Globalization:

A Primer

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Introduction

What is "globalization" and why should anyone care about it? There are a lot of different answers to this question, depending on whom you ask. The dominant view among people who write and speak about the issue is that globalization is an inevitable, technologically driven process that is increasing commercial and political relations between people of different countries. For them, it is not only a natural phenomenon, but primarily good for the world, although it is recognized that the process produces both "winners and losers."

There is a much deeper skepticism about the process among the general population. For example, a recent *Wall Street Journal*/NBC News poll found that 58% of Americans believed that trade had reduced U.S. jobs and wages, a view that is almost never expressed by commentators or those who shape public opinion.

This widening gap between elite and public opinion is striking, because it is not difficult to imagine how economic globalization might lower living standards for the majority of people in the United States. For example, the idea that increasing competition from low-wage imports would drive U.S. wages downward seems only logical. And there is now a wealth of evidence, even from prominent economists who strongly favor free trade, that this has happened over the last two decades.

The fact that the real wage of the typical American worker has actually fallen over the past 25 years, as the economy had become increasingly globalized, is also an indicator that something is wrong with the process of globalization. According to traditional economic theory, wage and salary earners gain from more open trade, because they get cheaper consumer goods. But it is clear, according to universally accepted measures of wages and salaries in the United States, that for most employees these gains from trade have been more than canceled out by other forces that have pushed their pay downward.

The last two years have seen a significant widening of the debate among economists about international "capital flows"—investment and borrowing across national boundaries. In the wake of the Asian, Russian, and Brazilian economic crises, a number of prominent economists have been rethinking their views, and have decided that the process of opening national economies to these capital flows has perhaps gone too far. But this debate within the economics profession has yet to influence the agenda of the major policy makers or corporations, who continue to strive for increasing globalization.

This primer will try to sort out some of the most important issues, especially as they affect the majority of people in the United States and the world. The goal is to make the reader economically literate enough to be able to discuss current international economic issues of pressing importance—and think critically about them—without putting anyone to sleep.

International Trade and Investment

We will start with the simplest economic definition of globalization, one that is relatively value-neutral, and then fill in the picture enough to ask some important questions, such as "who gains and who loses from this process?" We can define globalization as an increase in trade and capital flows across national boundaries.

This invites some more definitions (sorry, no avoiding them). An import is a good or service that is produced in another country but consumed here (for simplicity, we'll take the United States and its economy as the reference point). A computer that is manufactured in Taiwan and bought here is an import. Trade in services enters into our balance of payments in the same way: if you go to France as a tourist and spend money there, that's an import, too.

An export is the opposite, something that we produce here but is consumed elsewhere. Hollywood movies are, for better or worse, one of America's most influential exports.

You may have noticed that another term was sneaked in without a definition: balance of payments (BOP). This sounds a little more jargon-like, but it's really just an accounting of a country's transactions with the rest of the world. And that means all of the country's transactions, both public and private.

What does the balance of payments include? It is divided into two parts: the first part we have just about defined—it's the balance of trade.

Economists call this the current account, because it includes more than just trade—things like foreign interest payments and transfers (say you are an immigrant worker in the United States and you send money home to your family in El Salvador). While "current account" is the proper term, many people use "trade balance" and "current account balance" interchangeably, since trade is the biggest item in the current account—and we can do that, too, when it doesn't cause mistakes.

The second part of the balance of payments is called the capital account. This measures the purchase and sale of assets across national boundaries. German investors buy U.S. Treasury bonds: that is measured in the capital account. It has a name, too: portfolio investment. If German investors build a factory in the U.S., that is also a capital account transaction, but it is called foreign direct investment.

A simple way to distinguish between the two accounts of the balance of payments is that the capital account measures international investing, borrowing, and lending—whereas the current account measures just about everything else.

The Trade Balance and Jobs

Why did we torment you with all these definitions? Well, consider the debate about the U.S. trade deficit. (A trade deficit means that imports are greater than exports). The U.S. trade deficit is expected to hit record levels this year and next, mainly as a result of the economic crisis in Asia. What does this mean for the U.S. economy?

The most immediate impact is on jobs: some 1.5 million workers, mostly in manufacturing, would lose jobs as a result of the increase in the trade deficit.[1] That's because the production of imports, which takes place in other countries, does not employ people here.

But it gets a little more complicated than that. First, it should be noted that this is a loss of 1.5 million jobs as compared to the number of jobs that the economy would have created if the trade deficit had not increased. If the economy is growing, as it normally is, the demand generated by this growth will cancel out some of the job losses that would have resulted from the increased trade deficit. Second, not everyone who is laid off will be permanently unemployed; many will find other jobs, although often at lower pay. In fact, if the economy is growing fast enough, the unemployment rate for the overall economy need not increase.[2] But there is still a serious cost to the people who lose their jobs, spend time unemployed, and end up working for lower pay. And there is a waste of capital, too—there is plant and equipment that will rust and lie idle before its time is up.

Running a current account deficit has other consequences, too. If a country is importing more than it exports, it must find a way to pay for this. It is analogous to you spending more than your income, as a household. How can you spend more than you earn in a given year? There are basically two ways: you can borrow, or you can sell something you own (e.g. your house).

Foreign Debts

The international balance of payments accounting is very similar. If we import more than we export, we must either borrow or sell assets internationally, in order to finance that trade deficit. That means we are adding to our foreign debt. (This is not to be confused with our national debt, which is owed mainly to people and institutions here).

For the United States, our foreign debt is not big enough to present any problem for our economy or people, even though we are the largest foreign debtor in the world with more than $1.5 trillion in debt. That's because this debt is still not that big relative to our economy, so we don't have a large debt service burden.

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[1] See Robert E. Scott and Jesse Rothstein, "American Jobs and the Asian Crisis: The employment impact of the coming rise in the U.S. trade deficit," Economic Policy Institute, January 1998.

[2] In fact the overall unemployment rate has not increased over the last year, as the trade deficit has risen. In the United States, the Federal Reserve basically determines the rate of unemployment through its control over interest rates. As a result, over the long run, the trade deficit does not necessarily affect the unemployment rate. For example, if the increasing trade deficit over the last year had not slowed the economy, it is almost certain that the Fed would have done so, by raising interest rates.

But for many poorer, indebted countries, it is a major problem. Mozambique, for example, spends 25% of its export earnings on debt service. This represents a huge drain of resources out of the country, and prevents them from investing in things that they desperately need. In fact their debt payments exceed the country's spending on health care and education. If just half of Mozambique's debt service payments could be spent on health care, it would save the lives of 115,000 children each year, as well as 6,000 mothers who die in childbirth, according to estimates derived from the analysis of UN economists.[3]

As we will see, such horrific, unsustainable debt burdens raise the question of whether some countries might be better off just defaulting on their debt—that is, refusing to pay it—even if they were punished by international banks and investors. The answer to this question depends partly on how one evaluates the gains that they get from international trade and investment—i.e., increasing globalization.

But first let's make sure we all understand the basic definitions and balance of payments accounting. Say we have $950 billion in imports, and $700 billion in exports. That gives us a trade deficit of $250 billion. Ignoring the other items in the current account, this would mean that we must borrow or sell assets (including foreign direct investment in the United States) to the tune of $250 billion. This adds to our foreign debt.

Similarly, when a country like Japan runs a current account surplus, it is accumulating assets in the rest of the world. This increases its net creditor position internationally.

Currencies

So far we haven't said anything about money. Countries have different currencies, and so this introduces certain problems that we don't have in commerce between, say, Indiana and California. If you can stay awake a little longer, it's worth throwing this into the mix. Some motivation: think of the Asian economic crisis, which began in August of 1997 with the decline of the Thai baht. Or the collapse of the Russian ruble in the summer of 1998, which resulted in Russia's default on some of its debt. Or Brazil's financial crisis last year, where interest rates rose to more than 40% in order to keep the Brazilian currency from falling. All these events are part of an ongoing global economic turbulence, and before examining how these national and regional crises are related (or not related), we need to know a little bit about currencies.

What determines the value of the dollar in terms of other currencies? This is important because it helps determine how much our imports and exports will cost. The United States has what is called a flexible exchange rate, which means that the value of the dollar goes up and down, depending on supply and demand for the currency.

When you buy a bottle of French wine, you are supplying the international currency markets with dollars. Somewhere before that winery in France pays its employees, those dollars have to be converted into Francs. So our imports constitute a supply of dollars; similarly, our exports generate demand (by foreign citizens) for dollars.

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[3] See UNDP, Human Development Report 1996, (New York: Oxford University Press, 1996) and Jubilee 2000 Coalition, "Mozambique Gains Little or Nothing from Debt 'Relief,'" June 1998.

When we run a current account deficit (ignoring capital flows for now), it means that the supply of dollars is greater than the demand for dollars. This would cause the dollar to fall in value, as would happen to any other commodity that had more sellers than buyers.

Is a falling dollar a bad thing? Not usually. When the dollar falls, our imports become more expensive. That's because you need more dollars to buy the same amount of francs that the winery needs to produce a bottle of wine. Similarly, our exports become cheaper in foreign markets. If everything works they way it is supposed to, our imports would decline and our exports would increase, reducing or even (in theory) eliminating the trade deficit.

Reducing the trade deficit gives our economy a boost, too, because a smaller trade deficit means more production in the Unites States.

There is an important lesson right here. Many people get nervous when the dollar falls, thinking that this is somehow bad for the economy. But in fact it is often positive.

The only down side is that the increase in the price of imports can add to our inflation rate. But since only about 13% of our economy consists of imports, this has never posed much of a threat. The dollar lost a third of its value between 1985 and 1987, without causing any serious inflation or other economic problems.

This is important, because it means that the United States can pursue whatever domestic economic policies that it prefers, without worrying about the international financial repercussions. Many people are not aware of this, and believe that U.S. economic policy is very much constrained by "the dictates of the global economy." But this is not true. For example, if our government wanted to have low interest rates in order to stimulate economic growth and employment, we could do that without worrying about the effects of a falling dollar (it would fall because some investors would sell dollars and take their money elsewhere in order to get a higher return). The fact that our government does not pursue full employment policies has very little to do with any potential repercussions from the global economy.

Most countries do not have this much independence. France, for example, has imports equal to about 30% of its economy. France would have much more inflation than we would if their currency fell sharply. These well-developed links between the economies of the European Union constitute the main argument for the creation of the Euro, a single currency for the EU countries which was initiated this year. There is controversy over this move, however, and we can see why: the eleven countries who have adopted the Euro have given up their ability (however limited) to directly pursue their own monetary policy.

International Financial Crises ...and Washington's Response

Now we can look at the Asian and other financial crises. When the Thai baht began to fall in August of 1997, investors became convinced that it was going to fall much further. When this happens there is panic selling, and this sends the currency down even more. The panic

selling spread to other countries in the region, such as South Korea, Malaysia, Indonesia, and the Philippines.

These currencies crashed, losing as much as 75 or 80 percent of their value within months. This can cause serious economic disruption, including a sharp increase in inflation. As foreign lenders call in their loans, domestic firms and banks in these countries that are not necessarily unhealthy go under, because they cannot get credit. The burden of foreign debt also increases for many debtors, because each dollar of debt service that they need to pay is more expensive in terms of local currency.

The main cause of the crisis was the international financial "liberalization" of the previous decade. In other words banks, other financial institutions, and corporations in South Korea, Indonesia, and elsewhere were allowed to borrow large amounts of money in international markets. Furthermore, a large proportion of this debt was short-term debt. This created the situation in which a falling currency sets off a panic: investors, both foreign and domestic, have reason to fear that they will not be able to convert their domestic currency into "hard" currency—e.g. dollars or yen. As everyone heads for the exits, the government runs low on foreign exchange reserves—these are basically sums of foreign currency held by the central bank. This causes even more panic and further downward spiraling of the domestic currency.

One way to avoid a financial collapse is to intervene early, providing large enough sums of reserves to the central bank so that investors do not panic. Interestingly, the Japanese government proposed to do just that in September of 1997, before these currencies had collapsed. It offered a plan for an Asian Monetary Fund of about $100 billion and quickly lined up the support of Taiwan, China, and other governments in the region. But the U.S. Treasury Department killed this plan, insisting that any bailout plan go through the IMF (International Monetary Fund).[4]

The IMF failed to act in time to stem the outflow of capital or to prevent the currency collapses. But even worse than that, the conditions that the IMF attached to the loans helped send the regional economy into a downward spiral. These conditions are known as austerity, and include such measures as very high interest rates and fiscal tightening (that is, cutting government spending and raising taxes). Japan, the world's second largest economy, had already been in a slump for six years, and was further injured by the shrinkage of its most important export markets in the region.

The IMF came under heavy fire, for the first time in its 53 year history, from prominent economists—including Joseph Stiglitz, the Chief Economist of the World Bank—who accused the institution of making the crisis worse.[5] The Fund defended its policy by arguing that the high interest rates were necessary to keep more capital from fleeing the country. But these currencies did not have much further to fall, and so it is very questionable whether it is worth causing a recession, or even a depression, in order to avoid the possibility of further currency depreciation.

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[4] See, e.g., Paul Blustein, "Summit Stresses Trade, Leaving Bailouts to IMF," *Washington Post*, November 27, 1997; David Felix, "IMF: Still Bungling in Asia," Journal of Commerce, July 9, 1998.
[5] See David Sanger, "Decisions by U.S. and I.M.F. Worsened Asia's Problems, the World Bank Finds," *New York Times*, December 3, 1998.

Perhaps more importantly, there are ways to stem a currency collapse without sacrificing the growth and health of the economy through sky-high interest rates. As MIT economist Paul Krugman has suggested recently, a country can use capital controls, including restrictions on currency conversion.[6] In other words, a government doesn't necessarily have to let anyone convert their domestic currency into foreign currency any time they want to, in unlimited amounts, or regardless of the reasons. China, for example, does not allow its domestic currency to be converted into dollars except for certain specified purposes, mainly trade and investment. Regardless of their political perspective, observers have noted that this and other regulatory features in place in China have enabled it to weather the regional storm with the least amount of damage: the Chinese economy continues to grow at an annual rate of about 7%, as compared to the depression (in 1998, an annual contraction of 5.5% in South Korea, and 13.7% in Indonesia) suffered by its neighbors. Malaysia has been the first country to take Krugman's post-crisis advice and restrict the convertibility of its currency, and early results seem to be that it has helped the country's economic recovery. The main way such controls can work, when they do, is by allowing the country to keep capital from fleeing the country and the currency, without having to strangle the economy by jacking up interest rates.

The majority of economists, as well as policy makers, oppose currency controls on the grounds that they cause "distortions"—that is, they cause prices to differ from their "natural" or market price. Black markets and other inefficiencies can also result. The latter concern is not trivial, and the question of whether to use such controls, and how best to use them, will vary depending on the customs and institutions of the country, the administrative capabilities of the government, and other local conditions. This would seem to make a good argument for not having universal policy prescriptions, often devised by foreign economists at the IMF or the World Bank, who do not necessarily know enough about the specifics of the countries (now numbering 75), for which they make the major economic decisions.

Brazil: The IMF's Latest Patient

Brazil provides a recent test case of the "Washington consensus," as it is called—the combination of policy prescriptions consistently advocated by the IMF and the U.S. Treasury Department. In November of 1998, Brazil concluded a $41.5 billion agreement with the IMF, which called for continued high interest rates (over 40%), an increase in taxes and large cuts in government spending—a combination pretty much guaranteed to send any economy into a recession. From the IMF's point of view, a recession was "necessary" in order to reduce the country's current account deficit (which was running at about 4% of the economy).

Here's how it works: A recession reduces a current account deficit by shrinking demand for goods and services. When people lose their jobs and their income falls, they buy less of everything, including imports. This is one way to improve the trade balance. We could reduce our own current account deficit this way also; a depression could wipe it out entirely. But our government would not adopt such policies, because of the political backlash it would provoke.

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[6] See Paul Krugman, "Saving Asia: It's time to get radical," *Fortune*, September 7, 1998.

An alternative policy for Brazil would have been to devalue its currency—that is, let the value of its currency fall relative to the dollar. This would reduce the trade deficit (see above). The increased demand for Brazil's exports (and lower demand for imports) would stimulate its economy. And most importantly, interest rates could come down to normal levels, allowing economic growth to resume.

The downside of devaluation is of course the inflation that would be caused by the resulting increase in the price of imported goods. But Brazil's imports are only 7% of its economy, so the inflationary risk of a currency devaluation is not that great.

Given this situation, why would economists from the IMF (and some within the Brazilian government) insist on maintaining the fixed exchange rate? Fixed exchange rates do have certain advantages over flexible rates. Most importantly, they can reduce or eliminate the uncertainty and fluctuations in the price of traded goods, as well as financial securities. They can also eliminate some of the waste and destabilization of speculative buying and selling of the domestic currency. But a fixed exchange rate is a very difficult thing to maintain, in general, because the government has to convince everyone that the currency is not going to be devalued at any time in the foreseeable future.

In light of these difficulties, and the enormous price that countries like Brazil (and Russia until the ruble collapsed last year, despite the IMF's best efforts) have paid to fix their exchange rates, critics have charged that the Fund's priorities are skewed. A fixed exchange rate is good for foreign investors, and of course the latter are against capital controls or any restrictions that would make it more difficult for them to get their profits or capital out of the country. The Fund's focus on maximizing the freedom of foreign investors, while protecting the latter from currency risks (often at the expense of the national treasury), is not necessarily in the best interests of the host country.

In the Brazilian case, the fixed exchange rate policy certainly failed. Within two months of the November IMF agreement, the Brazilian currency came under speculative attack, and the government lost tens of billions of dollars in a futile attempt to defend it. But the fixed exchanged rate could no longer be maintained— just as the IMF's critics had predicted.[7] The Brazilian currency lost nearly half of its value, but the dreaded hyper-inflation that the Fund and its allies had warned about did not occur. After an increase to a 4.4% annual rate in the month following the currency collapse (January), inflation soon ceased to be a threat. Over the last year (June 1998–June 1999), consumer prices in Brazil have risen only 3.1%.

The depreciated currency has improved Brazil's trade balance. However, the Fund's continued insistence on high interest rates has hampered the country's recovery.

The Brazilian case illustrates some of the problems that arise when a country's major economic policies are determined by institutions like the IMF, or even by international financial markets. The crisis was brought on by the herd behavior of international investors, in response to the collapse of the ruble. But Russia has very little commerce with Brazil, and many of the investors who fled Brazil may have done so simply because they were afraid that other investors would leave "emerging markets" because of the Russian crisis. The IMF then

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[7] See Jeffrey Sachs and Steven Radelet, "Next Stop: Brazil," *New York Times*, October 14, 1998.

worsened the crisis both by prescribing the wrong economic medicine, and by insisting that the Brazilian Congress enact certain measures (e.g. cuts in pensions for retired workers) that were very unpopular. When the Fund demands that such measures be taken in order to "restore the confidence of international investors," and they are not immediately enacted, this has the effect of deepening the crisis.

Of course the most effective way to deal with the financial crises that we have seen recently would be to prevent them, and the Asian financial crisis has sparked considerable debate in even the most "insider" policy circles about how to do that. Even the most pro-globalization economists and policy makers have now joined a discussion about how a "new global financial architecture" can be constructed that will be less vulnerable to such meltdowns. But so far there has been no change in policy from those who have to power to make such changes.

In fact, the Clinton administration continues to pursue the same agenda in its foreign economic policy: increasing "free trade" and international investment flows through a variety of new international agreements. And in spite of the fact that most of the experts in the field acknowledged that the IMF's prescriptions actually made the Asian economic crisis much worse, the Clinton administration subsequently won an $18 billion increase in funding for the IMF. (This will add $90 billion to the Fund's coffers when the other member nations contribute their corresponding increases.)

The Human Costs of the Asian Crisis

Before leaving this topic it is important to call attention to the enormous human costs of the Asian economic crisis and depression.

Tens of millions of people have been thrown into poverty, with many millions of Indonesians now earning less than the amount necessary to purchase a subsistence quantity of rice.[8]

In the countryside, millions are eating leaves and grass, tree bark, and insects in order to survive.

Decades of social progress have been undermined or reversed, as girls are pulled out of school to help their families survive, with a rising number being sold to brothels, for example, in Thailand.[9]

Jobs in sweatshops that just a year and a half ago would have been avoided by most workers are now being fought over.[10] In spite of all this, the IMF's managing director Michel

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[8] See World Bank, "Latest World Bank poverty update shows urgent need to better shield poor in crises," June 2, 1999, for the latest poverty data on Indonesia.
[9] See Nicholas D. Kristof, "Asia Feels Strain at Society's Margins," *New York Times*, June 8, 1998.
[10] See Nicholas D. Kristof, "Asia's Crisis Upsets Rising Effort to Confront Blight of Sweatshops," *New York Times*, June 15, 1998.

Camdessus has called the Asian economic crisis a "blessing in disguise," even repeating and defending this statement after it drew criticism.[11]

The Rules of the Game

Is globalization progress? Nearly all of the experts and journalists who write about this subject would answer at least a qualified "yes" to this question. For some, there is a natural progression from the medieval fiefdoms of Europe to the nation-state, to the increasing importance of international institutions such as the UN or the IMF. Others are in less of a hurry to build the institutions of world government, but nonetheless see the increase in trade and commercial relations between countries as a step forward for humanity. And almost everyone views the process of globalization as inevitable in any case, flowing naturally from advances in communications, transportation, and other technological changes.

It is certainly possible to imagine a world in which globalization could raise the standard of living for the majority of the world's people. It could increase the size of markets and the efficiency of production, allow countries who are short on capital to borrow from those who have a surplus, and even break down some of the barriers and prejudices that have contributed to military conflicts in the past.

But the historical record of the current era of globalization is quite another story. As noted above, the typical wage earner in the United States has suffered a decline in real wages since 1973. It is important to recognize that this decline is at least partly a result of a choice to pursue a particular form of globalization. Our political leaders have chosen to negotiate, over a period of decades, a set of rules that has thrown U.S. workers into increasing competition with much lower-paid counterparts throughout the world. This has had the effect, not surprisingly, of lowering wages for most Americans.

But the same thing could have been done with the salaries of doctors. Our government could set up and monitor licensing and training procedures in foreign medical schools, and greatly increase the supply of doctors here. Without any sacrifice in the quality of health care, doctors' salaries would fall (even European doctors are currently paid much less than American doctors). The potential savings in health care costs to consumers are quite large. But no such plan has ever gone forward, partly because the medical profession is powerful enough to protect itself from such an occurrence.

The Impacts of Globalization: Africa and Latin America

For most of the poorer countries of the world, the opening up of their economies in the last two decades has coincided with a sharp decline in their rate of growth. Income per person in Mexico, for example, increased by 3.9% annually in the 1960s and 3.2% in the 1970s; since 1980, it has been stagnant. The figures are similar for Latin America as a whole (see graph).

[11] "IMF's Camdessus Still Describes Asian Crisis as Blessing in Disguise," *Wall Street Journal*, September 24, 1998.

It is important to understand what an enormous difference this makes in people's living standards. When per capita income grows at a rate of 3.9% a year, it means that the average person's income will double in about 18 years. For the average Latin American, income has gone nowhere over the last 18 years. This means that a whole generation of poor people, which in many of these countries is the majority of the population, has lost the chance to improve their living standards.

And this does not even take into account the increased inequality in the distribution of income; in Mexico, for example, workers' real wages have fallen below their level of the 1970s, and have continued to fall sharply over the last three years in spite of rapidly growing productivity.

For Africa, the era of globalization has been even more disastrous, with per capita incomes actually falling (see graph). Asia is the exception, with countries like China, and until the recent crisis, South Korea, Indonesia, and Malaysia, showing high growth rates over the last 20 years. But these countries, to varying degrees, have kept a heavy role for government in the economy: industrial policy, planning, state control over the financial system, and other interventions enabled these economies to benefit from expanding access to foreign markets. Although there is debate among economists over how much these state interventions contributed to the growth rates of the "Asian tigers," the once-popular idea that "free market" globalization was the key to their success has been discarded.

And then there is the problem which is known more generally as a "fallacy of composition": What works for one part of the system may be impossible if everyone tries it at the same time. Clearly the "export-led" growth of countries like South Korea and Taiwan could not serve as a path to development for more than a handful of relatively small countries, because the developed economies can only absorb a limited amount of imports.[12]

Defenders of the status quo would not deny the historical record of the last 25 years of globalization. Instead, they argue that we are in a period of transition, and that the advances in efficiency and productivity that the global economy can provide will eventually raise living standards for everyone.

There is a sense in which this is true: capitalism is a dynamic system, and productivity is constantly growing. If the gains from this productivity growth continue to accrue to the upper reaches of the income distribution, eventually the majority of people will demand, and get, some of these gains. The question is not whether this will happen, but when. For example, will large-scale social unrest have to occur before the domestic social contract is rewritten to allow the majority of the labor force to share in the benefits of growth? During the industrial revolution in Britain, there was a 50-year period in which the average person's income hardly grew, while at the same time there was enormous exploitation and misery that accompanied economic change.

The critics of today's globalization process argue that there is no reason to condemn such a large part of humanity to a similar fate at the turn of the millennium. Certainly there is no

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[12] See William R. Cline, "Can the East Asian Model of Development be Generalized?" World Development (Vol. 10, No. 2, 1982), pp. 81-90.

recent period in American economic history in which the gains from growth went exclusively to such a small segment of the population. In the poorest countries of the world, the need for very substantial change is much more desperate—not only growth, but large-scale redistribution of income and wealth will be necessary to pull hundreds of millions of people out of crushing poverty. It is difficult to imagine these changes taking place while the architects of the global economy negotiate agreements that place more power in the hands of private corporations, at the same time that they restrict the options of governments.

For critics of globalization, this is the heart of the problem: the dominant globalizing institutions are continuously altering the rules of the game so as to redistribute income and power upwards. Agreements like NAFTA are a case in point. By making it easier and more profitable for U.S. corporations to relocate to Mexico, NAFTA increases their bargaining power against workers who try to organize unions. A study commissioned by the labor secretariat of NAFTA found that the agreement did in fact have that effect.[13]

Moreover, NAFTA gave private foreign investors and corporations the right to sue governments directly for profits lost as a result of regulatory measures—a right they did not have under previous trade or commercial agreements such as the GATT (General Agreement on Tariffs and Trade). This right has already been exercised by an American corporation against the Canadian government, which had instituted a ban on the gasoline additive MMT. This additive is effectively banned in the US, but the Ethyl Corporation was able to sue under NAFTA's provisions and force the Canadian health ministry to reverse its ban in July of 1998. The corporation also collected $13 million in damages for lost profits.[14]

It is cases like these that have reinforced critics' most compelling claims about the process of globalization: that it is a means of moving economic decision-making away from elected bodies such as congresses and parliaments, and placing more authority in the hands of unelected, unaccountable institutions such as the IMF, NAFTA, or the transnational corporations themselves. In the process of doing so, globalization is undermining the institutions that have alleviated the worst excesses and irrationalities of the market: the social safety net, environmental legislation, and various forms of financial regulation.

Comparative Advantage and Development

The latter set of problems has been recognized, to varying degrees, by pro-globalization economists and policy-makers. However, these people tend to emphasize the benefits or potential benefits of globalization. For trade, they rely on a simple but abstract economic theory: the principle of comparative advantage. This theory asserts that all countries are made better off by moving toward freer trade. The idea is that different countries are relatively more efficient at producing different things. On this basis it is easy to demonstrate that the world can benefit if each country specializes in the production of those goods that it can produce most efficiently and trades with other countries who do likewise. The British classical economist David Ricardo illustrated this principle a century and a half ago, with a

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[13] Kate Bronfenbrenner, "Final Report: The Effects of Plant Closing or Threat of Plant Closing on the Right of Workers to Organize," Cornell University, September 1996.
[14] See Preamble Center, "Ethyl v. Canada: Implications for U.S. Commercial Policy," forthcoming, November 1999.

relatively simple numerical example. Modern (or "neo-classical") economics has added some more variables, but retained the basic logic and conclusion.

There are a number of problems with this theory when it is applied to the real economy. First of all, even the theory itself does not assert that everyone in each country is made better off through freer trade. There are "winners and losers," and the theory only predicts that for the entire country the gains outweigh the losses. The modern version of the theory would actually predict that in the United States, freer trade would make "unskilled" labor worse off—which is just what has happened over the last 25 years. (A common definition among economists of "unskilled" labor includes all those without a college degree, or more than 70% of the U.S. labor force).

The theory also assumes full employment. If the economy does not normally run at full employment (as ours does not), then free trade can inflict further losses; although as noted below, the overall unemployment rate is primarily determined by our Federal Reserve's interest rate policies.

Defenders of increasing unrestricted trade often point to the benefits that accrue to underdeveloped countries. Here the theory of comparative advantage is even more problematic. Any country that wants to grow and develop its economy will have to change its comparative advantage: for example, the countries with higher income today moved from agriculture to industry as their main economic activity as they developed. Japan was told by prestigious Western economists at the end of World War II that heavy industry (steel, automobiles) was not in the cards for them because they did not have a comparative advantage in this area—due to their lack of the appropriate raw materials (iron, coal, etc.). Fortunately for the Japanese people, their planners ignored this advice, and Japan became one of the world's leading industrial powers.

There remains today a division of labor between rich and poor countries. Although manufacturing has certainly grown as a proportion of the less developed countries' economies, the richer countries still tend to monopolize the "cutting edge" technologies that have the most potential to raise national income. At the same time the IMF and the World Bank have used their enormous influence to steer the poorer countries in the direction of producing for world markets according to their present, and narrowly conceived, comparative advantage. This generally means producing primary products (agricultural products, raw materials) or sometimes light assembly manufacturing, with the latter generally based on imported parts, very cheap labor, and not contributing much to the development of the local economy.

In other words, there is a profound bias against any kind of national economic development strategy. The obvious problem with this application of the theory of comparative advantage is that it rules out most of the strategies that the developed countries of the world have used in order to attain the standard of living that they enjoy today. The extreme case can be seen in Russia, where industry has been practically dismantled under IMF supervision since the demise of the Soviet Union. The country now produces almost nothing but energy. In the process, Russia's economy has shrunk by more than half in just a few years, and they have suffered an increase in poverty and declines in life expectancy that are historically unprecedented, in the absence of war or natural disaster.

All of this underscores the importance of national economic sovereignty in the process of economic development. This issue is rarely raised in the United States, where it is commonly assumed that our foreign policy experts and the economists at the IMF know what's best for everyone. But the failures of the last two years—especially in Asia, Russia, and Brazil—have shown very clearly that they do not know what's best, even if they were to have the best of intentions. Indeed, critics of globalization would argue that the experience of the last two decades—in which the architects of the global economy have increasingly re-crafted the economies of most of the world towards their ideal of unified international markets—has been a failure by almost any measure of economic performance. And there is no reason to assume that institutions that are controlled by a small group of people from one or a handful of high income countries would adequately represent the interests of the world's poor and working people.

The Russian example is most striking because the foreign economists in charge of policy were attempting to engineer a transition from a planned to a market economy, in a very short time. But the general principles of subordinating the domestic to the international economy, and precluding any national development strategy, are commonly applied. Countries like Haiti are told that they have a comparative advantage in producing coffee and mangos, and some light assembly (with wages of about $2.10 per day), and that these exports will be the key to their growth and development. This application of comparative advantage is similar to telling someone just out of high school that their comparative advantage is to work at McDonald's. That may be true at the given moment, but the more important question is how to change that comparative advantage—through education, for example—so as to increase one's opportunities.

Institutions like the World Bank would respond by saying that they support increased government spending on education, and they do, at least in theory—when they are not lining up behind the IMF's typical demands for government budget cuts. But without a national development strategy that would enable a poor country to advance to more profitable areas of production, and shape their economy according to their own needs (rather than those of world export markets), even the raising of educational levels will have a limited effect on national income.

Capital Mobility and Foreign Investment

The efficiency arguments for increasing globalization are even more clouded when applied to capital flows rather than trade. The theory of comparative advantage, which is based on relative efficiencies in production, no longer applies. So how do countries, especially poor ones, gain from increased foreign investment within their borders? This question needs to be examined carefully, because there is a lot of confusion that surrounds it in most discussions of foreign investment.

The main form of investment that is promoted by advocates of increasing globalization is called Foreign Direct Investment (FDI). This is basically investment in which the owner has a controlling share—for example, General Motors recently spent $750 million to build a Buick assembly plant in China. FDI is to be distinguished from the other major form of

international investment, portfolio investment. The latter is basically the purchase of stocks, bonds or other financial assets in another country, without acquiring a controlling interest.

There are several ways in which foreign investment of either type can help a country's economy. First, it can allow the country to tap foreign savings, thereby enabling its economy to grow faster than it could grow if it only had domestic savings to finance investment. It should be emphasized that even if this increased growth occurs, the country will have to pay interest or returns to the foreign investors in the future. But if the present return to the host country is greater than what it has to pay back in the future, than there is a net benefit from foreign investment.

But not all foreign investment augments domestic savings. To understand why not, consider the conditions which would have to hold true: the country receiving the foreign investment would be using it to finance a current account deficit, importing capital goods (e.g., machinery, equipment—things that add to the country's productive capacity). So, for example, China today is the world's largest recipient of foreign direct investment among "emerging market" economies, receiving about as much FDI as all other less developed countries combined. But China is running a current account surplus. This means that foreign investment is not contributing directly, as described above, to China's economic growth. In other words, the foreign funds are not providing extra resources to supplement domestic savings. If that foreign investment were not available, the Chinese economy would not necessarily grow any slower.

Similarly, if foreign investment allows a country to run a trade deficit, but only increases the country's consumption (e.g. of imported consumer goods) rather than investment, it does not contribute to the host country's economic growth.

Of course, there are other ways in which foreign investment can facilitate economic growth and development. One of the most often cited of these is through technology transfer. For example, the Chinese may acquire technology and skills from the Buick plant located there, which would have taken them much longer to develop on their own. The evidence on how much FDI has contributed to the economic development of host countries through technology transfer is not that conclusive.[15] But one thing is for sure: agreements like the GATT, MAI, and NAFTA, would limit the ability of less developed countries to ensure that they do benefit in this way from the FDI that they receive. That's because these agreements prohibit what are called "performance requirements." These are conditions that governments place on foreign investors—for example, that they must hire a certain percentage of local citizens as managers or engineers, or take other measures that would result in technology transfer to the host country. One of the main purposes of recently negotiated commercial agreements has been to make such requirements illegal under international law.

Given the limited and situationally specific ways in which foreign investment can contribute to economic development, it should not be surprising that foreign investment played little role in the fastest-growing economies of the last 50 years—for example, China, Japan, and South Korea. Yet the major policymakers in Washington and the world economy insist that

[15] See Edward Graham, Global Corporations and National Governments, Washington, DC: Institute for Intl. Economics, 1996, Appendix A.

it is the key to any developing nation's economic future. Of course, in many cases poorer countries are in dire straits in terms of their balance of payments—running large and unsustainable current account deficits, for example. So they are in desperate need of hard currency (e.g. dollars), just to finance imports that they need for domestic production, or even more vital needs such as oil and medicines. In such cases they are very much in need of foreign capital inflows—indeed they are addicted to them. But to recognize this need is not the same thing as to make a sober assessment of what role foreign investment can reasonably be expected to play in the development of the poorer countries' economies, an assessment which is very much missing from most discussions today.

The same is true with regard to exports. It has also become part of the conventional wisdom that increasing a country's exports, as a percentage of its economy, is an end in itself. But there is little economic reasoning to suggest that it is better to produce exports than to produce for domestic consumption or investment. And this is in fact the trade off, if we assume (as most pro-globalization economists do) that all resources are fully employed. In other words, if the economy is producing all that it is capable of producing, then increasing exports requires reducing production for domestic use.[16]

Third World Debt

Critics of globalization have argued that institutions such as the IMF and the World Bank promote "export-led growth" because they are unduly concerned with the collection of the enormous Third World debt ($2.2 trillion). In order to make payments on this debt, countries must earn hard currency through exports. Thus any increase in exports by debtor countries, even if it comes at the expense of vitally needed domestic consumption or investment, is good for the debt collectors.

Here, too, there is a clash of political views. A growing number of religious and non-governmental organizations have argued that the third world debt represents an unconscionable burden and an insurmountable obstacle to economic and human development, and should be canceled. Much of it was borrowed by corrupt, autocratic governments, often going right out of the country into foreign bank accounts, without adding anything to the economy's ability to produce. Furthermore, the maintenance of an unpayable debt burden allows the creditor countries—mainly through the IMF and World Bank—to dictate economic policy to the debtors.

The Fund and the Bank have recently conceded the need for limited debt relief for the most heavily indebted countries, but so far there has been no significant reduction of any country's debt burden. This is partly because much of the debt is unpayable. For example, imagine you owe $50 million and are paying all of your income for debt service, other than rent and food. If the bank reduces your debt to $30 million, this is a large reduction in your debt but it will not change your debt service—the latter will still eat up all available income.

[16] This assumes full employment of labor, too. Of course most people outside the economics profession do not make this assumption. But if there is unemployment, and therefore exports can create jobs, then it must also follow that any kind of domestic spending, such as government deficit spending, will also create jobs. So there is still no reason to favor exports over production for the domestic economy.

Furthermore, the debt relief proposed by Washington has strings attached—namely, the same conditions that form the basis of the "structural adjustment" agreements that the IMF and World Bank generally require.[17] Critics charge that these requirements—further opening to foreign investment and trade, export-led development policies, etc.—have failed elsewhere and will inflict further damage on some of the world's poorest countries.

The Debate over "Reform"

For the most prominent policy makers and writers on this topic, "reform" is synonymous with the opening of markets, privatization, and reducing the role of government in the economy. Indeed this has become the standard definition of reform in the media, and it is used without quotation marks in this way. For most of these people, the recent economic turmoil is just a bump in the road toward a more integrated world economy and the social progress that it promises. They generally favor increased regulation for "emerging market" banking and financial systems, as well as greater "transparency"—that is, better information for investors.

However, since the onset of the Asian financial crisis two years ago, a debate has begun within the economics profession about whether some of the "reforms" that opened up these markets may have gone too far. Indeed, there is a fairly wide recognition—shared by most people outside of what one prominent economist has called "the Wall Street-Treasury complex"[18]—that some different kinds of reforms might be needed to ensure the stability of the international financial system.

Most prominent among these reforms are what economists call "capital controls." These are restrictions on international borrowing and lending, investment, or the conversion of currencies. For example, to prevent a financial meltdown of the type that set off the Asian crisis, governments could restrict the amount that domestic banks and firms could borrow—especially short-term—in foreign currency. (There were more such restrictions in place in countries like South Korea and Indonesia until recently; hence the conclusion by some economists that recent "reforms" have gone too far.) Or they could require foreign investors to deposit a percentage attached to any new investment in an account that could not be withdrawn for some time, say a year.

Currency controls are still opposed by the vast majority of economists, as well as Washington policy makers, and they are unlikely to form part of any international financial reform. But particular countries may adopt them in spite of this pressure, as Malaysia did (see above).

Critics of globalization welcome the debate over capital controls, and see it as an overdue break from what they have long argued was a dogmatic and de-stabilizing insistence on opening financial markets. However, there are questions as to whether reform in this area would address the more important problems that globalization has created.

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[17] As of this writing, only three countries have qualified for the IMF/World Banks HIPC (Heavily Indebted Poor Countries) program of debt relief: Mozambique, Uganda, and Guyana.
[18] Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs*, May/June 1998.

In particular, there is the downward harmonization of labor and environmental standards—the oft-described "race to the bottom" that has accompanied the increased power of transnational corporations to avoid regulation and play one government against another. There is also the increased poverty and inequality that have accompanied these forms of globalization, and the reduced ability of governments to take remedial measures. Critics charge that any international reform, which does not reverse these trends, will provide little improvement in the lives of most people on the planet, even if it helps to stabilize the international financial system.

Of course, there is something to be said for any reforms that could help prevent a repeat of the Asian financial meltdown. But what if these reforms grant more power and authority to unaccountable international institutions like the IMF, the World Bank, or a newly created World Financial Authority (as some reformers have proposed)? Would they still be a step forward?

On these questions there is disagreement among the critics of globalization. Some analysts see an analogy to the domestic economy: all modern capitalist economies have a central bank, for example, to regulate the money supply and act as a lender of last resort. Our own Federal Reserve was established in 1913. Together with New Deal reforms that increased the government's role in regulating the national economy, we have created a much more stable economy than we had, for example, in the previous century. This is true in spite of the fact that the Fed is a largely unaccountable institution which often accords first priority to the interests of large bondholders and bankers, keeping unemployment much higher and wages lower than they should be. Few of the Fed's critics would want to return to the economic instability of the 19th century.

On this basis, proponents of rebuilding "the global financial architecture" argue that institutions like the IMF and World Bank must be reconstituted, or new international institutions created, to perform the functions that central banks and other regulatory institutions perform at the national level.

Other reformers are more skeptical about these possibilities. While welcoming any positive changes in existing institutions such as the IMF and the World Bank, they are not convinced that any such unaccountable bodies can have a net positive impact. As noted above, there has been no change in the policies of the governments that control these institutions—especially the United States.[19] Why, they ask, would we expect such institutions to go against the firm and established policies of the governments that control them?

Relying on institutions controlled by the same narrow interests is also a threat to the national sovereignty of the world's nations—sovereignty that these critics see not only as a matter of

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[19] It is widely acknowledged, even by observers who are not critical of the IMF, that it is "essentially a proxy for the United States" (Michael Wines, *New York Times*, December 26, 1998: "Yeltsin Agrees To Closer Ties With Belarus," p. A1) and is controlled by the U.S. Treasury Department. In fact, at a recent Congressional hearing it was noted that the representatives of member countries rarely vote—there have been 12 votes in the last 2000 decisions (Karin Lissakers, U.S. Executive Director, International Monetary Fund, Testimony to the House of Representatives Committee on Banking and Financial Services, General Oversight Subcommittee, April 21, 1998).

principle, but as a matter of necessity for economic development and social progress in the poorer countries.

Most importantly, they argue, from the perspective of reform, the international economy is not analogous to the domestic economy. At the level of the national economy it is certainly true that even an unaccountable, oligarchical central bank is better than no central bank. But the same cannot be said for the institutions of the global economy. At the national level, there has been no alternative but to create regulatory institutions and then try to make them more accountable to the electorate. At the level of the global economy, however, there is an alternative: regulation at the national level. As we have seen, some of the most important regulatory measures—including capital controls—can still be implemented at the national level. We can expect that more and more governments will look for national solutions as the global economy fails to meet the needs of the majority of their citizens, and the latter put pressure on their elected (or in some cases, non-elected) officials.

In the United States, whose government has been the most powerful advocate of the current form of globalization, measures to ameliorate the worst excesses of the global economy—either here or abroad—will most likely not be warmly received. If history is any guide, proponents of such changes throughout the world will be dismissed as "trying to turn the clock back," "protectionists," and worse. And, as often happens in the real world, some of their leaders or followers—as in Malaysia or Russia today—will have right-wing or authoritarian ideologies attached to them. But this does not mean that their pro-national, regional, or local economic development policies are misguided. Or that the men who have been working overtime to "write the constitution of a single, global economy"[20] are right.

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[20] Renato Ruggerio, Director General of the World Trade Organization, speech delivered to UNCTAD's Trade and Development Board (October 8, 1996). "We are writing the constitution of a single global economy," he said, in reference to the WTO's efforts to develop a Multilateral Investment Agreement.

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