

ALPHABET SOUP: THE POLITICAL ECONOMY OF THE GREAT RECESSION

A NEW GLASSHOUSE FORUM SCENARIO STUDY

Alphabet Soup:
The Political Economy
of the Great Recession
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Glasshouse Forum

Glasshouse Forum's executive summary

The current global economic crisis, which began as a subprime crisis and developed into a general credit crisis, is the deepest since the Depression of the 1930's. There are many signs that we are now facing the beginning of a structural sea change. But what will it be like?

To get a better understanding of the medium-term effects of the crisis, Glasshouse Forum asked Daniel W. Drezner, Professor of International Politics at The Fletcher School, Tufts University, and author of the Glasshouse Forum report *White Whale or Red Herring? – Assessing Sovereign Wealth Funds*, to draft scenarios and make qualified estimates based on as much objective data and historical parallels as possible.

One structural cause of the crisis was the extent to which savings/investment balances were

skewed beyond historical norms. Will the crisis force Americans to save more? Will capital exporters – Germany, China and Japan – consume more? How will these changes affect the global economy?

An immediate effect of the crisis has been to vastly expand the role of states in key sectors of the global economy. In the USA, the government has already taken on an expanded role in the finance, housing and automobile sectors – with healthcare on the horizon. How permanent will the state's role be in the post-crisis economy?

It is easy to envisage how the crisis could lead to populist outrage at the finance sector, or globalisation more generally. Will there be political support for continued trade liberalisation and economic globalisation, or will the course be reversed? Will the crisis lead to greater macroeconomic policy coordination, or a return to beggar-thy-neighbour policies? Will there be a rise in instability, diversionary war, or other forms of political violence?

Based on the evidence to date, Drezner sees three possible economic trajectories: paths “U”, “L” and “W”. Which path the economy follows will have profound effects on the macropolitical variables of concern.

In the “U-style” recovery, where economic growth rebounds fairly quickly, there would be a reverse of the deglobalisation trend, and therefore a decrease in the likelihood of greater political violence.

In an “L” economy, growth stays feeble or flat for several years to come, and there is no return to

pre-2008 output levels. An L-shaped economic path would increase both protectionist and fiscal pressures on many states. The incentive to pursue beggar-thy-neighbour policies would increase, decreasing interdependence and lessening the constraints reducing interstate conflict. On the other hand, an L-shaped economic path is also somewhat more predictable. The lower the level of economic volatility, the more the likelihood that state elites can retain control without resorting to extralegal measures.

The most likely scenario, according to Drezner, is the “W” economy. The global economy could get stuck in a “policy uncertainty trap” and we would see several mini-booms and mini-busts as government officials try to calibrate their responses. The severity of the crisis, combined with the magnitude of the government response, could lead to an increase in overall volatility. This path has the opposite effects to those of an L-shaped path. Periods of economic growth would be likely to lessen protectionist pressures. On the other hand, economic volatility would be likely to trigger greater domestic instability – which could, potentially, spill across borders. There would also be an increased demand for expanded government insurance programmes and state regulation. Savings would increase to hedge against sharp downturns.

This study touches upon other Glasshouse Forum projects, particularly “A consumed society?” and “Globalisation and the middle class in the West”.