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Global Markets: Evaluating Some Risks the U.S. May Face

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Summary

The last 30 years have seen a rapid expansion of trade in goods and assets and a general rise of economic interdependence across the world economy. Globalization is the popular term given to this ongoing process. To most economists, globalization is seen as a force that enhances the power of the market and gives greater scope for realizing the gains from trade. This is an enriching process, with improved economic well-being growing out of increased specialization of world production and elevated economic efficiency. To others, however, globalization is seen as a clear threat to their economic well-being, perceived to be retarding the growth of worker wages, increasing wage inequality, undermining domestic social relations, and raising the exposure of the American economy to foreign economic contagion.

The Bush Administration is expected to ask Congress for a renewal of presidential fast-track authority. It also seems likely that the President will pursue policies to further open trade, particularly with Latin America. These initiatives will likely raise the heat under these simmering issues.

The concern that expanding trade erodes the wages of American workers stems from the observation of two recent trends in U.S. wage behavior. One, there has been a significant slowdown in the rate of advance of worker real wages. Two, there has been a marked increase in the inequality of wages between skilled and less-skilled workers. This report suggests, however, that there is likely little causality running from a rising level of trade to poor domestic wage performance. Slow average wage growth is fully and credibly linked to poor productivity growth. A small share of rising wage inequality can be linked to trade, but most of this trend appears to be more soundly rooted in a rising demand for skilled workers.

Nevertheless, there are industries and workers adversely affected by expanding trade. In these circumstances an increasingly urgent concern is that as more trade occurs with countries that do not play by the same economic and social rules as the U.S. , there will be a steady undermining of the economic position of workers in the U.S. and the undermining of important social conventions and institutions that frame the terms for acceptable economic competition. There is a strong sentiment that there is a difference between economic gains generated by a comparative advantage based on factor endowments or consumer preferences and gains generated by a comparative advantage based on institutional choices in the exporting country that conflict with the norms of the importing country. Where trade with a country that has different social standards inflicts economic harm on domestic workers, the case can be made that trade liberalization cannot be treated as an end in itself, without regard to how it affects broadly shared values at home. The economic benefits of larger and more integrated international capital flows are significant. But increased cross-border capital flows also carry the elevated risks of contagion from negative foreign economic shocks and financial market instability. The size, orderliness, and resiliency of U.S. financial markets leave the U.S. well disposed to take full advantage of the benefits of these asset flows with a minimum of risk.

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Introduction

The last 30 years have seen a rapid expansion of trade in goods and assets and a general rise of economic interdependence across the world economy. Globalization is the popular term given to this ongoing process. In the United States, the real volume of trade in goods has grown twice as fast as real output bringing total trade (exports plus imports) from about 10% of Gross Domestic Product (GDP) in 1970 to over 27% in 1999. Trade in assets (e.g. bank accounts, stocks, bonds, and real property) has grown even faster with cross-border flows of portfolio investment, for example, rising by a multiple of nearly 200 ($5 billion to $1040 billion) between 1970 and 1997.

The United States has been much involved in this process of globalization, both as a leader in securing successive rounds of trade liberalization and the establishment of the World Trade Organization (WTO), as well as an active participant in world trade. As in the past, many would expect the U.S. to play a pivotal role in any further opening of the global trading system. Without U.S. leadership many believe that the prospect of a successful multilateral liberalization would likely be nil. At the same time, however, U. S. trade policy makers had and will likely continue to face substantial domestic backlash against further moves toward globalization. Recent manifestations of this trend have been congressional denial of presidential "fast-track" authority[1] and a major political initiative to seek new protection for the steel industry.

The Bush Administration is expected to show great interest in more open trade, particularly with Latin America. The President has already indicated that he will ask Congress for a renewal of "fast-track" authority, a tool likely critical to achieving significant trade liberalization. Congressional deliberation over "fast-track" authority (and any subsequent trade agreements) can be expected to raise the heat under a number of simmering concerns over the effect of expanding trade and trade policy responses on the U.S. economy. What are the burdens of a rising tide of imports on

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[1] Fast-track refers to procedures, initiated under the Enactment of Trade Act of 1974, to implement trade agreements negotiated by the President. Those procedures established mandatory deadlines, limited debate, and a no amendment requirement on congressional deliberation of trade agreements. This authority expired in 1994 and has not been renewed. See: U.S. Library of Congress. Congressional Research Service. Fast-Track Implementation of Trade Agreements: Issues for the 107th Congress. CRS Report RS20039 by Lenore Sek.

the American worker? What standing should concerns about labor and environmental standards have in trade liberalization initiatives? What are the risks to economic stability of the near explosive growth of cross-border asset flows? Questions such as these are likely to be central to upcoming policy debates over the United States' role in an ever more globalized economy.

To most economists globalization is seen as a force that enhances the power of the market and gives greater scope for realizing the gains from trade. This is an enriching process, with improved economic well-being growing out of increased specialization of world production and elevated economic efficiency. To others, however, globalization is seen as a clear threat to their economic well-being, perceived to be retarding the growth of worker wages, increasing wage inequality, undermining domestic social relations, and raising the exposure of the American economy to foreign economic contagion.

There can be no doubt that market forces in the process of raising the economic well-being of the nation may worsen the plight of many sub-groups. The free market, as the economist Joseph Schumpeter noted, is a force for "creative destruction." Markets create wealth by continually reallocating resources to more efficient uses that increase total well-being. But that process of reallocation must also destroy inefficient uses of resources, deteriorating the economic circumstances of those whose job or business is eliminated or downgraded. A critical dimension of a successful market economy is how well it manages the achievement of higher efficiency *and* the adjustment of those hurt by these dynamic wealth-creating forces. Much popular and political debate about globalization, however, is heavily shaded with the image of rising international trade, particularly with low-wage developing economies that do not compete "fairly", as a threat to the U.S. workers' economic well-being. In addition, greater asset market integration raises the specter of economic and financial instability abroad quickly spreading harm to the United States. For many, it would seem globalization is felt to be more "destructive" than "creative."

This report will examine three prominent concerns about globalization and U.S. economic performance: one, the effect of trade on worker wages, particularly those of less-skilled workers; two, the question of trade and fairness, namely trade with countries that have much lower worker and environmental standards; and three, the expanding cross-border trade in assets and the risk of financial and economic instability.

Globalization and U.S. Wages

The concern that expanding trade erodes the wages of American workers stems from the observation of two recent trends in U.S. wage behavior, coincident with rising globalization. One, there has been a significant slowdown in the rate of advance of worker real wages. For example, between 1980 and 1999 real hourly compensation in the business sector had a relatively slow cumulative increase of 18.3%. Two, there has been a marked increase in the inequality of the distribution of wages between skilled and less-skilled workers as measured by education levels. For

example, the difference between the earnings of the college educated and those with a high school education rose 18% between 1973 and 1994.[2]

Trade can have strong effects, good and bad, on worker wages. The plight of the worker adversely affected by imports comes quickly to mind. On the other hand, workers in industries that export benefit from expanding trade. What is, perhaps, less well understood is that, because all workers are also consumers, they will benefit from the expanded market choices and lower product prices that trade provides. There is no necessary reason to assume that the overall effect of trade on workers is bad, but sound economic analysis also suggests that trade, even as it raises overall well-being, can also sharply alter the distribution of income among the several factors of production, including labor. This section of the report first evaluates critically whether an increasing level of trade and interdependence has played a role in the slow growth of the *average level* of real wages of American workers and then examines whether rising globalization has made the *distribution* of worker wages more unequal.

Globalization and the Average Level of Wages

Effect of Relative Labor Abundance. We consider first whether an expanding level of trade is responsible for slow average real wage growth. Economic theory suggests that increased trade, while making the overall economy better off, can have strong effects on the distribution of income among factors of production. That theory points to the possibility that, if labor is relatively more abundant in the rest of the world than at home, an expansion of trade with the rest of the world could increase the "effective supply" of workers to the U.S. economy and reduce worker wages relative to rewards paid to other factors of production, most importantly capital. Since trade has clearly raised the living standard of the country, a general decline in the real wage of U.S. workers would have to mean that labor's share of the economic pie has shrunk. This has not occurred, however. Labor's share of national income shows no significant trend, up or down, over the past four decades, typically falling between 68% and 72%, depending on the year examined[3].

Effect of the Terms of Trade. Real living standards depend not only on workers' share of domestic production, but also on their ability to exchange that output for foreign output (i.e., to realize gains from trade). That gain can be eroded if import prices rise faster than home prices, causing a fall in the real purchasing power of any given level (or share) of national income. The ratio of U.S. export prices to import prices — *the terms of trade* — is a measure of changes in the home economy's share of the gains from trade. It is plausible that expanding trade in a world economy, increasingly populated with technologically capable foreign producers, could have put downward pressure on U.S. export prices, reduced the *terms of trade, and lowered* the real wages of workers. The data do not support that scenario, however. The terms of trade did fall in the 1970s, but the cumulative effect

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[2] For further discussion of these trends see: Murphy, Kevin M. "Changes in Wage Structure in the 1980s: How Can We Explain Them?" Memo. University of Chicago, 1992. And also: U.S. Library of Congress. Congressional Research Service. *Earnings Inequality in the 1980's and 1990's.* CRS Report 97-142E by Gail McCallion.

[3] The White House. *Economic Report of the President*, February 2001, p. 306

on real income was relatively small (less than a 2% decline over the decade). Through the 1980s and the 1990s, the U.S. terms of trade have slowly risen tending to increase worker real wages rather than erode them.[4]

Effect of the Trade Deficit. What about our persistent, large trade deficits over the last 16 years? Have they dampened worker wage growth? First, trade deficits are not a symptom of globalization and a rising level of trade. Rather, they are mainly a consequence of domestic macroeconomic behavior, such as a high rate of domestic investment relative to domestic saving, that has pushed domestic spending beyond domestic production requiring a net inflow of goods — a trade deficit — to sustain the excess domestic spending. As such these trade deficits do not represent a reduction in domestic output, nor a reduction in the demand for labor. Second, even if the trade deficits had reduced domestic output, the size of those trade deficits and the potential scale of the effect on domestic labor markets is *far* too small to explain the slow growth of American real wages[5].

Evidence from U.S. Multinationals. The recent behavior of U.S. multinational manufacturing companies gives some added confirmation that there has not been any sharp swing in the demand for labor away from domestic sources and toward foreign sources. It is estimated that U.S. multinational firms account for about half of all domestic manufacturing employment, making them good barometers of trends in the tradeable goods sector, particularly if those trends are reflective of changing economic attractiveness of different countries as locations for production. If low-wage countries provide a significant cost advantage, then we would expect to see a shift of employment from the domestic parent to these foreign affiliates. The data reveal, however, that multinational manufacturing employment has fallen *both* at home and abroad. Between 1977 and 1993, domestic employment in these firms fell about 21% (or about 2.6 million jobs), while employment in their plants in the rest of the world fell 17% (or about 830,000 jobs). If we look at manufacturing affiliates in only developing countries, employment did increase about 5% (or about 85,000 jobs). But, these gains amount to less than 4% of the reduction of domestic manufacturing employment. This implies that the multinational's U.S. workers have maintained their relative productivity. Consequently, there is no great outrush of U.S. multinational firms to increase employment in their low-wage affiliates at the expense of their domestic counterparts.[6]

Effect of Slow Productivity Growth. If a rising level of trade is not the culprit behind slight real wage growth, what is? We know that wages are basically a function of how productive workers are. High levels of productivity (output per worker) are associated with high wages, and rapid productivity growth is associated

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[4] See: U.S. Department of Commerce. Bureau of Economic Analysis. Survey of Current Business, various issues. Table 1.11.

[5] See: Lawrence, Robert, and Matthew Slaughter. *International Trade and American Wages in the 1980's: Giant Sucking Sound or Small Hiccup?* Brookings Papers on Economic Activity, vol. 2. Washington, Brookings Institution, 1993.

[6] For these data and a discussion of this phenomenon see: Lawrence, Robert Z. *Globalization and Trilateral Labor Markets*. The Trilateral Commission, No. 49. P. 32.

with rapid wage growth. Therefore, it is highly credible that the sharp slowdown in average productivity growth since the early 1970s in the United States is the cause of slow wage growth over the same period. Measures of U.S. worker compensation, appropriately deflated using a price index for the goods workers produce, gives a measure of inflation adjusted or *real* compensation that moves in step with the trend path for productivity over the last 25 years. In other words, workers' share of the economic pie is not getting smaller, the pie is just not growing as fast as it once did. Underscoring the importance of productivity growth for wage growth, more rapid productivity advance evident since 1997 has been associated with more rapid growth of real compensation.[7]

Globalization and the Inequality of Wages

The Effect of Relative Supplies of Labor on Wage Inequality. Even if expanding international trade has not adversely affected the average level of wages, it can still have a distorting effect on the distribution of wages among workers. Labor is not a homogeneous resource, and market forces, including trade, can help one class of worker while hurting another. In recent years, wages have been steadily skewed in favor of high-skilled workers relative to low-skilled workers. It is conceptually possible that expanding trade, particularly with countries that have a relative abundance of low-skilled workers, will tend to increase the "effective supply" of low-skilled workers available to the U.S. economy, working to put downward pressure on the wages of low-skilled workers in America. Other forces, unrelated to trade, could give the same outcome, however. For example, a strong general increase in the demand for skilled workers presumably growing out of the evolving pattern of final demand (increased demand for skill-intensive products) and the nature of technological change requires higher and higher inputs of "skill." What does the evidence show? This remains an area of some contention. Yet, the weight of evidence from most careful studies suggests that trade has been a minor factor contributing to rising wage inequality, causing perhaps 5% to 15% of the observed rise in wage inequality.[8]

For international trade economists looking at this issue, a critical bit of evidence regarding trade's effect on the distribution of wages is the behavior of the *prices* at which goods trade. Foreign workers do not compete with home workers directly, but indirectly through the price of the goods they produce. If foreign low-wage workers provide an efficiency advantage over domestic workers, then that advantage must, through trade, manifest itself as a lower price of the foreign goods in the home market. Reduced profitability of the domestic industry that competes with the low-price import induces a reallocation of resources toward more profitable skill-intensive

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[7] See: Lawrence, Robert and Matthew Slaughter op. cit; and Lawrence, Robert Z. and Robert E. Litan Globaphobia: The Wrong Debate Over Trade Policy. The Brookings Institution. Washington, 1998.

[8] See: Cline, William R. *Trade and Wage Inequality* . Institute For International Economics, Washington , DC, 1997;; and Borjas, George, and Richard B. Freeman; Lawrence F. Katz. *How Much Do Immigration and Trade Affect Labor Market Outcomes?* Brookings Papers on Economic Activity p. 1-90; Susan Collins, *Trade and the American Worker,* Brookings Institution, Washington, D.C., 1997; and Lawrence and Litan, op. cit.

applications, and a general decrease in the demand for and wage of domestic low-skilled workers. In this chain of causation, the critical factor is not the volume of trade, but rather traded goods prices. This leaves us with the empirical question: Have the prices of import competing goods that use low-skilled workers intensively fallen relative to the price of goods that use high-skilled workers intensively? With appropriate deference to data problems, relative prices have not moved in a pattern consistent with the conjecture that trade has adversely affected low-skilled domestic workers.[9] (In some cases there is evidence that this critical price ratio has moved in the opposite direction, in a direction consistent with trade helping low-skilled workers relative to high-skilled workers.)

Reasons for Trade's Limited Effect on Wage Inequality. That globalization has, so far, had a relatively minor effect on the level and distribution of U.S. worker wages is, perhaps, less surprising if one considers that, despite the sizable growth of trade with low-wage developing countries, such trade still remains a relatively minor component of total U.S. trade and is particularly small when compared to the total size of the U.S. economy. Imports from countries where wages are less than half of U.S. wages was equal to 2.6% of GDP in 1990, up only slightly from 1.8% in 1960.[10] By and large, for the United States, the great bulk of trade in manufactures is with other high-wage economies. It has been estimated that, in 1990, the trade-weighted average hourly manufacturing wage of U.S. trade partners was 88% of that in the United States, not a large enough difference to cause the observed change in wage inequality.[11] Thus, trade's impact on the domestic labor market can also be expected to be small. This is reinforced by the data on U.S. multinationals' employment changes in recent years. That is, those data are also consistent with the notion that there has been no differential shift of employment toward low-skilled foreign workers and away from low-skilled domestic workers.

An Upper Bound for Trade's Effect on Wage Inequality. Of course, as trade with developing countries grows, so might its contribution to wage inequality. Economic analysis suggests, however, that there may be an upper bound to this potential effect and that it could be reached fairly quickly as the cost differences between home and foreign production widen. It is credible that a condition of *complete specialization* might be reached after only a relatively small price disadvantage appears. That is, the United States would find it most efficient to stop producing the import competing goods as increased specialization leads to trade in *noncompeting* sectors. If there is no domestic industry that uses low-skilled labor intensively in the production of tradeable goods, there can be no downward pressure on U.S. wages caused by trade with developing countries.[12] It is also important to be mindful that trade can also set in motion other forces that can have a favorable effect

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[9] See: Lawrence, Robert and Matthew Slaughter. Op.cit. P. 161-226; and Sachs, Jeffery and Howard Shatz. *Trade and Jobs in U.S. Manufacturing*. Brookings Papers on Economic Activity, vol. 1. Washington D.C. 1994. P. 1-84.

[10] See: Lawrence and Litan, op. cit.

[11] See: Economic Report of the President. February 1998, p. 243.

[12] See: Krugman, Paul. *Growing World Trade: Causes and Consequences*. Brookings Papers on Economic Activity, No. 1, 1995.

on all domestic workers. For example, economies of scale can be more fully realized through expanding trade. Further, trade may heighten competition and raise efficiency. Such forces may be strong enough to allow all factors of production to see their real return rise.

What is Causing Wage Inequality? Many economists argue that "biased" technological change likely is the primary cause of rising U.S. wage inequality. Modern production techniques have generally raised the demand for skill in the labor market. In effect, "skill" is suspected of becoming more complementary to capital and "less-skill" more of a substitute for capital. Thus, the process of capital accumulation and technological change will tend to lower the wage of low-skilled labor.[13] Other minor causes might be immigration, deunionization, and falling real minimum wage. So far the evidence does not give a full picture of the nature and extent of this process.

Trade and Fairness

Even though the evidence is that trade has had little overall effect on wages in the United States, there are industries and workers adversely affected by trade expansion. Their plight gives rise to the concern that trade with countries that do not play by the same economic and social rules as the United States can undermine the economic position of U.S. workers. Worse, it can undermine important social conventions and institutions that frame the terms for acceptable economic competition. Most importantly this includes labor standards that set rules for minimum age, maximum hours, health and safety norms, as well as collective bargaining rights; and environmental standards that regulate industries' use of land, air, and water. Employers in many developing countries, it is observed, do not meet labor standards common in advanced countries, nor are they subject to the same costly environmental standards of the advanced nations. The cost advantages afforded by these lower production standards, it is argued, will steadily put competing American industries and, most often, low-skilled American workers at a major disadvantage as well as erode established domestic social relations.

From the standpoint of economic gain or loss does such "unfair competition" matter? A cheaper product, regardless of how it was made cheaper, is an *overall* gain to the importing economy. It is certainly possible for those who gain to compensate those who lose and still be better off. Adequate compensation, in practice , is most often problematic, however. Of course, the loss to the displaced worker in the import competing industry is the same whether caused by "unfair" foreign practices or "state of the art" technological prowess. Yet, the former is often seen to be far less acceptable.[14]

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[13] See: Grilliches, Zvi. Capital-Skill Complementarity. Review of Economics and Statistics, no.465, 1967, P.51.

[14] The discussion in this section draws extensively on: Rodrik, Dani. *Has Globalization Gone too Far*. Institute for International Economics. Washington D.C. , 1997.

Under what circumstances does "fair-trade" represent a valid argument against free trade? There are three possible situations. While the economic case argues against restriction in all three cases, the degree to which other "social requirements" are met varies.

When Trade Conflicts With a Domestic Social Norm. For many people the acceptance of the gains from trade will hinge on whether those gains emerge from a process where all trading parties adhere to social norms of "fair play." For example, different child labor rules can afford a basis for trade. The United States, with long held restrictions on child labor in its domestic practices, can find it economically beneficial to trade with a country that has a low level or no restriction against child labor. Lower child labor standards could give a production cost advantage to the foreign producer. If the exports of the low labor standards country compete directly with U.S. industries, the price advantage of those lower standards will encourage a higher level of imports to the United States. These imports will come at the expense of domestic production. U.S. workers in the affected industry will lose jobs. With time these workers may find new jobs but most likely at a lower wage. In the aggregate, both nations are economically better off through this exchange, but the distribution of income has been changed in the United States as the income of the import competing workers falls.

Is this an acceptable outcome, or should trade policy(tariffs, quotas, etc) be used to protect the affected domestic workers from this outcome? The hard core economic response would be that this is an acceptable outcome and that the use of trade policy to alter it would be inefficient, reducing the gains from trade, hurting domestic consumers, and hurting workers in the foreign export industry. It may be concluded that the harmed American workers can be more efficiently helped with income transfers and adjustment assistance. The gains from trade are large enough to compensate the displaced workers and still leave everyone better off.

While this is certainly an efficient outcome, it is, however, an outcome that likely violates a prevailing social norm (i.e. domestic adult workers should not have to compete against child labor), and will be seen as unacceptable to many. If it is unacceptable to have child labor in a purely domestic context, why would it be acceptable to have domestic workers living standard reduced by competing *indirectly* through trade with countries with more lax child labor laws? The overriding sentiment in this circumstance is that there is a difference between gains from trade generated by a comparative advantage based on factor endowments or consumer preferences and trade generated by a comparative advantage based on institutional choices in the exporting country that conflict with the norms of the importing country.

In this circumstance, where trade with a country with different social standards inflicts economic harm on domestic workers, the case can be made that trade liberalization can not be treated as an end in itself, without regard to how it affects broadly shared values at home. Economic activity occurs in a social and moral context which tells us that there are unacceptable ways of imposing a burden on fellow citizens. In concept, a trade restriction can be justified in this case to protect the *strongly* held social norm. In practice, however, under the rules of the World Trade Organization (WTO) it would be improper to use trade policy to curtail imports from countries using child labor because WTO rules, while prohibiting trade in products

made by prisoners, generally do not allow discrimination on the basis of the *mode* of production. Of course, WTO rules do have the so called "escape clause" mechanism that allows seeking relief from damage caused by certain types of import surges. We can imagine an elaboration of the "escape clause" mechanism that could be used for providing relief from damage done by unacceptable modes of foreign production. In its current form, however, WTO rules governing the use of that mechanism provide a very limited scope for using trade restrictions and has been little used by member nations.

When Trade Does Not Conflict with a Domestic Social Norm. When trading partners have essentially the same economic and social framework, there may be another commonly cited "unfair" trade practice –- foreign *dumping* of exports. Dumping is the selling of a good for a price that is less than the cost of production. Economic analysis clearly demonstrates that the lower price of the 'dumped' import raises *overall* economic well-being in the importing country. But particular workers and firms that compete with the imported product will likely be hurt. Is this, like the child-labor case above, a situation where an alleged unfair practice is violating a domestic social norm and therefore an appropriate target for restrictive trade policy?

Price cutting is not generally seen as violating a strongly held domestic social norm. Rather, price cutting is most often a basic element of competition in the market place that serves efficiency and overall well-being, and is widely practiced in the domestic economy.[15] WTO rules make provision for nations using trade restrictions as part of an anti-dumping policy. Because it is relatively easy to invoke, an anti-dumping safeguard mechanism has been a widely and often used device for seeking relief from surging imports that are harming particular workers and firms in the home economy. Many economists argue that the anti-dumping safeguard mechanism is being greatly overused. Rodrik, for example, believes there has been excessive use of the anti-dumping procedure which "subverts the trade regime, gives safeguards a bad name, and crowds out an effective outlet for legitimate concerns."[16] Industries harmed by dumping, however, believe such measures are necessary to preserve a "level playing field."

Trade Without Effect on the Distribution of Income. The fairness issue takes a somewhat different form if imports from a country with lower social standards do not compete with any domestic industry. In this circumstance there is no effect on the distribution of income in the U.S., nor are there any harmed domestic workers. Objections to trade with these nations must arise out of humanitarian concerns for foreign workers and citizens. If so, then the standard economic argument against the use of restrictive trade policy to attempt to force more humanitarian outcomes abroad may have more resonance. Restrictive trade policies in this case do not protect any domestic practice nor remove any economic burden. They will, however, lower economic welfare at home and abroad. Foreign workers in the exporting country

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[15] A possible exception would be instances of dumping that are "predatory" and part of a plan to establish monopoly power. Such predatory practices reduce economic welfare in the long-run and preventing them is in our economic interest. However, predatory pricing appears to be rare.

[16] See: Rodrik, op.cit. p 82.

would most likely be harmed, as reduced demand for the products they produce pushes them out of a job or, at best, into some inferior alternative. Those who acknowledge such values, but oppose using trade restrictions may argue that other mechanisms would be a more efficient response. Direct technical or financial assistance, for examples, might better serve raising labor and environmental standards than would restrictive trade policy. Others holding these values, who believe access to the U.S. market is a potent incentive for moderating other countries behavior, often advocate trade restraints.

Reconciling Economic Efficiency and Social Fairness

Resolving questions of "fairness" is likely to be central to any continuation of the process of trade liberalization among nations. Negotiations aimed at increasing global market integration will likely be concerned with issues that extend well beyond differences at the border to include domestic social and political arrangements. In such cases, policy responses based only on an economic basis are very likely to be insufficient. Yet, the current WTO rules governing international trade do not provide an efficient mechanism for reconciling often divergent economic and social goals. The failure of the WTO meetings in Seattle in December of 1999 has meant that there is no clear vision of how and when future multilateral trade negotiations would proceed. Overcoming this state of drift in the world trading system may require the U.S. to take a pivotal leadership role in shaping a vision for the world economy.

In contemplating that future form several points drawn from the discipline of economics and the insights of political economy might be useful. First, economics makes clear that the very existence of "gains from trade" arises from some economically exploitable *difference*. If all nations were alike in resource endowments and social institutions there would be little reason to trade. A crucial question underlying the efficacy of trade and continued market integration is what differences, particularly in social norms, are an acceptable basis for mutually beneficial trade.

Second, the power of the market to bring steady economic improvement does not grow out of good intentions; rather, it is the quite unintended consequence of entrepreneurs pursuing their own self interest and seeking profit from what small advantages might exist in a developing economy. In many poor nations the acceptability of having children work long hours and of denying labor the right to collective bargaining may be the only way they perceive to produce a tradeable good today and improve economic well-being in the future.

Third, the United States and other advanced nations have an interest in improving economic conditions in poor nations. Rising prosperity helps to undergird political and social stability, but it also likely enhances the willingness and ability of these nations to adopt higher labor and environmental standards.

Finally, to some degree concerns about "unfair" trade might be allayed if harmed workers in the U.S. were more confident of receiving equitable compensation and other adjustment assistance. Insurance against adverse labor market outcomes has been part of a social bargain in the U.S. and other advanced countries that has enabled these nations to make fuller use of the wealth creating potential of the market

economy, including trade liberalization. If further global market integration is to occur it may be necessary to reevaluate the sufficiency of our social insurance programs.

Expanding Trade in Assets and the Risk of Instability

Capital markets have achieved a higher degree of globalization than has goods trade and carry a somewhat distinct set of potential problems and policy concerns. The extent of capital market integration is evident in the huge increases in cross-border flows in most financial realms over the last 20 years. These include bank deposits, securities (stocks and bonds) and foreign exchange. Beyond their size, asset transactions are far more fluid than goods transactions, able to move quickly and change direction just as quickly.

The economic benefits of international capital flows are significant. The presence of well functioning international asset markets can extend the benefit of international trade well beyond the gains associated with the exchange of goods and services. International capital markets can facilitate a more efficient allocation of saving and investment across nations, allowing an optimal spreading of consumption spending over time. International trade in assets can also enable greater diversification of investment portfolios, leading to reduced investor risk. In conjunction with flexible exchange rates, high capital mobility also enhances the power of monetary policy, and as well alters how monetary forces are transmitted and distributed through the economy.

Increased capital market integration also carries risks. One risk is that with more points of economic and financial contact there is also a raised probability for the inward transmission of negative economic shocks, sometimes called "contagion" effects. Another risk is seen arising from the great size and fluidity of asset markets themselves, which give them the potential to be destabilizing and able to generate periodic economic crises. The unsettling prospect in this regard is that in the current international financial system with large volumes of highly mobile international capital, an economy is open to assault by currency speculators who may incite excess volatility of exchange rates and other assets, and impose economic instability and hardship on the U.S. economy.

Exposure to External Shocks

Increased interdependence increases the points of contact among the economies of the world. Most often these enhanced linkages are a positive construct that help raise economic efficiency, but from time to time they can play a negative role as conduits for economic "contagion." With increased globalization, economic maladies on the other side of the world will spread more quickly, perhaps bringing undeserved economic misfortune to U.S. citizens.

Expanding trade in goods and assets and the associated increase of global market integration will increase the risk of economic shocks carrying from one economy to

another. In practice, however, such shocks are seldom carried from the initiating country to others on the same scale. This attenuation of the transmitted shock is largely due to differences in economic size and to differences in the degree of integration. The U.S. is far larger then any single trading partner. Further, trade for the U.S. is a small share of total economic activity. Taken together, these two factors most often assure that a foreign economic calamity has small ripple effects on the United States. Of course, these factors can be expected to exert less and less of an attenuating effect as trade, interdependence, and the relative size of our trading partners grows, but there are other forces that will likely work to attenuate the impact of foreign economic shocks.

Factors That Dampen International Shocks. First, well functioning markets will provide automatic offsets to external shocks through movement of exchange rates, interest rates, and prices. Second, quickly responding and prudently applying economic policy, most often monetary policy, can help to mitigate the effects of external shocks. A third factor attenuating the impact of external shocks is that increased global integration also allows shocks to be absorbed by a far larger global market, thereby arguably reducing the effect on any individual economy. Fourth, to the extent they provide more rapid and more comprehensive flow of market information about risk and profitability of investment prospects around the globe, integrated asset markets help facilitate a quicker adjustment to disruption and a more efficient allocation of the world's limited saving in both the short-run and the long-run.[17]

For the United States in particular, financial markets have a breath and depth that affords a high degree of resiliency to financial and economic storms. Recent troubles in Asia highlight the problems that large flows of financial capital can pose for systems that have relied too heavily on the "banking system" for financial intermediation and have not adequately regulated and supervised that system. In contrast, the U.S. financial system employs an array of well developed financial intermediaries (stock markets, bond markets, and banks) that achieve a higher proficiency at risk management, and subjects those institutions to a high level of regulation and supervision.

Impact of the Asian Economic Crisis on the United States. In recent years the American economy has prospered despite substantial economic ills in Japan, Europe, and Mexico. Nor have troubles in several Asian countries had a sizable effect on the United States. During these crises the U.S. has maintained vigorous economic growth, achieved record low levels of unemployment, and avoided any re-acceleration of inflation.

The Asian crisis did have an impact, however, in that it contributed to a substantial widening of the U.S. trade deficit. Sizable inflows of Asian capital, seeking high and more certain U.S. asset yields, pushed up the dollar exchange rate, weakening exports and encouraging imports. Several tradeable goods sectors of the economy were hurt by these changes. On the export side, agriculture and commercial

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[17] For further discussion see: *International Capital Markets :Developments, Prospects, and Key Policy Issues.* IMF, September 1998.

aircraft experienced damped export sales. On the import side the steel industry and the textile and apparel industries came under considerable pressure from low price competition from the crises-affected countries.

On the other hand, there have been economic benefits derived from that crisis. Lower import prices have elevated real income in the United States and dissipated inflation pressures. In addition, large capital inflows have kept domestic interest rates lower than they otherwise would be, a boon to U.S. borrowers and interest sensitive sectors such as housing and consumer durables.

Weighing Risk and Reward. Increased global integration probably does raise the exposure of the U.S. economy to external shocks. But, such integration also boosts the rewards to the economy through improved efficiency. So far there is no conclusive evidence that the added risk exceeds the added reward. While individual sectors were hurt, the overall U.S. economy weathered recent international storms with little difficulty and some benefit. Moreover, we have seen that the prudent application of domestic macroeconomic policy can do much to assure that on balance the rewards from this ongoing process continue to exceed the economic risks.

Asset Price Volatility and Periodic Misalignments

Beyond their potential for transmitting economic shocks, integrated financial markets themselves can be the source of problems. Specifically, those markets may produce excess "volatility" of asset prices, most importantly exchange rates, causing economic disruption and costly adjustment. Because exchange rates communicate important economic signals to those involved in international trade and investment, the argument can be made that any tendency for foreign exchange markets to "overreact" to events will transmit confusing and error-filled data to international traders and investors, causing a misallocation of global resources.

Has Volatility Been Excessive? It is difficult to determine what constitutes "excessive" volatility. Where one person perceives volatility and disruption, another sees global asset markets working quickly and usefully in response to changes in economic fundamentals that affect risk and profitability. Whether international asset markets overreact and whether such overreaction carries more costs than their efficiency benefits warrant is an open question. While exchange rates have in recent years appeared to be rather volatile, evidence does not point to significant increases in the variability of other asset prices. And even the increase in exchange rate volatility has not been conclusively shown to be excessive in the sense that it has gone beyond what could be attributable to an efficient market function.[18]

The currency crisis in several Asian countries highlights these issues. The international capital market has clearly induced sharp and painful depreciations of the foreign exchange value of these countries' currencies. Yet, what is also increasingly evident is that these countries were pursuing "questionable" macroeconomic policies, had "suspect" banking and financial practices, and promoted "imprudent" exchange

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[18] See: Bank for International Settlements. *Financial Market Volatility : Measurement, Causes, and Consequences*, BIS Conference Papers, March 1998.

rate management regimes. International asset markets serve economic efficiency by reacting quickly and strongly when evidence of "bad" fundamentals emerges.[19] Thus, globalization and rapid capital flows, in this view, have a positive role in limiting the ability of countries to pursue incompatible and unsound economic and financial policies.

On the other hand, to the extent that there is a degree of overreaction by currency and other asset traders, it is possible that economies will be forced through a measure of "unnecessary" adjustment. In such cases, there are international adjustment mechanisms for assistance. An economic role of the International Monetary Fund (IMF), for example, is to provide adjustment aid to help weather international financial crises. But we might keep in mind that the economic purpose of IMF assistance in such circumstances is not to bail-out enterprises generally, rather it is to offset the *unnecessary* adjustments forced by the currency markets *over-reaction*. It is possible that the global markets in conjunction with well targeted economic assistance may be a workable and efficient mix, enhancing the operation of the world economy, and providing indirect benefit to the U.S. as it improves the wealth and stability of our economic "neighborhood."

The Problem of Asset Price Misalignment. A more critical issue for the United States and other industrial economies in an international environment of large and rapid capital flows is the prospect for asset prices becoming *misaligned*, that is, straying, and remaining for a time, well beyond a level that is consistent with underlying economic fundamentals. This was likely true for the dollar in the 1984-85 period, for the U.S. stock market just prior to the crash in 1987, and for the Japanese Yen in 1995. Such misalignments often impose disproportionate burdens on sectors of the economy (*e.g.*, exchange rate impacts on tradeable goods sectors) and their correction is potentially disruptive to the wider economy (*e.g.*, inducing financial market instability).

Misalignments are difficult to identify at the time they are occurring because there is usually a substantial margin of uncertainty about whether a given level of asset prices is inconsistent with macroeconomic fundamentals. Those fundamentals will most often be consistent with asset prices moving in the direction they are moving. The problem is deciding if they have moved too far.

Once identified, misalignments can be hard to correct because of the huge volumes of private capital flows that may need to be offset. The corrective actions of the central bank of one nation may be unable, in some circumstances, to counter the tide of private capital supporting the misalignment. In these cases coordinated intervention by several governments may be more effective at correcting the misalignment. Such coordinated strategy did help to correct the soaring dollar in 1985 and the "overvalued" yen in 1995. Such actions are also thought to carry an important "signaling" function in the sense that their effectiveness does not stem so much from the quantity of their financial market actions but from their role as an indicator of the participating governments' commitment to more sustainable economic policies. In general, the governments of the industrial economies may not have shown a capacity

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[19] See CRS Report 97-1021, *The Asian Financial Crisis*, by Dick K. Nanto.

to always avoid the periodic policy missteps that induce asset market misalignments. To an extent, however, they have revealed a capability to deal effectively with the misalignments in a way that is not overly disruptive to economic activity.

Foreign Finance and Economic Stability. A related concern with globalized asset markets is that countries with open capital markets will from time to time be recipients of large net inflows of financial capital, which will just as quickly leave. These rapidly shifting funds can be a destabilizing force, creating inflationary pressure and pushing up the real exchange rate. On the other hand, capital inflows can be a useful and efficient source of financial capital. The desirability and undesirability of such inflows will hinge critically on the factor or factors that caused them. If the capital inflow is the consequence of flawed or misguided macroeconomic policies, then, such capital flows may quickly desert the economy, and perhaps precipitate a crisis. If, on the other hand, those inflows are caused by sound economic policy and good long-term investment prospects, then such inflows can be enduring and beneficial.

Conclusion

There is little doubt that the process of trade liberalization and the development of ever more integrated global markets has been on balance an enriching endeavor for the United States and the world economy. Nevertheless, it has of late become a particularly contentious process, with a very vocal opposition. At the moment there is little or no momentum for undertaking a new round of multilateral liberalization of trade in goods. For the advanced nations like the United States, the moderate and widely dispersed benefits of more open trade are countered by localized and sharply felt costs. For many poorer trading nations it is often the case that the benefits of expanded trade will be reduced or not realized if they are compelled to operate their industries subject to the costly social and economic "rules" that the advanced nations maintain.

Breaking this impasse will require leadership and the United States has played a central leadership role in past trade liberalization initiatives. For the United States to assume that role now, it may have to assuage the heightened concerns of its citizens about the costs and risks accompanying the process of globalization. While the data indicate that the costs of trade to the United States are less than commonly perceived, concerns do exist. It may be the case that an adequate response to these concerns will require reform and expansion of the U.S. system of social insurance for workers. But, it may also require an expanded scope and use of the WTO "escape clause" mechanism to more readily allow trade policy remedies in cases where trade is undermining strongly held social norms. But an enhanced "escape clause" can only emerge from new multilateral negotiations.

Expanding trade in assets proceeds with greater speed and with less encumbrance then does trade in goods. It seems clear that, short of a dramatic shift in the form of the world trading system, large and often rapidly shifting flows of international capital are a fact of life, irresistible and irreversible. The size, orderliness, and resiliency of U.S. financial markets leaves the United States well disposed to take full advantage of the benefits of these asset flows with a minimum of risk. However,

the importance of global stability points to the United States having an interest in helping to develop and support an international financial architecture that will extend the benefits of international capital to the world's smaller economies, that often fare less well with global capital markets.