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Financial Weapons of Mass Economic Destruction

By Harold James

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The approach of the 100th anniversary of the outbreak of World War I in 1914 has jolted politicians and commentators worried by the fragility of current global political and economic arrangements. Indeed, Luxembourg's prime minister, Jean-Claude Juncker, recently argued that Europe's growing north-south polarization has set the continent back by a century.

The lessons of 1914 are about more than simply the dangers of national animosities.
The origins of the war include a fascinating precedent concerning how financial globalization can become the equivalent of a national arms race, thereby increasing the vulnerability of the international order.

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In 1907, a major financial crisis emanating from the U.S. affected the rest of the world and demonstrated the fragility of the entire international financial system. The response to the current financial crisis is replaying a similar dynamic.

British essayist Walter Bagehot's 1873 classic "Lombard Street" described London as "the greatest combination of economic power and economic delicacy that the world has ever seen." In one influential interpretation, popularized by novelist Norman Angell in 1910, the interdependency of the complex global economy made war impossible. But the opposite conclusion was equally plausible: Given the extent of fragility, a clever twist to the control levers might facilitate a military victory by an economic hegemon.

The aftermath of the 1907 crash drove Britain, the predominant hegemonic power of the time, to reflect on how it could use its financial clout to enhance its overall strategic capacity. That is the conclusion of an important recent book, Nicholas Lambert's study of British economic planning and World War I, entitled "Planning Armageddon." Lambert demonstrates how, in a grand strategic gamble, Britain began to marry its military — and especially naval — predominance and its global financial leadership.

Between 1905 and 1908, the British Admiralty developed the broad outlines of a plan for financial and economic warfare against Germany, Europe's rising power. Economic warfare, if implemented in full, would wreck Germany's financial system and force it out of any military conflict. When Britain's naval visionaries confronted a rival in the form of the Kaiser's Germany, they understood how power could thrive on financial fragility.

Pre-1914 Britain anticipated the private-public partnership that today links technology giants such as Google or Apple to U.S. intelligence agencies. London banks underwrote most of the world's trade, while Lloyds provided insurance for the world's shipping companies. These financial networks provided the information that enabled the British government to discover the sensitive strategic vulnerabilities of the opposing alliance.

For Britain's rivals, the financial panic of 1907 demonstrated the necessity of mobilizing financial power themselves. The U.S., for its part, recognized that it needed a central bank analogous to the Bank of England. U.S. financiers were persuaded that New York needed to develop its own commercial trading system to handle bills of exchange in the same way as the London market and arrange their monetization (or "acceptance").

The central figure in pushing for the development of U.S. acceptance market was Paul Warburg, the immigrant younger brother of a prominent Hamburg banker who was the personal adviser to Germany's Kaiser Wilhelm II. The Warburg brothers were a trans-Atlantic tandem, energetically pushing for U.S.-German institutions that would offer an alternative to British industrial and financial monopoly. They were convinced that Germany and the U.S. were growing stronger year by year, while British power would erode.

Some of the dynamics of the pre-1914 financial world are now reemerging. In the aftermath of the 2008 crisis, financial institutions appear as dangerous weapons of mass economic destruction and as potential means for the application of national power.

In managing the 2008 crisis, foreign banks' dependence on U.S.-dollar funding constituted a major weakness and required the provision of large swap lines by the Federal Reserve. Addressing that flaw requires renationalization of banking and breaking up the activities of large financial institutions.

For European bankers, and some governments, current efforts by the U.S. to revise its approach to the operation of foreign bank subsidiaries within its territory highlight that imperative. They view the U.S. move as a new sort of financial protectionism and are threatening retaliation.

Geopolitics are intruding into banking practice elsewhere as well. Russian banks are trying to acquire assets in Central and Eastern Europe. European banks are playing a much-reduced role in Asian trade finance. Chinese banks are being pushed to expand their role in global commerce. Many countries have begun to look at financial protectionism as a way to increase their political leverage.

The next step in this logic is to think about how financial power can be directed to national advantage in the case of a diplomatic conflict. Sanctions are a routine, and not terribly successful, part of the pressure applied to rogue states like Iran and North Korea. But financial pressure can be much more powerfully applied to countries that are deeply embedded in the global economy.

In 1907, in the wake of an epochal financial crisis that almost brought a complete global collapse, several countries started to think of finance primarily as an instrument of raw power that could and should be turned to national advantage. That kind of thinking brought war in 1914. A century later, in 2007-08, the world experienced an even greater financial shock, and nationalistic passions have flared up in its wake. Destructive strategies may not be far behind.

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