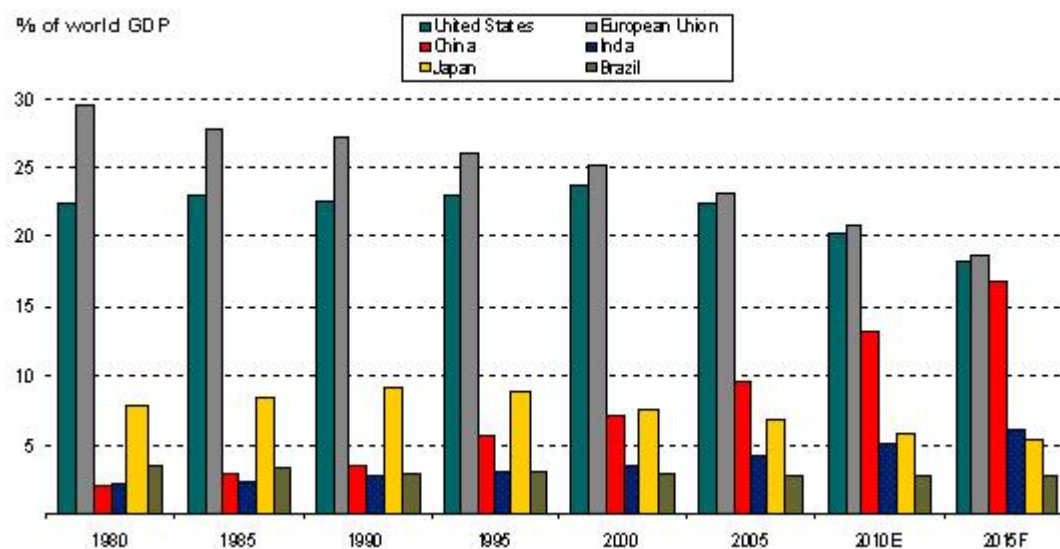
Source: International Monetary Fund, *World Economic Outlook Database April 2010*. (2010)

That said, where the bilateral focus is actually not that misleading is in the fact that the Chinese economic success story puts that particular economy well ahead of any of the other big emerging markets (Figure 6). Put bluntly, right now, no other emerging market is in the same league in terms of economic weight.

The continued rise of the emerging markets is now embedded in consensus forecasts of the world economy, and there is widespread agreement that the coming decades will see the list of the world's largest economies (measured in terms of GDP) increasingly dominated by middle income economies.³²

³² Mark Thirlwell, *Our consensus future: the lay of the land in 2025*. Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, September, 2010.

Figure 6: The changing global line-up, 1980-2015F



Source: International Monetary Fund, *World Economic Outlook Database April 2010*. (2010)

One notable feature of this particular version of our consensus future is that it has remained intact despite the dramatic shock to the world economy supplied by the GFC. Further, it now looks like that the Great Convergence has been given an additional boost by the GFC and the subsequent multi-speed recovery, which has seen growth in emerging markets significantly out-pacing their developed economy counterparts.³³ The dynamics of the post-GFC world are working to accelerate the convergence process, not retard it, although there remain questions regarding the longer term impact.³⁴

The shift in the distribution of economic weight triggered by the Great Convergence is not just being felt in the relative GDP sizes of nation states. Another widely predicted consequence of the rise of the middle-income economies is the expansion of a global middle class and a big shift in its composition away from its current dominance by developed economy populations towards a much greater share for people from emerging economies.³⁵ It's hard to imagine that these big distributional shifts will occur without significant domestic political consequences, which in turn are likely to exert an important influence on the international strategic environment.

³³ See for example David Pilling, Unruffled Asia resumes its economic ascent. *Financial Times*, 12 May 2010.

³⁴ Mark Thirlwell, *All change or plus ca change? The global financial crisis and four key drivers of the world economy*. Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, February, 2009.

³⁵ See for example Homi Kharas, *The emerging middle class in developing economies*. OECD Development Centre Working Paper No. 285. Paris, OECD, 2010. Also Dominic Wilson and Raluca Dragusanu, *The Expanding Middle: the exploding world middle class and falling global inequality*. Goldman Sachs Global Economics Paper No. 170, July, 2008.

Emerging alongside this new global middle class is a group of the billionaires who are reaping the economic gains of a globalised world, and as a result are growing in economic and political influence.³⁶ An example of the role played by this expanding global plutocracy is the rise of the so-called philanthrocapitalists like Bill Gates, who are currently in the process of trying to remake the international aid industry.³⁷ These super-empowered individuals are in the process of acquiring the potential to exert considerable influence on the international economic – and security – environment.³⁸

In fact, globalisation is encouraging the empowerment of a broad range of non-state actors, ranging from NGOs and corporations through to more shadowy players such as militias and criminal organisations. This has even led some analysts to argue that the best description for the emerging new order is not a multi-polar world, but a non-polar one.³⁹

It's no surprise, then, that many strategic thinkers view all of these big economic shifts as heralding similarly big changes in the international distribution of power more generally. Here, for example, is an assessment from the US National Intelligence Council's outlook for 2025:

*'The international system . . . will be almost unrecognizable by 2025 owing to the rise of emerging powers, a globalizing economy, an historic transfer of relative wealth and economic power from West to East, and the growing influence of nonstate actors. By 2025, the international system will be a global multipolar one with gaps in national power continuing to narrow between developed and developing countries.'*⁴⁰

In summary, a great many strategic conversations today are about the shift to, and consequences of, a multi-polar world. Or, more narrowly, about the consequences of the economic rise of China. If we want to understand where that new world order is coming from, then we have no choice but to look to international economics, and in particular to the forces driving the Great Convergence that is now reshaping the international economic order.

³⁶ Chrystia Freeland, Global super-rich no longer look so benign. *Financial Times*, 1 January 2010.

³⁷ Matthew Bishop and Michael Green, The big thinkers of giving: how philanthrocapitalists are reshaping the world of charity. *Foreign Policy* 2009.

³⁸ I sometimes refer to this tongue-in-cheek as my 'James Bond Supervillain' theory.

³⁹ Richard N. Haas, The age of nonpolarity: what will follow US dominance. *Foreign Affairs* 87 (3) 2008.

⁴⁰ National Intelligence Council, *Global trends 2025: a transformed world*. Washington DC, National Intelligence Council (NIC), November, 2008.

#2. Globalisation and the *Pax Mercatoria*

One of the most important of those forces is globalisation – by which I mean the narrow version of that term: international economic integration, or the cross-border integration of markets for goods, services, capital and labour. Since globalisation is in many ways helping to shape the nature of the convergence process, then predictions about the ultimate outcome of the Great Convergence are also tied to predictions about the consequences of globalisation. So here is another critical point at which economics, geopolitics and national security start to mesh: can the big shifts in global economic power that are an inevitable product of the Great Convergence be achieved peacefully?

One important version of the optimistic answer to this question can be couched in terms of the theory of the commercial peace, or *Pax Mercatoria*.

The proposition that commerce can reduce the likelihood of war can be traced all the way back to Montesquieu ('peace is a natural effect of trade'), Kant ('The spirit of commerce, which is incompatible with war, sooner or later gains the upper hand in every state') and J S Mill ('It is commerce which is rapidly rendering war obsolete').⁴¹ Perhaps the most infamous version of this analysis comes from Norman Angell, who in the years preceding the First World War argued that the old assumptions 'that a nation's relative prosperity is broadly determined by its political power; that nations being competing units, advantage, in the last resort, goes to the possessor of preponderant military force' no longer applied. This old view, he argued

*'. . . belongs to the stage of development out of which we have passed; that the commerce and industry of a people no longer depend upon the expansion of its political frontiers; that a nation's political and economic frontiers do not now necessarily coincide; that military power is socially and economically futile, and can have no relation to the prosperity of the people exercising it; that it is impossible for one nation to seize by force the wealth or trade of another to enrich itself by subjugating, or imposing its will by force on another; that, in short, war, even when victorious, can no longer achieve those aims for which peoples strive.'*⁴²

⁴¹ Charles de Secondat (Baron de Montesquieu), *The spirit of laws*, trans. Thomas Nugent (1752). Kitchener, Batoche Books, 2001 (originally published 1748); Immanuel Kant, *The spirit of laws*, trans. Ted Humphrey. Indianapolis, Hackett Publishing Company, 1983 (originally published 1795); and John Stuart Mill, *Principles of political economy, with some of their applications to social philosophy*, vol. II. Boston, Charles C Little & James Brown, 1848.

⁴² Norman Angell, *The great illusion: a study of the relation of military power in nations to their economic and social advantage*. New York and London, G P Putnam's Sons, 1911.

Angell's diagnosis of the material futility of war in the modern age turned out to be spot on, but as a forecast of the immediate future it was dead wrong (Figure 7).⁴³

While the outbreak of the First World War may well have served as a powerful rebuke to naïve faith in the *Pax Mercatoria*, the events of the 1920s and especially the 1930s provided evidence of a very different kind. The pre-1914 global trading system had splintered into competing trade blocks, and the international rise of protectionism meant that quantitative restrictions affected between 50% and 70% of world trade by the 1930s.⁴⁴ As the international trading system fragmented, world trade volumes collapsed, and by 1933, with world trade shrinking even faster than world output, the world economy was in a downward spiral that contributed to the economic dislocation and political extremism that were a precursor to the Second World War.⁴⁵

It was the memory of these disastrous events during the interwar period that encouraged Allied policymakers such as US Secretary of State Cordell Hull to make the restoration of a functioning, integrated international economy a key priority for the post-war period.⁴⁶ As Douglas Irwin puts it:

*'By the mid-1940s, protectionism in the field of economic policy was likened to appeasement in the realm of diplomacy, a mistake that helped make the decade of the 1930s a political and economic disaster.'*⁴⁷

One product of this lesson – the General Agreement on Tariffs and Trade (GATT) – has arguably been one of the most successful international economic and international security initiatives of the modern era (Figure 8).

⁴³ See for example J. Bradford DeLong, The great illusion. *Project Syndicate*, 20 May 2004.

⁴⁴ Nicholas Crafts, *Globalization and growth in the twentieth century*. IMF working paper WP/00/44. Washington DC, International Monetary Fund, March, 2000.

⁴⁵ Mark Thirlwell, *The new terms of trade*. Lowy Institute Paper 07. Sydney, Lowy Institute for International Policy, 2005.

⁴⁶ Under the original Bretton Woods system, that integration would not be extended to capital flows.

⁴⁷ Douglas A Irwin, *Free trade under fire*. Princeton and Oxford, Princeton University Press, 2002, p 159.

Figure 7: Norman Angell's infamous forecasting error



British trench near the Albert–Bapaume road at Ovillers-la-Boisselle, July 1916 during the Battle of the Somme. Source: Wikimedia Commons.

Since the establishment of the GATT, the basic idea that economic interdependence between economies will reduce the likelihood of conflict has continued to be refined, with one of the famous modern statements of the commercial peace coming from Solomon Polachek, who argued that mutual economic interdependence would make conflict more costly, and hence increase the chances of peace.⁴⁸ Other variants on the same theme have come from John Mueller and more recently still by self-described ‘Norman Angell with nukes’ Thomas Barnett.⁴⁹

But does the data support the theory? If one plots globalisation (measured as the ratio of world trade to GDP) and the occurrence of conflict (measured as the number of country pairs which in a given year are in a military conflict, divided by the number of existing country pairs) over the period 1870 to 2001, then the result suggests that there is no simple

⁴⁸ Solomon W Polachek, Conflict and trade. *The Journal of Conflict Resolution* 24 (1) 1980.

⁴⁹ John Mueller, *Retreat from doomsday: the obsolescence of major war*. New York, Basic Books, 1989. Thomas P M Barnett, *The Pentagon's new map: war and peace in the twenty-first century*. New York, Putnam, 2004.

relationship between the two. So, for example, the first era of globalisation (roughly 1870-1914) is marked both by growing openness *and* by rising military conflict. Later on, the sharp rise in trade integration since 1970 appears to have been associated with a relatively stable pattern of international conflict.⁵⁰

Figure 8. Successful security initiatives (aka trade rounds)

The trade rounds			
<u>Year</u>	<u>Place / name</u>	<u>Subjects covered</u>	<u>Countries</u>
1947	Geneva	Tariffs	23
1949	Annecey	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-61	Dillon Round	Tariffs	26
1964-67	Kennedy Round	Tariffs, anti-dumping measures	62
1973-79	Tokyo Round	Tariffs, non-tariff measures, framework agreements	102
1986-1994	Uruguay Round	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO	123
2001-?	Doha Round	Ongoing	153

Source: Adapted from material and tables on the WTO web site

Of course, this shouldn't be a complete surprise. Any sophisticated version of the commercial peace theory would have to assert that trade discourages conflict, *all else equal*. That last qualification is vitally important since in reality, all else is never equal. This means that it's helpful to use statistical techniques to try to isolate the influence of trade on conflict.

To date, political scientists rather than economists seem to have made most of the running on this. In a large literature on the subject, they have tended to focus on the relationship between bilateral trade interdependence and military conflict. So, for example, one important early contribution from John Oneal, Bruce Russett and co-authors uses this approach to find empirical support for the hypothesis of a commercial peace.⁵¹ On the other side of the debate, Katherine Barbieri's work has suggested that things are not quite so straightforward: instead of a negative relationship between bilateral trade interdependence and military conflict,

⁵⁰ Philippe Martin, Thierry Mayer and Mathias Thoenig, *Does globalisation pacify international relations?*, VoxEU.org, 4 July, 2007.

⁵¹ John R Oneal, Frances H Oneal, Zeev Maoz and Bruce Russett, The liberal peace: interdependence, democracy and international conflict, 1950-85. *Journal of Peace Research* 33 (1) 1996.

Barbieri finds a *positive* one.⁵² Oneal and Russett have found that this result is sensitive to the way trade interdependence is measured.⁵³ Taken overall, however, I judge that the surveys of this literature suggest that the majority of empirical studies do broadly support the idea of a negative relationship between bilateral trade and conflict.⁵⁴

Economists are relative newcomers to this debate. One recent contribution comes from Philippe Martin, Thierry Mayer and Mathias Thoenig. Their work confirms the proposition that for a given pair of countries a higher level of bilateral trade produces a lower probability of bilateral war.⁵⁵ But they also report a more surprising finding: countries more open to trade in general have a *higher* probability of war.⁵⁶

Another recent paper, this time from Jong-Wha Lee and Ju Hyun Pyun, also finds that bilateral trade interdependence is associated with a lower probability of conflict. Moreover, and in contrast to the findings of Martin, Mayer and Thoenig, they also find that global interdependence is good for peace, with the peace-promoting effects of trade varying depending on the degree of geographical proximity. Their results suggest that greater bilateral interdependence seems to produce larger peace-promoting effects for neighbouring countries, while greater global trade openness has a relatively greater positive effect on peace for distant countries.⁵⁷

At this point, it's worth noting that the debate on the commercial peace has tended to focus mainly on trade flows. But globalisation, even narrowly defined, encompasses more than the market for goods. While there has been some work on the relationship between conflict and

⁵² Katherine Barbieri, *The liberal illusion: does trade promote peace?* Ann Arbor, University of Michigan, 2005.

⁵³ John R Oneal and Bruce Russett, Assessing the liberal peace with alternative specifications: trade still reduces conflict. *Journal of Peace Research* 36 (4) 1999.

⁵⁴ Edward D Mansfield and Brian M Pollins, eds., *Economic interdependence and international conflict: new perspectives on an enduring debate*. Ann Arbor, University of Michigan Press, 2003. Gerald Schneider, Katherine Barbieri and Nils Petter Gleditsch, eds., *Globalization and armed conflict*. Boulder, Colorado, Rowman and Littlefield, 2003.

⁵⁵ Summarised in Martin, Mayer and Thoenig, *Does globalisation pacify international relations?*

⁵⁶ They explain this result by arguing that, while the probability of war is lower for countries that trade more bilaterally because of the opportunity costs associated with lost trade, greater multilateral openness has the opposite effect because, by reducing the level of bilateral dependence, it reduces the opportunity cost of any given conflict. Multilateral trade openness therefore affects the nature of war: it increases the probability of local wars but deters global conflicts, a prediction which they argue fits well with the stylised fact that military conflicts have become more localised over time. The same authors have built on these results to suggest that free trade agreements are good for peace.

⁵⁷ Summarised in Jong-Wha Lee and Ju Hyun Pyun, *Globalisation promotes peace*. VoxEU.org, 21 March, 2009.

other variables (such as foreign direct investment), this seems to be an area which is still relatively under-explored.⁵⁸

It's also important to note that the causality between globalisation and peace runs in both directions: that is, the expansion of trade typically benefits from peaceful conditions. So, for example, recent work by Reuben Glick and Alan Taylor finds a very strong adverse impact of war on trade volumes. They estimate that the costs of war in terms of lost trade are large, and comparable in scale to the other costs of war such as loss of human life. Glick and Taylor also find that the damage to trade is persistent, so that even after a conflict ends, trade does not resume its pre-war level for many years.⁵⁹

More general support for this kind of result is provided by Blomberg and Hess, who look at the economic cost of violence more broadly, including terrorism and internal conflict as well as external wars. They too find that the economic cost of violence for trade is large and comparable to the cost of other trade barriers; indeed, they find that the positive impact of peace on trade is larger than the trade-supporting effects of WTO membership or bilateral trade arrangements.⁶⁰ Finally, some recent work by Daron Acemoglu and Pierre Yared goes beyond conflict to look at the relationship between militarism more broadly and international trade. They find that increased militarism, measured by military spending and size, is negatively associated with trade.⁶¹

Summing up the evidence, then, I would judge that while empirical support for the *Pax Mercatoria* is not conclusive, nevertheless it's still strongly supportive of the general idea that international integration is good for peace, *all else equal*. Since there is also even stronger evidence that peace is good for trade, this raises the possibility of a nice virtuous circle: globalisation (trade) promotes peace, which in turn promotes more globalisation. In this kind of world, we should not worry too much about the big power shifts described in the previous section, since they are taking place against a backdrop of greater economic integration which should help smooth the whole process.

⁵⁸ For an example of this kind of work see Solomon W Polachek, Carlos Seiglie and Jun Xiang, *Globalization and international conflict: can FDI increase peace?* Working Paper #2005-04, Rutgers University Newark, September, 2005.

⁵⁹ Reuben Glick and Alan Taylor, *Collateral damage: trade disruption and the economic impact of war*. NBER Working Paper 11565, National Bureau of Economic Research, July, 2005.

⁶⁰ S. Brock Blomberg and Gregory D Hess, How much does violence tax trade? *The Review of Economics and Statistics* 88 (4) 2006.

⁶¹ Summarised in Daron Acemoglu and Pierre Yared, *Trade and militarism: the political limits to globalisation*. VoxEU.org, 7 March, 2010.

Instead of ending this section on that optimistic note, however, it's worth thinking about some reasons why the *Pax Mercatoria* might nevertheless turn out to be a poor, or at least overly-optimistic, guide to our future.

The first is captured by that all important get-out-of-gaol-free card, '*all else equal*'. It's quite possible that the peace-promoting effects of international commerce will end up being swamped by other factors, just as they were in 1914.

Second, perhaps the theory itself is wrong. Certainly, a realist like John Mearsheimer would seem to have little time for the optimistic consequences of the rise of new powers implied by the theory. Here's Mearsheimer on how the US should view China's economic progress, for example:

*' . . . the United States has a profound interest in seeing Chinese economic growth slow considerably in the years ahead . . . A wealthy China would not be a status quo power but an aggressive state determined to achieve regional hegemony.'*⁶²

Such pessimistic (or are they tragic?) views of the world would also seem to run the risk of being self-fulfilling prophecies if they end up guiding actual policy.

Finally, there is the risk that the shift to a multi-polar world might indirectly undermine some of the supports needed to deliver globalisation. Here I am thinking about some simple variant on the idea of hegemonic stability theory (HST) – the proposition that the global economy needs a leader (or 'hegemon') that is both able and willing to provide the sorts of international public goods that are required for its smooth functioning: open markets (liberal or 'free' trade), a smoothly functioning monetary regime, liberal capital flows, and a lender of last resort function.⁶³ Charles Kindleberger argued that 'the 1929 depression was so wide, so deep, and so long because the international economic system was rendered unstable by British inability and US unwillingness to assume responsibility for stabilizing it', drawing on the failures of the Great Depression to make the original case for HST:

' . . . the international economic and monetary system needs leadership, a country that is prepared . . . to set standards of conduct for other countries and to seek to get others to

⁶² John J Mearsheimer, *The tragedy of great power politics*. London, W.W. Norton & Co., 2001.

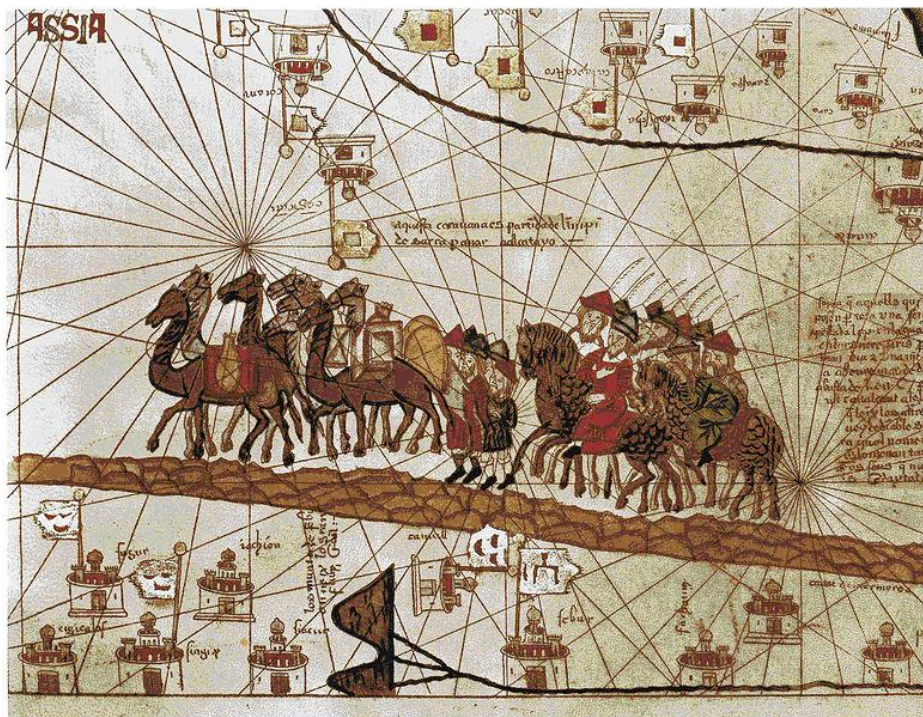
⁶³ A public good is defined as one that is non-excludable (inclusive) and non-exhaustive. The classic example is a lighthouse.

follow them, to take on an undue share of the burdens of the system, and in particular to take on its support in adversity...⁶⁴

Kindleberger's assessment appears to capture a rough empirical regularity: As Findlay and O'Rourke remind us, 'periods of sustained expansion in world trade have tended to coincided with the infrastructure of law and order necessary to keep trade routes open being provided by a dominant "hegemon" or imperial power'.⁶⁵ Thus periods of globalisation have typically been associated with periods of hegemonic or imperial power, such as the *Pax Mongolica*, the *Pax Britannica* and, most recently, the *Pax Americana* (Figure 9).

The risk, then, is that by reducing the economic clout of the United States, it is possible that the shift to a multi-polar world economy might undermine either the willingness or the ability (or both) of Washington to continue to supply the international public goods needed to sustain a (relatively) smoothly functioning world economy.⁶⁶ That in turn could undermine the potential virtuous circle identified above.

Figure 9: Enjoying the benefits of the *Pax Mongolica*



A scene from the Catalan Atlas depicting Marco Polo travelling to the East.

Source: Wikimedia Commons.

⁶⁴ Charles P. Kindleberger, *The world in depression 1929-1939*. Berkeley, University of California Press, 1986, p 11.

⁶⁵ Findlay and O'Rourke, *Power and plenty: trade, war and the world economy in the second millennium*. For a view on the beneficial economic effects of empire, see Deepak Lal, *In praise of empires: globalization and order*. New York, Palgrave Macmillan, 2004.

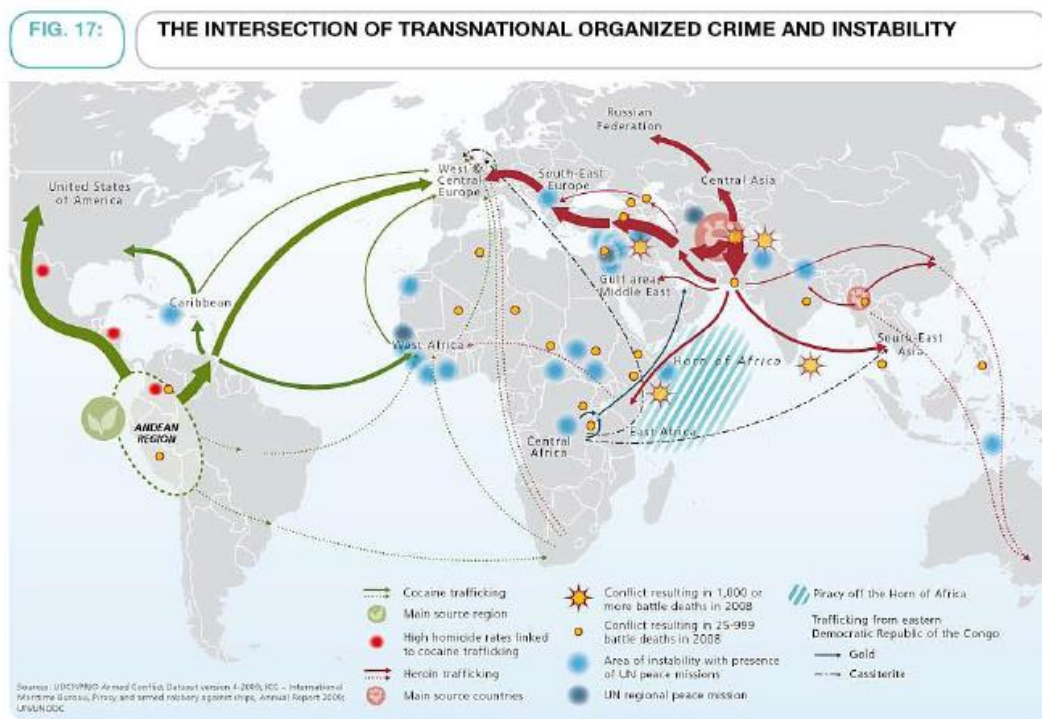
⁶⁶ See for example Adam Posen, Who will sustain globalization? *Current History* 108 (72) 2009.

#3: The dark side of globalisation

So far I have defined globalisation in a narrow economic sense as the international economic integration of markets for goods, services, and labour. Usually when I refer to these markets, I am thinking of their formal, legal versions. There is however, another, darker side to globalisation that also has strong implications for national security.

Back in 2003, Moises Naim wrote about the ‘five wars of globalisation’ in a piece for *Foreign Policy*, noting that since the 1990s, the illegal trade in drugs, arms, intellectual property, people and money was booming. Governments, said Naim, had been fighting and losing wars to stem these illicit flows for centuries. But thanks to changes driven by globalisation, ‘their losing streak has become even more pronounced.’⁶⁷ Naim later turned his article into a book, and similar themes have been covered by other authors, including recent contributions from Misha Glenny and Carolyn Nordstrom.⁶⁸

Figure 10. The international impact of globalisation’s dark side



Source: United Nations Office on Drugs and Crime (UNODC), *The globalization of crime: A transnational organized crime threat assessment*. (2010)

⁶⁷ Moises Naim, The five wars of globalization. *Foreign Policy* (134) 2003.

⁶⁸ Moises Naim, *Illicit*. New York, Doubleday, 2005. Misha Glenny, *McMafia: a journey through the global criminal underworld*. New York, Knopf, 2008. Carolyn Nordstrom, *Global outlaws: crime, money and power in the contemporary world*. Berkeley, University of California Press, 2007.

Naim and others argue that globalisation and some of its key drivers – primarily technology and deregulation – have provided a major boost to international crime. So, for example, financial market deregulation and innovations in information and communications technology have not only made things easier for legal international capital flows, they have also helped make life easier for money launderers.

How big are the illicit flows found on the dark side of globalisation? Potentially, they are very large indeed. According to a recent report by the United Nations Office on Drugs and Crime (UNODC), the total annual value of illicit flows is around US\$125 billion, of which about 85% is generated by drug markets (although the report is careful to note the tentative nature of some of its numbers).⁶⁹ The same report warns that ‘organised crime has diversified, gone global, and reached macro-economic proportions.’

Combine these kinds of estimates with fears of a global crime wave, the sort of disorder seen this year in Mexico, Jamaica and elsewhere, and mix in some post-9/11 worries about the links between international crime and international terrorism, and you can see why writers like Naim claim that ‘Global criminal activities are transforming the international system’.⁷⁰ Others have warned of the onset of a new Middle Ages.⁷¹ According to UNODC, activities ranging from drug cartel-related violence in Central America, the Caribbean and West Africa; collusion between insurgents and criminal groups in Central Africa, the Sahel and Southeast Asia, and piracy off the Horn of Africa are all contributing to global instability (Figure 10).⁷² Here, then, is another area where international economics and security overlap.

There is a significant qualification to be made here, however. Given the nature of these flows, it's actually very difficult to estimate just how important they really are. As RT Naylor puts it in a critical review of Naim's book, these ‘are alarming developments...The only problem is to find evidence that any of them is actually true.’⁷³ Naylor stresses the lack of hard data available, arguing, for example, that the common claim that laundered money represents between 2% and 5% of world GDP, ‘far from being the result of assiduous research...was invented on the spot by an aide to the IMF chief when he desperately needed a figure to give to eager reporters at a press conference’.⁷⁴

⁶⁹ United Nations Office on Drugs and Crime (UNODC), *The globalization of crime: a transnational organized crime threat assessment*. Vienna, UNODC, 2010.

⁷⁰ Naim, *The five wars of globalization*.

⁷¹ John Rapley, *The New Middle Ages*. *Foreign Affairs* 85 (3) 2006.

⁷² United Nations Office on Drugs and Crime (UNODC), *The globalization of crime: a transnational organized crime threat assessment*.

⁷³ R T Naylor, *Marlboro Men*. *London Review of Books* 29 (6) 2007.

⁷⁴ *Ibid.*

#4. The rise of State Capitalism

My fourth reason for the return of geo-economics is in large part a product of my first one. One consequence of the Great Convergence has been an international shift in economic weight towards those countries that award a relatively larger role for the state in their economies. Here, for example, is Larry Summers in the *Financial Times*, arguing that:

‘ . . . much of the momentum in the global economy is coming from countries . . . that are pursuing economic strategies directed towards wealth accumulation and building up geopolitical strength rather than improving living standards for their populations . . . Nations are increasingly preoccupied with their relative economic standing . . . Issues of strategic leverage and vulnerability now play a bigger role in economic policy discussions.’⁷⁵

Granted, Summers probably takes this too far: in the case of China, for example, it seems clear that improving living standards *is* a major preoccupation for Beijing, even if their policy choices are not always those that Summers might approve, and even if they are prepared to sacrifice some potential gains in the short term.⁷⁶ But there is still something to his claim about a relative change in international priorities.

Note that here I am making a point about cross-country change, rather than change over time: that is, as the balance of economic weight in the world economy (say) shifts towards China and away from the United States, that indicates a shift towards an economy where the state plays a larger economic role. This is not to dispute the argument that, at least until recently, the state’s role in the Chinese economy has been declining over time.⁷⁷ What it does mean is that there has been a significant change in the balance of international ideology as applied to the role of the state. Moreover, the aftermath of the financial crisis has further cemented that shift:

‘State-led economic development by the developmental states of East Asia such as Japan and Korea has been a wonder of the world, cutting decades if not generations off the predicted times for their emergence as prosperous, modern economies...Now that the financial crisis has freed them from the fetters and blinders of the Washington consensus and the neoliberal

⁷⁵ The author realises that more than a few readers at this point are likely to respond, “Nothing new there, then”. The Summers quote is from Lawrence Summers, The global consensus on trade is unravelling. *Financial Times*, 24 August 2008.

⁷⁶ Exchange rate policy is an obvious example here.

⁷⁷ For how Beijing’s response to the GFC might have changed this trend, see Yang Yao, The end of the Beijing Consensus. *Foreign Affairs* 2010. Also Michael Wines, China fortifies state businesses to fuel growth. *The New York Times*, 29 August 2010.

*ideology, the governments will attempt to deploy their market-rigging economic instruments – their money, their sovereign wealth funds, their stimulus packages, along with the various nonmonetary instruments at their disposal – to accelerate their rise to prosperity. Will they succeed? Probably not...But they will try.*⁷⁸

The rise of what Aznar Gat has described as the ‘authoritarian capitalists’ is an increasingly prevalent theme, although the more common description is the rise of state capitalism.⁷⁹ I think it should be conceded up front that, at least to some extent, state capitalism is very much in the eye of the beholder. Still, here’s an attempt at a definition from Ian Bremmer:

*‘State capitalism is not the re-emergence of socialist central planning in a twenty-first century package. It is a form of bureaucratically engineered capitalism particular to each government that practices it. It’s a system in which the state dominates markets primarily for political gain.’*⁸⁰

For Bremmer, the tools deployed by the managers of this newly energised version of state capitalism are captured by a set of acronyms: national oil (and gas) corporations (NOCs), other state-owned enterprises (SOEs), privately owned national champions, and sovereign wealth funds (SWFs).⁸¹ Another obvious candidate to add to this list would be state-owned banks (SOBs).

In the run-up to the global financial crisis, there is little doubt that the element of state capitalism that received the greatest attention was the rise of SWFs. Even though they had been around for decades, particular in some oil-exporting nations, the rest of the world only really started to take notice of these funds around 2007. In large part this was because, thanks to a combination of soaring commodity prices and big current account surpluses, the funds at the disposal of these government-controlled investment vehicles had surged (Figure 11) and was widely predicted to keep on growing.⁸² But it also reflected the presence of new entrants in the SWF listings – in particular, China and Russia. The ability of foreign governments to deploy this growing pool of capital may well have been viewed as a great profit opportunity

⁷⁸ Stephen S. Cohen and J. Bradford DeLong, *The end of influence: what happens when other countries have the money*. New York, Basic Books, 2010, pp 122-123.

⁷⁹ Azar Gat, The return of authoritarian great powers. *Foreign Affairs* 86 (4) 2007.

⁸⁰ Ian Bremmer, *The end of the free market: who wins the war between states and corporations?* New York, Portfolio, 2010, p 23.

⁸¹ *Ibid.* p 54.

⁸² See for example Stephen Jen, *How big could sovereign wealth funds be by 2015?* Currencies, Morgan Stanley Research Global, 3 May, 2007. Also Gerard Lyons, *State capitalism: the rise of Sovereign Wealth Funds*. Standard Chartered, 15 October, 2007; The Economist, Sovereign Wealth Funds: the world’s most expensive club. *The Economist*, 24 May 2007.

by financial institutions, but it was also treated as a potential security challenge by many of the rich world's governments.⁸³ Post-crisis, SWFs have continued to be important players in terms of global investment: UNCTAD data, for example, show that the value of FDI directed by SWFs from their funds increased in 2009, accounting for some US\$22.9 billion of FDI that year.⁸⁴

Figure 11. Who has the money?

The top ten SWFs			
<u>Fund</u>	<u>Country</u>	<u>Size (e)</u> <u>US\$ bns</u>	<u>Source</u>
Abu Dhabi Investment Authority	UAE – Abu Dhabi	\$627	Oil
Government Pension Fund – Global	Norway	\$443	Oil
SAMA foreign holdings	Saudi Arabia	\$415	Oil
SAFE Investment Company	China	\$347.1	Non-oil
China Investment Corporation (CIC)	China	\$332.1	Non-oil
Govt of Singapore Investment Corp. (GIC)	Singapore	\$247.5	Non-oil
HKMA Investment Portfolio	Hong Kong SAR	\$227.6	Non-oil
Kuwait Investment Authority (KIA)	Kuwait	\$202.8	Oil
National Social Security Fund (NSSF)	China	\$146.5	Non-oil
National Welfare Fund	Russia	\$142.5	Oil

Source: SWF Institute <http://www.swfinstitute.org/fund-rankings/>. Updated June 2010.

In practice, the challenges thrown up by SWFs are little different than those raised by foreign investment channelled through SOEs and SOBs. Indeed, it might even be the case that SWFs raise fewer issues, at least to the extent that they are relatively more inclined to act as portfolio investors.

Either way, it's quite clear that there has been a negative reaction to the rise in government-controlled foreign investment.⁸⁵ It's equally clear that in many of these cases non-economic

⁸³ Benjamin J Cohen, Sovereign wealth funds and national security: the Great Tradeoff. *International Affairs* 85 (4) 2009.

⁸⁴ United Nations Conference on Trade and Investment (UNCTAD), *World Investment Report 2010: Investing in a low-carbon economy*. Geneva, United Nations Conference on Trade and Investment, 2010.

⁸⁵ Alan Beattie, Stephanie Kirchgaessner and Raphael Minder, Left in the cold: Foreign bidders find themselves out of favour. *Financial Times*, 24 April 2008.

factors are a big part of the explanation.⁸⁶ Take for example the Australian debate over the Chinalco bid for Rio: much of the focus here was on the fact that Chinalco was a SOE, and therefore could not be assumed to act in the same way as a purely commercial operation.⁸⁷ In general, it is this explicit connection between the state and the financial and corporate institutions that are channelling its funds overseas that has *automatically* injected international politics into issues of international economics. As a result of this, one consequence of the rise of state capitalism is to further advance the case for a return of geo-economics.

Finally, before leaving this issue, it's worth pointing out that although state capitalism has largely been treated as a feature of emerging markets, the global financial crisis has also seen the state injected back into developed economies in a quite dramatic way.⁸⁸ Initially, this was in the form of bank bailouts and other government handouts, including some (effective) nationalisations. But it's also taken the form of new regulations and controls, with Germany's ban on naked short-selling a good example of an increased willingness on the part of some states to take on markets. This is a development that has made some market participants jumpy about regulatory risk and suggests that businesses and investors now face what has already been termed a new age of political risk.⁸⁹

#5. The Age of Crises

As noted right back at the start of this essay, early on in the financial crisis some analysts identified the GFC as a major threat to national security. When it became clear that the world had successfully avoided re-running a version of the Great Depression of the 1930s, such fears began to look a bit overdone. Since then, however, developments that have included major riots in Greece and protests and strikes in other countries have provided some further support for the idea of focusing on the links between economic crises and national security issues, although the implications have mainly been for domestic stability. In addition, however, there is of course the overarching theme of the loss of economic credibility incurred by the United States and other developed economies as a result of the regulatory and macro policy failures that contributed to the crisis, and the consequences this has had for Washington's relative international standing.

⁸⁶ See for example Paul Betts, EU wary as Russia puts velvet glove on iron fist. *Financial Times*, 11 December 2007.

⁸⁷ Andrew Shearer and Mark Thirlwell, *Is the FIRB acting fairly?* Paper prepared for the IPA conference on Australia's Open Investment Future, Melbourne 4 December 2008. Sydney, Lowy Institute for International Policy, 2008. See also Mark Thirlwell, *Dealing with the dragon: Australia and Chinese inward investment*. Clingendael Asia Forum 5. The Hague, Netherlands Institute for International Relations, 1 April, 2010.

⁸⁸ The Economist, Leviathan stirs again: the return of the state. *The Economist*, 21 January 2010.

⁸⁹ James Surowiecki, The new age of political risk. *The New Yorker*, 24 May 2010.

More generally, the GFC is just the latest (albeit largest) in a long line of financial accidents to hit our crisis-prone world economy (Figure 12). Such crises are so common that Roubini and Mihm have labelled them ‘white swans’.⁹⁰

Figure 12: Our crisis-prone world economy

Financial crises	
<u>Year</u>	<u>Event</u>
1982-90	Latin American debt crisis (‘The lost decade’)
1986-1995	US Savings & Loan crisis
1987	Black Monday Stock Market Crash
1990-1	Japanese Stock Market and Property Bubble Cashes
1990-93	Scandinavian Banking Crises
1992-93	ERM Cisis (including Black Wednesday)
1994-95	Tequila Crisis (Mexico)
1995	Barings Collapse
1997-98	Asian Financial Crisis
1998	Russian Crisis / LTCM collapse
2001	Dot.com Bust / Enron collapse
2002	Argentine default
2007-2010?	Global Financial Crisis
2010 - ?	Greek / Euro Crisis

By definition, financial crises take a significant toll on the near-term economic prospects of the countries involved. There is also an interesting literature on the medium- and long-term implications. So, for example, recent work by the IMF analysing the lessons to be drawn from a review of 88 banking crises over the past four decades, finds that major crises are typically followed by persistent output losses relative to the pre-crisis trend, and only gradual recoveries in the rate of growth of output.⁹¹

Importantly in the current context, it’s also the case that economic and financial crises can have significant non-economic effects. Take, for example, the Asian financial crisis of 1997-98. As well as wreaking economic devastation across the region, it also triggered a series of

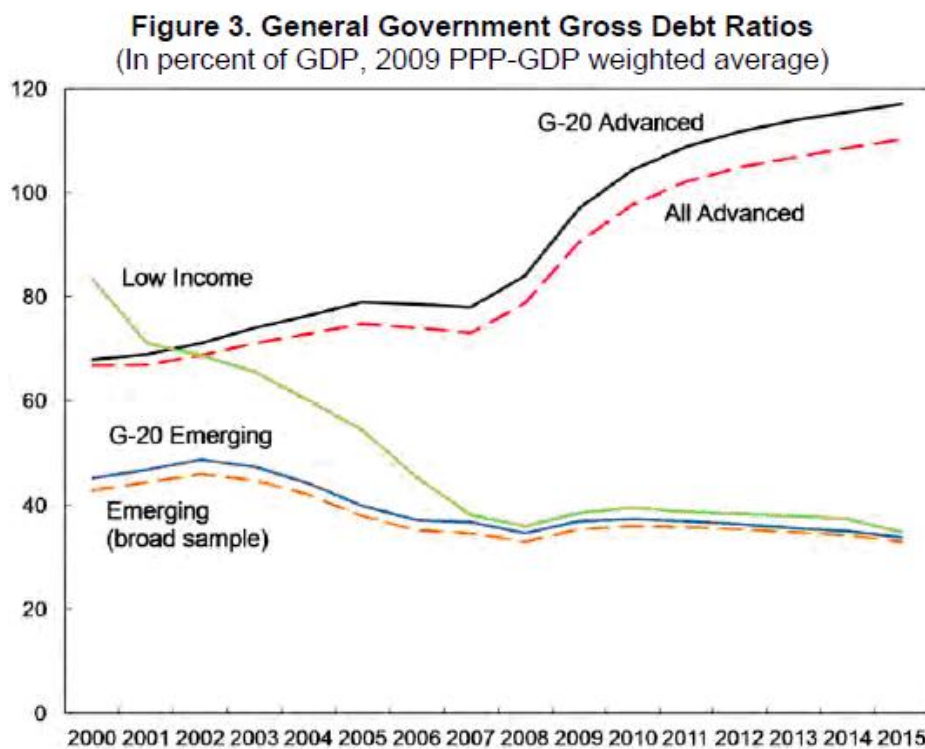
⁹⁰ Nouriel Roubini and Stephen Mihm, *Crisis economics: a crash course in the future of finance*. New York, The Penguin Press, 2010.

⁹¹ International Monetary Fund (IMF), What’s the damage? Medium-term output dynamics after financial crises, in *World Economic Outlook: Crisis and recovery*. Washington DC, International Monetary Fund, 2009.

dramatic political transitions, including, but not limited to, the collapse of the Soeharto regime in Indonesia.

Another lesson to be drawn from past crises is that they often sow the seeds of future disruptions. So, for example, to some extent the current problems in the periphery of the Euro-area (particularly in Greece but also in the other so-called PIGS) arose as a result of fallout from the GFC.⁹² Looking ahead, I think two particular risks are worth highlighting here.

Figure 13: The Great Sovereign Risk Shift



Source: IMF staff estimates based on the April 2010 WEO projections.

Source: International Monetary Fund (IMF), *Fiscal Monitor: Navigating the fiscal challenges ahead*. (2010)

The first risk relates to the fact that one major consequence of the GFC has been a marked deterioration in the fiscal positions of many of the world's developed economies (Figure 13). According to the IMF, for example, the average ratio of gross general government debt to GDP for advanced economies is forecast to rise from about 73% in 2007 to almost 98% by the end of 2010, to 110% by 2015.⁹³ In contrast, when it comes to emerging markets the IMF

⁹² Although I would argue that this was mainly a trigger for problems caused by structural problems with the euro area. The PIGS are Portugal, Ireland, Greece and Spain.

⁹³ International Monetary Fund (IMF), *Fiscal Monitor: Navigating the fiscal challenges ahead*. World Economic and Financial Surveys. Washington DC, International Monetary Fund, 14 May, 2010.

reckons that the average debt burden will only have risen from 37% of GDP in 2007 to an estimated 38% of GDP as of the end of 2010, and is forecast to fall to 34% by 2015.⁹⁴ These developments imply a quite pronounced shift in the distribution of sovereign risk as measured by traditional debt indicators away from developing and towards developed countries. Moreover, given that a range of developed economies face quite tough medium- and long-run fiscal challenges as a product of ageing populations, the fiscal story looks set to deteriorate further in the absence of offsetting policies.⁹⁵

I have already mentioned one result of this fiscal deterioration: the problems facing the Euro area. Once again, it seems clear that these will have consequences that are much broader than the economic. For example, a commonly heard view before 2007 was that the EU was ‘punching below its weight’ in international affairs due to its preoccupation with internal developments, a diagnosis that is now unlikely to change.

Another result is heightened concern about the longer-term fiscal health of the United States, a concern which feeds into broader worries about Washington’s ability to continue to act as Commander-in-Chief of the world economy. Paul Kennedy once famously predicted that the United States would face a problem of ‘imperial overstretch’.⁹⁶ Until recently, the judgment was that he had got it wrong: now there is a view that he might have been right, just a little premature.⁹⁷

In fact, a look at the current debt burden of the United States suggests that for now, at least, these concerns are probably overdone.⁹⁸ According to the Congressional Budget Office (CBO), US federal debt held by the public will stand at 62% of GDP at the end of fiscal year 2010, having risen from 36% at the end of fiscal year 2007.⁹⁹ It’s unlikely that this is

⁹⁴ Ibid.

⁹⁵ See for example Stephen G Cecchetti, M S Mohanty and Fabrizio Zampolli, *The future of public debt: prospects and implications*. BIS Working Papers No 300, Bank for International Settlements, 2010.

⁹⁶ Kennedy, *The rise and fall of the great powers: economic change and military conflict from 1500 to 2000*.

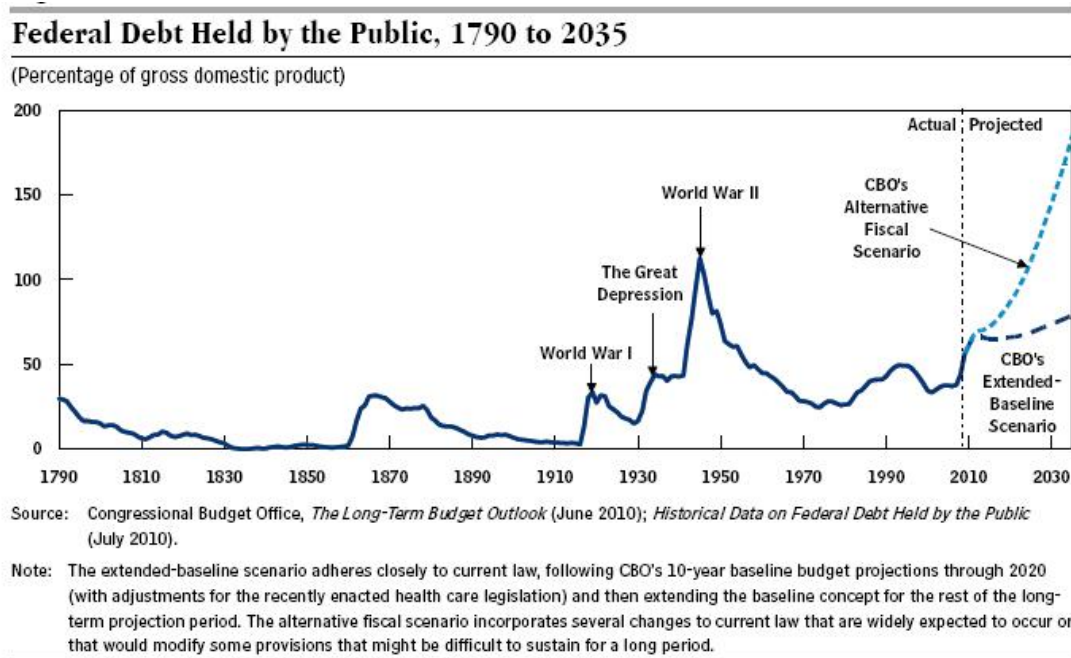
⁹⁷ For a recent view on this, see Niall Ferguson, *Fiscal crises and imperial collapses: historical perspective on current predicaments*. Ninth Annual Niarchos Lecture. Washington DC, Peterson Institute for International Economics, 13 May, 2010.

⁹⁸ Although a sudden change in market expectations, for example, leading to a big enough shift in US interest rates relative to the growth rate could change this. As yet, there is no sign of any such effect in US bond yields. Niall Ferguson’s take on this is to highlight the fragility of complex systems. Niall Ferguson, *Complexity and collapse*. *Foreign Affairs* 4 (89) 2010.

⁹⁹ The CBO argues that when it comes to debt sustainability, debt held by the public is the relevant concept. Another chunk of federal debt is held by government trust funds and other government accounts. According to the CBO, the latter only represents internal government transactions. Congressional Budget Office (CBO), *Federal debt and the risk of a fiscal crisis*. CBO Economic and Budget Issue Brief. Washington DC, Congressional Budget Office, 2010.

sufficient to generate an imminent fiscal crisis. But this is not to downplay the matter. That jump in debt – of 25% of GDP and rising – is comparable to the increases produced by the US Civil War and World War I. Granted, it's still well below the nearly 80% of GDP surge produced by World War II (Figure 14). That said, however, a common point here is that the period after the Second World War is the only other one when US federal debt held by the public has exceeded 50% of GDP.

Figure 14: US debt in the long run



Source: Congressional Budget Office (CBO), *Federal debt and the risk of a fiscal crisis*. (2010).

Moreover, looking ahead, according to the CBO's extended baseline scenario the debt ratio will continue to rise, heading to about 80% of GDP. That scenario assumes no changes to current law. But as the CBO points out, some changes to current legislation are expected over the next few years, and according to the CBO's alternative fiscal scenario, debt held by the public could exceed its historical peak of about 110% of GDP by 2025, and reach about 180% of GDP by 2030.¹⁰⁰

The second risk of a new crisis is a product of the changed international financial landscape. At this point, it looks likely that interest rates (and returns on investment more generally) in much of the developed world are likely to be depressed for some time. In contrast, prospects look much brighter for the developing world. That suggests that the future will entail a multi-speed world economy characterised, among other things, by large-scale capital inflows into

¹⁰⁰ Ibid.

the faster-growing emerging markets. Many of the crises listed in Figure 12 (Mexico, the Asian crisis, and the Argentine crisis to name a few) were a product of substantial capital inflows into emerging markets. History might not repeat itself, it often rhymes. So there is some risk that, down the track, a classic, major emerging market crisis will end up being another consequence of the GFC. Given that the big emerging markets, and in particular China, are becoming steadily more important players in the world economy, the risks of such a crisis having systemic consequences are now quite high, and still rising.

#6. *The Age of Scarcity*

The final item on my list of factors driving the current focus on the connections between international economics and geopolitics is the recent return of long-running fears about resource security.

There is a lot of history here. In 1798, Thomas Robert Malthus published (anonymously) *An Essay on the Principle of Population*.¹⁰¹ Famously, Malthus wrote about the inability of agricultural productivity to keep pace with population growth and in the centuries following the publication of his *Essay*, his name has become inextricably tied to the fear that a growing world population would eventually exceed the planet's capacity to produce food, triggering massive famines. In fact, Malthus turned out to be writing at a time just before a series of major developments – including the acceleration of the industrial revolution, a dramatic expansion of international trade, the emergence of new agricultural producers in North America, Argentina and Australia, and the onset of the demographic transition – would allow a progression of countries, led by his own, to break free from the Malthusian trap he had just identified.¹⁰²

Since then, fears about supposed Malthusian constraints to growth have been a recurring phenomenon. They emerged in the late 1960s and early 1970s, when the world experienced a period of rising nominal and real food prices.¹⁰³ Then neo-Malthusianism got another run in the mid-1990s when, following a period of virtual stagnation in global production of cereals

¹⁰¹ Thomas R Malthus, *An essay on the principle of population, as it affects the future improvement of society with remarks on the speculations of Mr. Godwin, M. Condorcet, and other writers*. London, J. Johnson, 1798. The *Essay* is available online in various forms. See for example <http://www.econlib.org/library/malthus/malPop.html>.

¹⁰² See for example, The Economist, Malthus, the false prophet. *The Economist*, 15 May 2008. For a good description of the Malthusian trap, see Chapter 2 and also Chapter 3 of Gregory Clark, *A farewell to alms: a brief economic history of the world*. Princeton, Princeton University Press, 2007.

¹⁰³ Justin Lahart, Patrick Barta and Andrew Batson, New limits to growth revive Malthusian fears. *The Wall Street Journal*, 24 March 2008. The classic reference is Donella H Meadows, Dennis L Meadows, Jorgen Randers and William W Behrens III, *The limits to growth: A report for the Club of Rome's project on the predicament of mankind*. New York, Universe Books, 1972.

during the first half of that decade, food stocks declined and (nominal) world market prices rose sharply.¹⁰⁴

Now the worries are back again. One consequence of the rapid industrialisation and urbanisation of some of the world's most populous economies has been a surge in demand for resources that in turn has produced a period of higher commodity prices. Indeed, not just higher prices: the 2003-2008 commodity boom, which saw average commodity prices double in US dollar terms, delivered the longest and strongest resource price surge for at least a century (Figure 15). That same boom saw the price of oil peak at around US\$147/barrel in July 2008 and prompted a food crisis in 2007-08 that involved riots and other social unrest.¹⁰⁵

Figure 15: Commodity booms in historical perspective

Table 2.1 Principal characteristics of major commodity booms

Common features	1915–17	1950–57	1973–74	2003–08
Rapid global real growth (average annual percent)	—	4.8	4.0	3.5
Major conflict and geopolitical uncertainty	World War I	Korean War	Yom Kippur War, Vietnam War	Iraq conflict
Inflation	Widespread	Limited	Widespread	Limited second round effects
Period of significant infrastructure investment	World War I	Postwar rebuilding in Europe and Japan	Not a period of significant investment	Rapid buildup of infrastructure in China
Centered in which major commodity groups	Metals, agriculture	Metals, agriculture	Oil, agriculture	Oil, metals, agriculture
Initial rise observed in prices of	Metals, agriculture	Metals	Oil	Oil
Preceded by extended period of low prices or investment	No	World War II destroyed much capacity	Low prices and a supply shock	Extended period of low prices
Percent increase in prices (previous trough to peak)	34	47	59	131
Years of rising prices prior to peak	4	3	2	5
Years of declining prices prior to trough	4	11	19	—

Source: World Bank.
— = Not available.

Source: World Bank, *Global economic prospects 2009: Commodities at the crossroads*. (2008)

While it's true that the subsequent onset of the GFC triggered a sharp fall in commodity prices, it is also the case that, in marked contrast to other periods of global downturns, prices have remained remarkably resilient in the face of much weaker developed country demand – thanks, of course, to sustained demand from emerging markets.

¹⁰⁴ Nikos Alexandratos, The world food outlook: a review essay. *Population and Development Review* 23 (4) 1997.

¹⁰⁵ On the food crisis see Alan Dupont and Mark Thirlwell, A new era of food insecurity? *Survival* 51 (3) 2009.

History suggests that governments tend to be quite sensitive to resource security concerns: feeding your population and powering your economy are pretty fundamental, after all. Concerns about security and ownership of supply have long been a feature of the oil market, and one consequence of this is that today's world economy is marked by the growing domination of world oil reserves by NOCs: on some estimates, private companies now control only some 13% of global reserves, and NOCs account for all of the world's top ten holders of petroleum reserves.¹⁰⁶ There are signs that the food crisis is now encouraging at least some governments to think about food security in similar terms.

Issues of resource security tend to lend themselves more naturally to zero-sum thinking. Put at its crudest, this thinking says that in a world of finite resources, the more I consume, the less there is for you. More generally, since OPEC wielded the oil weapon in the early 1970s (and arguably long before then), geopolitical considerations have always been close to the surface of world oil markets.¹⁰⁷ The food crisis has also seen a tightening of the links between food security and energy security, and past experience confirms that food and energy prices can at times have major geopolitical consequences. Yegor Gaidar, for example, has argued that to some extent it is possible to explain the collapse of the Soviet Union with respect to developments in the markets for grain and oil.¹⁰⁸

Summary and conclusion

I began with the proposition that thinking about the national security environment also requires trying to understand at least some aspects of the changing international economic environment, including the far-reaching implications of globalisation. Our current international environment is marked by an increasingly dense entanglement of issues related to international economics, national security and foreign policy, and this situation lends itself to a return to the idea of geo-economics.

That said, this is very much a relative change rather than an absolute one, since the connections between economic forms of power and power in its other dimensions are (very) long-standing.

¹⁰⁶ Jad Mouawad, As oil giants lose influence, supply drops. *The New York Times*, 18 August 2008.

¹⁰⁷ See for example Daniel Yergin, *The prize: the epic quest for oil, money and power*. New York, Free Press, 1992.

¹⁰⁸ Yegor Gaidar, *The Soviet collapse: grain and oil*. On the Issues. Washington DC, American Enterprise Institute for Public Policy Research, April, 2007.

I then proposed six reasons why some revised version of geo-economics was likely to be particularly relevant in the current conjuncture. This list suggests that the version of geo-economics that applies to the current period would be quite different in character to the one that originated some two decades ago. Then, geo-economics was mainly focused on the prospect of a supposed economic competition between the United States and Japan (or, in some cases, the European Community). Today, the issues are broader and less well-defined. The concept as it has been used here is intended to capture the existence of a range of areas where issues of international economics, foreign policy, and national security are all connected, with the six identified here being: the Great Convergence and the consequent rise of a more multi-polar world; globalisation and the commercial peace; the dark side of globalisation; the rise of State Capitalism; the risks posed by financial crises; and a return to long-running fears regarding resource scarcity

I will finish with two potential consequences of a return of geo-economics, one positive and one negative.

- The positive one is that the cross-disciplinary approach implied by the broad idea of geo-economics offers what may be a very useful way to look at the world. Tempering the views or adjusting the models of economists with input from foreign policy or security specialists, and vice versa, has the potential to strengthen the quality of the overall analysis. Certainly, that's the kind of approach that a body like the Lowy Institute tries to adopt.
- The negative consequence that needs to be set against this, however, is the risk that the return of a geo-economic mind set results in the injection of an underlying assumption of zero-sum outcomes (or the logic of conflict, to cite the original Luttwak definition) into areas where such assumptions are typically deeply problematic, such as international trade or international investment. (Remember, part of Vernon's critique of the original version of geo-economics was that it did a poor job of explaining some important features of the world economy.) In many cases, a zero-sum approach is typically not only going to be an unhelpful way to think about the issues involved, but it actually risks creating problems where there are none. In these cases, we would all be better off if the geostrategic thinkers were to defer to the economists.

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